

As a further alternative, delegation to a nonpolitical body deserves to be considered. This might be the Federal Reserve, or some other group that would have to be established with a degree of independence from political pressures. The usual objection to such procedure, that it is undemocratic, seems to me beside the point. It is true that tax changes are not purely a technical matter, but contain a political element. But the same is true of many decisions that today are made by the regulatory agencies of the Government and even by the Judiciary. If the Congress retained a right to veto the action of this group, it is hard to see how serious damage could be done.

(Letter from Gerhard Colm responding to Senator Javits' request :)

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JOINT ECONOMIC COMMITTEE,
Senate Office Building,
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GENTLEMEN: The following is my response to the question raised by Senator Javits as to whether the Congress should authorize the President to raise or lower the income tax within the limits of 6 percent for a specific period of time, e.g. for one year.

I agree with the objective of this proposal, namely to expedite limited changes in the income tax in response to actual or expected changes in economic conditions. It may well be that delegation of authority to the President to make such changes within specific limits is the only feasible solution. However, it appears preferable to me if a method could be worked out by which the Congress would share with the President responsibility for such changes without causing undesirable delay.

My preference is based on the following reasons:

- (a) It is politically desirable to have Congress directly share responsibility for changes in the tax burden even if they are of limited size and duration.
- (b) If the President has sole responsibility for such action he might hesitate or even fail to act for political reasons, particularly when an increase in taxes is involved.
- (c) There are not many cases in which the President recommended a change in taxes to Congress but in which action was unduly delayed because of protracted Congressional deliberation.
- (d) Not all economic conditions require the identical change in tax measures. There may be situations in which a change in both individual and corporate taxes, or in only either one, is warranted. In other situations a change in excise taxes may be desirable. If there is an authority to make changes only in one particular way the President may use this authority even though under the circumstances a different type of tax change may be desirable.

I believe that the recommendation made by the Joint Economic Committee's Subcommittee on Fiscal Policy in May 1966 (see pp. 16 f.) suggests one possible procedure for prompt legislative action.

I suggest that the tax-writing committees consider and propose to the Congress stand-by legislation providing for up- and downward changes in tax liabilities, leaving open the effective date and, perhaps, stating only a maximum percentage of change, leaving the exact ratio of change within these limits open. In case of need the effective date and the exact ratio of the changes could be adopted by a Joint Resolution recommended either by the President and/or the Joint Economic Committee after hearings which should not exceed, say, one week. If the hearings are held by the tax-writing committee, separately or jointly, the views of the Joint Economic committee should be heard at the hearings.

I recommend experimenting with such a method of Executive/Legislative cooperation before considering the delegation to the President of the power to make such changes by decree.

Sincerely yours,

GERHARD COLM.

Senator JAVITS. If the Chair desires Mr. Lekachman to address himself to the questions, it is fine with me.

Chairman PROXMIRE. You mean the previous question?

Mr. LEKACHMAN. The previous question, yes.

I want to make just a comment or two on the guidepost issue rather than the goals question that was raised.

It seems to me that the record of other countries, besides ourselves, with formal boards of review, has not been entirely encouraging. The English record has not been good. The Dutch system, after some years of success, broke down. And I am not encouraged, in other words, by proposals to increase the formal administrative machinery for application.

There are two other comments I just want to make very briefly. One is that as is conceded everywhere, the guideposts have been, practically speaking, inoperative in the downward direction. Corporations don't reduce their prices when application of the guideposts would suggest that they do so, and this is another way of saying that there is an inflationary bias built into the guideposts, given present arrangements.

The second comment is simply this: That the guidepost mechanism, for better or for worse, is a conservative mechanism. It assumes that the distribution of income between property and labor is a reasonably satisfactory one and the guideposts in effect sanction that division.

Chairman PROXMIRE. Congressman Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

First, Senator Javits, I wonder if in the question that you suggested be answered in writing about the power to raise and lower taxes, that we make it very clear that it might be answered in an either/or situation. In other words, it might be that we grant the President power to raise taxes, but do not grant him the power to lower taxes or vice versa.

Senator JAVITS. Oh, yes. Mr. Moorhead, my office will write a confirming letter.

Representative MOORHEAD. Thank you.

Professor Wallich, I would like to continue the discussion that you were having with Congressman Reuss about the variable interest rates on housing mortgages. First, sir, would it be your idea that the monthly payment would, except in the case of a very wide fluctuation, remain constant, and the amount attributable to interest and principal would be the thing that would vary?

Mr. WALLICH. Yes. That is how they work it in England. A man finds that if interest rates go down, his mortgage is shortened, and if they go up, it is lengthened. If interest rates fluctuate, he doesn't much care.

Representative MOORHEAD. Do you know, sir, if under the present law the banks and/or the savings and loans in the United States could make such contracts?

Mr. WALLICH. Yes, I think they could. I have had some correspondence as a result of what I wrote about this, and if it's an overt contract and not as in the case of one California savings and loan association, something that the borrowers didn't know about, then there seems to be no reason why this should not be done.

There are some technical problems. One is that the mortgage may not be easily negotiable. But so far as I can find out, this is not a serious impediment.

Another question is how one gets the savings and loans to reduce deposit rates when the time comes, so that rates on mortgages will also go down and the period can be shortened. One can to some extent rely on the market. Lenders will not be able to write high-interest-rate mortgages. But it is conceivable that some kind of legal tie would have to be established between mortgage rates and deposit rates. No doubt there will turn out to be a lot of special cases, grace periods on deposits, and so forth, that will require definition to make it equitable and make it firm.

Representative MOORHEAD. Professor Lekachman, I was very much interested in your suggestions in your testimony about the negative income tax and the Federal Government as the employer of last resort. I wasn't quite clear as to the interrelationship of the two ideas. I can think of it as an either/or proposition. I can think of a combination where you would say anybody who is employable should be employed and put to work, and only those people such as let's say mothers with small children should be granted the negative income tax. But what is the interrelationship? Who would come under one program and who would come under the other?

Mr. LEKACHMAN. I was thinking of two groups, Representative Moorhead, with some coincidence between them I can see. But the two groups I had in mind were individuals whose practical chances or even desirability of offering employment to was not very great.

Many of the elderly, who are getting social security payments, which leaves them in precarious condition if they accept employment; many families of small children headed by women; individuals who are handicapped mentally or physically, not to the point of institutionalization. There are other categories. These individuals it seems to me now get various forms of either social security or welfare payments. In many cases the amounts are inadequate, and these people would be natural candidates, it appears to me, for some form of income maintenance.

Now there is another group of individuals who are currently unemployable, that is to say by labor market definitions in effect, market definitions. They can't get jobs. And what I among many others, have been speculating about is the fact that there is coinciding with this pool of personally unemployable a large number of public service jobs requiring rather little skill and training, which might readily be filled, the missing nexus being cash and in fact a program which would supplement public service employment in a great many areas.

So I don't think of these programs as substitutes for each other. I think they are supplements. In one case, one is addressed to the relief simultaneously of poverty and unemployment; in the other case, to the relief of poverty alone.

Representative MOORHEAD. In connection with your testimony, Professor Lekachman, I certainly want to reecho your sentiments about the Model Cities Program. I certainly agree with you it would be nothing less than a disaster to snatch from the cities the funds and the hopes so recently held out to them.

I think that we have stimulated the mayors into activity, and if we deny them this assistance which we almost promised them, why I think it would be very discouraging to the morale of the city officials and, more importantly, the city dwellers.

I notice with some interest that Mr. Colm and Mr. Lekachman gave relatively little, if any, attention to the problem of the balance of payments, whereas Professor Wallich, I think, stressed this very heavily. Was this because you wanted to address yourself strictly to domestic economic problems, or do I infer that the two of you considered the balance-of-payments problem considerably less serious than does Mr. Wallich?

Mr. LEKACHMAN. I consider them quite serious, Mr. Moorhead, but at the same time I suppose my difference with Mr. Wallich is primarily this, that I want to minimize the effect that our balance-of-payments situation has upon other policies, particularly domestic social programs, and being of this mind, I would be far more inclined to concentrate on doing something directly upon balance-of-payments situations in the way of specific controls, or enlarge present controls rather than to allow present domestic policy to be seriously affected. But I don't think that I differ with Mr. Wallich with the seriousness of the problem. It is undoubtedly a great problem.

Representative MOORHEAD. Mr. Colm?

Mr. COLM. I pretty much agree with what my colleague, Mr. Lekachman, has been saying. The reason why I didn't elaborate on that was in part because I knew Mr. Wallich would be on the panel. He has given it more thought. It happens not to be my field of specialization.

I agree that it's a serious problem. I am more concerned with the long-range problem, with the competitiveness of the American economy. Productivity is the basis for our high wage level relative to other countries. We have the long-term tendency that productivity travels much faster from country to country than in the past; for example, in Japan you find steelworks which are as modern as the most advanced American steelworks. We are only surprised by the statistics. They still employ about three times as many workers relative to output, and this is probably because of the relatively low wage level. But I think there are serious problems.

I also agree with Mr. Lekachman that for a short term we may use more specific devices. I express perhaps more of an emotional feeling, but I think I could rationalize it. It doesn't make sense to me that we should have mass unemployment in order to solve our balance-of-payments problem. That would be a sort of admission of inability to deal with the problem, and I cannot believe that the only solution consists in depressing our economy, thereby depressing imports and giving allegedly an incentive to exports.

I cannot agree with that philosophy, though I cannot elaborate on the technical consequences of that statement.

Certainly as I have stated in my prepared testimony, the balance-of-payments considerations are a restraining factor on credit relaxation, but I think particularly for housing that does not apply. In part as an answer to the previous question by the Chairman, I think more money is being made available for housing even though the interest rate is still very sticky. Making money available for housing at lower interest should be possible without any drastic effect on the balance of payments.

Representative MOORHEAD. Thank you.

Thank you, Mr. Chairman.

Chairman PROXMIER. Thank you, Mr. Moorhead. Congressman Rumsfeld.

Representative RUMSFELD. Mr. Chairman, I apologize to our three distinguished guests for being tardy. I had a meeting of the Science and Astronautics Committee.

I understand, Dr. Wallich, that you indicated that you favored removal or reduction of the gold backing now required on Federal Reserve notes. Is that correct?

I would also like to have comments from the other two gentlemen on this question.

Mr. WALLICH. Yes. That is something I think we ought to do. The true purpose of the gold reserve is to be used for international payments and to back the dollar internationally. The domestic backing has lost much of its original significance, which was to convert notes into gold coin.

It serves an indirect purpose in restraining fiscal and monetary policy, but that same purpose is served by using it exclusively for international purposes. The Government is on notice that when we run out of this reserve, we will be in a pretty desperate situation with devaluation or tight exchange control our only alternatives.

I would not say that removing the limit does not take some constraint off the Government. The fact that they are moving toward a limit rather than being able to operate against a \$13 billion reserve does create some added pressure to put the balance of payments in order. I don't think that that gain is worth the drawbacks that we have from maintaining the limit. It raises a doubt in the mind of the world as to what will happen as we approach the limit. Will we pull the plug on the dollar and devalue, or will we remove the limit?

Since in practice I feel very confident that we would remove the limit if we got close to it, we might as well remove it now that we are still \$3 or \$4 billion away from it.

Representative RUMSFELD. Thank you.

Is that roughly the view of our other guests?

Mr. LEKACHMAN. I agree with Mr. Wallich in general and in particular I think on this issue, an unusual position for one economist to find himself in with another.

I think that quite rightly Mr. Wallich pointed to the fact that the limitation has lost its meaning. We don't have an internal gold standard. This was one principal meaning of this. And I think also on the specific point that we would create an unnecessary crisis for ourselves if we retained the limit as we approached the point where our flexibility came into question.

It would be a wholly unnecessary financial crisis, and we have enough unavoidable ones without adding one that we needn't face at all.

Mr. COLM. This is a strange case of consensus among three economists.

Representative RUMSFELD. Thank you. I would also like, if we could have in the closing minutes here, another comment from each of you. We have had testimony from among others, Walter Reuther, to the effect that escalator clauses are not inflationary. I would like a

comment from each of you on whether or not you feel that escalator clauses are or are not inflationary?

Mr. WALLICH. I think Mr. Reuther must have been arguing on the assumption that there are wide profit margins that permit absorption of above productivity wage increases. Moreover, with respect to his own industry, productivity increases may well be above average, so that it would be possible even without reduction in profit margins to absorb normal wage increases, plus an escalator.

But for the economy as a whole, it seems perfectly clear that escalator clauses will be inflationary, unless we are to assume that profits can be continually squeezed. The guideposts made very clear that labor as a whole, if income shares are to be maintained, cannot get wage increases in excess of productivity gains. If those are 3 percent and we give labor 7 percent, then the only way to get back to the 3 percent that labor can get is to have inflation of 4 percent. That would be the result of escalating.

If then, we further escalate the 7 percent to 11 percent because of the 4-percent inflation, what we do is to escalate the inflation as well as wages. I see no alternative.

Mr. LEKACHMAN. I think, in general, I agree with Mr. Wallich once more on the effect of escalator clauses, but I would stop short of saying that because they have an inflationary tendency they are necessarily to be resisted at all cost. They do embody a measure of protection. If you like, you can even think of a series of labor contracts containing escalator clauses as putting some pressure upon the Government to use the kind of fiscal policies which would make them inoperative.

I don't think that that is necessarily what Mr. Reuther had in mind, but it might be indeed an effect of such a widespread writing of contracts.

Mr. COLM. I don't know what Mr. Reuther had in mind, but there is one fact. The way the escalator clauses are written and operated, they do put a timelag between the price rise and the wage increase. To that extent, whether they are inflationary or not may be a question of semantics. They are more inflationary than if there were no wage increase. But they are a factor slowing down the transmission of the price rise through the economy.

For instance, the British during the war managed the price index to make the most use of this price lag, so that actually apparent escalation was actually a mechanism designed to slow down inflation. Some of the unions oppose the automatic escalation because they think by reopening negotiations they can get more, trying to anticipate future price increases. This would certainly be more inflationary.

We also should consider why we have price increases. If we have a price increase because of lack of fiscal measures, then the price increase acts in a way as a crude substitute for a tax. And the more groups are protected, the smaller those are, who find that they have to carry the burden. In that respect, I would say full cost of living adjustments add to inflationary pressure. But much depends on the mechanism of how they operate, the time lag between the actual price rise, the reporting of the index, and the application to the next payment.

There is the factor of slowing down. I must admit I am trying to make some sense of the statements that Mr. Reuther made, because I know he is a very intelligent person.

Representative RUMSFELD. Thank you, gentlemen; and thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Rumsfeld.

Dr. Wallich, I would like to follow up on something that I let you escape from the last time we talked. That is the soundness of following fiscal and monetary policies for the purpose of restraining inflation, that is by keeping the unfortunate consequences which you and I recognize—that unemployment would remain at a very high level.

When we have no analysis and no agency that I know of in or out of Government that I know of trying to make analysis of the impact of this restraint on specific commodity prices. In other words, it seems to me that we are talking through our hat.

Governor Martin, when he appeared before this committee, said that they had no idea what restraint, monetary restraint, what effect it would have on particular commodity prices. His agency made some kind of a study years ago for the Commission on Money and Banking. Indeed they do have a general feeling that monetary restraint under demand-pull circumstances will keep prices down, but he couldn't give me any documentation, let alone qualitative analysis. He couldn't break it down in the food category and in the medical category, the interest rate category, that would give us any kind of a precise picture.

Now, isn't it desirable, if we are going to have a better economic policy in the future, in view of the enormous importance and the weight to be placed on restraining inflation, the burden of unemployment that we impose on the country in doing so, that we have at least an effort to try and get at the effect of these policies on specific commodity prices?

Mr. WALLICH. I think this is a very good thought. All I can do is to respond with what little knowledge there is, which is probably very familiar to you, Mr. Chairman. As you know, monetary policy works principally against investment, and there principally against housing, and, to a smaller extent, against borrowing by small business, perhaps State and local. It touches least, plant and equipment spending.

Fiscal policy works principally against consumption. Therefore, if we are going to talk about the impact on commodities, then I suppose fiscal policy is the first thing to study—what happens to prices as demand is reduced.

This resolves itself, I suppose, into a question such as this. If a tax increase were to be introduced now, what are the personal budget items that consumers are most likely to cut back on? And to that, I think a competent economist could give quite a few answers, because we know the behavior of people with respect to their household budget as their income rises or falls.

Chairman PROXMIRE. Then we would want to relate that, wouldn't we, to the particular situation. We would know, for example, to reverse it a little bit because this is so clear in my mind, if we do have an increase in social security benefits, much of which will be spent on

food, that particular aspect of the expenditure would not necessarily be inflationary, because at least our assumptions have been that food prices are not very responsive to increases or decreases in demand. They are more responsive to production factors, Government policy factors, and so forth.

Mr. WALLICH. It seems clear to me that economic analysis increasingly will move into this direction of dividing up problems, looking at specifics, particular sectors, particularly commodities. I haven't heard the suggestion made, but it seems to me an eminently sensible one.

Chairman PROXMIRE. Thank you very much. I would like to pursue another question that has been raised with you two or three times today. I would like to pursue it in a different way.

As I listened to your testimony this morning, I got the impression, which surprised me a little, that you were siding with Walter Reuther and with Alvin Hansen in accepting incomes policy at least to some extent, because you—and I think very wisely and properly—talked about real wages. Not money wages, which is something that most economists haven't paid as much attention to as they should, in talking about wage-price guideposts.

Now, as Hansen argued it, if we had a real wage guideline, we would, for example, in this year, forgetting about any catching up, and took, say, the 3.2-percent productivity factor, and then took the assumption of the Council of Economic Advisers on a 2½-percent increase in the cost of living, we might have a guideline this year of 5.7 percent.

What this would do would be to keep labor's real income in line with its productivity increase, and the argument by Dr. Hansen was that this would not be inflationary in his view.

At the same time, this is tying wages to a cost-of-living escalator in a real sense, or at least you might say this, and you would argue that to do so is inflationary.

Mr. WALLICH. Well, you are quite right, Mr. Chairman. I lean toward an incomes policy, and I do think that the guideposts are incomes policy. It happens to be one that keeps income shares constant.

I think the proper way to read these income shares in history is to look at periods of high employment rather than low employment, because shares fluctuate over time. The labor share rises with unemployment and falls as unemployment declines—that is in booms it is lowest. Like the full employment budget, I would like to look at full employment income shares as the norm.

Now to do as my distinguished teacher, Alvin Hansen, proposes, and I realize that I disagree with him at my peril, would single out for protection a single sector. Something happened last year that somehow raised food prices and service prices. These are calamities that befall everybody. Why escalate one particular sector? Why not also—

Chairman PROXMIRE. No, no, I don't want to be rude, but I think you are shifting the scenery on me a little bit. What he talked about was not past. He wouldn't take the 3.3 percent increase in the cost of living we had last year. He would do one of two things. He would either take the estimate of what we are going to have this year, or what he might do consistent with what he said is simply have an escalator so you would have a reflection of what actually happens this year.

You have the productivity increase of 3.2 percent and then you would have whatever cost of living you have this year. Therefore, labor wouldn't get anything except compensation for its real productivity increase. In other words, that it would be paid in real wages, not money wages.

And you are dead right when you pointed out the impossibility, the perniciousness really, as far as labor is concerned in having a wage guideline this year that doesn't have any recognition at all of the cost of living in it, or having it last year where you had a 3.3 percent rise in the cost of living, a 3.2 percent guideline, so that labor's real income went down, if they abided by the guideline, at a time when their productivity was increasing.

Mr. WALLICH. I suspect if we did what Hansen proposes, that is put in a 5.7-percent guidepost, and it were abided by, it wouldn't change anything. Prices would rise sufficiently to reduce the real increase to what productivity permits.

That is indeed the meaning of this action. And so labor is likely to end up no better than it would otherwise be. But what it would do is to make sure we would get a substantial price increase which then the following year would again justify a further above productivity increase in wages, and so on.

Chairman PROXMIRE. The estimates are that now this year you are going to have settlements in the area of 5 or 6 percent. Many people think it is going to be higher. Income guidelines would provide for, say, a 5.5 or a 5.7-percent increase, which would mean perhaps that the wages wouldn't be higher, and also you would have a more equitable principle involved.

You would have more effective public pressure on those who happen to have strong unions or weak employers or a situation in the industry that would permit wages to go up excessively, and you would have greater equity throughout the economy.

Mr. WALLICH. How would we ever end the inflation then? It seems to me at this rate the inflation will continue at 3 percent or thereabouts.

Chairman PROXMIRE. I can't get it through my thick head why the wage increase is inflationary as long as it is keyed to real productivity increases. That is what it would be keyed to. Otherwise, it isn't related to it.

Mr. WALLICH. It is keyed to that, but it also assumes that prices will rise by the difference between the guidepost and productivity gains. In other words, if the guidepost is 5.7, and productivity were 3.2, which I think is too high, prices will rise 2.5. So we have a 2.5 percent price increase, and we continue next year with wages on the same basis, and we have another price increase. By what process is inflation ever going to come down?

Chairman PROXMIRE. What we have had in the last 4 or 5 years is a steady increase in prices, low but modest up until last year, around 1½ percent or 2 percent. You had a guideline principle that was enforced by some unions.

The result was that you had wages that conformed increasing far less than profits. And you had an inequity developing in the economic system because of it. I am not sure that you would necessarily

have less inflation than you would have had if you had had a modest escalator.

You would then have been able to preserve the guideline principle on a sound basis, the basis which I understood you to argue that it should be keyed to real income and not to money income, because money income is pernicious.

Mr. WALLICH. The German Council of Economic Advisers has struggled with this problem because they have had high rates of inflation for longer than we have had, and the system they recommend is to sort of deescalate gradually, not to raise wages by productivity plus past inflation, but productivity plus some part of the past inflation. If they do this over a period of years they think they can get down to stability.

Chairman PROXMIRE. Did you want to comment, Dr. Lekachman?

Mr. LEKACHMAN. If I might for just a moment, Mr. Chairman. This is the first I heard of Professor Hansen's proposal, but it seems to me in listening to the discussion of it, that there is something that is implicit in this, and that is that there be a much firmer application of the price guideposts.

Chairman PROXMIRE. That is exactly right.

Mr. LEKACHMAN. Than up to now.

Chairman PROXMIRE. He said we should have administered prices more effectively controlled than has been done in the past. And if we didn't do it, administrative price powers is the element that is going to be unsettling, inflationary, and disturbing.

Mr. LEKACHMAN. If we could do that, I am not enormously hopeful about the administrative possibilities, but if we could do that this it seems to me would then tend to solve one of the problems of the existing arrangement.

If some firms raised their prices and others did not, when prices were rising in general, in effect, the real prices of some firms would go down and should go down on the assumption that these are the firms with exceptionally high productivity experience, and very likely high profit.

In other words, you can restore some implicit flexibility to the price system if you could, which is the central question in my mind, if you could develop the administrative mechanism more firmly to hold prices to permissible increases.

Chairman PROXMIRE. I would like to ask Dr. Colm one other question. Dr. Colm, you indicated you thought it would be wise for the Congress now to give the President the authority to increase taxes on July 1. Do I state your position correctly, or did you indicate you felt we should pass a tax increase as the President suggested?

Mr. COLM. I did recommend the tax legislation, with an effective date of July 1, and hearings before the effective date which would make it possible to reconsider this decision, either at the initiative and the recommendation of the President to drop it, or by the initiative of Congress.

Chairman PROXMIRE. What disturbs me about your proposal is that these hearings would be by the tax writing committees, and without as much economic emphasis as they ought to give it. In other words, if they would rely on what you also refer to, which really disturbs me—

you refer to the notion of budgetary considerations; that is, if our expenditures exceed our revenues, that this should be an important element in determining whether or not we should have the tax increase in July. I would assume that this would not be the important element.

The important element would be the state of the economy, because clearly if the state of the economy is bad, you are going to have a bigger deficit, and a much worse argument for a tax increase. Therefore, we should not be concerned as far as this particular tax increase is concerned with the budget deficit.

What you should be concerned with is the impact of the tax increase on the economy. If it is soft, we should not have it. And if it is expansionary, as you expect it might be in the second half, we should have it. Is that right?

Mr. COLM. Mr. Chairman, I am delighted to hear you argue this way. That is the way we economists have been arguing for sometime, and we are happy that so much of this so-called new economics has found more response.

But I do think there is a difference between a deficit which is caused by an unexpected increase in expenditures, and a deficit which is the result of a lower income and therefore a fall in revenues.

You are absolutely right, it would be paradoxical or perverse if we have a larger than expected deficit because of a fall in economic activity, then to increase taxes. I mean that was proposed in 1932 and I thought we have learned something since then.

As your statement has indicated, we all have learned a lot since then. But what I am concerned with is that if there is the outlook for defense expenditures much larger than anticipated, then we may need the tax increase, and I think we agreed, at least Mr. Wallich agreed with that, and I am not so much—

Chairman PROXMIRE. Yes, but even still, Dr. Colm, even if there is a supplemental that comes down and we find that we are off by \$5 billion in the Vietnam war, it is the state of the economy it seems to me that must be the determining factor, regardless of the expenditures we have to take into account, whatever impact these expenditures are going to have on the economy. But even if the expenditures are as you say greater than we thought they would be, unless we recognize exclusively, really exclusively the effect of that tax increase and what it is going to do to the economy and what it in terms of inflation and employment, and so forth, is, it seems to me we will be making a serious error. Isn't that correct?

Mr. COLM. I couldn't agree more with your principle, Senator. The point which I would make is we should be concerned not with the state of the economy in June 1967 but what it is likely to be during the next 12 months, and if then—I thought I was rather tolerant with respect to what deficit our economy could absorb. Now with the present defense estimate, we expect a national income account deficit of I think it was something like \$6 to \$7 billion without a tax increase.

If we now have on top of that a larger than expected increase in defense expenditures, I think we would have to expect some old-fashioned demand inflation during the year—

Chairman PROXMIRE. It has a tendency to increase demand inflation, there is no question about it. Why should we not wait then until

September or October? The situation is so uncertain now. Congress isn't to go home until the fall. Wouldn't it be wise under these circumstances rather than having an effective date of July 1, when economists do disagree on what the situation is going to be, and I think a preponderance of economists before this committee have indicated they don't agree with the Council's optimism on the last half of 1967.

Under these circumstances why shouldn't we wait another 3 or 4 months and take a later look at the economy?

Mr. COLM. That is an offer to compromise, Senator. Perhaps the tax legislation should be written with the effective date to be supplied later by joint resolution of Congress.

What my concern is, Mr. Chairman, is the decision under conditions of uncertainty. I know if things turn out as they did last year, and I don't expect a repetition of that, but even if there is a smaller change in the defense budget, and the nondefense budget, if that becomes apparent, and then the forecast is for inflationary pressure—if then the Congress starts considering a tax bill that takes time. Therefore, I think it would be prudent to have a tax bill written, and perhaps put the effective date in later, or if not needed, drop it.

This is only a kind of insurance. In my opinion, it is a better way of getting the flexibility than the delegation of power about which Senator Javits asked us to write a statement. I think under present conditions this would be a substitute for something Congress at this moment I think would not be willing to give the President; namely, discretionary power. I don't think Congress should.

Chairman PROXMIRE. Dr. Wallich?

Mr. WALLICH. The argument of uncertainty on which I agree with Mr. Colm seems to me to argue both ways. One could also say: let's pass a tentative tax reduction in case there is a de-escalation of the war, since we don't know what is ahead, and another possible increase.

These two approaches don't really convince me. I think we ought to take advantage of the situation to put tax changes on a permanent flexible basis. I must say I am profoundly disillusioned by the experience of last year, which seemed to show that had we had presidential discretion, it would not have helped.

Perhaps it's asking too much to expect the President to put in a tax increase before there has been plain and obvious evidence that the people are hurting from inflation and high interest rates. On these grounds, the proposals that were evolved by Mr. Griffiths' committee seem to me perhaps more hopeful, and I would also weigh rather highly the point I think made by Mr. Mills, that one shouldn't tamper too much with the tax system by too many different kinds of changes. These are unsettling.

We ought to have one single kind of change that goes up or down, whatever the situation requires, but avoid the mixture of flexible fiscal policy plus some kind of reform that we would like to introduce at the same time. I think that is what Mr. Mills objects to.

Chairman PROXMIRE. I want to thank you gentlemen very much. I do have one question that the staff asked that I ask Mr. Colm. On the wage-price-productivity board, when you appeared before the Reuss subcommittee their feeling was that you asked for a factfinding board,

and today you seem to ask for a decision by the board. They would have hearings and make a decision. Have you changed your view in the meanwhile?

Mr. COLM. No, I have not, Mr. Chairman. I may not have made this clear in my brief—unfortunately not so brief—summary, I still feel that the board should make a factfinding report, and submit it to the President.

Chairman PROXMIRE. Action on the facts would still be voluntary.

Mr. COLM. The President in consultation with the Council then, if he feels that that is warranted, would make a recommendation to Congress of his own. The board would make a factfinding report about how the principles of the guidelines, spelled out by the President and the Council, do apply to this particular case, and what would follow from the guidelines.

Chairman PROXMIRE. Thank you very much, and I thank all of you gentlemen for a most enlightening and interesting morning. I appreciate it.

The committee will resume its hearings on Thursday morning in room 318, the caucus room of the Senate Office Building at 10 o'clock. We will hear from two experts on wage-price guidelines.

(Whereupon, at 12:35 p.m., the committee adjourned until Thursday, February 23, 1967, at 10 a.m.)

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 23, 1967

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The joint committee met at 10:05 a.m., pursuant to recess, in room 318, Old Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Sparkman, and Percy; and Representatives Patman, Bolling, and Reuss.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Donald A. Webster, minority economist.

Chairman PROXMIRE. The Joint Economic Committee will come to order.

This morning's hearings will be the last for our extensive and very profitable inquiry into the President's Economic Report and the major current issues in our economy. Let me take this occasion to reiterate the committee's profound appreciation and gratitude to the witnesses for the excellent insights and analyses they have given us. It has been a most stimulating experience.

Today it is fitting that we close with testimony from two outstanding experts on one of the crucial issues of economic policy, that of wage-price stability. This Nation must resolve the wage-price question if it is to deal successfully with the requirements of the Employment Act. Our members and the Congress as well as the public are deeply concerned about this issue and we look forward to this morning's testimony.

Our first witness will be Prof. Carl A. Auerbach, of the Law School of the University of Minnesota, and our second witness will be Jules Backman, professor of economics at New York University. If there is no objection, I shall revert to the practice adopted on Monday of this week when 1 hour and 15 minutes was allowed to each of the morning's witnesses. If that is agreeable I shall ask that Professor Auerbach testify first, with the additional request that you limit your initial statement to 20 minutes. If you can do so, we can devote more time to the colloquy.

If you want to skip over part of it we will put your full statement in the record, and I might add for the record that Professor Auerbach is an old friend of the chairman and an old friend of Congressman Henry Reuss. We have known him as an extraordinarily able and competent law professor, and as a very fine person, and we are delighted to have you here this morning. Go right ahead.

TESTIMONY OF CARL A. AUERBACH, PROFESSOR OF LAW,
UNIVERSITY OF MINNESOTA

Mr. AUERBACH. Thank you, Mr. Chairman. It is a pleasure to appear before this committee, with you as chairman. I hope that the kind words you have said about me will be repeated after my testimony.

Chairman PROXMIRE. I am sure they will.

Mr. AUERBACH. You have asked me to discuss principally the wage-price policy set forth in the 1967 Economic Report.

Both the President and the Council of Economic Advisers have been criticized in recent weeks for abandoning the wage-price guideposts. But this criticism, in my opinion, is too general and, therefore, unfair.

I think the most significant change in the administration's policy is not that it has refused to specify a single figure as the wage guidepost for 1967—neither President Truman who originated the guidepost policy, nor Presidents Eisenhower and Kennedy, who further elaborate it, ever specified such figures. Rather, the most significant change is that the President has announced that the Government's weapons of intervention in private wage and price decisionmaking would be limited to information and persuasion and efforts to apply "sanctions" to "violators" of the guideposts would be abandoned.

If this is a correct interpretation of administration policy, the change is to be welcomed, not deplored; and particularly if Congress now seizes the opportunity to accomplish the objective which Congressman Reuss has urged upon it in recent years.

I say this because very serious criticism may be directed at the way the guidepost policy has been formulated and administered up to now. To be clear about the problem we face, we must begin with the fact—which Presidents Truman, Eisenhower, Kennedy, and Johnson, their Councils of Economic Advisers and, I think, this committee have accepted—that structural characteristics of the American economy are responsible for the tendency of wages and prices to rise, even before full employment is achieved. Historical experience has led us to accept this fact. Prices increased rapidly in 1937, despite massive unemployment and under utilization of resources. The defense program of 1940 and 1941 produced inflation even though the economy was then operating far below capacity. Events from 1956 to 1958 again showed that we could have inflation in the absence of excess demand and, indeed, even in the face of declining demand. The experience of the last year only adds to the proof.

Experience has also demonstrated that monetary and fiscal policies alone cannot prevent an inflationary price-wage spiral without sacrificing the twin objectives of income growth and full utilization of resources. In other words, we constantly hesitate to use monetary and fiscal policies, to the extent necessary to attain these objectives, for fear of inflation. To eliminate the necessity for such hesitation is the principal purpose of the guidepost policy. Through this policy, it is hoped price and wage restraint will come to be practiced in certain otherwise unregulated sectors of the private economy.

The guidepost policy has been defended as a means of assuring such private restraint principally on the ground that it is not a policy of compulsion but one that calls for voluntary compliance with its re-

quirements. It would seem that the advocates of a policy which depended for its effectiveness upon the voluntary action of labor and management should have tried to enhance its acceptability by affording these groups an opportunity to participate in its formulation. Yet, there is no evidence that representatives of labor and management, or even the President's Advisory Committee on Labor-Management Policy, participated in the formulation of the original guideposts in 1962 or in their subsequent elaboration.

As a consequence, both the AFL-CIO and spokesmen for various industry groups have attacked the guidepost policy. Secretary of Labor Wirtz, before this committee, has said that it seemed to them to constitute stabilization without representation.

The failure to recognize the necessity for participation of the major interests affected by the guidepost policy in its formulation is due in my opinion to the somewhat technocratic attitude of the Kennedy and Johnson administrations toward the policy. President Kennedy most clearly expressed this attitude in his celebrated 1962 commencement address at Yale University when he called for "more basic discussion of the sophisticated and technical questions involved in keeping our mighty economic machine moving steadily ahead." The present Council is fond of speaking about the "arithmetic" of the guideposts. But in truth, the problems of stabilization are not merely "sophisticated" and "technical" and arithmetic alone will not solve them.

The participation of labor and management in the formulation and administration of a wage-price policy may nevertheless be unnecessary, if general agreement existed on what this policy should be and how it should be applied. But I need not tell the members of this committee that there is no such consensus.

Probably all of us agree that full employment, rapid economic growth, and price stability are desirable. We may also agree that uncontrolled inflation of long duration not only will interfere with the process of production itself and jeopardize the possibility of full employment, but also will result in inequities that may threaten to undermine our social and political structure. But there is no agreement about how much price instability at any particular time may be tolerated in the interest of fuller employment or for how long such price instability may be endured without risking uncontrollable inflation.

Paul Samuelson and Robert Solow wrote in 1959, and it remains true today, that the country has a "menu of policy choices" which involve the balancing of different levels of employment and output against varying degrees of price instability. Those of our people who live on fixed or relatively fixed incomes, those with secure jobs, savings depositors, owners of life insurance and mortgagees, would like to see the balance struck in favor of price stability. The unemployed and all who are troubled about the social costs of unemployment would like to see the balance struck in favor of still higher levels of production and employment. A wage-price policy should seek to lessen the degree of disharmony between full employment and price stability. But the disharmony cannot be avoided completely. Equally important, there is no agreement on the ingredients of a desirable wage-price policy. Technical experts, in time, may be able to resolve to everyone's

satisfaction, some of the issues on which conflicting opinions have been expressed before this committee. But any wage-price policy also raises questions as to what is a "fair" wage and a "fair" profit and an "equitable" distribution of the national income on which opinions and interests will remain in sharp conflict.

The conflicts of interest become apparent when we turn to the burning question whether wage rate increases should be limited by the trend rate of productivity growth, even in the face of significant increases in the cost of living. Whether unions whose contracts will be renegotiated in 1967 will be satisfied with only a partial and gradual adjustment for cost of living increases—as in effect the President urges—may well depend upon whether they are persuaded that the stabilization program will be applied equitably to all groups in the population. But obviously, there is no agreement in the country on what the principle of equality of sacrifice requires under present circumstances.

When it erected the original guideposts in 1962, the Council recognized that, if adhered to, they would perpetuate the existing "relative shares of labor and nonlabor incomes in total output." So it emphasized that "there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes." It thought it desirable that labor and management "should bargain explicitly about the distribution of income of particular firms or industries," so long as they did so within the framework of a stable price level. In 1964, the Council further explained that such bargaining should take place in an industry "whose trend productivity is growing more rapidly than the national average" only after prices were reduced "enough to distribute to the industry's customers the labor-cost savings [the industry] would make under the general wage guidepost." But since then the Council has vacillated on the desirability of bargaining about the distribution of income.

This year, for example, the Council warns that "attempts on the part of the unions to redistribute income from profits to wages through excessive wage increases in high-profit industries results primarily in higher prices in those industries," and in the redistribution of "real income from the rest of the community—who are mostly other wage earners—to the workers in question, with very little redistribution from profits to wages."

But of course, this is true only because management in high-profit industries has been unwilling to reduce prices and no means have been found to compel it to do so.

Recognizing that it is unfair to ask workers to restrain their wage demands if their restraint will only result in higher profits, the Council appeals for forbearance on the part of management. It asks producers to "absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices."

But there is no agreement in the country on any standard of "reasonable" profits that would tell us to what extent producers should absorb cost increases and how much lower profit margins should be. For this reason, we cannot tell whether a wage increase higher than that permitted by the wage guideposts should have the effect of redistributing the industry's income or should justify a price increase or a smaller price decrease than the guideposts call for.

Under these circumstances, very little is to be gained by asking management to adopt a policy of profit minimization, or by scolding it even for trying to maximize profits. Similarly, labor should not be scolded for trying to improve its position.

The point I wish to make is that the issues raised by the guideposts, or any wage-price policy, are the kind that are resolved in our democracy only by an accommodation of conflicting claims which all concerned find tolerable. To reach such an accommodation, labor and management must be given the opportunity to participate in the formulation of a wage-price policy. Furthermore, since any bargain that these groups may strike will affect the life of the ordinary citizen more than much legislation passed by the Congress, Congress must be the final arbiter.

Accordingly, I urge this committee to institute hearings immediately to determine what our wage-price policy should be in the period ahead. Representatives of labor, management, the public and, of course, the administration, should be heard. This committee should then write a report which would enable the appropriate legislative committees of Congress, if they approved it, to draft a bill setting forth the components of an overall wage-price policy.

It has been objected that it is unwise to legislate a wage-price policy, because that will give it "legal status and a flavor of compulsion," and destroy its voluntary character. But if it is agreed that representatives of labor, management, and the public should participate in formulating the wage-price policy, some way must be provided for settling controversies that may arise. Only the President or Congress can do so. I think Congress should do so, but that it should act in a manner that will require it to run the gauntlet of a possible Presidential veto.

Furthermore, I do not see why congressional formulation of a wage-price policy by itself will destroy the voluntary nature of labor-management compliance with the policy. No overall wage-price policy formulated by the President or Congress can be expected to set forth clear guides to action in every case. The more general and more flexible the statement of such a policy, the more difficult it will be to apply it to any particular industry or firm and, therefore, the more difficult it will be to judge whether a particular wage or price decision is in accord with the policy. To tailor the overall wage-price policy adopted by Congress to the circumstances and needs of particular industries and firms is an administrative task. In my opinion, this function should not be assumed by Congress, the Joint Economic Committee, or the Council of Economic Advisers. It should be given to an administrative agency. However, a tripartite committee, representing labor, management, and the consuming public, should be appointed by the President for each industry, to advise the agency in the formulation of a specific wage-price policy for that industry. It is important that such advisory committees be set up as quickly as possible in those industries in which wage agreements will be newly negotiated in 1967.

In addition, the agency should be required to hold public hearings on the wage-price policies proposed for particular industries and to issue written statements justifying the policies adopted for each industry. In time, this agency should have valuable advice to offer to all concerned with the formulation of the overall wage-price policy, which should be under constant review by the Congress.

If there is to be voluntary compliance with the wage-price policies thus formulated for an industry, and if the force of public opinion is to be brought to bear to help secure compliance, then labor, management, and the public must be able to know whether a particular wage or price decision accords with the policies laid down. The administration of the guidepost policy to date has not assured the availability of such knowledge. Indeed, the Council of Economic Advisers admits that when it meets privately with producers about price increase, "it ordinarily does not have the detailed information which would permit a clear judgment as to the appropriateness of the proposed price change on either the basis of the guidepost standards or other relevant considerations."

To determine whether a particular wage or price decision accords with the stabilization policies laid down is a task that must be performed by an impartial, respected public body. It requires a judicious approach which should include a full and fair hearing for the interested parties and for public representatives.

I do not think that the Council of Economic Advisers should be asked to perform this function of hearing and judging. Nor, with all due respect, do I think that this excellent committee is the appropriate body to do the job. This task is likely to be accomplished more expertly and fairly outside the Halls of Congress. I would recommend, therefore, that it be given to the agency charged with formulating the industrywide policies. This agency will thereby gain experience with particular situations which will help it in formulating these policies. In turn, its experience in elaborating these policies will help it to judge specific cases.

Furthermore, because it is always difficult to secure the rescission of action that has been taken, Congress should require labor and management to give this agency advance notice of any proposed wage or price increase. The agency should then be relied upon to institute hearings in those cases in which it thinks that a proposed wage or price increase may threaten national economic stability. After hearing, the agency should be required to publish its findings and recommendations in the case.

It is also very important to authorize the agency to initiate hearing in those cases in which it thinks price decreases are called for by the stabilization policies, and the failure to make the decreases threatens national economic stability. The Government's past interventions to secure compliance with the guideposts have raised serious questions of propriety. Too often they have become public tests of strength between the President of the United States and the executives of a great industry or a great labor union.

"In any such confrontation with the President," Alcoa's President Harper has said, "there can and should be only one outcome." But precisely here is the difficulty. In such a test of strength, the President must not lose. But this necessity itself creates the danger that the outcome may be arbitrary.

Furthermore, whenever, in order to have his way, the President must resort to means other than persuasion—such as selling stock-piled materials, awarding contracts to producers who have not raised their prices, instituting tax or antitrust investigations—he will subject himself, inevitably, to criticism for allegedly abusing his authority.

Equally troublesome, there can be no certainty in this situation that the President will deal even-handedly with all those who are similarly situated. Not only is the fairness of this system of enforcement in question, but the haphazard quality of Presidential intervention also makes it an ineffective way to enforce stabilization policies.

Finally, in time, labor and management will appreciate that even the powers of the President are limited and begin to flout the President's policies with impunity. I am afraid that the President's 1967 Economic Report reflects his estimate that this time has already come.

The suggestions that I have put before this committee may make it possible to carry out the overall wage-price policy adopted by Congress effectively and equitably without the personal intervention of the President. I would hope and expect that these suggestions will maximize the possibility of securing the voluntary cooperation of labor and management, and, if necessary, of mobilizing public opinion to induce such compliance.

For this reason I do not recommend that Congress, at this time, should impose any sanctions for noncompliance with the wage-price policies that will be elaborated under the authority of the legislation I have outlined.

I would not object, however, if Congress should decide to impose such sanctions. I would not object to sanctions because I do not think that the controls which Congress would then be legislating would displace a free market. On the contrary, they would displace the exercise of private power over the market by the exercise of public authority in the interest of economic stability.

It is very important, in my view, Mr. Chairman, that we should not be ruled by a taboo against price and wage controls. They constitute a way of managing the economy which must be compared and evaluated with other ways. We are told by Chairman Ackley that if the actions of labor and management "create an inflationary spiral, the most likely outcome will be restrictive fiscal and monetary policies which will aim to stop further price increases but will in the process also reduce output, cut back profits, and reduce employment." Because of its impact on our balance of payments, Chairman Ackley adds that the inflationary spiral will also have to be fought by "cutting back or eliminating expenditures on foreign economic assistance, by yielding to restrictionist pressures in our trade policy, and by further limitations on the outflow of capital to friendly nations."

Certainly, Mr. Chairman, even direct controls deserve the most serious consideration as an alternative to policies that would have these disastrous consequences. They may permit us once and for all to abandon the idea of managing the economy through unemployment. And they may even eliminate any possible necessity for a tax increase in 1967.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Auerbach follows:)

PREPARED STATEMENT OF CARL A. AUERBACH

Mr. Chairman, you have invited me to discuss the wage-price policies set forth in the President's Economic Report and the Annual Report of the Council of Economic Advisers. Both the President and the Council have been criticized

in recent weeks for abandoning the wage-price guideposts. Yet this criticism is too general and, therefore, unfair. This Committee will come to grips with the difficult problems of economic stabilization we face this year only if it is clear about the specific nature of the changes in the Administration's wage-price policy.

HAVE THE GUIDEPOSTS BEEN ABANDONED?

The President regards the restoration of price stability as "one of our major tasks."¹ the accomplishment of which will require "the responsible conduct of those in business and labor who have the power to make price and wage decisions."² The President is also quite definite about what conduct of business and labor would be irresponsible. "If unions now attempt to recoup in wages all of the past or anticipated advance in the cost of living—in addition to the productivity trend" and "if businesses now seek to pass along rising costs when it would be possible to absorb them or do not reduce prices when costs fall," then, the President warns, the result will be a wage-price spiral "damaging to business, damaging to labor, and disastrous to the Nation."³

Furthermore, the Council of Economic Advisers has attempted to define the affirmative requirements of responsible conduct on the part of labor and business. So far as wage policy is concerned, the Council is still firmly of the opinion that the "only valid and noninflationary standard for wage advances is the productivity principle."⁴ Nothing in its Report gives any indication that the Council has abandoned its position that the trend of productivity which should govern wage movements is 3.2 percent a year.⁵ "If price stability is eventually to be restored and maintained in a high-employment U.S. economy", the Council insists, "wage settlements must once again conform to that standard."⁶

Those who seek a specific wage guidepost figure in the Council's Report will find that it continues to be 3.2 percent a year. But as a practical matter, the Council—and the President—recognize that the 3.3 percent increase in the cost of living in 1966 and the unusually high profits earned in recent years make "it unlikely that most collective bargaining settlements in 1967 will fully conform to the trend increase of productivity."⁷ And the President obviously thinks it would be futile for him to try to see that these settlements do so conform.

Since the Council, even under current conditions, adheres to the productivity principle, it "sees no useful purpose to be served by suggesting some higher standard for wage increases, even on a temporary basis."⁸ It calls for "restraint in wage settlements" and defines "restraint" to mean "wage advances which are substantially less than the productivity trend plus the recent rise in consumer prices."⁹ It also calls upon producers to "absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices."¹⁰ In like vein, the President appeals "to business and labor—in their own interest and that of the Nation—for the utmost restraint and responsibility in wage and price decisions."¹¹

HOW HAS ADMINISTRATION POLICY CHANGED?

In my opinion, the most significant change in the Administration's policy is not that it has refused to specify a single figure as the wage guidepost for 1967. Neither President Truman, who originated the guidepost policy, nor Presidents Eisenhower and Kennedy, who further elaborated it, ever specified such figures. It is more significant that President Johnson has apparently abandoned the policy—which on occasion was also of President Kennedy—of using the influence and prestige of the Presidency to assure that particular wage and price decisions satisfy the requirements of the public interest as viewed by the President.

Gone from the President's 1967 Economic Report are his 1964 and 1965 pledges that he would "not hesitate to draw public attention to major actions by either

¹ 1967 Economic Report of the President, at 11.

² *Ibid.* at 12.

³ *Ibid.*

⁴ 1967 Annual Report of Council of Economic Advisers, at 128.

⁵ See *id.* at 123.

⁶ *Ibid.* at 128.

⁷ *Ibid.*

⁸ *Ibid.*

⁹ *Ibid.* at 129.

¹⁰ *Ibid.* at 133.

¹¹ 1967 Economic Report of the President, at 13.

business or labor that flout the public interest in noninflationary price and wage standards";¹² or his 1966 declaration that "it is vitally important" that labor and industry follow the guideposts.¹³ Instead, we have the presidential "appeal to business and labor—in their own interest and that of the Nation—for the utmost restraint and responsibility in wage and price decision."¹⁴

The Council, which has been the President's executive arm for administering and enforcing the guideposts, has stated that it will continue to meet privately with "leaders of business and labor" in order "to underscore the public interest factor in wage and price decisions and to solicit the cooperation of union and corporate leadership in specific situations."¹⁵ But it does not state that it will henceforth, as it has on occasion in the past, issue "formal statements to the public commenting on particular wage or price decisions."¹⁶

While there is no firm basis for reading into the President's Economic Report an espousal of a policy of non-intervention in private wage- and price-decision-making, it is fair to interpret it as adopting a policy of limiting the Government's weapons of intervention to information and persuasion and renouncing future efforts to apply "sanctions" to "violators" of the guideposts.

If this is a correct interpretation of administration policy, the change is to be welcomed—not deplored—and particularly if Congress now meets its obligations and acts to accomplish the objectives which Congressman Reuss has urged upon it in recent years.

DIFFICULTIES WITH GUIDEPOST POLICY AND SUGGESTIONS FOR OVERCOMING THEM

Very serious—and legitimate—criticism may be directed at the way the guidepost policy has been formulated and administered to date. It has tended, in my view, to jeopardize the values which we associate with the rule of law in our democracy.

Need for a wage-price policy

To be clear about the problem we face, we must begin with the fact—which Presidents Truman, Eisenhower, Kennedy and Johnson, their Councils of Economic Advisers and, I think, this Committee, have accepted—that structural characteristics of the American economy are responsible for the tendency of wages and prices to rise even before full employment is achieved. Historical experience has convinced us of this fact. Prices increased rapidly in 1937 despite massive unemployment and under-utilization of resources. The defense program of 1940 and 1941 produced inflation even though the economy was then operating far below capacity. Events from 1956 to 1958 again showed that we could have inflation in the absence of excess demand, and indeed, even in the face of declining demand. The experience of the last year only adds to the proof. "The critical economic problem to be solved in the year ahead", the Council tells us, "is that of maintaining income growth and full utilization of resources without becoming trapped in an inflationary price-wage spiral."¹⁷

Experience has also demonstrated that monetary and fiscal policies alone cannot prevent an inflationary price-wage spiral without sacrificing the twin objectives of income growth and full utilization of resources. In order words, we constantly hesitate to use monetary and fiscal policies to the extent necessary to attain these objectives for fear of inflation. To remove this hesitation, it is commonly accepted, price and wage restraint will have to be practiced in certain sectors of the otherwise unregulated private economy. Differences quickly arise when the discussion shifts to the means of assuring that such private restraint, in fact, will be practiced.

Stabilization without representation

The guidepost policy is defended as a means of assuring such private restraint principally on the ground that it is not a policy of compulsion but one that calls for "voluntary" compliance with its requirements. As Chairman Ackley succinctly put it, having "been exposed to persuasion and willing to risk

¹² 1964 Economic Report of the President, at 11; 1965 Economic Report of the President, at 13.

¹³ 1966 Economic Report of the President, at 12.

¹⁴ 1967 Economic Report of the President, at 13.

¹⁵ 1967 Annual Report of Council of Economic Advisers, at 126-127.

¹⁶ *Id.* at 127.

¹⁷ *Id.* at 72.

the censure of public opinion," labor and management are "able in the end to violate the guideposts with impunity."¹⁸

It would seem that the advocates of a policy which depends for its effectiveness upon the voluntary action of labor and management should have tried to enhance its acceptability by affording these groups an opportunity to participate in its formulation. Yet there is no evidence that representatives of labor and management—or even the President's Advisory Committee on Labor-Management Policy—participated in the formulation of the original guideposts in 1962 or in their subsequent elaboration. It is interesting in this connection that the only reference to the President's Advisory Committee on Labor-Management Policy in the current Economic Report is the Council's statement that its activities in 1967 included meeting formally with a number of advisory groups, one of which was the President's Advisory Committee.¹⁹

Both the AFL-CIO and spokesmen for various industry groups have attacked the guidepost policy. Secretary of Labor Wirtz thinks that a "good deal of the objection to" the guidepost policy "is that it seemed to constitute 'stabilization without repression'."²⁰

Lack of consensus about wage-price policy

The failure to recognize the necessity for participation of the major interests affected by the guidepost policy in its formulation is due, in my opinion, to the technocratic attitude of the Kennedy and Johnson Administration toward this policy. President Kennedy most clearly expressed this attitude in his celebrated 1962 Commencement Address at Yale University when he called for "more basic discussion of the sophisticated and technical questions involved in keeping our mighty economic machine moving steadily ahead."²¹ The present Council is fond of speaking about the "arithmetic" of the guideposts.²² But, in truth, the problems of stabilization are not merely "sophisticated" and "technical" and "arithmetic" alone will not solve them.

The participation of labor and management in the formulation and administration of a wage-price policy might nevertheless be unnecessary if general agreement existed on what this policy should be and how it should be applied. But I need not tell the members of this Committee that there is no such consensus.

How much unemployment should be tolerated in the interest of price stability?

There probably is agreement in the country that full employment, rapid economic growth and price stability are all desirable. Probably there is also agreement that uncontrolled inflation of long duration not only will interfere with the process of production itself, thereby jeopardizing the possibility of full employment, but also will result in inequities that will threaten to undermine our social and political structure. But there is no agreement about how much price instability at any particular time may be tolerated in the interest of fuller employment or for how long such price instability may be endured without risking uncontrollable inflation. There is no shared understanding of when employment is "full" or how rapidly our economy should grow.

Paul A. Samuelson and Robert M. Solow wrote in 1959 that the country has a "menu of policy choices" which involve the balancing of different levels of employment and output against varying degrees of price instability.²³ Those of our people who live on fixed or relatively fixed incomes, those with secure jobs, savings depositors, owners of life insurance and mortgages would like to see the balance struck in favor of price stability. The unemployed—and all who are troubled about the social costs of unemployment—would like to see the balance struck in favor of still higher levels of production and employment. It is the purpose of a wage-price policy to "lessen the degree of disharmony between full employment and price stability."²⁴ But the disharmony cannot be avoided completely.

¹⁸ Hearings on H.R. 11916 before a subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 67 (1967) (statement of Chairman Ackley).

¹⁹ 1967 Annual Report of Council of Economic Advisers, at 206.

²⁰ Hearings on H.R. 11916 before a subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 93 (1966) (statement of Secretary Wirtz).

²¹ Wall Street Journal, June 12, 1962, p. 20, col. 1.

²² 1967 Annual Report of Council of Economic Advisers, at 120; Hearings on H.R. 11916 before a subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 52 (statement of Chairman Ackley).

²³ Samuelson and Solow, Our Menu of Policy Choices, in *The Battle Against Unemployment* 74 (Okun ed., 1965).

²⁴ *Id.* at 75-76.

Should wage rate increases be limited by the rate of increase in productivity; if so, how?

Equally important, there is no agreement on the ingredients of a desirable wage-price policy. This Committee has heard testimony that the wage guideposts should not always tie wage rate increases to the rate of increase in productivity because the increasing productivity of capital may require, for a while, that wage earner gains exceed productivity gains in order to restore economic equilibrium.²⁵ It has also heard the wage guideposts criticized because, allegedly, they reinforce the myth in the public mind "that everyone is entitled to some average productivity increase in wages annually."²⁶

Among those who accept the principle that wage rate increases should be tied to productivity rate increases, there is disagreement as to whether the standard should be the nation-wide trend rate of productivity-increase or the rate of productivity-increase in the particular industry in question.²⁷ There is also disagreement as to how the trend rate of productivity increase, on the one hand,²⁸ and employee compensation per man-hour, on the other,²⁹ should be measured. These may be issues which, eventually, technical experts should be able to resolve to everyone's satisfaction. But the guidepost policy also raises questions as to what is a "fair" wage and a "fair" profit and an "equitable" distribution of the national income on which opinions and interests will remain in sharp conflict.

Should increases in real, not money, wages be used for guidepost comparisons?

The conflicts of interest become apparent when we turn to the question whether wage rate increases should be limited by the trend rate of productivity growth even in the face of significant increases in the cost of living. The guideposts assumed that real wages would go up as productivity increased. But this has not happened because price stability has not been maintained. Under these circumstances I agree with Mr. Gerhard Colm that it is not realistic or equitable to expect a "union whose contract is under consideration . . . to pay the penalty for the failure of government, business and other unions to do their part in the stabilization effort."³⁰ Therefore we should not blame such a union for seeking to improve its position.

Whether particular unions will exercise restraint in this struggle and be satisfied with only a "partial and gradual adjustment" for cost of living increases³¹—as Mr. Colm recommends—may depend upon whether labor is convinced that the stabilization program is being applied "equitably to all groups in the population."³² But obviously there is no agreement in the country on what the principle of equality of sacrifice now requires because there is no agreement on what is an "equitable" distribution of income.

Bargaining about distribution of income

When it erected the original guideposts in 1962, the Council of Economic Advisers recognized that, if adhered to, they would perpetuate the existing "relative

²⁵ Hearings on 1963 Economic Report of the President Before Joint Economic Committee, 88th Cong., 1st Sess. 727 (1963); Hearings on 1965 Economic Report of the President Before Joint Economic Committee, 89th Cong., 1st Sess., pt. 4, at 27 (testimony of Mr. Leon Keyserling).

²⁶ Hearings on 1964 Economic Report of the President Before Joint Economic Committee, 88th Cong., 2d Sess. 219 (1964) (testimony of Professor Walter D. Fackler).

²⁷ See 1950 Annual Economic Review of Council of Economic Advisers, at 101; Hearings on H.R. 11916 Before a Subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 82-83 (statement of Chairman Ackley); Joint Economic Committee, Report on Jan. 1964 Economic Report of the President, S. Rep. No. 931, 88th Cong., 2d Sess. 38 (1964) (minority views); Hearings on 1964 Economic Report of the President Before Joint Economic Committee, 88th Cong., 2d Sess., pt. 2, at 158 (testimony of Mr. W. A. Boyle, President of United Mine Workers); N.Y. Times, Aug. 9, 1966, p. 1, col. 8 (views of Secretary of Commerce John T. Connor).

²⁸ See for example, Hearings on 1966 Economic Report of the President Before Joint Economic Committee, 89th Cong., 2d Sess. 398 (1966) (testimony of Mr. Walter Reuther); *id.* at 617-618 (testimony of Mr. Leon Keyserling); Joint Economic Committee, Report on Jan. 1964 Economic Report of the President, S. Rep. No. 931, 88th Cong., 2d Sess. 38 (1964) (minority views).

²⁹ See for example, Hearings on 1965 Economic Report of the President Before Joint Economic Committee, 89th Cong., 1st Sess., pt. 3, at 102 (1965) (testimony of Mr. Leon Keyserling); Hearings on 1966 Economic Report of the President Before Joint Economic Committee, 89th Cong., 2d Sess. 444 (1966) (testimony of Mr. Elisha Gray II).

³⁰ Hearings on H.R. 11916 Before a Subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 7, 8 (1966) (statement of Mr. Colm).

³¹ *Id.* at 8.

³² See statement of AFL-CIO Executive Council, The American Federationist, Sept. 1966, p. 8.

shares of labor and nonlabor incomes in total output.”³³ So it emphasized that “there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes.”³⁴ It thought it desirable that labor and management “should bargain explicitly about the distribution of income of particular firms or industries”, so long as they did so within the framework of a stable price level.³⁵ However, if such bargaining resulted in price increases, the Council pointed out labor and management would not be redistributing income within the industry involved; they would be redistributing income “between that industry and other segments of the economy through the mechanism of inflation.”³⁶

The Council affirmed this position in 1964, stressing that price behavior in an industry in which such bargaining was going on must remain consistent with the general price guidepost. This guidepost, as we know, requires that in an industry “whose trend productivity is growing more rapidly than the national average, product prices should be lowered enough to distribute to the industry’s customers the labor-cost savings it would make under the general wage guidepost.”³⁷ In effect, the Council was saying that bargaining about the distribution of income in such an industry should take place only *after* prices are reduced to the extent indicated. Labor might then receive a larger share of the industry’s income if it won greater wage increases than the productivity standard permitted or a larger share might go to profits if the workers were granted smaller wage increases than the productivity standard permitted.

But the Council has vacillated on the desirability of bargaining about the distribution of income. In 1965 it felt constrained to warn that experience during the 1950’s demonstrated that such bargaining “proved self-defeating”, that neither labor nor capital “gained, and both lost through higher prices, weaker markets, reduced profits, and lower employment.”³⁸ In 1966, apparently, it felt that it had gone too far in advising labor not to bargain collectively for a change in the distribution of income. So it retreated to the position that “public policy is and should remain neutral with respect to wage and price decisions that attempt to change the distribution of industry’s income between labor and capital”—so long as such decisions do not produce inflationary pressures.³⁹ This year, however, the Council repeats its warning “that attempts on the part of unions to redistribute income from profits to wages through excessive wage increases in high-profit industries results primarily in higher prices in those industries” and in the redistribution of “real income from the rest of the community—who are mostly other wage earners—to the workers in question, with very little redistribution from profits to wages.”⁴⁰

But of course this is true only because management in high-profit industries has been unwilling to reduce prices and no means have been found to require it to do so. Recognizing that it is unfair to ask workers to restrain their wage demands if their restraint will only result in higher profits, the Council appeals for forbearance on the part of management. It asks producers to “absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices.”⁴¹ For the first time, too, the Council states that profit margins appropriate for the boom stage of a boom and bust economy—to which it likens 1966 average profit margins of manufacturers which were higher, as a percentage of equity, than in any prior year since the highly inflationary year of 1950—are too high for a steadily expanding economy.⁴² Indeed, the Council maintains that lower profit margins may be essential to maintain a steadily expanding economy.⁴³

But there is no agreement in the country on any standard of “reasonable” profits that would tell us to what extent producers should absorb cost increases and how much lower profit margins should be. For this reason, we cannot tell whether a wage increase higher than that permitted by the wage guideposts should have the effect of redistributing the industry’s income or should justify a price increase or a smaller price decrease than the guideposts would call for.

³³ 1962 Annual Report of Council of Economic Advisers, at 186.

³⁴ *Ibid.*

³⁵ *Id.* at 188.

³⁶ *Ibid.*

³⁷ 1964 Annual Report of Council of Economic Advisers, at 119.

³⁸ 1965 Annual Report of Council of Economic Advisers, at 109.

³⁹ 1966 Annual Report of Council of Economic Advisers, at 91.

⁴⁰ 1967 Annual Report of Council of Economic Advisers, at 132.

⁴¹ *Id.* at 133.

⁴² *Ibid.*

⁴³ *Ibid.*

Under these circumstances little is gained by asking management to adopt a principle of profit minimization or even to blame it for trying to maximize profits.

Yet the fact remains that unless agreement is reached on some standard of "reasonable" profits to guide price policy in the administered-price industries, organized labor cannot reasonably be expected to acquiesce in absorbing any part of the cost of living increases due to the rise in prices in other sectors of the economy—in farm products and services, for example. Nor can it be expected to heed the Council's advice that it pay for the higher minimum wage by accepting lower wage increases than the average permitted by the productivity standard.⁴⁴

A proposal for congressional formulation of a wage-price policy

I shall not try to suggest answers to the many questions I have raised. The point I wish to make is that the issues raised by the guideposts—or any wage-price policy—are the kind that are resolved in our democracy only by an accommodation of conflicting claims which all concerned find tolerable. To each such an accommodation, labor and management must be given the opportunity to participate in the formulation of a wage and price policy. Furthermore, since any bargain that these groups may strike will affect the life of the ordinary citizen more than much legislation passed by Congress, Congress must be the final arbiter.

Accordingly, I urge this Committee to institute hearings immediately to determine what our wage-price policy should be in the period ahead. Representatives of labor, management, the public—and of course the Administration—should be heard. This Committee should then write a report which would enable the appropriate legislative committees of Congress, if they approved it, to draft a bill setting forth the components of an overall wage-price policy.

It has been objected that it is unwise to legislate a wage-price policy because that will give it "legal status and a flavour of compulsion" and destroy its voluntary character.⁴⁵ But if it is agreed that representatives of labor, management and the public should participate in formulating a wage-price policy, some way must be provided for settling controversies that may arise. Only the President or Congress can do so; I think Congress should do so but that it should act in a manner that will require it to run the gauntlet of a possible Presidential veto.

Furthermore, I do not see why congressional formulation of a wage-price policy, by itself, will destroy the voluntary nature of labor-management compliance with the policy.

Translating the overall wage-price policy into specific policies for particular industries

Flexibility was the key to the 1962 formulation of the guideposts. In addition to the factors making for flexibility which I have already mentioned, the 1962 formulation recognized exceptions in the interests of "efficiency and equity."⁴⁶ Exceptions from the general wage guidepost were envisaged for an industry which was unable to attract sufficient labor and for one which was unable to provide jobs for its entire labor force; and for industries in which wage rates were either exceptionally low or exceptionally high compared with those earned elsewhere by similar labor.⁴⁷ Similarly, exceptions from the general price guidepost were expected in industries in which the level of profits was insufficient to attract the capital required to finance a needed expansion in capacity or in which the relation of productive capacity to full employment demand showed the desirability of an outflow of capital; in industries in which costs other than labor costs had either risen or fallen; and in which excessive market power had resulted in rates of profit substantially higher than these earned elsewhere on investments of comparable risk.⁴⁸

In 1964, for the first time, the Council announced that the general guideposts could "cover the vast majority of the wage and price decisions" and that the exceptions recognized in 1962 were "intended to apply to only a relatively few cases."⁴⁹ The Council affirms this position in its 1967 report. While it con-

⁴⁴ Id. at 130.

⁴⁵ Hearings on H.R. 11916 Before a Subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 91 (1966) (statement of Chairman Ackley objecting to the Reuss bill which would not go as far as the suggestion made above).

⁴⁶ 1962 Annual Report of Council of Economic Advisers, at 188.

⁴⁷ Id. at 189.

⁴⁸ Ibid.

⁴⁹ 1964 Annual Report of Council of Economic Advisers, at 119.

tinues to recognize exceptions from the general wage guidepost "that serve an economic function by assisting in the reallocation of labor toward shortage occupations and industries," it points out that "the remaining labor shortages this year will be concentrated in unorganized professional and technical occupations."⁵⁰ The Council also seeks to confine the "comparable wages" exception from the general wage guidepost.⁵¹

But the Council's continuing attempt to prevent the flexibility that must be part of any wage-price policy from becoming the means to defeat the policy itself is negated this year by the practicalities of the situation the Council faces. It does not believe that any firm rules will or can be applied for the movement of either wages or prices in 1967.

In fact, no overall wage-price policy formulated by the President or Congress can be expected to set forth clear guides to action in every case. The more general and more flexible the statement of such a policy, the more difficult it will be to apply it to any particular industry or firm and therefore the more difficult it will be to judge whether a particular wage or price decision is in accord with the policy.

A proposal for administrative implementation of the overall policy adopted by Congress

To tailor the overall wage-price policy adopted by Congress to the circumstances and needs of particular industries and firms is an administrative task. In my opinion, this function should not be assumed by Congress, the Joint Economic Committee or the Council of Economic Advisers. It should be given to an administrative agency. However, a tripartite committee—representing labor, management and the consuming public—should be appointed by the President for each industry to advise the agency in the formulation of a specific wage-price policy for that industry. It is important that such advisory committees be set up as quickly as possible in those industries in which wage agreements will be newly negotiated in 1967. In addition, the agency should be required to hold public hearings on the wage-price policies proposed for particular industries and to issue written statements justifying the policies adopted for each industry. In time, this agency should have valuable advice to offer to all concerned with the formulation of the overall wage-price policy, which should be under constant review by the Congress.

Determining whether a particular price or wage decision accords with the wage-price policies adopted for the industry

If there is to be voluntary compliance with the wage-price policies thus formulated for an industry—and if the force of public opinion is to be brought to bear to help secure compliance—then labor, management and the public must be able to know whether a particular wage or price decision accords with the policies laid down. The administration of the guidepost policy to date has not assured the availability of such knowledge. Indeed, the Council of Economic Advisers admits that when it meets privately with producers about price increases, "it ordinarily does not have the detailed information which would permit a clear judgment as to the appropriateness of the proposed price change on either the basis of the guide post standards or other relevant considerations."⁵² Nor has such detailed information been made available even in those cases in which the Council has issued formal statements to the public commenting on particular wage or price decisions. Yet in many cases, labor and industry spokesmen have challenged the Council's application of the guideposts to their situations. For example, the steel industry in 1962 and 1966, the aluminum industry in 1966 and the machinists in the airline industry in 1966 challenged Council conclusions.

A proposal for hearings to determine propriety of particular wage or price decisions

To determine whether a particular wage or price decision accords with the stabilization policies laid down is a task that must be performed by an impartial, respected public body. It requires a judicious approach which should include a full and fair hearing for the interested parties, including public representatives.

⁵⁰ 1967 Annual Report of Council of Economic Advisers, at 130.

⁵¹ *Id.* at 130-131.

⁵² *Id.* at 126.

I do not think the Council of Economic Advisers should be asked to perform this function of hearing and judging. Nor, with all due respect, do I think that this excellent Committee is the appropriate body to do the job. This task is likely to be accomplished more expertly and fairly outside the halls of Congress. I would recommend, therefore, that it be given to the agency charged with formulating the industry-wide policies. This agency will thereby gain experience with particular situations which will help it in formulating these policies. In turn, its experience in elaborating these policies will help it to judge specific cases.

Advance notice of proposed wage and price actions

Furthermore, because it is always difficult to secure the rescission of action that has been taken, Congress should require labor and management to give this agency advance notice of any proposed wage or price increase. This requirement will apply, it should be recalled, only to those industries in which labor and management have a substantial measure of discretion in setting wages or prices. The agency should then be relied upon to institute hearings in those cases in which it thinks that a proposed wage or price increase may threaten national economic stability. After hearing, the agency should be required to publish its findings and recommendations in the case.

The Council of Economic Advisers reports 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."⁵³ For this reason, it is important to authorize the agency to initiate hearings in those cases in which it thinks price decreases are called for by the stabilization policies and the failure to make them threatens national economic stability.

Securing compliance with wage-price policies

The government's past interventions to secure compliance with the guideposts raise serious questions of propriety. Too often, they have become public tests of strength between the President of the United States and the executives of a great industry or a great labor union. "In any such confrontation with the President," Alcoa's President Harper has said, "there can and should be only one outcome."⁵⁴ Precisely here is the difficulty. In such a test of strength, the President must not lose. But this necessity itself creates the danger that the outcome may be arbitrary.

Furthermore, whenever, in order to have his way, the President must resort to means other than persuasion—such as selling stockpiled materials, awarding contracts to producers who have not raised their prices, instituting tax or antitrust investigations—he will subject himself, inevitably, to criticism for allegedly abusing his authority.

Equally troublesome, there can be no certainly in this situation that the President will deal even-handedly with all those who are similarly situated. Not only is the fairness of this system of enforcement in question, but the haphazard quality of president intervention also makes it an ineffective way to enforce stabilization policies. Finally, in time, labor and management will appreciate that even the powers of the President are limited and begin to flout the President's policies with impunity. I am afraid that the President's 1967 Economic Report reflects his estimate that this time has already come.

The suggestions that I have put before this Committee may make it possible to carry out the overall wage-price policy adopted by Congress effectively and equitable without the personal intervention of the President.

At this time, I do not suggest that Congress should impose any sanctions for non-compliance with the wage-price policies that will be elaborated under the authority of the legislation I have outlined. I would hope—and I expect—that Congressional adoption of a wage-price policy, subsequent administrative implementation of the policy on an industry-by-industry basis and public hearings to determine whether particular wage-price decisions accord with the policies formulated—will maximize the possibility of securing the voluntary cooperation of labor and management and, if necessary, of mobilizing public opinion to induce such compliance.

I would not object, however, if Congress decides to impose some sanctions; if, for example, it specifically authorizes and directs the President to manage the

⁵³ Id. at 125.

⁵⁴ Harper, A Businessman's View of Guideposts, in Committee for Economic Development, *Managing a Full Employment Economy* 39 (1966).

country's stockpiles of materials so as to help effectuate price stabilization objectives or to write into every Government contract and subcontract a requirement that the contractor comply with the wage-price policies formulated for his industry. I would not object if Congress provides that wage increases in excess of those permitted by the applicable wage-stabilization policies should not be recognized as business costs for tax purposes and that net income attributable to price actions in conflict with applicable price-stabilization policies should be subject to a tax of 100%; or even if Congress makes available more traditional civil and criminal penalties. Some sanction may prove to be necessary to assure compliance with the requirement that advance notice be given of certain proposed wage or price actions. And it may prove to be impossible, without some sanction, to bring about the price and profit reductions which the stabilization policies may call for and without which the structure of voluntary compliance may collapse.

I would not object to sanctions because I do not think that the controls which Congress would then be legislating would displace a free market. On the contrary, they would displace the exercise of private power over the market by the exercise of public authority in the interest of economic stability.

It is important that we should not be ruled by a taboo against price and wage controls. They constitute a way of managing the economy which must be compared and evaluated with other ways. We are told by Chairman Ackley that if the actions of labor and management "create an inflationary spiral, the most likely outcome will be restrictive fiscal and monetary policies which will aim to stop further price increases but will in the process also reduce output, cut back profits, and reduce employment."⁵³ Because of its impact on our balance of payments, Chairman Ackley adds that the inflationary spiral will also have to be fought by "cutting back or eliminating expenditures on foreign economic assistance, by yielding to restrictionist pressures in our trade policy, and by further limitations on the outflow of capital to friendly nations."⁵⁵

Certainly, even direct controls deserve the most serious consideration as an alternative to policies that would have these deleterious consequences. They may permit us once and for all to abandon the idea of managing the economy through unemployment.

Chairman PROXMIRE. Thank you very much, Professor Auerbach. Let me see if I understand your proposal. You would establish boards for the various industries which are characterized by administered price behavior and by large unions. The boards would consist of representatives of unions, management, and the public. They would hold public hearings on labor-management policy within the particular industry.

They would then make recommendations. For the time being, you would not insist on sanctions to carry out those particular recommendations. What have I missed here?

Mr. AUERBACH. The principal board that I envisage would not be a tripartite board. It would be an agency in the executive branch of the Government, preferably answerable to the President—not an independent agency.

The representation of labor, management, and the public would come through committees that would be advisory to this public body which would have the ultimate authority. I do not envisage that the agency that would be entrusted with the authority would itself be a tripartite board.

Chairman PROXMIRE. A tripartite board would be an agency that would be for the purpose of giving representation.

Mr. AUERBACH. Correct.

Chairman PROXMIRE. The kind of thing that Secretary Wirtz said was absent in the present stabilization policy.

⁵³ 1966 Annual Report of Council of Economic Advisers, at 93.

⁵⁵ Ackley, *Why Stability of Copper Prices Is So Urgent an Objective of U.S. Policy*, No. 14, 1965, p. 3 (unpublished mimeo.).

Mr. AUERBACH. That is right.

Chairman PROXMIRE. And the agency itself would recommend the level of wage increases.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. And also recommend whether prices would be permitted to go up or down in a particular industry.

Mr. AUERBACH. Yes, sir. I think that a reasonable argument could be made that the agency itself should be a tripartite board. But I react against proposals to give tripartite boards governmental authority.

Chairman PROXMIRE. I think it is most important that it be only advisory.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. I think that is very important.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. Because if you have a tripartite group of this kind, it might very well become biased.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. In favor of higher wages, higher prices.

Mr. AUERBACH. I agree.

Chairman PROXMIRE. And accommodation for the industry, and represent the industry, the industry's viewpoint. I have seen that happen sometimes and so have you.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. So that you could then have a situation in which the educational process, which many say was the principal purpose of the wage-price guideline, would be enhanced by your advisory committees.

Mr. AUERBACH. I think so.

Chairman PROXMIRE. And in addition, you would have a public agency that would make specific recommendations?

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. Then you say the sanctions would not be applied at least at first; is that correct?

Mr. AUERBACH. That is correct. I do not envisage that any sanctions would be provided at this time.

Chairman PROXMIRE. What would this do? Take an instant situation: A day or two ago American Motors announced that they were reducing prices on their automobiles, some of them very sharply, and this is a most encouraging development to many of us, not only those of us living in Wisconsin—we hope it means more jobs there—but it also means some initiative in the automobile industry itself to get lower prices.

Wouldn't the kind of process you propose tend to perhaps discourage that sort of initiative, that sort of competition? Wouldn't it tend to freeze a pattern, in which companies would be less inclined to take the initiative?

Mr. AUERBACH. I don't think so. A similar argument has been made against the guideposts themselves, that they would create rigidity by discouraging price decreases for fear that subsequent increases would have to be justified. But I don't believe that price decreases would be so discouraged. The competitive pressures which

induced American Motors to take this action would continue to operate even if my proposals were adopted.

Chairman PROXMIRE. It seems to me you are kind of institutionalizing this more, and making it more formal, and because you establish this kind of pattern, with a natural tendency for management to push for higher prices, and labor to push for higher wages, and the feeling that this is where you get your ultimate wage determination, where you get your ultimate price determination, I would be somewhat concerned about that possibility.

Let me ask you—is there any similarity between your proposal and the experience they have had in Britain, in their attempts to stabilize wages and prices? Do we gain anything from the results of their experience?

Mr. AUERBACH. You mean the current experience?

Chairman PROXMIRE. Yes.

Mr. AUERBACH. Well, the current experience is with a prices and incomes freeze—or standstill, as the British call it.

Chairman PROXMIRE. Yes; but the current experience some critics say has been the product of the failure of the boards that may be somewhat similar at least in objective to what you have recommended here, to achieve stability. What is your reaction to that?

Mr. AUERBACH. I think that it is true that the British National Board for Prices and Incomes may be similar to the stabilization agency that I have proposed. I don't believe, however, that the situations faced by the two countries are essentially the same, because the problems in Britain are longstanding problems of slow economic growth.

Chairman PROXMIRE. I understand that the recent decision by Britain was very probably independent of any wage-price problem. It was dependent on their international payments situation.

Mr. AUERBACH. Principally so, though the wage-price picture is part of the larger problem.

Chairman PROXMIRE. But what I am getting at is whether or not the experience prior to this that the British have had over a period of years would suggest this proposal will or will not work.

Mr. AUERBACH. I think that, on the whole, the prices and incomes policy that the Labor Party began to introduce when it came to power recently was different from the policy followed by its predecessor government. I don't think it can be said, definitively, that experience under this new policy was discouraging.

In fact, Prime Minister Wilson, if he holds to what he has told Parliament, intends to retain this policy after this period of freeze is over. His long-range plan is to return to the National Board for Prices and Incomes and require proponents of wage and price increases to justify their proposals before this Board.

We don't have enough experience, Mr. Chairman, to be confident that such boards are going to work effectively. All Western democratic countries face this problem of reconciling full employment and economic growth with price stability. It would not be accurate or helpful to say that any of them has succeeded in solving this problem, or that my proposals are certain to do the job. The verdict is not yet in.

Chairman PROXMIRE. Professor Auerbach, you have obviously done a lot of thinking about the overall principles involved in price stabilization. How do you resolve something that has come before the committee again and again? Professor Hansen brought it up in a very convincing way the other day, I thought; and both Walter Reuther and Mr. Goldfinger also brought it to our attention.

How do you resolve this real income dilemma? The whole principle as I understand it is that labor should receive an increase in real income comparable to their productivity increase. You indicate here, in discussing what Colm said the other day that you think you have got to compromise with this and give them something half way between their money income and their real income. That is what you would do, is provide for the increase in productivity and make a partial adjustment for the increase in the cost of living.

Now as soon as you do that, don't you erode the worker's benefit? Don't you create a situation in which he is going to get less than his productivity increase in real terms, and why should workers with a strong labor union, and with their principle supported by such eminent economists as Hansen and others, accept that?

MR. AUERBACH. Well, Professor Hansen poses a dilemma which we haven't resolved and which I would like to comment on briefly.

The suggestion that Professor Hansen made is attractive and just. But surely labor understands that so long as there are no institutional means to control prices, any effort to obtain wage-rate increases equal to the rate of productivity increase plus post cost-of-living increases plus anticipated cost-of-living increases will create the threat of inflation. This is precisely how the wage-price spiral gets started.

Once the spiral gets started, labor as a whole will not benefit. The less tightly organized, the less fortunate segments of labor are going to suffer the most; the more tightly organized, the more fortunate segments of labor, at best, may hold their own.

In other words, I think that the equitable claim that labor makes for increases in real income cannot be denied. But those who are moved by this claim ought to give more attention than they have in the past to the problem of how you prevent the wage-price inflationary spiral from arising. When you begin to concentrate on that problem, you begin to talk about price control and the equitable distribution of income in the United States.

Chairman PROXMIRE. Senator Percy?

Senator PERCY. Good morning, Doctor. I certainly welcome the comment that you made when you said:

The change in the administration's policy is a welcome one, whereby formal statements to the public commenting on particular wage and price decisions might not be made as freely.

It is unusual for politicians to protect steel companies, but a rise in the steel price oftentimes is only a reflection of thousands of price increases and wage increases that the steel companies have already had. They simply have reflected in their price increase the increase in costs that they have been forced to absorb and feel that they can't, in the long-range good of their own industries—research, development, plowback of profits—continue to carry on. And yet they are the ones that are singled out as the whipping boys and in the industry

leadership made to appear as though they are not working in the public interest.

I am less enthusiastic about this concept of a council on prices and wages from the standpoint of advance notice, unless I have failed to understand it. How much advance notice would really be required by you before a price increase goes into effect? Is it a simultaneous public announcement?

Mr. AUERBACH. No, sir.

Senator PERCY. Of advice to the board, or what?

Mr. AUERBACH. No, sir. I am proposing that a requirement be imposed on people who exercise great power in our economy to justify their decisions publicly. This justification must take place before the action is taken. It ought not to be a post hoc rationalization. It ought to be a justification pursuant to a procedure which will make the actors—labor and management—receptive to counterargument. The actors must be able to hear what other people have to say and, in the light of what they have heard, decide whether they want to go through with their proposed actions or abandon or modify them.

In order to establish such a procedure, you obviously have to have a reasonable period of time elapse between the time the proposal is made and the time when the final decision is made.

Senator PERCY. I know that this problem comes up when the Congress gets into a discussion of the removal of or increase of an excise tax. At the moment it is apparent that there may be a reduction or an increase, it does affect buying at the marketplace.

Mr. AUERBACH. Yes, sir.

Senator PERCY. If a notification were given by a powerful industry, such as the automotive industry, or an electronic industry such as television, that a price reduction was going into effect as of a certain date, why would anyone buy the product until such time as that price reduction took effect?

Mr. AUERBACH. I would not contemplate that advance notice of price reductions would have to be given.

Senator PERCY. Only increases.

Mr. AUERBACH. Yes, sir; only increases.

Senator PERCY. I am still not clear as to how much timelag you would feel would be a requirement between the notification to the Government Advisory Board, whatever it may be called, and the time it takes effect in the market.

Mr. AUERBACH. Senator, if you were on such a board, how much time do you think you would need to become acquainted with the issues, to hear or read the evidence, to make up your own mind, and to elaborate the recommendations that you would like to make for the benefit of the public? I would accept whatever you thought was the time you needed for these purposes. I don't know that I can fix it. If I had that kind of responsibility and sat down with my colleagues to discuss the problem, I am sure we would be able to agree on how much advance notice it was reasonable to require.

There have been various periods mentioned in different bills that have been proposed. Isn't there a current bill by Congressman Celler on this point? You may, Senator Percy, know what period of time for advance notice is specified in the current Celler bill. The times

mentioned are usually 60 or 90 days. But I don't think that a precise figure is vital.

We need to accept or reject the principle underlying my proposal. If we don't accept the principle that people who exercise power should be held publicly accountable for the way they exercise that power, and ought to justify their actions before they take them, then we don't want any advance notice of these actions.

But if we accept this principle, then the problem of deciding how much advance notice is required to make it work will not be a problem on which reasonable people will differ very strongly. I think it would then be a minor problem.

Senator PERCY. Could you name the product, product lines or industries that you would feel would be major enough to have this impact?

Mr. AUERBACH. The industries may be defined in a number of ways. They have been defined in some of the bills by reference to the total value of their output. For example, advance notice may be required of any industry in which gross sales total \$200 million or more a year.

Other bills that I recall have tried to identify these industries in terms of the percentage of their total output accounted for by four or five firms in the industry, generally saying that any industry in which four or five firms account for 70 percent or more of the product must give the required advance notice. We are interested in advance notice only from firms in industries in which labor and management have a substantial measure of discretion in setting wages or prices and can take action that pervades the whole economy.

Senator PERCY. Would you say that an industry such as the meat-packing industry, which is a very large industry, would be exempt because of the nature of the product?

Mr. AUERBACH. No, sir. It is not the nature of the product that is crucial. It is crucial whether a few sellers in an industry have such control over the output that they have all of the characteristics of what the economists call oligopoly and can administer prices. In other words, do they exercise power over the market or not?

Senator PERCY. But, Professor, can you conceive that in an industry such as that, where prices change hourly from one bid to the next, that it is possible to give 60 or 90 days' notice on some sort of a price increase? I think this is theoretically and totally unrealistic as related to the marketplace, and I can name hard goods that are exactly the same way. In the radio industry, which is subject to tremendous competition from abroad, transistor radios prices change twice in a week in retail stores, by manufacturers responding to changes in market conditions, and yet that is a gigantic industry. Can you imagine the control for establishing reviews of price increases? It would be utter chaos.

Mr. AUERBACH. There are ways this problem could be handled. It really isn't as difficult as it sounds. For example, Senator, the public agency I propose could simply say that any industry may effectuate whatever changes it wishes in the relative prices of all the commodities it sells, without giving any advance notice, so long as the total effect of its actions is not to increase its gross revenues. After all, we are not really concerned about the relative prices of bacon and hamburger or of the various cuts of meat. We are concerned with overall

price stability—with the total impact of all the prices of all the commodities sold by the meatpackers on their profits and, consequently, on the wage demands which will be presented to them.

Senator PERCY. You have said that management in high-profit industries is unwilling to reduce prices.

Mr. AUERBACH. Yes, sir.

Senator PERCY. The point is often made that the Consumer Price Index really overstates the increase in prices, simply because quality changes that have been introduced have not been fully taken into account. Isn't your point considerably weakened when quality changes are taken into account?

Mr. AUERBACH. I think the criticism of the Consumer Price Index which you mention may well be justified. I don't know to what extent it is justified. But even if it were, I don't think it would affect the point that managements in high-profit industries are unwilling to reduce prices.

This is a serious point because the possibility of success of the guideposts, the arithmetic of the guideposts to which the Council refers, depends upon price reductions in those industries in which productivity-rate increases exceed the trend productivity-rate increase. These reductions have not occurred and it is precisely this fact that will give great impetus this spring to demands for higher wages.

Senator PERCY. Mr. Chairman, Paul McCracken, of the University of Michigan has written a paper which tests the market power theory and concludes that the problem is not, I think, nearly as serious as many people have pointed out. I would like unanimous consent to insert this statement in the record.

Chairman PROXMIRE. Without objection that will be done.

(The statement referred to follows:)

STATEMENT OF DR. PAUL W. MCCrackEN, EDMUND EZRA DAY UNIVERSITY PROFESSOR OF BUSINESS ADMINISTRATION, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, THE UNIVERSITY OF MICHIGAN *

PRICE-COST BEHAVIOR AND EMPLOYMENT ACT OBJECTIVES

Dr. McCracken. Mr. Chairman, the stern strictures of the chairman here in regard to the time allotted to us has imposed on me, as is true for most of the other participants, the painful task of excising a good many pages of priceless prose. I dare say that when this venture is concluded, Grover, we ought to cite you to the Anti-Vivisection Society.

What is the relevance of the Nation's price-cost performance to the objectives of the Employment Act? This question may not be the most fundamental issue of economic policy before us to day, but it is probably a leading candidate for the most vexatious piece of unfinished business. The price-cost question naturally divides itself into about three questions. How important is a reasonably stable price-cost level to the more fundamental objectives of full employment and rising levels of living widely shared? Is there a market-power dimension to the price-level problem? Third, what are the policy implications of these matters for the objectives of the Employment Act?

I

Certainly the case for attaching high priority to a reasonably stable price level seems to be a persuasive one for reasons concerned with both our external and our domestic economic performance. Given the large noncurrent burdens on our

*Excerpted from "Twentieth Anniversary of the Employment Act of 1946—An Economic Symposium," hearings before the Joint Economic Committee, Feb. 23, 1966, 89th Cong., 2d sess.

balance of payments, the sharp recovery in the balance on current account, after it had dipped into a deficit position in 1959, probably made the difference between an international dollar crisis and an external payments position that has been tolerable even if not comfortable. From 1954 to 1959 the U.S. export price index increased 8 percent compared with 3 percent for other industrial nations as a whole. During the next 5-year period (1959-64), however, our export prices rose only 3 percent, a markedly better record than the 8 percent in the first half of that decade and somewhat better than the average for other industrial countries. The fact that the U.S. price level did perform much better by international standards is undoubtedly relevant to our improved payments performance on current account in recent years.

In the domestic economy a reasonably stable price level is desirable in itself for many obvious reasons. A rising price level does, for example, pose problems of equity. Some incomes are, if not fixed, at least sticky. The real purchasing power of financial assets held by those of moderate means is more adversely affected than those held by the affluent. The empirical evidence about the relationship between price increases and rates of domestic economic expansion is more complex, but it presents no persuasive case that acceptance of a more rapidly rising price level enables a country to achieve a more rapid rate of economic progress. The record of 39 nations for the period 1950 to 1960 and 1960-63 reveals no significant relationship between rates of growth of GNP (total or per capita) and the rate of increase in the price level. In studies (largely of developing nations) by the International Monetary Fund there seems, in fact, to be some evidence of an inverse correlation between rates of economic growth and the rapidity with which the price level was rising.¹ Countries with a relatively stable price level have done somewhat better on the average than those experiencing strong upward pressures on the price level. There are persuasive reasons for expecting that things might work out this way. The pervasive expectation of continuing inflation does disturb economic decisions. The pattern of capital formation is distorted. It encourages an outflow of domestic capital, and it impedes the inflow of capital from the outside. On all of these matters there is supporting empirical evidence.

The relationship between the rate of growth of output and the rise in the price level for more developed nations such as the United States is again indistinct. For 17 of these nations in the 1950's there seems to be no discernible relationship between the rate of rise in the price level and the rate of growth in real per capita GNP. For total output there was a faintly perceptible negative relationship, but too low to be statistically significant. If we limit ourselves, in our quest for a price-level target, to the criterion of growth rates, international experience does not lend support to the view that a moderately rising price level is essential or inimical to vigorous growth in developed nations.² The desirability of a strong position on price-level policy must then rest reavily with such considerations as equity or our external economic position.

II

Suppose we turn now to the second question. Is there more to the problem of a stable price level than good monetary and fiscal policy? Is there a market power dimension to the problem? The decision does not automatically go to the affirmative. From 1909 to 1929 (excluding 1914-20) there were 14 years of rising business activity. In eight of these the price level rose, in three there was no change, and in three the price level declined from that of the preceding year. On the average the price level rose 1 percent per year for these 14 years. For

¹ Cf., for example, Graeme Dorrance, "The Effect of Inflation on Economic Development," staff papers, March 1963, pp. 1-47.

² Computations were made for 17 developed nations for the period 1950-60. They were: Australia, Austria, Belgium, Canada, Denmark, France, West Germany, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Sweden, Switzerland, United Kingdom, and the United States. The terms were: G —rate of growth in real total GNP; G^* —rate of growth in real per capita GNP; P —rate of rise in the cost of living. GNP growth rates are from the United Nations Yearbook of National Accounts, 1965, and the rate of increase in the cost of living was computed from data in International Financial Statistics. The results are:

Equations

$$\begin{array}{r} 1950-60 \\ G = 5.5 - 0.30P \\ G^* = f(P) \end{array} \qquad \begin{array}{r} R^2 \\ 0.060 \end{array}$$

the period 1949-65 there were also 14 years of economic expansion. The average price rise was 2.3 percent for these 14 years, and in only one expansion year (1955) did the price level recede. The average rise in rising years, however, was greater in the 1909-29 period than after 1949. The principal difference between these two periods seems to be the lesser frequency of any price decline at all, during expansion years, in the postwar period. The record does not seem to suggest that the price level now is prone to rise more rapidly during an economic expansion than in our earlier history. If anything it may be less so.

Our experience in the late 1950's was, of course, undeniably disturbing. From mid-1956 to mid-1958 the price-cost level was rising too rapidly, and after mid-1957 it was also a period of subnormal employment. Even that period in retrospect has its extenuating circumstances. Some of the wage adjustments that were pushing our cost level upward were the result of negotiations conducted in the ebullient climate of 1955. Moreover there was a swelling wave of inflation-mindedness. The proportion of people, for example, expecting the price level to continue rising for the long run tripled from 1953 to 1957. Here was a phenomenon of social psychology bearing perhaps some resemblance to the Salem witch hunts or the Communist hunts of the McCarthyism era. In retrospect these ground swells always seem a bit perplexing and inexplicable, but they are real and influential while they last. These expectations of inflation, the inflation-mindedness, considerably overshot the basic facts of economic life, of course, but for a time they were an important force nudging the price-cost level upward. Business response to union demands was in part reflecting these assumptions. Union demands for wage adjustments in turn were responsive to this climate. Each settlement, therefore, was followed by the higher prices that gave another thrust to the rising price level, seemingly confirming the wisdom of making decisions on the assumption that an age of inflation was ahead.

The disinflationary policies of 1957 to 1959 (except for a brief interlude from mid-November 1957 to about July 1958) were probably too severe, but they did perform the desirable function of puncturing this bubble of inflation-mindedness. And the more moderate pace of the price level in recent years dates from mid-1958—not, as all good things in economic policy are sometimes alleged to do, from January 1961.

Even so there probably is an element of the market-power phenomenon in the tendency for our price-cost level to edge higher. Since 1960 the price level has continued to drift upward at the rate of perhaps $1\frac{1}{4}$ percent per year, and costs per unit of output (in the corporate sector) have shown a comparable rise—even though unemployment averaged 5.8 percent of the labor force. Moreover, the rise in both the price level and costs per unit of output were apparently at a somewhat greater rate in 1965. This is a less impressive performance than, for example, the 1920's (1922 to 1929) when unemployment averaged about 4 percent, and the price level increased at the rate of only 0.2 percent per year. (The average annual rate of increase in output from 1922 to 1929 of 4.7 percent was also higher than the 4.5 percent average from 1960 to 1965.)

III

What, then, are some of the elements of a price-cost policy for the Nation? Clearly this has become once more an urgent question. The economy by the latter part of last year had regained reasonably full employment, and the tolerances began to narrow sharply. Once again we are in a zone where strengthening the capability of the economy to resist inflation, always desirable, must be given even higher priority.

Measures to avoid a rise in aggregate demand that outruns the economy's productive capability are now, of course, fundamental. Whatever differences may exist about other dimensions of the price-level problem, there would be a wide measure of agreement that inflationary pressures cannot be contained in an overheated economy. The most fundamental and basic requirements for a reasonably stable price level is, therefore, fiscal and monetary policies that do not crowd demand too hard against the economy's capability to produce. This is hardly controversial, in principle, and issues of fiscal and monetary policy have already been discussed, so we can move on to other matters.

There seems to be some measure of agreement that a modern industrial nation should have a wages or incomes policy. In the 1961 O.E.E.C. study on "The Problem of Rising Prices," the panel of distinguished economists agreed that

negotiated wage increases were "decisive in explaining why some countries have failed to a far greater extent than others to achieve price stability."³ On the problem of wages their report is quite explicit. "In the view of the majority of the group, the essential element to be stressed, first of all, is that the stabilization authorities must have a wages policy for dealing with the problem of wages—just as they have monetary and fiscal policies for dealing with the problem of demand."⁴

Our own venture into incomes policy has been via the guidelines. It has, on the whole, been a constructive step. It was the logical sequel to extensive academic and professional discussion, antedating the 1962 Economic Report, about the relationship between wages and prices. This ancillary discussion included increasing attention to the problem in successive Economic Reports during the Eisenhower Administration. The articulation of the guidelines has focused public attention and understanding more squarely on the problem, and in their absence it is reasonable to suppose that we might have had a somewhat higher price-cost level today.

We need to recognize, however, that the guideline approach also involves some important risks. For one thing there is danger that preoccupation with inevitably only a few highly visible price or wage settlements will cause inattention to the more fundamental matters of monetary and fiscal policy in the strategy for maintaining a reasonably firm cost-price level. The excessive rate of credit expansion in the closing months of 1965, at a time of a few highly visible price controversies, reminds us that this is not an academic matter. There is, in fact, real danger that an overly expansive policy, as in 1954-55, will force a sharp reversal, as in 1956-57.

Another danger is that the guideline approach, if it becomes *de facto* or *de jure* a program for extensive price control, would impede the mobility and fluidity of the economic system. And the more effective (and, therefore, extensive) the guideline program becomes, the greater is this danger. The trouble fundamentally is that the articulation of the guidelines principles largely ignores the role of changes in demand in our system. Our economy depends for its efficient operation on extremely complex and sensitively adjusting pricing relationships that serve as the communications system for promptly reflecting the ever-changing pattern of demand.⁵ There is not much recognition of this in the enunciation of the guidelines. "The general guidepost for prices," says this year's Economic Report, in the strong language of italics, "is that *prices should remain stable in those industries where the increase of productivity equals the national trend; that prices can appropriately rise in those industries where the increase of productivity is smaller than the national trend; and that prices should fall in those industries where the increase of productivity exceeds the national trend.*"⁶ On the next page we learn that increases above this may be appropriate to reflect increases in unit material costs, if not otherwise offset, or to correct an inability to raise capital. This latter exception is quite explicitly not considered to be "widely applicable in the present environment."

Now this simply describes a cost-plus economy. It will not do even as a short statement of our pricing system. A rise in prices for industries with a productivity rise below average may be quite inappropriate and inconsistent with economic efficiency if the industry is declining and should be extinguished. Price increases may be a desirable means of signaling for increased production of a product even when the industry has average or above-average gains in productivity if demand has intensified.

These are not academic matters. An economy whose pricing system operates according to the guidelines as enunciated would certainly find its capability for progress weakened.⁷ Half of our gains in output have come from uncovering more effective ways of utilizing productive resources of labor and capital, and through open competition diffusing these across the economy generally. A cost-plus

³ P. 45. The authors of the report were William Fellner, Milton Gilbert, Bent Hansen, Richard Kahn, Friedrich Lutz, and Pieter de Wolff.

⁴ P. 56. Cf. also Henry Smith, "Problems of Planning Incomes," *Lloyds Bank Review*, January 1966, pp. 30-40.

⁵ My colleague, Prof. Charles N. Davisson, pointed out to me the full significance of this point.

⁶ Economic Report, January 1966, p. 90.

⁷ Cf. Arthur F. Burns, "Wages and Prices by Formula," *Harvard Business Review*, March-April 1945, pp. 55-64.

economy would tend to prolong the lives of decaying industries, and it would slow responses to areas of increasing demand.

The problem here is fairly clear. It is the danger of attempting to apply an aggregative macroeconomics rule relevant to the general price level to the ever-changing relationships among specific prices in microeconomics. The pricing system that we would get if this cost-plus pricing were fully implemented would, to an observer from the University of Mars, look like a highly primitive and crude version of what we now have.

Problems of equity will also inevitably become more difficult if attempts to apply the guidelines to specific situations become more extensive. Even though the guidelines recognize exceptions, most situations will actually be measured against the average. The steel wage settlement is an example. If it was on the 3.2-percent average, it really exceeded the guidelines because it has been an industry with more than its share of unemployment, wage rates were relatively high already, and profits have been relatively low. These are conditions that, according to the Council's articulation of the guidelines, call for a below-average wage settlement. Yet the settlement was pronounced to be right on target—because it came out on the average.

The procedures for singling out price and wage candidates for attention will inevitably be uneven and capricious. Steel would be apt to get the works even though prices of some other products in the aggregate might be just as important. The price which, according to the guidelines, ought to go down and does not would probably be safer from official wrath than the price that ought to stay put but goes up. And there is the question of equity as among wage settlements. The USW or UAW member is apt to find his income more affected by guidelines than a member of the construction union. And it is almost inevitable that a larger proportion of the wage area will be under surveillance than of prices. An industry that has one major labor contract may have hundreds of prices. This is bound to create political strains that either weaken the guidelines or force the Government in the direction of price control.

Another important dilemma of the guidelines approach (or any variant that is some *de facto* form of direct price or wage control) is that it introduces some upward biases of its own. Because price increases when needed may involve some abrasive moments, there would be considerable incentive to resist any price declines. And there would be strong incentives to take the maximum price rises that could plausibly be attributed to such exogenous factors as wage settlements or higher material costs.

There is also an issue of government here. We have probably gone about as far down the guideline road as is appropriate in the absence of legislative action. A form of price-wage control could ultimately come to have the force of law because of the formidable power that the Federal Government can assemble against any miscreant in pricing or wagemaking. If these programs are to become significant instruments of economic policy, the Congress should debate the issue and, if persuaded of their wisdom, take the necessary legislative steps to authorize administration action. The come-let-us-get-together approach can be a device that builds up a power structure in Government which circumvents the legislative process, and in the private sector which circumvents the normal market disciplines of competition. This is not desirable in our political system or in our economy.

The basic reservation about the guideline approach, however, is the evidence that it is of quite limited practical effectiveness. There has not been much displacement in the relationship between our price-level performance and the pace of the economy. In their paper before the American Economic Association 5 years ago Professors Samuelson and Solow suggested that to achieve a stable level of labor costs per unit of output unemployment might have to be 5 to 6 percent, and to achieve "the nonperfectionist's goal" of 3 percent unemployment the price index might have to rise 4 to 5 percent per year.⁸ If we make a simple linear interpolation between these two points of their modified Phillips curve, the 4.6 unemployment rate for 1965 would imply about a 1.7-percent rise in the price index. The Consumer Price Index actually rose 1.7 percent from 1964 to 1965, and the rise would have been somewhat higher except for the effect on the index of reduced excise taxes. The guidelines do not seem to have been holding the rise in the price level to anything markedly different from what would have been expected, given our volume of unemployment. Moreover, international experience also suggests cautious expectations about what guidelines can accom-

⁸ Paul A. Samuelson and Robert M. Solow, "Analytical Aspects of Anti-inflation Policy," American Economic Review, Proceedings, May 1960, p. 192.

plish. The trend of wages and prices in European countries does not suggest that the incomes-policy approach is apt to provide strong defense against inflation. The results from the United Kingdom's policy for incomes and prices, launched just over a year ago, are not auspicious, and the next version will apparently be legislation to require advance notice of price change and of wage negotiations.⁹

The articulation of the guidelines, let me repeat, has been useful. It has certainly given the whole subject greater public visibility and understanding, and that has been helpful. Their job is to make a marginal contribution—to field the few wild-ball price and wage situations that might occur—under circumstances where fiscal and monetary policies are the basic defense against inflation. At the same time the hard evidence here or abroad does not suggest that they are a strong or highly effective anti-inflationary weapon. And if they divert attention from more fundamental matters of fiscal and monetary policy, they could give the price level an upward bias while they are also reducing the capability of the economy to sustain vigorous economic progress. At this point they would collide squarely with any reasonable interpretation of the Employment Act's section 2.

It is, however, high time that we move on to other matters. One possible contribution to a more stable price level is squarely within the domain of the Federal Government's operational activities. The fact is that important Government programs and actions give a direct and significant upward thrust to the price-cost level. At a time when rising food prices have been a significant factor in the higher cost of living, which in turn will influence wages, the Government will spend on agriculture an estimated \$4.3 billion this fiscal year and \$3.4 billion in fiscal year 1967. Proposals to increase the minimum wage are inimical to the objectives of the Employment Act if we are concerned about price-cost-level problems, and if we are also trying to draw into regular employment those in the labor force only marginally employable. Secretaries of Labor in their administration of the Bacon and the Walsh-Healey Acts have usually interpreted prevailing "minimum" wages for Government contracts to be synonymous with union rates even in localities where these rates had no real relevance to local situations.¹⁰ Obviously the rationale that these programs reflect "political realities" will no longer do. Political gain is to the political arena what profits and wages are to the economic arena. A Government requesting unions and managements to rise above their self-interest on wage and profit decisions can be asked to lead the way itself in some of these operational programs.

If society decides to channel more of its national income into the public sector, and to do so via sales and excise taxes, it makes no sense to have this affect the Consumer Price Index. In an era where demands in the public sector are going to be heavy, we have arranged things so that the use of a tax with substantial popular support would quite directly push upward our most widely used measure of changes in the price level. During 1965 the Consumer Price Index rose 2 percent, but the rise would have been 2½ percent except for the reduction of excise taxes. And we are in the odd position of increasing excise taxes in 1966 to counter inflation, though their increase will directly raise the price index—and directly and indirectly have an effect on wage movements.

It would be in the public interest for the Joint Economic Committee to conduct an exhaustive study of all Federal programs that have direct effect on costs and prices. They might be found to be consequential.

Few things are more effective in neutralizing the exercise of power than availability of alternatives. Even our powerful corporations cannot force or cajole consumers into buying what they do not want. They cannot because the consumer has alternatives. If the gas company suffers from delusions of grandeur, it will be brought back to earth by marginal shifts of energy requirements to electricity or oil. If Chevrolet buyers were to feel abused, Ford or Chrysler would be eagerly ready with alternatives. A part of our price-cost policy could usefully be exploration of ways to widen alternatives further. The increasing internationalization of economic life offers a major opportunity. The alternative of imports has already served as a significant restraint on the dour ritual of large increases in wage rates duly succeeded by ample price increases.

⁹ Cf. Ray Vicker, "Holding the Guidelines," Wall Street Journal, Feb. 7, 1966, p. 14. Also International Financial News Survey, Jan. 14, 1966, p. 10.

¹⁰ Gordon F. Bloom and Herbert R. Northrup, "Economics of Labor Relations" (Irwin, 1961), pp. 549-550.

In some cases it has had a notably therapeutic effect on more aggressive product development. Further relaxation in constraints on the availability of alternative foreign products and services would make a useful contribution to the Nation's price-cost performance, and it would also make for better jobs and a stronger economy. The administration is to be commended for its insistence on adjustment assistance for hardship cases as trade barriers are relaxed, rather than the route of blocking tariff reductions.

Things which might increase the ease with which capital could be substituted for labor must also be classed in the category of broadening alternatives. It is a grisly thought, but the labor cost per unit of classroom output might be under less severe upward pressure if a teaching machine could more readily be substituted for professors. Capital budgeting came upon the industrial scene belatedly, but it has made great strides. If the capital budgeters and the capital goods engineers could increase the substitutability of capital for labor, we would come close to getting the best of three worlds—an upgrading of jobs; a more stable cost-price level; and an accelerated rate of economic progress.

IV

Suppose that even with appropriate fiscal and monetary policy, supported by as much marginal help from other policies and programs as it is reasonable to expect in this world, the price level is still not quite stable. This is probably a reasonable expectation. The last sustained period of full employment, vigorous economic growth, and a stable price level was the period from about 1922 to 1929. And for the entire period from 1900 to 1929 (excluding the war periods), 80 percent of the expansion years saw some rise in the price level.

The objective of a stable price level is an important one, but it does remain a facilitating and not a fundamental objective. It is important largely to the extent that it is essential for full employment, vigorous economic growth, and high and rising levels of incomes widely and equitably shared. We must not be so obsessed by building the bridge over the Kwai that we lose sight of the larger picture. It would be better to retain the motility and adaptability of our free-market economy, for example, than to contract economic arthritis through extensive direct intervention into the specifics of economic life—out of zeal for a flat price index. It is possible, however, that emergent inflation-mindedness may become a problem. We must in that case contemplate occasional episodes of disinflation. These might briefly reduce the proportion of the labor force employed by perhaps a percentage point. It should, however, be quite possible to achieve results through short periods of moderately reduced growth, still avoiding any significant recedence in the economy. Episodic disappointed inflationary expectations would probably be enough to serve as a reminder that caution is appropriate even if the general trend is up because it is also necessary to survive shorter run contingencies.

It is to be hoped that a stable price-cost level becomes possible with full employment. The fact is that with the existing state of the arts of economic policy severe insistence on price-cost stability is a recommendation for the distortions of suppressed inflation that enervate the economy—and probably for a lower trend rate of growth. Obviously we cannot close down the economy until we know more about achieving a stable price level without retarding the economy's growth. We therefore face the inevitable problem of feeling our way along with a mix of real growth, high employment, and some concession to the price level—with the mix itself changing a bit from time to time—if we are to achieve the maximum rise over a long period of time in widely diffused levels of living.

V

Since the act which we honor today was signed, every President has explicitly recognized the importance of a reasonably stable price level to the performance of our economy and to the quality of our Nation's economic life. This clearly continues to be the case, and it is wise. As is true of our objectives for employment, production, and purchasing power, we sometimes fall short of our price-level goal, and we shall probably have our shortfalls in the future. We can, however, say of this goal what Beardsley Ruml said of the Employment Act's objectives two decades ago when he told a Senate committee that "this statement of the goal of our sincere efforts to attain it will make the reality much closer to the ideal than if the ideal had never been expressed."

Chairman PROXMIRE. Congressman Bolling?

Representative BOLLING. Dr. Auerbach, I think perhaps your statement and the discussion that followed is the most stimulating that I have heard or read during this hearing. I say "read" because I haven't been at all of the hearings.

I would take it that your purpose is to attack the problem that all of us have given lipservice to, or recognition of, that of getting the public represented at the bargaining table in some fashion or another, rather than try to develop arguments that would persuade us to do nothing.

I believe that your idea, while not to me an entirely new one, is better worked out and better supported by the discussion than any I have heard, and all I will say further is that I note that we plan to have further hearings of the full committee on this, and I hope that we will pursue this particular point, because I think you have made a very important and timely contribution.

Mr. AUERBACH. Thank you, Congressman Bolling.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

I want to associate myself with what Congressman Bolling has just said. I think you have made a real contribution to the thought processes of this committee.

You have sketched out a program for the future which would enable this country to live with something like full employment without inflation. However, this committee and the country now confront a situation where it is very important to keep prices stable in 1967 for both domestic and foreign reasons, and yet the Economic Report, unfortunately, I won't say throws up its hands at the problem, but doesn't really, in my judgment, come to grips with it.

I feel that we are a little in the position of the widower who was returning from the funeral of his young and beautiful wife, and somebody seeks to console him and pats him on the back and says, "Joe, don't take it so seriously. You will find another wonderful wife in the next year or two." And Joe looks at his comforter and says, "Yes, but what am I going to do tonight?"

That is the problem of the economy as I see it: What are we going to do in 1967? Would you address yourself to an immediate set of actions, if you can, which would enable us to keep our prices stable?

Mr. AUERBACH. May I tell you honestly, Congressman Reuss, that your story occurred to me as I was writing my statement.

Representative REUSS. It's quite an old story.

Mr. AUERBACH. You pose a very difficult problem. You have been one of the men in Congress who, very properly in my view has been asking the Congress to take greater responsibility in this area. If the guideposts constituted a good program for the President of the United States, they were also good for the Congress and the Congress should have said so in some responsible way. If they did not constitute a good program of stabilization for the Congress, Congress should not have permitted the President to administer them.

Nevertheless, in spite of your urgings over the years, nothing was done to avert the impasse we now confront. It is difficult, in the light of this past history, to answer your question. "All right, what do we do now?" But I acknowledge that you are right in criticizing

my statement for not directing itself to the immediate problem. In fact, what we can do about the immediate problem is limited but, nevertheless, I will venture some suggestions.

It is clear that even if Congress should agree with the proposals I have made, and frankly I don't have any real hope that it will, nothing will happen for quite awhile, at least not before the spring negotiations begin. A wage-price spiral may get underway before any effective action can be taken.

It seems to me that the basic principle that I have tried to emphasize may nevertheless have immediate application; namely, the principle that labor and management should be held to public accountability for decisions they take that affect the public as a whole. Possibly, the public interest may be served if this committee were to turn to the administration and say "Don't give up so soon, we are now willing to participate and to help"; if a public review board were created, composed of administration representatives and representatives of this committee and the public; if their immediate steps were taken to get the representatives of labor and management who will be involved in negotiations in 1967 to appear before this public review board and justify the actions they propose to take.

Representative REUSS. What would you think as a goal for 1967 in terms of a guidepost? We don't have any now really.

Mr. AUERBACH. I think that the goal in 1967 ought to be overall price stability. I would envisage that the public review board would say to representatives of labor and management appearing before it:

What we want for 1967 is price stability. Tell us what can and ought to be done on the assumption that prices are not going to go up, that they are going to stay where they are for the remainder of 1967.

Representative REUSS. In other words, you would invite an industry which is faced with some sort of a wage demand to indicate what kind of a wage demand it thinks it can absorb.

Mr. AUERBACH. Yes, sir.

Representative REUSS. And what kind of a wage demand it asserts it would have to pass on in the form of higher prices.

Mr. AUERBACH. Yes, sir. I would hope that the public review board would call together the representatives of labor and management well in advance of the time the collective bargaining agreements are due to expire and ask them what they contemplate doing, what wage demands are going to be made, what kind of settlement will assure price stability this year, what price reductions will have to be made—so that no wage-price spiral gets underway.

Representative REUSS. In addition to your "hold the line on prices" policy, and the machinery you have suggested for implementing it, would you envisage the executive branch exercising more anti-inflationary effort than it is now doing, particularly on the supply side? Would you think it useful to have someone in the administration, whether it be an Esther Peterson representing the consumer or somebody, really look at all of these areas, including food prices and agricultural policy and services and all the difficult fields, to see what can be done either by increasing supply or holding down cost to keep both the Wholesale Price Index and the Consumers Price Index just as close to stability in this crucial year as possible?

Mr. AUERBACH. I think that is an excellent suggestion, Congressman Reuss. I would like to see Miss Peterson's office move more aggressively into the price area. But this is a difficult area and yet this possibility ought not to be neglected.

Representative REUSS. Thank you. You have certainly given an answer to my "what can we do now" question.

Thank you, Mr. Chairman. That is all.

Chairman PROXMIRE. Thank you very, very much, Professor Auerbach. You have been an excellent witness this morning—most stimulating. You challenged whether I would be saying as nice things about you after you finished as before. I certainly can, and even more so. As Congressman Bolling indicated, you have brought an extremely interesting and constructive suggestion to us.

It is one thing to criticize and it is very helpful, very important. Something else though, it is much harder to make a concrete specific proposal and make it stand up, so I think you have been a very helpful witness, and we are mighty grateful.

Mr. AUERBACH. Thank you, Senator Proxmire.

Chairman PROXMIRE. Our next witness is an old friend of the committee and an extremely competent economist—Dr. Jules Backman, research professor of economics of New York University, who has quite a different view on the subject. It will be a very stimulating morning.

We are very happy to have you, Professor Backman.

TESTIMONY OF JULES BACKMAN, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY

Mr. BACKMAN. Thank you, Mr. Chairman. It is always a pleasure to appear before the committee. While the temptation is very great to plunge into the discussion that has already taken place, so that I could register my disagreement with the previous witness on many of the points, I will try first to outline my basic position and then hope these questions will be raised later.

The CEA has made a constructive contribution to public understanding by emphasizing that fringes as well as wages must be considered in measuring worker's gains, and that regardless of the name given to a wage increase, whether it be a cost-of-living adjustment or a productivity increase, it represents a labor cost. However, the CEA presentation does a disservice to economic education when it uses erroneous assumption to supply this policy.

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 man-hour) is the major factor in wage determination.

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-

ing. Where shortages prevail, a reduction in price is exactly the wrong prescription and will tend to result in a less efficient use of resources.

Regarding the assumption that productivity (output per man-hour) is the major factor in wage determination. The CEA states "The only valid and noninflationary standard for wage advances is the productivity principle." For some key industries, the rate of change in output per man-hour nationally is one factor considered in collective bargaining.

The guideposts attempt to convert a long-term truism, namely, that the level of living can only increase as the quantity of goods goes up, into a policy which is effective on a year-to-year basis. Productivity is considered by negotiators in some industries, but it is neither the only factor nor the most important one. Other factors include the general state of the economy, the growth rates of specific companies and industries, changes in the Consumer Price Index, rival union leadership, comparative wages and profitability.

In the real world, wage relationships are of critical importance both to the firm that seeks to hire labor and to the union leadership which must produce results for its members. It is true, as the CEA notes, that proper comparisons often are difficult to make. But each party is more skillful at countering the claims of the other than the CEA seems willing to recognize so that neither party can arbitrarily select only comparisons favorable to itself and make them stick.

In discussing prospective settlements, the CEA states that "many wage settlements in 1967 will exceed the trend increase of productivity." In effect, it treats changes to compensate for rising living costs as "an additional margin" beyond the productivity total. The reality of collective bargaining will be just the reverse.

The first factor considered by negotiators during periods of rising living costs is what increase is required to restore real wages to the level prevailing when the previous contract was negotiated. Then, consideration is given to how much more the adjustment should be to compensate either for anticipated further rises in living costs or to increase real earnings.

The Council has said, and I heard it repeated here this morning, that first we get the increase in productivity and then we hope to get back part of the loss of the cost of living. What really happens in collective bargaining is the reverse. First they negotiate whether to restore the living standards which are eroded by a rise in living costs, and after they have agreed or disagreed upon that point, then they negotiate upon how much more should be given in a particular negotiation. In other words, the first test in a period of rising living costs is what has been happening to the Consumer Price Index.

I agree with the Council that, if in 1967 labor should attempt to obtain an increase in wages and other fringe benefits equal to the combined effect of the rise in living costs and the so-called productivity standard, we would have very great pressure on prices. I do not agree that this large increase in unit labor costs, which will aggregate this year at least 4 percent and possibly a little higher, will be translated into any automatic increases in prices. On the contrary, I am convinced that in 1967 these increases in unit labor costs will be ac-

accompanied by a cut in profit margins and by some increase in unemployment.

Incidentally, 1967 provides an excellent illustration of what is wrong with the guideposts. The assumption that we can increase real living standards by some uniform rate from year to year is one from which the Council departs in this year, and properly so. Historically, living costs, comparative wages, and other factors have been important criteria for wage adjustments. It is a fact that, historically, real wages over long periods of time have gone up as much as productivity. But on the short-term basis, this just has not been the situation at all, as I will indicate in a moment.

There is another assumption which was contained in the CEA's figure of 3.2 percent, namely, that the Council can measure changes in productivity, and then that they use the right numbers.

A year ago the Council was in the embarrassing position of abandoning its own arithmetic. You may recall that when the 5-year average didn't work out, the Council sort of walked away from it and said, "Oh, yes, it may be 3.6 percent, but we really don't think that is important, so we will stick with the 3.2"

If the Council had stayed with its goal of economic education, it necessarily would have stated that changes in output per man-hour cannot be pinpointed, and that only a range of changes could be identified. The Council would then have avoided the situation which increased expectations and may have contributed to the larger increases negotiated later in 1966. The Council also would have been spared the questions raised about its own integrity.

Now why do I raise a question about these figures? Students of the productivity trend are fully aware of certain limitations in terms of their usefulness as a standard for wage increases. For example, about one-half a point of this increase is attributable to the rise in output per man-hour in the agricultural sector. There has been a large shift of manpower from agriculture to industry, and when a worker moves from the farm economy to the nonfarm economy, he slots into the wage level which already is prevailing in the non-agricultural economy; in effect, he gets the gain in productivity.

In other words, the numbers show a gain in productivity, but since we have no composite figure for the economy on wages, there is no wage figure which shows that the average level of wages has gone up because we have more people working at \$2.50 an hour and fewer at \$1 an hour. In other words, the mix in wages has moved in the same direction as productivity.

In addition to that, we have had an important change in the non-agricultural sector. A smaller proportion of the labor force is now production workers, and a higher proportion are scientists, professional workers, and others who get higher wages. This mix uses up part of the gain in productivity, and, in fact, it goes even further when production workers require greater skills in today's technology. As they move up the ladder, they get part of the gains. This is one of the reasons why the use of such numbers is a mistake.

The recent abandonment of the announced guidepost of 3.2 percent was a constructive move. The CEA, of course, hasn't really abandoned the guidepost. It has only abandoned this exercise in economic

marksmanship. The CEA reports it is still wedded to the guidepost approach, and although Mr. Auerbach suggested that the President and the Council may have abandoned their policy of intervention, I call your attention to the experience in gasoline in the last few days. In this situation, the Department of the Interior has indicated that, at the suggestion of the Council, it is attempting to roll back the price increase announced for gasoline. There has been an abandonment of a number, but not of the process used to implement the number.

The fourth error, underlying the guideposts is the assumption that real labor income can or should increase at some uniform annual rate. I checked the changes in real hourly earnings over the past 46 years. Now real hourly earnings can increase in one of five ways. The data are contained in my statement.

You can have no change in wages and a decline in living costs. You can have no change in the cost of living and a rise in wages, and this is the combination which the Council has selected. You can have both going down with the cost of living going down more, and you can have both going up with the wages going up more, or you can have wages going up a little and the Consumer Price Index down a little.

In the past 46 years there was only 1 year in which the combination which the Council has chosen was the actual way in which real wages increased in the economy: in 1929, there was no change in the Consumer Price Index, and there was a rise in real hourly earnings because wages went up a little. And, incidentally, even these figures don't tell the whole story, because in 6 years, real wages went down, which means that in other years we must have larger than long-term average increases in order to achieve the average.

Incidentally, under the guidepost policy, real labor income has risen irregularly and has fallen short of the goal of the guideposts. If anyone had gotten 3.2 percent a year in each of the years since 1962, although that figure wasn't in effect for the whole period, he would have found a significant part of this increase eroded by the rise in living costs, which was 1.7 percent in 1965 and 2.9 percent in 1966.

The actual increase in real hourly earnings during this period—and this includes fringes—was approximately 2 percent in manufacturing and 2.5 percent for trade, or short of the guidepost standards.

Much was said about the control which some companies have of our economy. In fact, the CEA has assumed, that if the highly visible industries conform to price guideposts, "the average of prices would also be stable in the other highly competitive industries, including agriculture and most services, where firms had no discretion." This is a naive view of the relationship between prices of agricultural products and services on the one hand, and those for industrial products on the other.

The assumption that prices of farm products and, in turn, food, would maintain a fixed relationship to other prices has not worked out, nor was there any reason to expect that it would, on the basis of the history of these price relationships.

The objective of stabilizing the price index could not be attained because of the inability to control or to prevent a rise in the prices of

many services, such as hospital care, education, personal care, et cetera, which represent essentially labor costs.

Incidentally, the Council has also stated that "businesses and unions can push up prices even when resources are not fully utilized." That was stated here again this morning. However, the record shows that from 1958 to 1964, when the economy operated substantially below capacity, wages and prices were not pushed up generally. Between those years, capacity utilization averaged between 74 and 86 percent in manufacturing. The unemployment rate was between 5 and 6 percent. Wholesale industrial prices recorded no change. The Consumer Price Index rose slightly more than 1 percent a year. And unit labor costs in manufacturing industries remained relatively stable, and for the entire corporate economy rose about 1 percent annually.

The assumption that big business has the market power which can be used to raise prices excessively is not a new one, and in this connection, it is instructive to keep in mind that the largest price rises in the past 2 years have been in farm products, foods and services, rather than in the products of big business.

In the absence of the guidepost policies, it is probable there would have been somewhat larger increases than actually developed in industrial prices. However, there is no evidence that they would have been as large as the rise for services or that they would have had an important impact on the CPI.

The question is not a new one. It was raised by Mr. Kefauver and the Kefauver committee in the middle 1950's. I have introduced two charts into my testimony. One shows the relationship between economic concentration and the rise in metal prices from May 1955 to May 1957. That chart showed there was absolutely no relationship between the extent of economic power as measured by economic concentration and the magnitude of price rises in those days.

I have just completed very extensive studies of the relationship between so-called market power inherent in intensive advertising and price changes, and in my statement I reproduce one of the charts which will be contained in that study scheduled to be published this spring. (See chart 2 p. 976.) Incidentally, that chart shows a line of regression moving downward slightly from left to right. To support the charge of relationship between market power and price increase it would have to move upward sharply from left to right on a somewhat different direction.

My conclusion of that phase of the advertising study was as follows:

The most intensively advertised categories of products have tended to show smaller increases in price than less heavily advertised categories during the post-World War price inflation. The postwar record of changes in wholesale and retail prices for broad groups of products and for selected foods and proprietary drugs reveals that there has been no relationship between the intensity of advertising expenditures and the magnitude of price increases.

These data indicate that heavy advertising expenditures did not create a degree of market power which gave the affected industries the freedom to raise prices substantially during this period of general price inflation.

These studies are cited to illustrate that market power need not necessarily be translated into higher prices.

I would like to say just a few words about the price and wage outlook for 1967, because these tendencies and trends will play an im-

portant role in terms of what should be done and the consequences of what we do. There will be two basic pressures for price rise in 1967. One is the deficit in the Federal budget, and I would like to say at this point that I support the request for an increase in the surtax of 6 percent, because I find it difficult to believe that we will be able to hold price inflation under control with a \$15 billion deficit in the administrative budget, regardless of what the cash or the national income budget shows. They have effects upon economic activity, but this administrative budget has an effect upon inflation.

But secondly, and the most important pressure for price inflation in 1967 will be the very large increase in labor costs which will take place this year.

Throughout the entire postwar years, regardless of what the consequences may have been—and I now go back to the earlier postwar years—there was no time in which unions were willing to settle for, nor management unwilling to give, at least the increase in the cost of living.

Most of the battles in the early postwar period, and I had the opportunity to participate in many of those proceedings, were concerned with how much beyond the cost of living one went. It was almost viewed as a matter of equity that labor should get at least the rise in the cost of living.

And so we start with contracts that have been in many cases 2-year contracts, the one exception is the automobile industry, because auto workers have received both cost-of-living and the productivity increases. In the past 2 years the Consumer Price Index has risen about 4.5 percent. I don't think there is any union of any size that is going to accept less than the 4.5 percent as a start.

In fact, and this is not generally realized, automobile workers received in 1966 a 7-percent increase in wages, which works out to between 5- and 6-percent increase in labor costs. This will be the minimum target for unions in 1967. And since the probability in 1967 is for a rise in productivity or output per man-hour of about 2 or 2.5 percent, we face the large rise in unit labor costs which I described earlier. And, as I indicated, I think this rise will be reflected largely in a cut in profit margins, and in some unemployment, and to a lesser extent, in higher prices.

What about the indications of stability in prices? One of the most important portents of the movement of wholesale prices is what happens to the index of 22 sensitive products. A year ago that index was 115 on a 1957-59 basis. Today it is about 102. The Wholesale Price Index has shown stability since last July. There has been little or no change in the comprehensive Wholesale Price Index for the past 7 or 8 months, and one of the very interesting points about this index is that if we break it down and study what I like to call the anatomy of prices, we find that every component of the index was rising through July 1966, but in the last 7 months, from July 1966 to January 1967, four of the 13 components have actually gone down.

I submit that a period when some components of the index are showing little or no change and others are going down is not the type of price behavior one expects to find in a period of general price inflation.

Second, there are indications that in the absence of a further escalation of Vietnam, the rate of increase in economic activity may slow down or may even come to a halt. The expansion which has lasted 6 years is looking tired, particularly in the civilian sector.

Third, the suspension of the 7-percent investment tax credit and of accelerated depreciation for buildings combined with tight money helped to slow down the boom in the plant and equipment. The narrower profit margins probable for this year will reduce the incentive as well as funds available to finance plant and equipment spending. On balance, a leveling off in plant and equipment spending is probable even if the investment tax credit is restored. Because we have been getting increases in capacity which exceed the growth in the economy, excess capacity is beginning to develop.

I see 1967 as a year in which there will be a slower rate of growth if the Vietnam war continues, and a moderate recession similar to the post-Korean one if the Vietnam war ends.

There is one other factor about 1967 that must be emphasized. Inventories have been accumulating at the rate of in excess of \$15 billion a year. Now what does this mean? It means that if gross national product is \$760 billion and \$15 billion is inventory accumulation, we have only been consuming \$745 billion, and it means that if we stop accumulating inventories, not liquidate them, merely stop the accumulation, we take \$15 billion out of the economy. That represents many jobs and a significant reduction of pressure on prices. And if we should liquidate some of these inventories, we could very easily get a swing which will take \$20 billion out of the gross national product, and will help to reduce, if not eliminate, the pressures for price rise.

As I see the price outlook, inflationary pressures are still present in the economy, particularly from higher labor costs. However, on balance there is a strong probability that we have seen the maximum rate of pressures for price inflation already. Prices should rise at a slower rate in 1967. Assuming no change in Vietnam, the rise in the Consumer Price Index will be 3 percent or less, and that in wholesale prices 2 percent or less. Incidentally, in the last 3 months the Consumer Price Index has risen about two-tenths of a point, and the Wholesale Price Index has shown minor changes.

The actual degree of price inflation will be determined to a large extent by events in Vietnam and by the fiscal and monetary policies adopted. It will not be determined by the wage-price guideposts.

Further escalation of the war would intensify the pressure for higher prices, unless fully offset by higher taxes. On the other hand, a stabilization of the war effort or a cutback would moderate significantly the pressures for price inflation. Since I have no way of determining which of these alternatives will develop, any projection of prospective price change must be qualified.

Let me conclude. I strongly endorse the educational objectives of the guideposts as originally described in 1962. It is useful to emphasize there are general limits to rates of gain in real wages, and in the levels of living that can be realized annually, particularly since public expectations seems to have far outdistanced the possibilities of even our affluent society.

However, the Council's analysis is based on so many erroneous assumptions that the educational value of the guideposts is open to serious question. There is little value to a program which educates the public to believe that unit labor costs determine prices, that only productivity determine wages, that real wages can increase at a uniform annual rate, that the general price level can be stabilized by controlling increases in labor costs, or that levels of living can be raised by 3 percent or more annually.

Moreover, educational goals stated in general terms is a far cry from the establishment of annual objectives expressed in numerical terms. The guideposts as used prior to this year, unfortunately, created expectations of steady, annual increases in real labor income at a 3.2 percent rate, or higher than is realistic and hence higher than actually developed.

Moreover, such a steady increase in real income each year ignores the fact that labor payments perform a rationing function as well as provide a source of purchasing power.

Different rates of change in labor income are appropriate for periods of recession than for periods of marked economic growth. The failure of the guideposts to provide for these cyclical variations is another weakness that usually is ignored.

We would be better off with the termination of this experiment in economic marksmanship. As a device to determine acceptable increases in wages and guideposts and prices, the guideposts leave much to be desired.

The implementation by persuasion has really had no administrative base and appears to be a hit-or-miss affair. If the objective is to overcome the market power of labor and business, the guideposts are a very crude tool, since they seek to contain the exercise of that power in a few instances rather than to attack it at the source.

If we desire to contain market power by business, the main instrumentality is the antitrust laws. Pressures on prices can also be modified by the timing of Government spending programs, lowering barriers to foreign trade and by sales from the stockpile.

It must be recognized that while the latter programs can be helpful in stabilizing the prices of some products, they cannot stabilize the general price level.

The elimination of make-work practices and of restriction of membership in some unions, retraining, training, and mobility programs, and repeal or modification of the Walsh-Healey Act and Bacon-Davis Act could help reduce the pressures on the labor front, but there would still remain the strong market power of the unions in many industries.

One difficulty is that problems may develop through small unions strategically located as well as the giant unions which are the usual targets for antimonopoly proposals.

The most constructive approach would require the mix of fiscal and monetary policies which would restrict excessive expansion in the economy, plus direct attacks on specific abuses of market power.

In the wage-price environment projected for this year, the guideposts can serve no useful purpose. On the contrary, they may

aggravate what already are certain to be excessively large increases in labor costs. By emphasizing long-term gains in output per man-hour and the accompanying rise in living standards, they encourage unions to seek increases large enough to cover both the past rise in the CPI and the so-called normal rise in real wages. This combination would mean labor-cost increases of 7 percent or more, and would result in a substantial rise in unit labor cost as the Council has warned.

The abandonment of a specific numerical value for labor cost increases was unavoidable under these conditions. The quiet burial of the wage-price guideposts would be equally constructive.

That concludes my statement, Mr. Chairman.

(The prepared statement of Mr. Backman follows:)

PREPARED STATEMENT OF JULES BACKMAN

THE WAGE-PRICE GUIDEPOSTS

The wage-price guideposts are now five years old. At the outset, the CEA emphasized the guideposts were designed to educate the business community, labor unions, and the public that there are limits within which real incomes can be expanded annually and that increases in excess of those amounts will be eroded by price inflation. The guideposts spelled out what the CEA considered to be noninflationary wage and price behavior.

If the wage-price guideposts described only the extent to which labor costs can rise without adding to unit labor costs, they would represent a simple exercise in arithmetic. However, they go further and state that if certain compensating changes in wages and prices take place, average unit labor costs will be unchanged and we could attain price stability. Such price stability, in turn, would convert the indicated rise in money labor income into an identical rise in real income. These latter conclusions are based upon a faulty understanding of the processes of wage and price determination and provide a completely wrong prescription for general price stability.

Under conditions of significant idle capacity (as from 1958 to 1964), the guideposts make no contribution to the stability of the price level. In fact, when there is idle capacity and unemployment, they could have just the opposite effect by encouraging increases in labor costs which are greater than warranted at such times. Such a development could impede the reemployment of idle workers who are priced out of the market.

Similarly, in a period of strong demand fueled by federal budgetary deficits (which still prevail) and an explosive growth in money and credit (which was finally brought to a halt in 1966), wage-price guideposts could not bring about price stability. At best they may have shaved off a small amount from labor settlements in a few highly visible major industries. However, they are ineffective in other negotiations as the experience with many settlements, particularly in the building trades, demonstrated last year.

Although specific situations which have directly experienced the impact of wage-price guideposts can be identified, the magnitude of the effect can not be determined. How much more, if at all, would the labor cost have increased in an industry in which intervention has taken place? How much more did weaker unions obtain because of the guideposts? How much would the prices of steel, aluminum, cigarettes, and other prices have risen if producers had not been aware of the actual or potential scrutiny of the Government? And would such increases have had a significant impact on the CPI?

These questions cannot be answered with any definitiveness. We have no standards to determine the overall impact, if any, of the guideposts on the general level of wages and prices. We have a dynamic economy in which many forces operate simultaneously and usually cannot be disentangled. However, the guideposts appeared to have had no impact on the vast majority of prices throughout the economy and no restraint upon some major segments of the cost of living including foods and services.

Overall price stability is mainly a function of fiscal and monetary policy with wage-price guideposts playing a very subordinate role. Of course, we know

that governments rarely are willing to make fiscal policy and monetary policy restrictive enough to assure an unchanging price level because the attainment of that objective may conflict with the objective of reducing unemployment. Some students have in fact concluded that price stability could only be assured at the cost of high unemployment. In this connection, it will be recalled that the relative stability of the general price level from 1958 to 1964 occurred during a period of unemployment and low levels of capacity utilization and that prices began to move up as we approached fuller utilization of resources. To the extent that there is a basic conflict between the two goals of price stability and reduction of unemployment, public policy might seek to moderate the upward tendencies of prices during periods of high level activity rather than to seek the goal of price stability.

In any event, if the goal of full utilization of resources is to be attained by expansionary fiscal and monetary policies, the wage-price guideposts can not achieve price stability. However, they may act to prevent needed adjustments in some sectors as when prices are held down under conditions of severe shortage (e.g. copper) or to encourage unbalanced increases in wages and prices as when they are held down in some highly visible industries but not in other parts of the economy.

Paradoxically, the guideposts may appear to be effective when there is minimal pressures for price inflation—and hence the guideposts are not needed. However, they cannot prevent increases in the general level of prices when there are strong pressures for price rises and the containing forces have been weakened. Thus, they are an unnecessary appendage when prices are stable and a futile device to prevent rises when there are strong upward pressures. In any event, it seems evident that price stability can not be achieved through the guidesposts. Nevertheless, the hope that the guideposts can be effective may slow up the implementation of tighter monetary and fiscal policies.

It is practically a truism that for the *entire* economy the real income of labor (wages plus nonwage benefits deflated by the consumer price index) must increase *over long periods of time* about in line with the increase in output per manhour. In fact, the average level of living can only increase when a larger quantity of goods and services is produced per worker. Mass production requires mass consumption.

In order to sell millions of automobiles, radios, television sets and huge quantities of other products, they must be bought by a broad cross-section of the consuming public representing an overwhelming majority of the population. Such purchases may be made possible, however, either by higher incomes, lower prices, or some combination of both. In the past, each of these alternatives has been important.

Although the general average rise in labor income has been in line with average gains in output per manhour, diversity of change has characterized wages and non-wage benefits among industries. In the dynamic and expanding American economy, diverse changes in labor incomes help to play a role in steering available manpower. Expanding areas and industries tend to have larger than average increases in wages in order to attract the additions to the labor force they require. Conversely, lagging industries should have less than average increases since they face a declining need for labor.

The diversity of wage changes is a response to a myriad of pressures, economic and political, which affect the magnitude and nature of settlements for different industries and often result in different changes for individual companies within an industry. These underlying forces are still operating and will continue to do so in the future.

In its initial analysis, the CEA indicated that exceptions could be made from its general guideposts for the above situations. But in 1964, the CEA stated that such exceptions should apply to "only a relatively few cases." (*Economic Report of the President*, January 1964, p. 119) Thus, an important element of flexibility in the 1962 guideposts was modified since ordinarily the exceptions have been very numerous.

The CEA has made a constructive contribution to public understanding by emphasizing that fringes as well as wages must be considered in measuring labor's gains and by indicating that regardless of the name given to a wage increase, whether it is a cost of living adjustment or a productivity increase, it

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 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.

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.

The CEA proposal that companies with above average gains in output per manhour 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." (p. 125) 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 rationing. Where shortages prevail a reduction in price is exactly the wrong prescription and will tend to result in a less efficient use of resources.

2. *The assumption that productivity (output per manhour) is the major factor in wage determination.*—The CEA states "The only valid and noninflationary standard for wage advances is the productivity principle." (p. 128) For some key industries, the rate of change in output per manhour nationally is one factor considered in collective bargaining. But it is neither the only factor nor the most important one. Other factors include the general state of the economy, the growth rates of specific companies and industries, changes in the consumer price index, rival union leadership, comparative wages, and profitability.¹

Apart from periods of rising living costs, the most important factor in the overwhelming number of wage negotiations is the wage comparison criterion. Although the CEA pays lip service to this criterion (p. 130), it emphasizes that "Very often the wage comparisons in collective bargaining are only part of a game of follow-the-leader which, at best, is irrelevant to resource allocation and, at worst, speeds up a wage-price spiral." (p. 131) It also appears to regret that in one settlement the "customary relationship" between different groups of workers in a company was not destroyed. (p. 131)

Certain key industries such as automobiles and steel have helped to establish patterns for general increases in wages and fringes in the postwar years. The CEA has been concerned primarily with such industries although initially it specifically stated that its guideposts do not constitute "a mechanical formula for determining whether a particular price or wage decision is inflationary." (*Economic Report of the President*, 1962, p. 188) However, settlements in other companies and industries do not always match the "key wage bargains".

For smaller companies and industries as well as in local bargaining, the guideposts have been of minor importance since the factors peculiar to the competitive situation, locality, or industry tend to have greater weight in the minds of the negotiators. It is not surprising, therefore that some of the largest departures from the guideposts have taken place in local bargaining. As a result, wage relationships among different sectors of the local economy are bound to be distorted.

In the real world, wage relationships are of critical importance both to the firm that seeks to hire labor and to the union leadership which must produce results for its members. It is true, as the CEA notes, that proper comparisons often are difficult to make. But each party is more skillful at countering the claims of the other than the CEA seems willing to recognize so that neither party can arbitrarily select only comparisons favorable to itself and make them stick.

In discussing prospective settlements the CEA states that "many wage settlements in 1967 will exceed the trend increase of productivity" (p. 128) In effect it treats changes to compensate for rising living costs as "an additional margin" (p. 128) beyond the productivity total. The reality of collective bargaining will be just the reverse.

The first factor considered by negotiators during periods of rising living costs is what increase is required to restore real wages to the level prevailing when the previous contract was negotiated. Then consideration is given to how much more the adjustment should be to compensate either for anticipated further rises in living costs or to increase real earnings.

¹ For a general discussion see Jules Backman, *Wage Determination*, D. Van Nostrand Co., Inc., Princeton, N.J., 1959, *passim*.

The CEA warns that if the labor cost increase in 1967 is large enough to include "a full allowance for productivity" and "to 'compensate' for past increases in living costs, unit labor costs would rise at a rate which would require living costs to continue their rapid rise." (pp. 128-29) I agree that such an increase would probably result in a rise of 4% or more in unit labor costs. But this does not mean a comparable rise in prices. It could be partly met by a cut in profit margins and a reduction in other costs, which means some unemployment. I believe that the 1967 economy will not permit companies to pass on their higher labor costs in full and that large increases in labor costs will result in lower profit margins and some increase in unemployment.

Thus, part of the price of lack of restraint in labor cost increases in 1967 will be unemployment and lower profit margins. The CEA recommends that "producers should absorb cost increases to the maximum extent feasible." (p. 133)

Moreover, 1967 provides an excellent illustration of a year in which real wages should *not* rise as much as output per man-hour because of the large increase required to achieve this objective. The CEA's recommendation for a hold down in total labor costs is a proper objective but it is inconsistent with its basic guidepost approach, namely, that increases "in average hourly earnings and fringes should be steady and smooth, not erratic." (p. 121)

3. *The assumption that reported increases in private output per man-hour indicate what is available for distribution.*—In its establishment of the productivity standard, the CEA utilizes the changes in output per man-hour in the entire private economy. Initially, it referred to long term gains but soon translated long term to mean five years, because it thought such a period "was sufficiently long to induce both the extraordinarily high productivity gains of a year of recovery (1962) and the extraordinarily low productivity gains of a year of recession (1960)." (*Economic Report of the President*, January 1966, p. 92)

In 1966, after five consecutive years of expansion, the CEA abandoned the five year average because it no longer included a recession year and hence reflected "unsustainable productivity gains". Although the CEA didn't identify the years covered, it concluded that "the long term trend, independent of cyclical swings, is slightly over 3 per cent." (*Ibid.*)

The unfortunate use of a five year moving average prior to 1966 placed the CEA in the embarrassing position of being forced to abandon its own arithmetic when it yielded an average of 3.6% for the 1961-65 period instead of 3.2%. (*Ibid.*) If the CEA had stayed with its goal of education, it necessarily would have stated that changes in output per man-hour cannot be pinpointed and that only a range of changes could be identified. The CEA would then have avoided the situation which increased expectations and may have contributed to the larger increases negotiated later in 1966. The CEA also would have been spared the questions raised about its own integrity.

The shift from agriculture

The changes in output per man-hour for the entire private economy, including agriculture, overstate the average gains that can be attained by workers. Part of the national increase in output per man-hour reflects the shift from agriculture to the non-agricultural economy where the output per man-hour is higher. The shift away from agriculture has been marked. During the period since 1947, agricultural employment has declined by 4 million while non-agricultural employment has increased by some 20 million.

Employment, 1947, 1961, 1966

	Total	Nonagri- cultural	Agricultural	Percent
	<i>Thousands</i>	<i>Thousands</i>	<i>Thousands</i>	
1947-----	57,813	49,557	8,256	14.3
1961-----	66,796	61,333	5,463	8.2
1966-----	74,065	69,859	4,206	5.7
Change, 1947-'66-----	16,252	20,302	-4,050	-----

Since the value of output per manhour in the non-agricultural sector is considerably higher (\$4.26 in 1958 dollars in 1965), than in the farm sector (\$2.31), this shift contributed to an increase in the average national gain in output per manhour.

Real value output per man-hour

[1958 dollars]

	1947	1965	Percent increase
Nonfarm.....	\$2.59	\$4.26	64.5
Farm.....	.77	2.31	200.0
Total private.....	2.27	4.12	81.5

Source: U.S. Department of Labor, Bureau of Labor Statistics, "Indexes of Output Per Manhour for the Private Economy 1947-65," (mimeo), Washington, D.C., October 1966, table 1A.

From 1947 to 1965 because of the tripling of the real value output per man-hour in the farm sector, the total rise in the entire private sector was 81.5% as compared with only 64.5% in the non-farm sector.

From 1947 to 1966, output per manhour in the non-agricultural sector of the economy increased 2.8% per year as compared with about 3.3% for the entire private economy. The workers who shifted from farming to the non-agricultural sector received the higher wages already prevailing in that area and hence the part of the gain in private output per manhour resulting from the shift in the mix of total employment already has been distributed. Actually, the maximum amount available for distribution is the increase in output per manhour recorded in the non-agricultural sector, not in the entire private sector.

Upgrading of labor force

In recent years, there also has been a shift in the composition of the labor force. For example, production workers accounted for 83.7% of total employment in manufacturing in 1947, 75.1% in 1960, and 74.4% in 1966.

The significant expansion in research and development has involved a large increase in the relative importance of personnel devoted to those activities; automation is having a similar effect. To the extent that non-production workers receive higher average salaries than production workers, part of the gains in output per manhour is required to finance the shift in composition of the labor force, and hence is not available for general improvements in wages and non-wage benefits.

Similarly, an increasing proportion of production workers is found in the skilled category. This changing composition of the labor force also results in a built-in increase in labor costs and thus reduces the amount of productivity gain available for distribution through general increases in wages or non-wage benefits, in higher profits, or in lower prices.

The CEA recognized in 1962 that "... it must be borne in mind that average hourly labor costs often change through the process of up-or-down grading, shifts between wage and salaried employment and other forces. Such changes may either add to or subtract from the increment which is available for wage increases under the overall productivity guide." (*Economic Report of the President*, 1962, p. 190). It is probable that on balance these changes have subtracted from the increment available for distribution.

In the light of the foregoing factors, it seems clear that neither the 3.3% annual rate of gain in output per manhour for the entire private economy nor the 2.8% gain for the non-farm economy from 1947 to 1966 is available for distribution. This is one important reason why the rise in real earnings has fallen short of such "guideposts" in the postwar period:

Between 1947 and 1965, the latest year for which data for wage supplements are available:

Real average hourly earnings in manufacturing increased at the annual rate of 2.3%.

Real average hourly earnings plus wage supplements increased at the annual rate of 2.7%.

The CEA has been using output per manhour data that are too high and thus building up expectations for annual rates of increase in real labor income which cannot generally be attained continuously over time.

Effect of announcing numerical goal

The high number announced by the Council quickly became the minimum acceptable target for unions and the maximum that some managements were

willing to pay. The CEA recognizes this development in its observation that various statements by the Council "have been interpreted as treating the guideposts as firm, though voluntary, rules, and those who fail to adhere to them as "violators." (P. 123.) This was inevitable and should have been recognized in advance particularly since the CEA says the guideposts "were designed to define more precisely to labor and business" the government policy. (P. 125.)

The recent abandonment of the announced guideposts of 3.2% was a constructive move. It was a mistake to have announced any number in the first place. The proposed modifications which were supposed to be a part of the guideposts were largely ignored except to justify above average increases. Some labor settlements above the target figure became subject to public criticism by the Council and the basis for White House intervention. (Illustrations include the airlines and the New York Transit Authority, p. 127). Similar actions attended reported price increases, as was illustrated by steel, copper, aluminum, molybdenum, cigarettes, and gasoline. (P. 127.)

The CEA hasn't abandoned the guideposts; it has only abandoned the numerical yardstick which it had established to indicate when selected collective bargaining settlement or price actions were in the ballpark. The CEA Report indicates that it is still wedded to the guidepost approach. Thus, after discussing its activities in connection with the price guidepost, it specifically states that "this activity will be continued by the Council." (P. 127.) On February 11th, the *New York Times* reported that in line with the guidepost policy, the Interior Department had requested a rollback of a 1 cent a gallon increase in gasoline prices.

4. *The assumption that real labor income should or could increase at uniform annual rates.*—The guidepost approach attempts to substitute relatively uniform annual increases in real wages for the irregular pattern of growth experienced in the past. Real wages have reflected a composite of changes in income and in the consumer price index and necessarily have risen irregularly rather than at an uniform rate over time. Real labor income can rise in any year as a result of five combinations of changes—

- (1) No change in labor income and a decline in the CPI.
- (2) An increase in labor income and little or no change in the CPI.
- (3) A small *rise* in labor income and a small *decline* in the CPI.
- (4) A decline in both with the CPI recording the larger decline.
- (5) A rise in both with labor income recording the larger rise.

Table 1 shows the annual changes in average hourly earnings and in the CPI for the 46 years between 1919 to 1966. The number in the last column is related to the five alternatives noted above. It must be recognized that the exact relationships shown might have been a little different if fringe benefits could have been included in the hourly earnings. Nevertheless, it is instructive to note that:

1. There were no years in which the hourly earnings remained unchanged and the CPI declined (Alternative 1) (Actually 1949 was such a year but this is not shown by the annual data because the unchanging earnings in 1949 averaged higher than in 1948).

2. There was only one year (1929) in which hourly earnings rose and the CPI remained unchanged (Alternative 2).

3. There were six years (1927, 1928, 1938, 1939, 1949, 1955) in which hourly earnings rose and the CPI declined (Alternative 3).

4. There were four years (1921, 1922, 1931, 1933) when the CPI declined more than hourly earnings (Alternative 4).

5. There were 29 years (including every year except two between 1948 and 1966) when hourly earnings rose more than the CPI (Alternative 5).

There is a sixth alternative, namely that real labor income may decline in some years so that the increases obtained under the first five assumptions must average more than the long term average annually in order to achieve such an average over time. There have been six such declines since 1919 (1925, 1926, 1932, 1945, 1946, 1947).

Despite this record, the CEA in its guideposts, relied upon alternative (2), an unchanged CPI and a rise in labor income. Its success would have imposed a fixed mold during good times and bad and during periods of stability and

inflation instead of the flexibility which has characterized our economy in the past.

Changes in real income, 1962-66

Real labor income since 1962 has risen irregularly but has fallen short of the goal of the guideposts. In light of the steady rise in the CPI by a little more than 1% annually in 1962, 1963 and 1964, 1.7% in 1965, and 2.9% in 1966, workers who obtained an average increase of 3.2% in money wages and fringe benefits annually during that period necessarily received a smaller rise in real income.

It must be kept in mind, as the CEA has pointed out from the start, that all labor costs including fringe benefits and social security taxes, must be considered in utilizing the guideposts. For example, the social security tax paid by employers increased from 3% of wages (up to \$4,800) in 1961, to 3½% in 1962, 3¾% in 1963 to 1965, and 4.2% (up to \$6,600) in 1966. The increase in the social security tax averaged 0.2% of hourly earnings annually from 1961 to 1966.

The changes in money income and in real income are shown in Table 2. The average rise in hourly earnings plus wage supplements¹ in manufacturing in money terms was 3.3% per year from 1961 to 1965. Somewhat larger annual increases were recorded in other sectors of the economy from 1961 to 1965: construction, 3.1%; wholesale and retail trade, 3.9%. (See Table 3) However, after adjustment for the rise in the consumer price index the increase in real terms averaged only about 2% annually in manufacturing and 2.5% for trade or short of the rise postulated in the guideposts.

In interpreting these data, it must be kept in mind that the increases in costs to employers were somewhat higher because these data do not reflect the cost of fringe benefits involving time off with pay. Nevertheless, it is probable that the increases in real earnings were less than the objectives established by the CEA. And this is really unavoidable because as was indicated earlier, the CEA standard is too high.

5. *The assumption that unorganized sectors would follow the leaders.*—From the outset of the guidepost policy in 1962, the CEA has directed its attention primarily to the "important segments of the economy in which large firms or well-organized groups of employees have same discretionary ability to affect the levels of their prices and wages." (p. 120) These may be described as the highly visible unions and industries.

The CEA assumed that "compensation in unorganized sectors would rise at the same average rate, equal to the gain in over-all productivity." (p. 122) Of course, this unorganized sector includes workers affected by federal minimum wages which have risen much more than the guideposts as the CEA recognizes (p. 129) (From \$1 in August 1961 to \$1.25 in September 1963 and \$1.40 in February 1967) But apart from this development it is of interest to note that the largest increases in consumer prices have been in the service sector which is largely populated by unorganized workers.

The CEA assumed that if the highly visible industries conformed to the price guideposts, "the average of prices would also be stable in the other, highly competitive industries (including agriculture and most services) where firms had no discretion." (p. 123) This is a naive view of relationship between prices of agricultural products and services and those for industrial products.

Prices of agricultural products are significantly influenced by supplies here and abroad and historically have fluctuated much more widely than industrial prices both in the long run and in short periods. For example, from 1940 to 1948, agricultural prices rose 184% as compared with the rise of 75% for industrial prices. In 1958, farm product prices rose 4.4% while industrial prices fell by 2%. In 1959, the trends were reversed. Table 4 shows the diverse annual changes since 1939.

Thus, the assumption that prices of farm products, and in turn food, would maintain a fixed relationship to other prices has not worked out nor was there any reason to expect that it would.

Similarly, the prices of services have risen without interruption in the past quarter of a century while the prices of goods in the CPI have recorded declines

¹ Data reported for wage supplements include legally required social security and unemployment compensation taxes and negotiated pension and welfare benefits.

as well as advances. For example, prices of all commodities in the CPI declined in 1949, 1953, 1954, and 1955 and prices of the durable goods component, an area of great visibility, declined in 1953, 1954, 1955, 1960, 1961 and 1965.

The objective of stabilizing the CPI could not be attained because of the inability to prevent a rise in the prices of many services (such as hospital care, education, personal care, etc.) which represent essentially labor costs. These are sectors of the economy which have relatively small improvements in output per man-hour so that higher labor costs tend to be translated more readily into higher prices. The impossibility of preventing rises in farm and food prices also was important. The CEA recognizes that these are "areas to which the guideposts have no applicability." (p. 128)

The fact is that the guideposts failed to stabilize the CPI from the outset even apart from the increases in foods and services, as the figures in Table 5 show. From 1961 to 1966, the total CPI rose 8.5%. If it had not been for the rise of 13.6% for services and 11.3% for food, the overall advance would have been considerably smaller but there would still have been a rise of about 5% or an average of about 1% annually.

Thus, the effort to contain price inflation by confrontation has not been successful. Criticisms of price increases in aluminum, steel, and other industries have held down prices in those areas and undoubtedly has resulted in a more cautious approach to price increases in other industries. However, the overall effect on the WPI has been minor and there probably has been little effect on the CPI.

In this connection, too, it should be noted that the incomes policy—the parallel approach in such countries as Western Germany and United Kingdom—has not prevented general increases in prices. In England, for example, the cost of living increased almost 5% in 1965 and almost 4% in 1966. The increases in West Germany were about one-half percentage less in both years.

Market power and prices

The CEA states that "businesses and unions can push prices up even when resources are not fully utilized." (p. 119). However, the record shows that from 1958 to 1964, when the economy operated substantially below capacity, wages and prices were not "pushed up" generally. (See Tables 6 and 7)

Between 1958 and 1964:

For manufacturing industries, capacity utilization averaged between 74% and 86%.

The unemployment rate was between 5.2% and 6.8%.

Wholesale industrial prices recorded no change with the annual indexes ranging between 100.3 and 100.7 (1957-59=100).

The consumer price index rose slightly more than 1% a year.

Unit labor costs in manufacturing industries remained relatively stable and for the entire corporate economy rose about 1% annually.

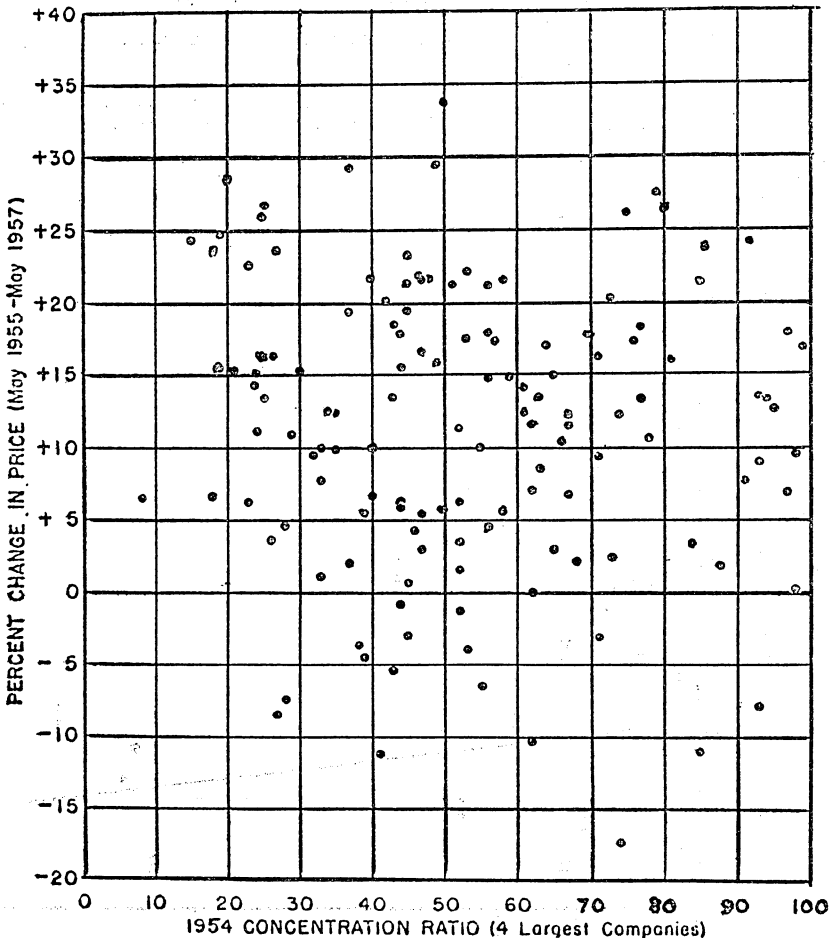
This period of relatively unimportant changes in prices and in unit labor costs includes the 3 years *before* the guideposts were formulated (1958 to 1961) and the first three years of their use (1962 to 1964).

In connection with the assumption that big business has market power which can be used to raise prices excessively, it is instructive to keep in mind that the largest price rises in the past two years have been in farm products, foods, and services rather than in the products of big business. In the absence of the guidepost policy, it is probable that there would have been somewhat larger increases than actually developed in the latter areas. However, there is no evidence that they would have been as large as the rise for services or that they would have had an important impact on the CPI.

Similar charges concerning the effects of market power upon prices were made in connection with the price rises in the mid-1950's. To check the factual basis for such an assumption, I studied the relationship between economic concentration as measured by the share accounted for by the Big Four in 1954, and the changes in wholesale prices from May 1955 to May 1957 for 136 groups of metals and metal products. Chart 1 shows that there was no relationship between the price change and the degree of concentration.¹

¹ Jules Backman, *Administered Prices, Administered Wages, and Inflation*, Current Business Studies, Society of Business Advisory Professions, New York University, October 16, 1957, pp. 5-24.

CHART 1. METALS AND METAL PRODUCTS CONCENTRATION VERSUS PRICE CHANGE



Source: Jules Backman, "Administered Prices, Administered Wages, and Inflation," *Current Business Studies No. 28*, Society of Business Advisory Professions, Inc., p. 13.

Similarly, it is frequently stated that large-scale advertising expenditures create market power. To determine the extent to which this market power has been exercised I have recently completed studies of the relationship between the intensity of advertising, as measured by the ratio of advertising expenditures to sales, and the changes in prices from 1947 to 1966.² Chart 2, which illustrates one of the comparisons made, is reproduced from that study. (See Table 8)

The general conclusion of my study is as follows:

"The most intensively advertised categories of products have tended to show smaller increases in price than less heavily advertised categories during the post-World War price inflation. The postwar record of changes in wholesale and retail prices for broad groups of products and for selected foods and proprietary drugs reveals that there has been no relationship between the intensity of advertising expenditures and the magnitude of price increases.

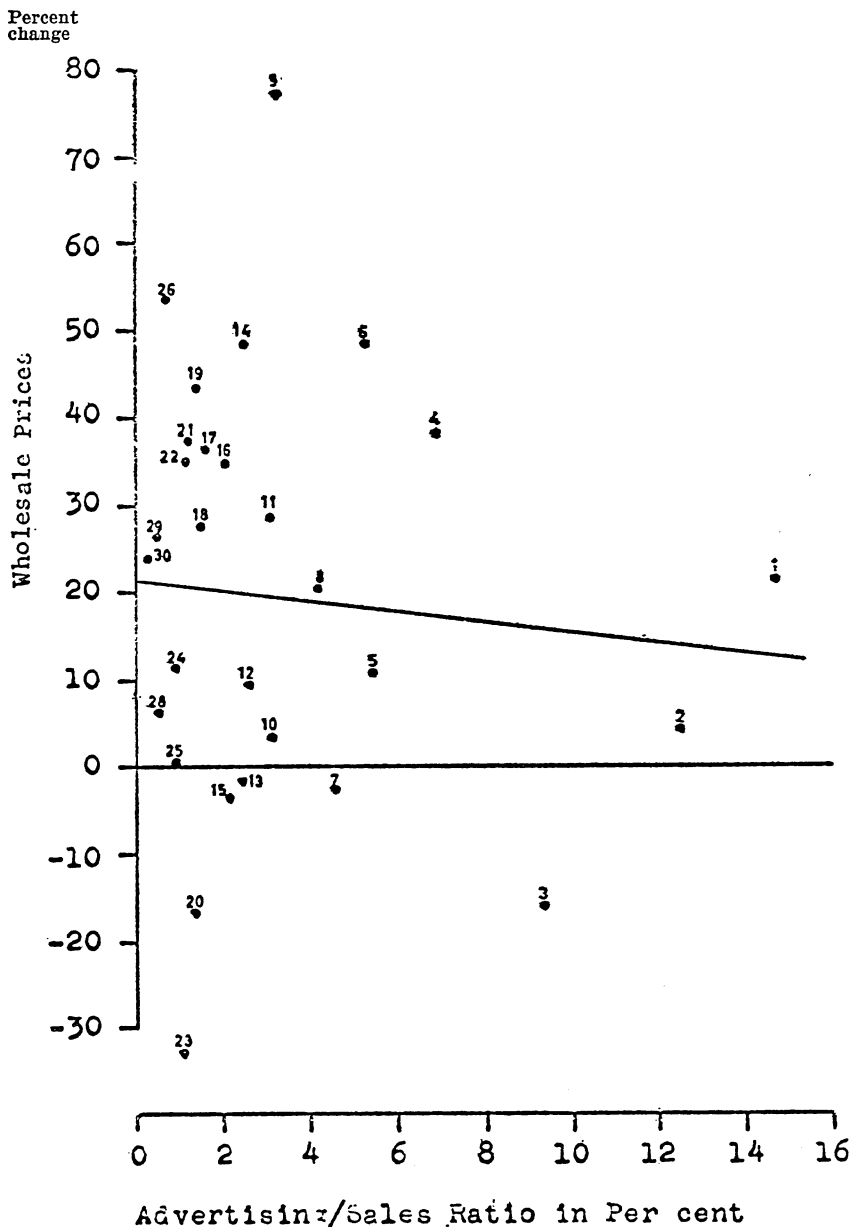
"These data indicate that heavy advertising expenditures did not create a degree of market power which gave the affected industries the freedom to raise prices substantially during this period of general price inflation. It may be asserted that these data merely show that the market power was unexercised but

² The detailed findings will be contained in *Advertising and Competition* to be published by New York University Press in the Spring.

remains a threat in the future. However, the earlier discussion indicated that the theory that brands create excessive market power is a myth. The price experience reinforces this conclusion."

These studies are cited to illustrate that market power need not necessarily be translated into higher prices.

CHART 2. ADVERTISING OUTLAYS PER DOLLAR OF SALES, 1962, AND PER CENT CHANGE IN WHOLESALE PRICES, 1947-65, FOR SELECTED COMMODITIES



Source: Jules Backman, *Advertising and Competition*, New York University Press, 1967.

PRICES AND WAGES IN 1967

I should like to examine now the prospective changes in wages and prices this year. Monetary and fiscal developments have been accompanied by a booming economy and by a higher rate of price inflation. The consumer price index rose about 3% in the past year as compared with an annual rate of slightly more than 1% between 1958 and 1965. Even more important, because there are daily reminders of its impact, food prices increased 3.8% as compared with an annual rate of about 1% in the preceding seven years. And practically all categories of foods have risen in price.

Retail prices have advanced across-the-board with every major category rising 2.0% or more. Increases exceeded 6% for public transportation, footwear, and medical care among the subgroups. (See Table 9).

Industrial wholesale prices increased 2.2% between December 1965, and December 1966. Most of this rise had taken place by July, 1966. Prices of processed foods rose through August and have since recorded a modest decline. (See Table 10).

A significant change has developed since July, 1966. During the nine months ending in July, when the index of industrial wholesale prices rose by 3.2%, each of the 13 groups of prices included in this index advanced. (See Table 11).

In the seven months from July 1966 to January 1967, a markedly different pattern emerged. The industrial price index rose only 0.6% as declines for four groups offset in part the increase recorded by nine groups of prices. This is not the pattern that develops when strong inflationary pressures are operating in the economy. It is apparent that inflationary pressures have subsided since July, 1966. One of the most important clues to the re-emergence of general inflationary pressures will be found in the anatomy of price changes. This is an area, therefore, to be watched carefully in the months ahead.

The more important factors to be considered in evaluating price trends in the year ahead may be summarized as follows:

Pressures for Price Rise

1. The federal budget will continue in the red even if the proposals to raise taxes are adopted. Any further escalation in Vietnam would intensify fiscal inflation unless it is offset by a rise in revenues including higher tax rates. Any cutback in our Vietnam commitment would virtually eliminate inflationary pressures from this source.

2. The major pressures for price inflation in 1967 will probably develop from higher unit labor costs. After five years of nominal increases in unit labor costs in the economy and small declines in manufacturing industries, we are now experiencing a rise. The increase in hourly wages and fringes plus higher social security costs added almost 5% to hourly labor costs in 1966. The net result was an increase almost 3% in average unit labor costs in manufacturing for 1966 and a rise of 4% for the corporate economy. This has meant increasing pressure on prices from the cost side. (See Table 6).

The prospect is for an even larger increase in unit labor costs in 1967. Wages and fringe benefits costs probably will rise more rapidly largely due to the increases in the consumer price index and to the relatively low level of unemployment. The increase in automobile hourly wages in 1966 will probably become a target for other unions. Auto workers received an annual improvement factor increase of 2.8% (with a minimum of 7 cents an hour) plus a two cents across-the-board increase plus cost of living increases aggregating 11 cents an hour. This appears to be a wage increase of about 7% in 1966. However, when this wage increase is related to total hourly labor costs including fringes, the rise probably is between 5% and 6%. For all manufacturing industries, hourly earnings rose by 4.1% in the year ending in December. (See Table 12).

In addition, the increase in the minimum wage from \$1.25 to \$1.40 an hour became effective February 1 and social security costs increased from 4.2% to 4.4%. An average increase of more than 5% in hourly costs is probable in 1967.

On the other hand, output per man-hour for the nonfarm economy should increase at a lower rate than in recent years, probably no more than 2%-2½%. The net result will be a rise in unit labor costs of several percent.

It is not going to be easy to pass on very large labor cost increases in higher prices. Moreover, other costs will not be cut rapidly enough to provide an offset to higher labor costs. The result will be a squeeze on corporate profits. It is

already underway. I think we can see this in some industries where mild declines in volume are generating an erosion in profits of significant amounts. So we will have an economy which will have areas of expanding profits and areas of declining profits, but on balance corporate profit should decline.

My feeling is that in 1967, higher unit labor costs will be accompanied by a narrowing of profit margins and by some increase in unemployment. Nevertheless, there will be some pressure for higher prices from labor costs. Higher labor costs could be the most inflationary force in 1967.

Indicators of Lower Prices

1. One important portent has been the movement of sensitive raw materials prices during the past year. Changes in these prices tend to precede those in the general price level. The raw materials index, which is fairly responsive to underlying pressures, rose about 11% in the year ending February, 1966, at which time it averaged 113.8 (1937-59=100), (the actual daily high was about 115). During the past year, despite the public concern with price inflation, this index has been drifting lower. On February 14, the index was 102.2 or about 10% below the February 1966 level. Every group of raw materials was below the level prevailing a year earlier. (See Table 13)

Wholesale industrial prices have recorded little change since last July. Moreover, as I noted earlier, four out of 13 groups of industrial prices declined between July 1966 and January 1967. Such behavior does not portend a higher rate of increase in consumer prices than we have been experiencing. Rather, it suggests that the increase will be at a lower rate.

2. There are indications that in the absence of further sharp escalation in Vietnam, the rate of increase in economic activity may slow down and may even come to a halt. The expansion which has lasted six years is looking tired, particularly in the civilian sector of the economy. Tighter credit was accompanied by sharp cutbacks in the building industry and this is affecting related lines of activity. There have also been reductions in automobile sales. It is improbable that inventories will continue to rise at the recent rate of more than \$1 billion a month. Any reduction in the rate of accumulations would reduce significantly the pressures for higher prices.

3. The suspension of the 7% Investment Tax Credit and of accelerated depreciation for buildings combined with tight money helped to slow down the boom in plant and equipment spending. Narrower profit margins, which are probable for this year, will reduce the incentive as well as the funds available to finance new plant and equipment. On the other hand, higher labor costs will increase the incentive to substitute machinery for manpower. On balance, a leveling off and then a decline in plant and equipment spending are in prospect. Such a development would contribute to the easing of credit and would act to reduce the pressure for higher prices.

I don't think that the restoration of the 7% tax credit on January 1, 1968, if it takes place, will do very much to arrest such a decline which will reflect fundamental readjustments in our economy.

If the Vietnam war ends, the level of real gross national product should decline from the level prevailing at the end of the war. I think there would be a swing in inventories, which alone would eliminate \$15 to \$20 billion from the national product.

I see 1967 as a year in which there will be a slower rate of growth if the Vietnam war continues, and a moderate recession, similar to the post-Korean one, if the Vietnam war ends.

I do not believe that any recession that develops will be deep and prolonged. The built-in stabilizers and the developments in federal fiscal policy and monetary policy would be such as to contain its magnitude, as it has in each of the postwar recessions.

4. Plant capacity has been expanding at a faster rate than the demand for goods and services so that excess capacity may develop in some industries in 1967. Such a development would make it difficult to raise prices and, in fact, would create pressures for price declines in the affected industries. We have already seen signs of this tendency in the chemical industry, and I think this will spread.

Price outlook

Inflationary pressures are still present in the economy, particularly from higher labor costs. However, on balance there is a strong probability that we have seen the maximum rate of pressures for price inflation. Prices should

rise at a slower rate in 1967. Assuming no change in Vietnam, the rise in the Consumer Price Index should be 3% or less, and that in industrial wholesale prices 2% or less.

The degree of price inflation will be determined to a large extent by events in Vietnam and by the fiscal and monetary policies adopted. Further escalation of the war would intensify the pressures for higher prices unless fully offset by higher taxes. On the other hand, a stabilization of the war effort or a cutback would moderate significantly the pressures for price inflation. Since I have no way to determine which of these two alternatives will develop, any projection of prospective price changes must be qualified.

THE FUTURE OF WAGE-PRICE GUIDEPOSTS

I strongly endorse the educational objectives of the guideposts as originally described in 1962. It is useful to emphasize there are general limits to rates of gain in real wages and in the levels of living that can be realized annually particularly since public expectations seem to have far outdistanced the possibilities of even our affluent society. However, the CEA analysis is based on so many erroneous assumptions that the educational value of the guideposts is open to serious question. There is little value to a program which educates the public to believe that unit labor costs determine prices, that only productivity determines wages, that real wages can increase at an uniform annual rate, that the general price level can be stabilized by controlling increases in labor costs, or that levels of living can be raised by 3% or more annually.

Moreover, an educational goal stated in general terms is a far cry from the establishment of annual objectives expressed in numerical terms. The guideposts as used prior to this year unfortunately created expectations of steady, annual increases in real labor income at a 3.2% rate, or higher than is realistic and hence higher than actually developed. Moreover, such a steady increase in real income each year ignores the fact that labor payments perform a rationing function as well as provide a source of purchasing power. Different rates of change in labor income are appropriate for periods of recession than for periods of marked economic growth. The failure of the guideposts to provide for these cyclical variations is another weakness that usually is ignored.

We will be better off with the termination of this experiment in economic marksmanship. As a device to determine acceptable increases in wages and prices, the guideposts leave much to be desired. The implementation by persuasion has really had no administrative base and appears to have been a hit or miss affair. If the objective is to overcome the market power of labor and business, guideposts are a very crude tool since they seek to contain the exercise of that power in a few instances rather than to attack it at the source.

If we desire to contain market power by business, the main instrumentality is the antitrust laws. Pressures on prices can also be modified by the timing of government spending programs, lowering barriers to foreign trade, and by sales from the stockpile. It must be recognized that while the latter programs can be helpful in stabilizing the prices of some products they cannot stabilize the general price level.

The elimination of make-work practices, and of restrictions on membership in some unions, retraining, training and mobility programs, and repeal or modification of the Walsh-Healey Act and Bacon-Davis Act could help reduce the pressures on the labor front but there would still remain the strong market power of the unions in many industries. One difficulty is that problems may develop through small unions strategically located as well as the giant unions which are the usual targets for anti-monopoly proposals.

The most constructive approach would require the mix of fiscal and monetary policies which would restrict excessive expansion in the economy plus direct attacks on specific abuses of market power.

In the wage-price environment projected for this year the guideposts can serve no useful purpose. On the contrary, they may aggravate what already are certain to be excessively large increases in labor costs. By emphasizing long term gains in output per manhour and the accompanying rise in living standards, they encourage unions to seek increases large enough to cover both the past rise in the CPI and the so-called "normal" rise in real wages. This combination would mean labor cost increases of 7% or more and would result in a substantial rise in unit labor costs as the CEA has warned (p. 129). The abandonment of a specific numerical value for labor cost increases was unavoid-

able under these conditions. The quiet burial of the wage-price guideposts would be equally constructive.

The test of a proper increase in wages and non-wage benefits in any specific negotiation cannot be some "guesstimate" of the average national rise in output per manhour. It is true that the average rise in real labor income for all industries will be close to the average rise in output per manhour for the national economy over a long period of time. But this relationship is neither close nor meaningful on a year to year basis for the entire economy nor for individual companies or industries. The rate of increase for specific industries, companies, or groups of workers will and should vary—often markedly—from the national average. Moreover, increases in money labor costs should not take place annually and if they do they should not be uniform each year. They can be larger in periods of prosperity and smaller or even nothing in periods of recession. They will tend to be greater in periods of inflation and smaller at other times. These variations in the magnitude of changes either annually or periodically are more in accord with the needs of a dynamic economy than any uniform rate of change. It is true that the CEA proposal has an escape hatch which provides for some exceptions to the productivity standard. If the hatch is used, however, the exception will become the rule and the use of the productivity standard the exception. And this is how it should be.

There is no simple wage formula which will yield the right answer for all negotiations in one period or for negotiations of any company or industry over time. The proposal discussed in this paper represents the triumph of the productivity criterion and is based upon the assumption that it will yield a stable price level. However, a proper national wage policy cannot be framed solely with the objective of preventing inflation. It also must consider the demand for labor and hence the impact on the volume of unemployment as well as other factors. If the international balance of payments problem becomes intensified, for example, national policy may have to seek to translate productivity gains into lower prices and an improved competitive position for our products *vis-à-vis* foreign products both here and abroad. Under these circumstances wage increases could be only minimal.

Nor does the proposed policy assure a stable level of prices since price levels are determined by a wide variety of forces of which stability in unit labor costs is far from being the most important. In fact, the whole underlying theory of price determination—namely that prices are determined by unit labor costs—has no basis in fact.

Among the other weaknesses of the proposed guidepost are the following: part of the gains in output per manhour is not available for general increases in wages and non-wage benefits because it is being absorbed by the increase in relative importance of scientific and professional workers and the upgrading in skills of production workers; the stresses created by equal annual rates of increase in labor income when output per manhour changes with great irregularity; the undesirability of freezing labor's share of national income; the varying importance of direct labor costs among different industries with the differing inflationary impact of relatively uniform increases in labor income; and the ineffectiveness of exhortation as the method of implementing the proposal and the undesirability and impossibility of imposing effective wage control.

Finally, it should be emphasized that the proposed guidepost is based on the assumption that gains in output per manhour should be distributed largely in the form of increases in labor income. The needs of an expanding economy, the attainment of high level employment, and our foreign competitive position would be better served if productivity gains were used to a larger extent to reduce prices. Lower prices would increase the real incomes of workers as well as of other groups who contribute directly or indirectly to the increase in output per manhour. Simultaneously, a price reduction would encourage an expanding volume of effective demand for the products directly affected by rising output per manhour. In the absence of a reduction in prices, volume does not expand, fewer workers are required to produce the former volume of output and hence one result is greater unemployment.

By lowering the price it is often possible to assure a prompter use of the released resources. Thus, price reductions help to reduce the threat of technological unemployment at the point of impact by expanding the effective demand

for the products which can be produced more efficiently.³⁴ Lower prices would be a more effective route to economic growth and expanding employment opportunities than increases in labor income. Therefore, the use of productivity as the guidepost for proper increases in wage and non-wage benefits should be rejected both on grounds of feasibility and economic desirability.

TABLE 1.—Year-to-year changes in average hourly earnings, manufacturing industries and in the Consumer Price Index, 1919–66

[1957–59=100]

Year	Average hourly earnings in manufacturing	Year-to-year percent change	Consumer price index	Year-to-year percent change	Relationship of average hourly earnings to CPI ¹
1919	\$0.472	-----	60.3	-----	-----
1920	.549	+16.3	69.8	+15.8	5
1921	.509	-7.3	62.3	-10.7	4
1922	.482	-5.3	58.4	-6.3	4
1923	.516	+7.1	59.4	+1.7	5
1924	.541	+4.8	59.6	+3	5
1925	.541	0	61.1	+2.5	6
1926	.542	+2	61.6	+8	6
1927	.544	+4	60.5	-1.8	3
1928	.556	+2.2	59.7	-1.3	3
1929	.560	+7	59.7	0	2
1930	.546	-2.5	58.2	-2.5	7
1931	.509	-6.8	53.0	-8.9	4
1932	.441	-13.4	47.6	-10.2	6
1933	.437	-.9	45.1	-5.3	4
1934	.526	+20.4	46.6	+3.3	5
1935	.544	+3.4	47.8	+2.6	5
1936	.550	+1.1	48.3	+1.0	5
1937	.617	+12.2	50.0	+3.5	5
1938	.620	+5	49.1	-1.8	3
1939	.627	+1.1	48.4	-1.4	3
1940	.655	+4.5	48.8	+8	5
1941	.726	+10.8	51.3	+5.1	5
1942	.851	+17.2	56.8	+10.7	5
1943	.957	+12.5	60.3	+6.2	5
1944	1.011	+5.6	61.3	+1.7	5
1945	1.016	+5	62.7	+2.3	6
1946	1.075	+5.8	68.0	+8.5	6
1947	1.217	+13.2	77.8	+14.4	6
1948	1.328	+9.1	83.8	+7.7	5
1949	1.378	+3.8	83.0	-1.0	3
1950	1.440	+4.5	83.8	+1.0	5
1951	1.56	+8.3	90.6	+8.0	5
1952	1.65	+5.8	92.5	+2.2	5
1953	1.74	+5.5	93.2	+8	5
1954	1.78	+2.3	93.6	+4	5
1955	1.86	+4.5	93.3	-3	3
1956	1.95	+4.8	94.7	+1.5	5
1957	2.05	+5.1	98.0	+3.5	5
1958	2.11	+2.9	100.7	+2.8	5
1959	2.19	+3.8	101.5	+8	5
1960	2.26	+3.2	103.1	+1.6	5
1961	2.32	+2.7	104.2	+1.1	5
1962	2.39	+3.0	105.4	+1.2	5
1963	2.46	+2.9	106.7	+1.2	5
1964	2.53	+2.8	108.1	+1.3	5
1965	2.61	+3.2	109.9	+1.7	5
1966	2.71	+3.8	113.1	+2.9	5

¹ Notes:

2 Average hourly earnings up, CPI unchanged.

3 Average hourly earnings up, CPI down.

4 Average hourly earnings down, CPI down more.

5 Average hourly earnings up more than CPI.

6 Real hourly earnings down.

7 No change in real hourly earnings.

³⁴ It is recognized, of course, that the extent to which effective demand will increase in response to lower prices will vary for different products.

TABLE 2.—*Hourly earnings, manufacturing industries, year-to-year percent change*
[Percent]

	Money		Real	
	Average hourly earnings	Average hourly earnings plus wage supplemental	Average hourly earnings	Average hourly earnings plus wage supplemental
1962.....	3.0	3.4	1.8	2.0
1963.....	2.9	3.4	1.8	2.4
1964.....	2.8	2.9	1.3	1.5
1965.....	3.2	3.5	1.3	1.9
1966.....	3.8	-----	1.3	-----
1961-1965 total.....	12.5	14.0	6.3	8.1
Per annum.....	3.0	3.3	1.6	2.0

TABLE 3.—*Average hourly earnings plus wage supplements in manufacturing, construction, communications, and trade, 1961-65*

MANUFACTURING

	Wages and salaries	Supplements	Percent	Average hourly earnings	Supplements	Total	Year-to-year percent change
	<i>Millions</i>	<i>Millions</i>					
1961.....	\$89,823	\$9,895	11.0	\$2.32	\$0.26	\$2.58	
1962.....	96,682	11,496	11.9	\$2.39	.28	\$2.67	3.4
1963.....	100,606	12,282	12.2	\$2.46	.30	\$2.76	3.4
1964.....	107,166	13,294	12.4	\$2.53	.31	\$2.84	2.9
1965.....	115,509	14,558	12.6	\$2.61	.33	\$2.94	3.5
Percent change, 1961-65.....	-----	-----	-----	12.5	-----	14.0	3.3

CONSTRUCTION

1961.....	\$15,843	\$1,329	8.4	\$3.20	\$0.27	\$3.47	
1962.....	16,842	1,435	8.5	\$3.31	.28	\$3.59	3.5
1963.....	17,802	1,664	9.3	\$3.41	.32	\$3.73	3.9
1964.....	19,446	1,744	9.0	\$3.55	.32	\$3.87	3.8
1965.....	21,105	1,859	8.8	\$3.69	.32	\$4.01	3.6
Percent change, 1961-65.....	-----	-----	-----	15.3	-----	15.6	3.7

COMMUNICATIONS

1961.....	\$4,613	\$514	11.1	\$2.37	\$0.26	\$2.63	
1962.....	4,816	554	11.5	\$2.48	.29	\$2.77	5.3
1963.....	5,013	574	11.5	\$2.56	.29	\$2.85	2.9
1964.....	5,405	686	12.7	\$2.62	.33	\$2.95	3.5
1965.....	5,764	747	13.0	\$2.70	.35	\$3.05	3.4
Percent change, 1961-65.....	-----	-----	-----	13.9	-----	16.0	3.8

WHOLESALE AND RETAIL TRADE

1961.....	\$46,211	\$2,872	6.2	\$1.84	\$0.11	\$1.95	
1962.....	48,740	3,255	6.7	\$1.90	.13	\$2.03	4.1
1963.....	51,416	3,544	6.9	\$1.97	.14	\$2.11	3.9
1964.....	55,132	3,703	6.7	\$2.06	.14	\$2.20	4.3
1965.....	59,166	3,935	6.7	\$2.13	.14	\$2.27	3.2
Percent change, 1961-65.....	-----	-----	-----	15.8	-----	16.4	3.9

TABLE 4.—*Year-to-year percent change in wholesale prices: All commodities, farm products, processed foods and industrials, 1940-66*

	Year-to-year percent changes			
	All commodities	Farm products	Processed foods	Industrials
1940	+1.9	+3.5	+0.5	+1.7
1941	+11.2	+21.3	+15.6	+7.5
1942	+13.0	+28.9	+17.3	+7.2
1943	+4.6	+15.8	+4.4	+1.5
1944	+0.7	+0.7	-2.2	+1.6
1945	+1.8	+4.0	+0.7	+1.3
1946	+14.2	+15.7	+27.1	+9.6
1947	+22.8	+20.4	+27.1	+22.0
1948	+8.3	+7.3	+8.0	+8.5
1949	-5.0	-13.5	-9.8	-2.1
1950	+4.0	+5.0	+4.3	+3.6
1951	+11.4	+16.4	+11.6	+10.4
1952	-2.8	-5.7	-2.3	-2.3
1953	-1.4	-9.3	-3.9	+0.8
1954	+0.2	-1.4	+0.6	+0.3
1955	+0.3	-6.2	-3.4	+2.2
1956	+3.2	-1.3	0	+4.4
1957	+2.9	+2.7	+3.8	+2.8
1958	+1.4	+4.4	+5.1	+0.3
1959	+0.2	-6.2	-3.6	+1.8
1960	+0.1	-0.3	+0.8	0
1961	-0.4	-0.9	+0.7	-0.5
1962	+0.3	+1.8	+0.5	0
1963	-0.3	-2.0	-0.1	-0.1
1964	+0.2	-1.5	-0.1	+0.5
1965	+2.0	+4.3	+4.1	+1.3
1966	+3.2	+7.3	+6.1	+2.1

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 5.—*Consumer prices, 1961-66*

[1957-59=100]

	Total CPI	Food	All services except rent	Rent	Commodities less food
1961	104.2	102.6	110.0	104.4	102.0
1962	105.4	103.6	112.1	105.7	102.8
1963	106.7	105.1	114.5	106.8	103.5
1964	108.1	106.4	117.0	107.8	104.4
1965	109.9	108.8	120.0	108.9	105.1
1966	113.1	114.2	125.0	110.4	106.4
Percent increase 1961-66	8.5	11.3	13.6	5.7	4.4

TABLE 6.—Unit labor costs, 1957-66

[1957-59=100]

	Labor cost per unit of output, man- ufacturing	Labor cost per dollar of real corporate GNP
1957.....	98.6	98.7
1958.....	102.2	100.8
1959.....	99.7	100.7
1960.....	100.6	103.2
1961.....	100.3	103.7
1962.....	100.4	103.3
1963.....	99.7	104.0
1964.....	99.7	104.5
1965.....	99.0	105.1
1965:		
February.....	98.9	104.5
May.....	98.9	105.3
August.....	98.6	105.3
November.....	99.9	105.4
1966:		
February.....	99.9	106.8
May.....	100.3	108.4
August.....	101.0	109.6
November.....	102.5	(1)
December.....	102.7	(1)

¹ Not available.

Source: U.S. Department of Commerce, Bureau of the Census, Business Cycle Developments.

TABLE 7.—Trends of capacity utilization, unemployment, prices, and hourly earnings, 1957-66

	Capacity utilization rate manu- facturing (percent)	Unemploy- ment rate (percent)	Consumer price index [1957-59=100]	Wholesale price index [1957-59=100]	Wholesale industrial prices	Average hourly earnings
1957.....	84	4.3	98.0	99.0	99.2	\$2.05
1958.....	74	6.8	100.7	100.4	99.5	2.11
1959.....	82	5.5	101.5	100.6	101.3	2.19
1960.....	81	5.6	103.1	100.7	101.3	2.26
1961.....	79	6.7	104.2	100.3	100.8	2.32
1962.....	82	5.6	105.4	100.6	100.8	2.39
1963.....	84	5.7	106.7	100.3	100.7	2.46
1964.....	86	5.2	108.1	100.5	101.2	2.53
1965.....	89	4.6	109.9	102.5	102.5	2.61
1966.....	91	3.9	113.1	105.8	104.7	2.71

Source: Economic Report of the President, Jan. 1967, pp. 236, 245, 253, 262, 264.

TABLE 8.—Advertising-sales ratio, 1962, and changes in wholesale prices, selected periods, 1947-66

[In percent]

	Advertis- ing out- lays per dollar of sales, 1962	Weights in whole- sale price index December 1962	Changes in wholesale prices			
			1947 to 1965	1957-59 to 1965	1957-59 to Decem- ber 1965	1957-59 to June 1966
1 Toilet preparations.....	14.72	0.355	21.6	4.2	4.8	6.6
2 Soap, detergents.....	12.55	.563	5.7	4.5	4.4	4.2
3 Drugs ¹	² 9.39	.859	-16.2	-5.6	-5.4	-5.5
4 Beer and malt.....	6.89	.674	38.0	0.9	1.6	1.4
5 Clocks and watches.....	5.45	.126	10.4	-4.2	-4.2	-3.0
6 Tobacco ³	5.28	.752	48.4	5.8	5.6	10.0
7 Wines, brandy.....	4.58	.103	-2.8	11.4	11.6	9.7
8 Confectionery ⁴	4.22	.099	20.7	-0.7	-6.6	-6.6
9 Cutlery, hand tools, hardware.....	3.28	.593	77.4	5.9	7.0	9.5
10 Grain-mill products ⁵	3.18	.449	3.1	13.3	15.3	22.8
11 Photographic equipment.....	3.11	.142	28.8	7.3	7.4	6.8
12 Canning ⁶	2.72	1.023	9.3	2.1	5.1	4.8
13 Appliances.....	2.48	.953	-3.6	-10.8	-11.2	-10.6
14 Bakery ⁷	2.48	1.397	48.2	7.9	10.4	12.4
15 Distilled liquor.....	2.18	.269	-3.3	-2.8	-2.8	-2.8
16 Tires and tubes.....	2.09	.533	34.7	-10.0	-8.9	-5.6
17 Paints and varnish ⁸	1.65	.312	36.5	5.4	5.9	6.8
18 Dairy products ⁹	1.57	2.594	27.5	8.5	11.3	17.0
19 Footwear.....	1.43	.786	43.2	10.7	13.8	19.1
20 Radio and television ¹⁰	1.37	.454	-17.0	-14.8	-11.5	-16.5
21 Household furniture.....	1.25	.957	37.5	6.2	6.7	8.9
22 Floor coverings.....	1.18	.228	34.9	-5.6	-6.0	-2.9
23 Knit goods.....	1.07	.082	-32.9	-8.4	-16.5	-20.4
24 Men's, youths' and boys' apparel.....	.97	1.182	11.6	8.7	10.1	11.3
25 Women's, misses and children's cloth- ing.....	.96	1.499	0.4	2.2	2.6	2.7
26 Motor vehicles.....	.74	3.923	53.7	0.7	0.5	0.7
27 Motorcycles and bicycles ¹¹	.67	.072	NA	-4.3	-4.2	-2.9
28 Meats.....	.56	3.579	6.1	0.8	12.1	8.6
29 Petroleum refining ¹²	.49	4.044	26.5	-4.1	-1.6	0.2
30 Sugar.....	.28	.383	24.0	11.0	12.8	11.0
Total wholesale price index.....	-----	-----	26.2	2.5	4.1	5.7

NOTE.—The price data used are indicated by the following footnotes.

¹ Drugs and pharmaceuticals.² 1961.³ Cigarettes, nonfilter tip, regular size.⁴ Candy bars; solid chocolate.⁵ Includes flour and flour base cake mix.⁶ Canned and frozen fruits and vegetables.⁷ Includes white bread, cookies and crackers.⁸ Prepared paint.⁹ Dairy products and ice cream.¹⁰ Television, radio receivers, and phonographs.¹¹ Bicycles.¹² Petroleum products, refined.

Sources: Advertising outlays per dollar of sales are from the Internal Revenue Service and published in Advertising Age, July 6, 1964, p. 59 and June 7, 1965, pp. 101-2 and U.S. Department of Labor, Bureau of Labor Statistics. Jules Backman, "Advertising and Competition", New York University Press, 1967.

TABLE 9.—Changes in consumer price index, December 1965–December 1966
(1957–1959=100)

	December 1965	December 1966	Percent increase
All items.....	111.0	114.7	3.3
Food.....	110.6	114.8	3.8
Food at home.....	108.9	112.6	3.4
Food away from home.....	119.9	126.3	5.3
Housing.....	109.4	113.0	3.3
Shelter.....	111.8	116.4	4.1
Rent.....	109.5	111.3	1.6
Fuel and utilities.....	108.1	108.4	.3
Household furnishings and operation.....	108.6	106.7	3.0
Apparel and upkeep.....	108.1	112.3	3.9
Men's and boys'.....	109.3	112.6	3.0
Women's and girls'.....	104.3	108.1	3.6
Footwear.....	115.6	122.9	6.3
Transportation.....	111.6	113.8	2.0
Private.....	110.1	111.7	1.5
Public.....	122.0	129.8	6.4
Health and recreation.....	116.6	121.0	3.8
Medical care.....	123.7	131.9	6.6
Personal care.....	110.0	113.7	3.4
Reading and recreation.....	115.4	118.4	2.6
Other goods and services.....	113.4	115.9	2.2

Source: Bureau of Labor Statistics.

TABLE 10.—Wholesale price indexes, by months, October 1965–January 1967
(1957–1959=100)

	All com- modities	Farm products	Processed foods	Commodi- ties other than farm products and foods
<i>1965</i>				
October.....	103.1	99.4	106.9	102.8
November.....	103.5	100.3	107.6	103.2
December.....	104.1	103.0	109.4	103.2
<i>1966</i>				
January.....	104.6	104.5	110.3	103.5
February.....	105.4	107.4	111.8	103.8
March.....	105.4	106.8	111.5	104.0
April.....	105.5	106.4	110.6	104.3
May.....	105.6	104.5	110.5	104.7
June.....	105.7	104.2	110.6	104.9
July.....	106.4	107.8	111.7	105.2
August.....	106.8	108.1	113.8	105.2
September.....	106.8	108.7	113.8	105.2
October.....	106.2	104.4	112.4	105.3
November.....	105.9	102.5	110.7	105.5
December.....	105.9	101.8	110.6	105.5
<i>1967</i>				
January.....	106.2	102.8	110.7	105.8

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 11.—*Wholesale Price Index, October 1964, October 1965, July 1966 and January 1967 (1957-59=100)*

	October 1964	October 1965	Percent change, October 1964- October 1965	July 1966	Percent change, October 1965- July 1966	January 1967	Percent change, July 1966- January 1967
All commodities.....	100.8	103.1	+2.3	106.4	+3.2	106.2	-0.2
Farm products.....	93.8	99.4	+6.0	107.8	+8.5	102.8	-4.6
Processed foods.....	101.7	106.9	+5.1	111.7	+4.5	110.7	-0.9
All commodities other than farm products and foods.....	101.5	102.8	+1.3	105.2	+2.3	105.8	+0.6
Textile products and apparel.....	101.4	102.0	+0.6	102.4	+0.4	102.0	-0.4
Hides, skins, leather and leather products.....	105.9	113.3	+7.0	122.7	+8.3	117.6	-4.2
Fuels and related products and power.....	96.6	99.4	+2.9	101.4	+2.0	102.2	+0.8
Chemicals and allied products.....	95.9	97.0	+0.7	97.9	+0.3	98.4	+0.5
Rubber and rubber products.....	92.1	93.4	+1.4	95.1	+1.8	95.5	+0.4
Lumber and wood products.....	100.3	101.6	+1.3	106.6	+4.9	102.3	-4.0
Pulp, paper and allied products.....	99.1	100.5	+1.4	103.2	+2.7	103.1	-0.1
Metals and metal products.....	103.8	106.3	+2.4	108.8	+2.4	109.4	+0.6
Machinery and motive products.....	103.0	103.9	+0.9	106.0	+2.0	103.3	-2.2
Furniture and other household dur- ables.....	98.6	97.8	-0.8	99.0	+1.2	100.5	+1.5
Nonmetallic mineral products.....	101.8	101.6	-0.2	102.7	+1.1	103.7	+1.0
Tobacco products and bottled bever- ages.....	107.6	107.7	+0.1	110.0	+2.1	110.3	+0.3
Miscellaneous products.....	100.0	111.2	+11.2	120.5	+8.4	121.2	+0.6

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 12.—*Average hourly and weekly earnings, manufacturing industries, 1955-66*

	Average hourly earnings			Average weekly earnings		
	Dollars	Year-to-year change		Dollars	Year-to-year change	
		Cents	Percent		Dollars	Percent
1955.....	\$1.86	-----	-----	\$75.70	-----	-----
1956.....	1.95	9	4.8	78.78	\$3.08	4.1
1957.....	2.05	10	5.1	81.59	2.81	3.6
1958.....	2.11	6	2.9	82.71	1.12	1.4
1959.....	2.19	8	3.8	88.26	5.55	6.7
1960.....	2.26	7	3.2	89.72	1.46	1.7
1961.....	2.32	6	2.7	92.34	2.62	2.9
1962.....	2.39	7	3.0	96.56	4.22	4.6
1963.....	2.46	7	2.9	99.63	3.07	3.2
1964.....	2.53	7	2.8	102.97	3.34	3.4
1965.....	2.61	8	3.2	107.53	4.56	4.4
1966.....	2.71	10	3.8	112.19	4.66	4.3
December.....	2.77	11	4.1	114.68	3.76	3.4

Source: U.S. Bureau of Labor Statistics.

TABLE 13.—*Spot market prices, 1966-67*

[1957-59=100]

	February 1966	October 1966	December 1966	Feb. 14, 1967
All items.....	113.8	103.7	102.8	102.2
Foodstuffs.....	101.9	100.1	98.6	97.6
Raw industrials.....	122.9	106.3	105.8	105.6
Livestock and products.....	120.7	97.4	94.9	94.4
Metals.....	147.3	128.4	125.3	124.2
Textiles and fibers.....	113.0	100.7	100.6	101.0
Fats and oils.....	109.5	102.5	96.4	92.6

Source: U.S. Bureau of Labor Statistics.

Chairman PROXMIRE. Thank you, Dr. Backman, for a very provocative and stimulating paper, and one that finds me in disagreement on many scores, although I must say you have made a very powerful case for your position.

There are a number of contradictions that appear here and I am sure that you can straighten many of them out. You make a strong case for a "tired" economy, and I think I can document that case in a couple of minutes here even more, not only a tired economy, but the kind of economy that seems to be close to a degree of price stabilization in the last few months.

I would point out to you, for example, that as you say, wholesale prices have been stable since October at 106.2 percent of the 1957-59 average. The Consumer Price Index went up from 114.5 in October to 114.6 in November to 114.7 in December, and then remained stable at 114.7 in January, so that that is most encouraging.

We had a dropoff in new orders for durable goods from \$25.3 to \$22.7 billion at an annual rate, in the most recent figure in January. We have had an increase at the same time, as you said, but a very, very sharp increase in manufacturers' inventories at exactly the same time when we have this dropoff in new orders.

We have a continued deterioration in new construction. It was \$72 billion in September; it is now down to \$69 billion. We have a dropoff in steel production though it has stabilized somewhat in the last couple of weeks, but it has stabilized at a substantially lower level than it was which is not encouraging for a dynamic, growing economy such as ours.

We have a sharp dropoff in the hours of work from 45.1 hours in September to 40.9 hours in January. We have a stabilization of unemployment that some people think is a satisfactory rate though I don't, and I think many other people don't regard 3.7 percent, 3 million people out of work, as satisfying, especially with all the emphasis we are trying to put on manpower training.

We have a very much slowed down rate of increase in manufacturer's investment in plant and equipment, which I think you point to. And we have a decrease in corporate profits, which I think is one that should concern us very much.

You put all these things together, and you find that there are almost no indicators that are pointing the other way, and you come in and tell us what we need is a tax increase, and restraint in fiscal and monetary policy as the solution for what you say is likely to be a cost-push situation in wages. I am puzzled as to this kind of conclusion.

Mr. BACKMAN. The question is not unexpected. Let me see if I can clarify my position. We have gone through a period now of about 30 years in which "compensatory fiscal policy" has been emphasized. I must confess that for many years I have been defining "compensatory fiscal policy" as a policy under which you spend more than you take in in bad times but in good times you spend more than you take in.

I think we have to look at the general level of the economy. We are talking about an economy in 1967 which the Council in my judgment mistakenly expects to average \$787 billion. Even if we reduce this estimate by \$10 billion, it is still a rather significant increase over last year. It is not an economy that has moved or is moving downward.

We are talking about an economy that was moving forward at a very frenetic pace through last summer. I think your summary of those figures is an excellent one. I agree with it. But the economy is still up in that stratosphere despite these weaknesses.

Now it would seem to me that at this level of economic activity, one could talk about a balanced budget. But I wasn't even talking about that. I am concerned about a \$15 billion deficit, because when we hear about the \$9 billion deficit, it is after the effects of the tax increase. And may I go a step further and point out that the deficit prior to the sale of participation certificates is even larger.

Now we are going to have to get that \$15 billion someplace, and what bothers me basically is this: It isn't a question of the surtax or nothing; it's a question of the surtax or something else. If we don't get part of this \$15 billion deficit through the tax route, how do we get it? Do we get it by a price rise? If we have a 1-percent rise in prices, that is \$7.5 billion. The economic costs of that kind of price rise, I think, are worse than the economic consequences of the so-called surtax.

By concentrating only upon the effect of a tax increase upon economic activity generally, and ignoring its effect upon the role of monetary policy and the other pressures in the economy toward price inflation, means that we only look at part of the picture. In fact, I think I have been one of the few outside of Government who has been calling attention to this leveling off and have been concerned about it. Nevertheless, I still believe that at this level of economic activity, with a war being fought, it should be paid for. We must pay the price somehow. I am prepared to pay it in the form of a tax increase.

Chairman PROXMIRE. Yes, but are you paying for it in the form of a tax increase, if many of us feel the tax increase may be counterproductive in terms of revenue alone. If you have a tax increase of \$5 billion at this time the psychological impact plus the very real impact of taking this much out of the economy could very well result in a lower, not a higher, amount of revenue.

Dr. BACKMAN, don't you feel that we should pay attention to the trend of the economy?

Mr. BACKMAN. Yes; as one factor.

Chairman PROXMIRE. I was one of those who voted against the tax cut in 1964, because I felt with an expanding economy, with unemployment dropping, with conditions improving, it was a mistake at that time for us to, what I thought would be overstimulate the economy. But, similarly, at this time when we are standing still and it seems to me moving down in many indicators, it would seem to be the worst time to increase taxes.

In other words, the important thing it would seem to me for this committee as an economic committee to pay attention to and for the Congress as a group of sensible men would be not whether the budget would be in balance necessarily, but whether the impact of fiscal policy and monetary policy in the economy would be appropriate in view of what we anticipate the state of the economy.

If you say the economy is sick, if you say you are worried about the economy, if you say you are one of those who called attention to

the difficulties in the economy, I don't see how at the same time you can say we should adopt policies that are going to make it a little sicker.

Mr. BACKMAN. Let me make this clear, Mr. Chairman. I don't think the economy is sick.

Chairman PROXMIRE. Maybe that is too strong a word, I would agree, but if you say that the economy is one which is tired—

Mr. BACKMAN. Yes, it is tired, it is advancing a little more slowly, and I think it should move along a little more slowly than it has. I am not concerned about the adverse impact of a tax rise on the economy to the same degree that you suggest you are concerned. I am concerned about that as only one factor, but I am also concerned about creating tinder boxes of inflation for which we must pay tomorrow.

Chairman PROXMIRE. Yes, but have we inflationary tinder boxes, or are we creating under present circumstances, when the pressure on prices seems to have abated from the overall demand situation, and when you have a real tinder box of a different kind? You have very heavy unemployment right now among minority groups. You have a situation in our cities where Negro teenagers, for example, are looking for work in large numbers.

You have a situation that has been documented again and again by the Secretary of Labor and by many other economists, showing that where you have pressure to hire people, because the economy is growing and developing and moving ahead, that under these circumstances, business is going to find ways of finding jobs for these minority groups, these people who are out of work.

Mr. BACKMAN. This is both true and false.

Chairman PROXMIRE. It is true in the sense that it has worked in the past, isn't that right, and it is also true in the sense that if the economy is not growing and unemployment is increasing, you are going to have a situation in our cities that this summer it could be really explosive.

Mr. BACKMAN. In the first half of 1966, despite an economy rising at a rate that could not be sustained, we still had 7 or 8 percent unemployment among these minority groups because it was impossible to absorb all of the unemployed merely by expanding the economy. At the same time there were major shortages of skilled workers. This is the area where retraining and education are so important.

Chairman PROXMIRE. Yes, but the area of retraining and education is something that the Government does maybe 5 or 10 percent of and private industry does maybe 90 to 95 percent of and private industry isn't going to do it unless they have a market to do it.

Mr. BACKMAN. But if we follow through completely on that suggestion, Senator Proxmire, last year, instead of having the great pressures we had, we would have probably blown the roof off of the economy in an effort to really pull the unemployment figure down much further.

Chairman PROXMIRE. It depends upon what time last year you are talking about.

Mr. BACKMAN. Let's talk about the early part.

Chairman PROXMIRE. I think you are right; if you are talking about the latter half of the year I don't think you are right. In talking

about the prospects for 1967, it seems to me that I take a different position.

Mr. BACKMAN. In the early part of the year we still had large unemployment among these groups, despite the high rate at which the economy was operating. I merely call attention to that to indicate that there are limits beyond which you can't solve this unemployment problem by stepping up the rate of economic activity.

Chairman PROXMIRE. Now let me get into something here with regard to the wage-price guideposts, because I have been a strong believer in this. I have argued many times on the floor of the Senate and around the country that the wage-price guideposts have been a great contribution, and you admit in the course of your testimony that they did hold down prices, although you seem to think there is some price that we pay in having had them.

Mr. BACKMAN. Pardon me, I think my testimony will show that I said that in the 3 years before we enunciated the truism involved in the wage-price guideposts, there was stability of prices, and in the first 3 years afterward, there was stability, but these were also periods of idle capacity and unemployment.

Chairman PROXMIRE. What I understood you to say was this. In the absence of guideposts, we would have had bigger increases in prices in these particular areas, but you didn't think they would have contributed very greatly.

Mr. BACKMAN. That is right, there would have been somewhat larger increases for some products.

Chairman PROXMIRE. I think that is an element, an admission, particularly in view of the fact that we were having something of a demand-pull inflation at that time.

In your summary you say "There is little value to a program which educates the public to believe that unit labor costs determine prices." I am certain that Gardner Ackley and Duesenberry and Okun would all disagree that unit labor cost determines price, only productivity determines wages, real wages can increase at a uniform annual rate, the general price level can be stabilized by controlling increase in labor costs. They don't make statements of that kind. This is a strawman.

I ask you to show me any place in here where they don't qualify greatly their references to wage-price guideposts saying this is only one part of stabilization policy. It is a limited part. It is an important part.

Mr. BACKMAN. Senator, I give the citations throughout my prepared statement. In every one of the Council's reports, the essence of the guideposts has been that if you can stabilize unit labor costs, you won't have a price rise. This is what they mean when they say "If you have an increase in wages and labor costs equal to productivity, you will have no change in unit labor costs, hence price stability."

This is what they mean when they say "If you get above average increases in some places, you must get offsetting below average increases in others." This is the essence of what they have been talking about for 4 or 5 years.

Chairman PROXMIRE. I want to call your attention to the qualifications later, but my time is up. Senator Percy?

Senator PERCY. If you want to carry on, you go right ahead.

Chairman PROXMIRE. No, thank you, Senator Percy; you may go ahead.

Senator PERCY. Dr. Backman, I would like to preside over "burial" of wage-price guidelines with you and just simply say "amen," because as I recall my economics some years back at the University of Chicago, the term I always heard my professors use was "other things remaining equal," and then they go on to some theoretical dissertation. I never found in the economy things did stay equal, and the price guidelines assumed a uniform condition in every part of the country, uniform demand for labor without any change. In a dynamic economy you have the forces and pressures of that marketplace which constantly have to respond, and in a totally and entirely different way. I, many times, would like to have just had a simple slide rule solution to wages. It is easy to figure 3.2. You wouldn't need management. You wouldn't need labor leadership. You would just need a clerk who could compute out what these increases should be each year. And I think the totally unrealistic concept we had there was that 3.2 was the magic formula that applied to everything.

It constantly pushed wages up to that level that didn't belong up there, and tended to hold down others that should have gone well above that, because of changing conditions.

I would like, however, to get your view on the previous testimony as to how you would stand on the establishment of a price-wage review board established by industries with a prior notification by any basic industry or any major industry or an industry that had a major impact on the economy, of 60 to 90 days before they could raise any prices, and what effect this would have on the economy.

Mr. BACKMAN. I think this is a highly unrealistic proposal. Your earlier illustration of meat is a good one. If we were to require pre-notification of 60 to 90 days or any other period, even if it's 2 weeks, the first effect on the part of customers would be to rush in and buy, so they could get the benefit of the lower price still prevailing.

The distortion such buying patterns could create are rather apparent.

Is this an area on which prior approval or prior notification is one that is desirable? I don't think it is. I think that the market power has been tremendously overexaggerated and I will tell you why.

Much of this reasoning and many of the conclusions are based upon our earlier postwar experience which was significantly affected and confused by the effects of inflation. Let me illustrate in an area about which I testified recently before another committee, the question of price leadership.

Up through about 1959, whenever any big company raised the price, they were followed by other companies and this was viewed as an indication, of what has been called tacit collusion. However, between 1959 and 1964, time and again large companies raised prices, and when other companies didn't follow, they were forced to rescind the increases. Now why were the leaders followed in the earlier periods? Because of market power? No. The main reason was a period of inflation.

During a period of inflation, everyone is anxious to raise prices because of increases in costs and other pressures to which they are subject and because demand is strong enough to make it possible to raise prices. However, most companies are waiting until Mr. Big does it, because they are afraid there may be adverse effects in terms of loss of market to other companies if they have any idle capacity.

And so the minute the leaders in an industry raise prices, other companies which were anxious to raise prices follow. In fact, there is ample testimony of this experience before many congressional committees. The Celler committee, for example, in 1949 heard the testimony from Jones & Laughlin officials that they were severely critical of the delay in raising steel prices, and when they were asked—I think it was \$6 or \$8 a ton at that time—was that adequate, they said “No, we would have raised it \$14 but we couldn’t.”

In other words, I think we must separate the effects of an inflation from the exercise of market power before we can really have a firm conclusion that it is market power that explains price leadership-followership.

Senator PERCY. Could I ask you this question? If you were a businessman, and you were establishing a price on a new product line, say bringing out colored television for the first time, and you knew that you could reduce your prices any time, but you knew under this system that you would have to give advance notice and justify any increase in price, then wouldn’t you tend to establish your price as high as possible, so that you wouldn’t get stuck, rather than as low as possible, which might be the tendency of a businessman trying to broaden his market for a new product?

Mr. BACKMAN. I think there would be that tendency, but it is subject to one extremely important qualification, and that is that he doesn’t have all of the freedom you suggest in setting his price. In other words, if he establishes the price too high under those circumstances, he is going to pay a penalty in loss of sales.

It seems to me there is inherent in the question the assumption he can set the price any place he wants. He can’t. He is forced by the pressures of the marketplace, not in the sense of classical economics in a perfectly competitive market, which has never existed except in textbooks, but in terms of the real pressures of the marketplace, including substitute products, the alternatives available, the competitors available, and today the other large companies, who would love to come into his industry if they found that a big profit was possible at this high price. In other words, the businessman doesn’t have the power to do what you have suggested he might do.

Senator PERCY. That has been my experience also, but I would like your verification of the faith in the pricing system of the marketplace.

Mr. BACKMAN. Senator Percy, I have participated in the pricing of many products and I can tell you I still have to find the situation where people sat around the table and in effect were able to set prices without regard to market forces. The usual questions are “What can we get, will customers pay these prices, what volume can we anticipate, what will our competitors do, what substitute products will be important, what imports will come in,” and so on and so on.

Senator PERCY. Do you know of any European countries where price-wage boards have actually worked and proved to be a constructive force in the economy?

Mr. BACKMAN. In every European country where they have had an income policy the price increases have been greater than in this country. This is true in England, West Germany and in other countries where they have attempted this. I have a couple of citations in my testimony.

Senator PERCY. I think it is also interesting to note that in recent years the index of durable goods, the price index has actually declined slightly. Now, these are certainly durable goods industries that have power and impact on the economy, and we have had a very strong economy, and yet their prices have actually declined. Doesn't this then in your judgment conflict with the thought that market power is the main reason why wages and prices rise before we have full employment?

Mr. BACKMAN. This is a very important observation, because the centers of so-called market power are largely in the heavy goods industries, and it is true that at the retail level the prices of appliances and other durable goods have not gone up as much as other prices, and in some years have gone down. There are at least a half a dozen years (1953, 1954, 1955, 1960, 1961, 1965) in the postwar period when durable goods prices actually went down. In 1965 and 1966, despite the rise of almost 5 percent in the Consumer Price Index, durable goods prices recorded practically no change.

Senator PERCY. Mr. Chairman, even though I may disagree with you occasionally, I would like to commend the Chair once again for bringing two very provocative witnesses, and for balancing out these meetings, so that we have a chance, in the same meeting, to hear opposing points of view, which I think is the essence of seeking the truth in these complex matters.

Chairman PROXMIRE. Thank you very much, Senator Percy, and I would certainly agree that Dr. Backman has done a fine job. I have some other questions for you.

You seem to refer, and Senator Percy did, too, to the so-called 3.2 percent guideline. I would agree that that was very badly misstated. It was grossly unjust. It was unfair. It couldn't be sustained, and I certainly wouldn't favor that at the present time.

On the other hand, you say in your prepared statement that:

By emphasizing long-term gains in output per manhour, and the accompanying rise in living standards, they encourage unions to seek increases large enough to equal the past rise in CPI and the rise in real wages. This combination means increase in labor costs of 7 percent or more and would result in a substantial rise in unit labor costs.

I would agree with your inveighing against a 7 percent guideline. I don't know anybody, though, who has ridden on that tired dead horse and said we ought to have a 7 percent increase, or made proposals that would result in that. Walter Reuther didn't, Goldfinger didn't, and certainly Alvin Hansen didn't. His position was that we ought to forget about the past, that if you try to catch up, you are in trouble, and that seemed to be the position supported by the labor people who are here.

Mr. BACKMAN. I suspect, though, Senator, that—

Chairman PROXMIRE. As far as the Hansen suggestion or guideline might work out. His suggestion was that you would take the productivity increase, let's say that is 2.8, add on to that the cost of living that we expected this year, we don't know what it would work out to if you made it on an escalator basis, but assume it is 2½, that may be wrong, that would be a 5.3 percent guideline.

Now you say the minimum labor is going to hit at with these militant unions this year is about 5½, and it is going to be higher. Well, on the basis of that analysis, I submit that a 5.3 guideline would be a very moderating influence in a cost-push situation, it would be very helpful and particularly because you could document that on labor's own terms.

You could point out that it includes labor productivity increase and the rise in the cost of living. It is at a moderate level. It seems to me it could have a very salutary effect in holding down this kind of pressure that would otherwise push up prices and enable us to have fiscal and monetary policies that might keep the economy growing better.

Mr. BACKMAN. Senator Proxmire, I must say that in all my experience in wage negotiations, which has included most of the major industries in this country, I have never heard of a settlement based on prospective increases in the Consumer Price Index, and ignoring past increases. I can tell you what will happen at the bargaining table.

"We made an agreement in June of 1965," Mr. Labor Leader will say, "and since then there has been an increase in consumer prices of let us say 5 percent. Now, the first demand is that we want to be made whole, that is we want a wage increase to compensate for the rise in the CPI since the last agreement."

Mr. Reuther isn't a good illustration because Mr. Reuther's workers have had no deterioration in real wages during this period. He has an automatic improvement factor plus a cost of living clause. Under this contract auto workers last year received an increase of 7 percent in wages alone, 7 percent. So they didn't experience any deterioration in levels of living. And if he comes into collective bargaining this year, and I have no way of knowing what is in Mr. Reuther's mind, of course, but if he comes in and says, "I want my 2.9 percent again plus cost of living," all he is doing in effect is saying, "I am going to get the 5 percent that Mr. Hansen or Senator Proxmire outline on top of the gains we have had under the old contract."

But you take all the unions which don't have cost of living clauses, and incidentally, very few do. They come in and the first thing they want to do is be made whole, and I will go a step further—

Chairman PROXMIRE. This is exactly the purpose of the guideline. In the absence of the guideline, you bet that is what they are going to do, and it is going to have considerable effect. It is going to be hard to resist. If you have the guideline, then you can say what we are trying to do is productivity plus the cost of living this year, and you don't have to do it prospectively on the basis of an estimate. You can do it through an escalator.

It is true that few of the contracts have the escalator now. They have had it many times in the past. It depends upon the particular economic situation. The escalator technique could be encouraged or discouraged. The policy of the executive branch now is to discourage it emphatically. I am not so sure that is right.

Mr. BACKMAN. I happen to agree it is a good idea to discourage labor cost increases of that magnitude. However, I will merely say what will happen in terms of the realities of collective bargaining, not theory.

There isn't an arbitration board, nor a fact finding board that won't start with a consideration of the deterioration in living levels resulting from the rise in the Consumer Price Index. They haven't ignored this factor in the last 20 years. And they won't start now.

We can improvise, we can issue numbers in Washington. The pressure on the union leaders from their membership, the desire on the part of industry to do what industrialists think may be right will all start with what is required to make their workers whole, and that is the expression that is used. What is required to restore the position to where they were.

I just participated in the hearings before the fact finding board in New York involving New York City and the policemen and firemen, and this was a critical factor. They want increases much beyond that amount. But the first point was "Look how much we have lost." And this is exactly what will be stated in negotiations throughout the country.

Chairman PROXMIRE. That is what you want to turn around. That is what I have been trying to get away from.

Mr. BACKMAN. But you can't turn it around.

Chairman PROXMIRE. You indicated that the Council of Economic Advisers have put all their emphasis on wage-price guideposts and have ignored these other factors. I quote to you a statement on page 119 when they say:

When demand outruns the growth of productive resources, prices and wages will rise, even in the most highly competitive markets. Indeed they may rise faster and farther than where large firms and long-term labor contracts give some degree of stability. That kind of demand-pull inflation can be held in check by fiscal and monetary policies which keep demand in line with productive capabilities. If labor markets are efficient, control of demand-pull inflation will not require restraints in demand that will lead to a high unemployment rate.

They always say monetary and fiscal are the most important elements of stabilization policy, but they do put emphasis on these relatively few industries but extremely important industries. What I would like to call your attention to are two things.

No. 1. What happened in this very period that you cite, the most important and interesting period, when you say that from 1959 to 1964 or 1965, when one company, the big company, would increase prices, the little boy didn't always follow and the big boy would rescind prices. Well, from 1962, 1963, and 1964, which is the period that I remember this taking place, it was because the Government followed a vigorous policy—

Mr. BACKMAN. Oh, no.

Chairman PROXMIRE (continuing). Of going after the big boy when he couldn't justify his price increase. The most spectacular example was in 1962 when Mr. Blough came to the White House and told the President he was going to increase steel by \$6 a ton, and the President used all the power he had to discourage him and won out.

I submit that that historic action by President Kennedy had a very profound effect on the relative price stability we had between 1961 and

1965, and we did have, and I think you would have to concede prices rose much less during that period than they had in an earlier period, although during that period there was some strain on resources.

We were moving ahead. We were expanding. We were growing. But because steel didn't have the push in prices, and because this affected, and the President followed up on many other prices and President Kennedy and President Johnson also worked hard to keep down prices of primary metals, they had some muscle there, I submit that this is part of the reason why prices didn't go up as they had in the past with more demand pushing.

Mr. BACKMAN. Senator Proxmire, early in my statement I call attention to the fact that "in a period of strong demand * * * wage-price guideposts could not bring about price stability," and point out this is one reason why you can't expect uniform increases annually as the Council postulates.

Chairman PROXMIRE. That is in your statement?

Mr. BACKMAN. No. 2. I did not include basic steel or automobiles among the almost 50 different illustrations I cited to the Hart committee of prices that were rolled back.¹

I took areas where the Government was not intervening, and also showed that during that period there were many illustrations of price cutting from list price in other industries where the Government was doing nothing, paper, office equipment, chemicals.²

I could run down the line. The few cases you have cited I don't consider roll-backs because of competition. I consider them roll-backs because the Government intervened. I agree they had an impact.

Chairman PROXMIRE. But that had an impact on the cost of living and an impact on prices.

Mr. BACKMAN. It didn't really have much of an impact on the Consumer Price Index.

Chairman PROXMIRE. Not only a technical impact on prices, but a strong psychological impact on the country and on labor union performance and on labor recognition.

Unions are very sensitive, especially with the Democratic administration, though they would be with any sympathetic administration, a Percy or Johnson or Romney administration, they are sympathetic to what the President of the United States calls for and asks for, especially when he can justify it on some kind of principle.

So to say, "Well, this happened and it was a mistake because there were some prices that had to be paid," I would say you would have to look at this. You would have to say that prices did not go up as you have said, and as I have documented in these areas, and have had some effect on the Consumer Price Index. Now, you will have to show to me what price we had to pay for this. Why did this hurt the economy? What was wrong with it?

Mr. BACKMAN. Senator Proxmire, let me make sure that we have the proper perspective.

First, I did not say that the Consumer Price Index would have gone up. A few years ago I made a study in connection with the

¹ See "Economic Concentration," hearings before the Subcommittee on Antitrust and Monopoly, pt. 2, March 1965, pp. 568-891, 890-895.

² Ibid., pp. 571-572, 896-898.

steel price increase in 1957 of \$6 a ton. I reached the conclusion that that had less effect upon the Consumer Price Index than either a 1-cent increase in the price of bread or a 1-cent increase in a package of cigarettes or a 1-cent increase in a gallon of gasoline or a 1-cent increase in a quart of milk.

At the same time, the Commissioner of Labor Statistics, after analyzing the same increase, announced that its impact upon the Consumer Price Index was, and I use his word "negligible," which, of course, was accurate. I think we have to recognize the nature of this Consumer Price Index.

The overall areas where steel or other products can have an effect are rather small. I agree with you that there may be some psychological effects. I wouldn't argue whether the overall Wholesale Price Index might have been up another point or so in the absence of the guideposts. I don't think it would have gone up much beyond that amount. But I do not agree that there would have been any perceptible effect upon the Consumer Price Index. I am not so sure about the restraint to which you refer in connection with the labor unions.

It seems to me that the 5-percent figure that emerged in the latter part of 1966 emerged despite the guideposts, and may I call attention to what is a fact; namely, that the largest departures from the guideposts took place not among the big unions, but by the relatively smaller unions. The building trades were a conspicuous illustration, despite various remonstrations from Washington and elsewhere. It continued to be an exception. And this I think is always the case.

There is an assumption inherent in the guidepost that if you hold Mr. Big either on the union line or on the price line, this automatically holds others. This is highly unrealistic.

Chairman PROXMIRE. I would certainly agree that it has only a partial effect, a limited effect. The effect on the Consumer Price Index you can show technically that that immediate increase in steel would not have been significant.

Mr. BACKMAN. That is right.

Chairman PROXMIRE. But on the other hand you can certainly also argue that this effect has a rippling effect, that when steel prices go up, appliance prices go up, automobile prices go up, and ultimately and eventually if you follow it through far enough, even if you disregard psychological and pattern price increases throughout the economy, disregarding that, it would seem to me logical that you could expect some significant increase in the cost of living.

Mr. BACKMAN. But let's take a look at that. The steel industry, to use that illustration, accounts for about 2 percent of the economy. Let's say we have a 5-percent increase in steel prices. I haven't heard an increase of that amount proposed, but let's assume it is. A 5-percent increase is equal to one-tenth of 1 percent of the economy. Now, what do you want to do, double, triple, or quadruple its effects?

Chairman PROXMIRE. No, I think it would increase many, many times more than that before the effect is ultimately felt throughout, when you consider the add-ons and the percentage. My own experience in business was that we always determined our prices on the basis of cost.

Mr. BACKMAN. So what do you do, double the increase?

Chairman PROXMIRE. The increase grows many times.

Mr. BACKMAN. Do you double the increase? Do you want to take it five times? We are talking about extremely small numbers, even if you take multiples which in my judgment aren't realistic.

Chairman PROXMIRE. And also I would say that the actual increase the steelworkers get and the auto workers get has an influence, maybe not immediately.

Mr. BACKMAN. I agree with that.

Chairman PROXMIRE. It has a significant influence in either the wages that are set or the compensation that is paid in other industries.

Mr. BACKMAN. I agree with that.

Chairman PROXMIRE. So I think from that standpoint there is an element of instability in excessive settlements that can be favorably influenced by Government policy to indicate what guideline will be fair and equitable throughout the economy.

Mr. BACKMAN. I agree that they have an effect, and therefore what are we going to say when other unions find that last year the auto-workers received an aggregate increase of at least 20 cents an hour, which happened to be roughly 7 percent of their wage rate, as I said earlier, or between 5 and 6 percent of their total labor cost. That is the actual increase in wages, wage rates in the automobile industry last year.

Chairman PROXMIRE. Let me say this: That when Reuther came before us, he had some interesting counterargument on that. It is very difficult when we have a highly productive industry like automobiles, where you have a basis for paying high wages, and yet achieving better profits, especially if it is expanding as it was last year.

Mr. Reuther said that he tried hard to negotiate in a situation, in which the productivity increase would be shared directly by a price reduction and a profit sharing with the workers, and a distribution to capital on a one-third, one-third, one-third basis. He wasn't successful in getting that adopted.

Mr. BACKMAN. But he didn't offer to forego the 2.8 percent productivity increase for that cut in prices.

Chairman PROXMIRE. You select the toughest kind of a case when you take the automobile industry, because it is hard to roll back prices. It is hard to get prices reduced. I hope that the action by American Motors is precedent setting.

Are you through, Senator Percy?

Senator PERCY. Have you one more minute?

Chairman PROXMIRE. Oh, sure.

Senator PERCY. This is a subject of great interest to me, Mr. Chairman. I have been concerned, Doctor, about the proposed tax increase as a depressant, on a potentially soft economy. But I was quite interested in a comment made by Ralph Lazarus, a member of the Business Council. He is the chairman of their domestic economy section, and as one of our largest retailers in the country knows a great deal about consumer buying habits.

He maintains that the tax increase will take dollars out of people's pockets, and therefore cause them to cut back their purchases, which would almost appear to be a axiomatic and automatic. He maintains

this: That in his judgment retail sales are based more on credit than on present dollars, and credit is based on confidence, and that confidence can be destroyed by a number of psychological factors. He feels that if the people of this country, who are some of the best informed people in the world, see that there is a huge deficit, a big war to pay for, and the Government fails to do what it should, particularly now that the President has said do it, that it could be that there would be only one conclusion they could come to as to why the Government wouldn't do it.

They would be fearful of the future, fearful of the economy, and therefore this destruction of public confidence and of the credibility of its own Government for doing something that it knows it should do, might be more of a depressant on retail sales than it would be if you just went ahead and did what you should do and raised taxes.

Now, this caused me to go back once again and let me take another look at this whole tax increase picture and I have asked Mr. Lazarus to write me in greater detail so that I can discuss it with the chairman, whom I know is earnestly seeking a right answer on this, also.

Would you care to comment?

Mr. BACKMAN. I think that is an interesting reaction in terms of alternatives. Despite the fact that it would support my position, I don't think I can go along with it completely. The history of retail sales is one of close relationship to consumer disposable income with temporary aberrations, for whatever the psychological forces may be, and when I say temporary, it might be 3 to 6 months. The reason why economists are concerned about any rise in taxes is that disposable income after taxes would be a little less and therefore the amount that could be bought presumably would be a little less.

On the other hand, if this reduces the pressures on the money markets because that \$5 billion must be obtained in some way—it is not the \$5 billion or nothing, it is the \$5 billion or something. If the government must come into the money market to borrow another \$5 billion and create pressure on interest rates, the peak of which I think already has been seen, then this also costs the consumer something. So I think one must look at the whole picture.

I am inclined to feel that a continuation over time of large deficits without doing something about it in a period even like 1967, can undermine confidence. You have to say to yourself, if the Government can't come closer to paying for the things it must buy, when we have a gross national product of \$770, \$780 billion, when are we going to do it? And I think the answer under those circumstances almost becomes it looks like never, and if it is never, then you can have a serious impact on confidence.

Chairman PROXMIER. May I just ask you, Mr. Backman, if it isn't true, under the circumstances, if the economy is tired and there is slack in the economy, resources available, people looking for work, what you simply do is to finance that \$5 billion by open market operations by the Federal Reserve Board. In other words, to put it bluntly, the Federal Reserve Board buys \$5 billion worth of securities. I would agree that that would be the worst possible kind of—

Mr. BACKMAN. That is the most inflationary approach.

Chairman PROXMIRE. In a tight economy it is inflationary, but in a slack economy it is not inflationary, and it doesn't increase interest rates, and it is something that can be done, and I am not sure that this wouldn't be the prescription, depending on the status of the economy.

Furthermore, if you talk about inflation, what is going to happen to these taxes? No. 1, the increase in the corporation income tax is going to be pushed onto the consumer to some extent. Certainly the increase in the corporate income tax in the regulated industry is going to be completely pushed onto the consumer, which is going to increase his cost of living and in other industries to a lesser extent but to some extent. It increases the cost of living of the stockholder, too, incidentally.

In the second place, unless we want to go to jail, we have to pay our taxes, and that is part of the price of living, to pay our taxes, so our cost goes up. I submit, I think you probably agree, the most desirable thing, if we can do it, is to cut spending.

Mr. BACKMAN. That I would agree with completely. I would say that a cut in spending is the No. 1 approach. I can't identify where it can be cut, but out of \$135 billion, there must be some things we can defer, whether it be in a highway construction program, the farm area, or be in any of the other areas where many billions go out.

This would be my first choice.

But let me note, Mr. Chairman, that the effect of a cut in spending is almost exactly the same as the tax increase in terms of narrowing the spread of how much the Government is contributing to the economy.

Chairman PROXMIRE. That is right.

Mr. BACKMAN. So I am happy to see you agree that if we do something in this area we can do it despite the prospect of a leveling off in the economy. I don't like the word "slack," because it implies a whole lot more than what you and I are talking about. I think slack to most people means large amounts of idle resources. What we are talking about is a small margin below the top, a relatively small margin.

We are in a war. We have costs in connection with this war. We must pay for it in some manner and it seems to me that the American people are willing to pay for it.

Do I like a tax increase? Not personally. But I am afraid that this isn't the test. The test is how long can the Federal Government go along in the red at \$10 billion, \$15 billion, or \$20 billion a year even at this level of economic activity?

I think we have become over-preoccupied with whether the production index is going to go down several points. I am afraid I am stuck with the recommendation of a tax increase, unless we can work out a large cut in expenditures or unless a significant downturn takes place.

Chairman PROXMIRE. Thank you very, very much for a most stimulating presentation. You certainly have fielded these questions beautifully.

I would like to ask unanimous consent that a letter by Seymour Harris in the Washington Post pertaining to our hearings, and our monetary policy especially, be included in the record at this point. (The letter referred to follows:)

A Communication¹

(The author of the following letter is Chairman of the Department of Economics of the University of California at San Diego, and a former adviser to President Kennedy.)

IN CALENDAR YEAR 1966 the Government did not introduce a general tax increase. But it was concerned over the large military outlays and inflationary pressures. Hence early in the year the government acknowledged that the stimulation of the economy as required in 1961-65 was no longer necessary. By removing \$9 billion from the economy in early 1966 through new taxes and acceleration of collection of some taxes; and in addition through the later suspension of the Investment Credit, the Government showed it was aware of the need of restraint.

In the first quarter of 1966 a number of outstanding economists urged the Government to introduce a general income tax rise as an anti-inflationary move. In January, Walter Heller suggested a temporary tax increase. At a Chamber of Commerce meeting of February 9, Paul Samuelson proposed a tax increase as well as other anti-inflationary measures. In conversations with the press afterwards he still seemed hesitant, however. Arthur Burns also expressed disapproval of anti-inflationary policies; but did not at this time suggest a general tax increase. In February the Chase Manhattan Bank and the New York Reserve Bank, though critical of anti-inflationary policy, did not propose an anti-inflationary tax increase. The emphasis of the more conservative elements was a reduction of spending or a more restrictive monetary policy rather than a rise of taxes.

IN A LATE FEBRUARY 1966 column, Hobart Rowen of The Washington Post welcomed Samuelson into the tax-rise camp, but complained of the silence of the others of the New Economics school. Soon after the New York Reserve Bank jumped aboard the tax rise caravan. By March the Executive Director of the American Bankers Association joined the tax brigade. By March 9, 1966, Murray Rossant of the New York Times welcomed as supporters of additional taxes, Heller, Samuelson, and Tobin, three of the top economists in the country and as knowledgeable in this area as any economist. But the orthodox business economists still tended to favor spending cuts rather than tax rises. Burns was now ready to accept a tax increase as well as push for reduced spending.

In March Rowen questioned 30 economists. Twenty-two urged a general tax rise. The New York Times also joined in the clamor for a tax rise. In May, 40 percent of the economists questioned approved a general tax rise; by late November only 12 out of 52 (23%) were for a tax increase.

Apparently March was the peak month of acceptance to tax policy as an anti-inflationary weapon. Now Heller would only get ready for a tax increase if needed; and Samuelson was worried that a very strong deflationary policy would be a mistake. Burns, Cary Brown, Buchanan and R. A. Gordon, however, still supported tax increases. Business Week still favored a tax rise as the best of three alternatives. And on March 22, Senator Jacob Javits would raise taxes modestly.

IN APRIL, the bankers who spoke out still seemed to be for tax increases and Samuelson in late April still adhered to the tax-anti-inflation view.

But defections were beginning at this time. Leading indicators increasingly began to point downwards. The Times reported on April 27 that the economists were turning against tax policy as an anti-inflationary weapon. The Administration had waited too long. Samuelson still supported a tax rise in late May but seemed to be wavering. Rowen now (April 27) reported that only some liberal economists were for tax increases, whereas labor, business and politicians were now opposed. It is of some interest that none of the Treasury's panel of 25 outstanding economists at their June meeting with the Secretary urged a rise of taxes. Apparently the signs of economic deterioration and the political

¹ Reprinted from Washington Post, Feb. 19, 1967.

difficulties of getting a tax bill through expeditiously resulted in a loss of enthusiasm.

It was clear that the adherents of tax increases were deserting in the second quarter of 1966. The President's Business Council in May seemed to be 3-1 or 2-1 against a rise of taxes.

RANKS OF THOSE favoring tax rises would have been depleted much more had not the Fed introduced a dear money policy which began to bite in May 1966, and its extent not anticipated nor even wanted by the Fed. The bankers now largely joined the tax increase group. They much preferred a tax increase which would allocate the burdens on the whole population to a severely restrictive monetary policy, which especially threatened them.

At various times the Republican leadership expressed views on anti-inflationary policy. As a rule they urged restrictive monetary policy and reduced federal spending. Congressman Melvin Laird speaking for the Republican Conference, in mid-April espoused a cut in spending; but not a rise of taxes. Senator Javits in May still was for the tax increase as was Dirksen in July, though reluctantly. A poll of Congressmen late in 1966 revealed 80 percent against a tax increase.

It was not easy to get the proper mix of monetary and fiscal policy. With monetary policy highly and dangerously restrictive, the Treasury was most hesitant in pushing through large tax increases in the last 8 months of 1965. The movement of leading indicators pushed the Treasury in the same direction.

ONCE MONETARY policy had eased greatly the Treasury could recommend to the President a tax increase though one that might be postponed or withdrawn if the economy faltered in the first half of 1967 or even later.

The Treasury was up against a mass of uncertainties as was almost everyone else. How much would Vietnam expenditures rise? How much would prices rise in response to wage escalation, reduced increases in productivity, and general reduction of excess capacity? How to weigh the decline suggested by the leading indicators against the uncertain rise of military outlays?

Government pronouncements reflected these uncertainties. Late in 1965 there were rumors from Paris that Secretary Fowler favored a rise of taxes. In February Fowler was considering all alternatives but emphasizing tax policy. But at the Joint Economic Committee hearings he would not press down on the brakes vigorously. He hoped that the Congress would be ready for a tax increase if needed. By March, Fowler announced that a modest tax rise may be necessary. The President apprised of the direction of the Leading Indicators in the latter part of March, was not convinced of a need of a tax increase. Much would depend on the spending of the Government. Fowler also wanted more data. A few days later the President would accept a rise of taxes if more restraint was needed. He might even ask for a tax increase in April if adequate economies were not to be achieved. In May Mr. Ackley agreed that a temporary tax rise may be necessary; but he would wait. And to Fowler the situation was not clear. Should the deficits rise greatly and prices and demand continue to rise, Arthur Okun of the Council feared that a rise in taxes would be triggered. The economic prospects still seemed uncertain to the President and the Secretary of the Treasury in June. But August the Treasury seemed more receptive to a tax increase as a means of achieving a better mix of monetary and fiscal policy. Ackley in August would reduce interest rates and increase taxes.

A VIEW HELD in some quarters was that had the Government introduced a general anti-inflationary tax policy in early 1966 many of our 1967 problems would have been solved. But there were serious obstacles. Not only the Congress but the public also were heavily against a general tax increase. The Congress favored a cut in spending at home which was not to be achieved. In this same period the financial groups stressed monetary rather than fiscal policy. Had the Government put a tax program into the works in late March (say) then assuming acceptance by the Congress by June-July—a bold assumption indeed—then a tax increase on top of the dangerous monetary situation might well have greatly damaged the economy. The only safe thing to do was to introduce a tax bill once the Fed had shown an inclination to end its costly restrictive monetary policy and also to ask for a tax increase—as it did in early 1967—that would be recalled should the economy falter.

In the light of the great advances in 1961-1966 in GNP, stability, employment, unemployment, standards of living, growth of assets both for business and the family—the disequilibria in 1967 which Senator Javits and others emphasize seem

rather unimportant. The great mistake of 1966 was the costly monetary policy, a setback for which the Independent Fed, not the Government, will have to assume responsibility.

The error was to introduce a dear money policy in December, 1965 without the cooperation of the Government. Had the Government, without a guarantee of monetary ease—which they could not get—have introduced a general income tax rise 1966, then the health of the economy would have been jeopardized. It would take time, even if the Fed cooperated, for an easing to have its impact. In the meanwhile two potent weapons would have helped deflate the economy. The lag in effects of monetary changes is evident in a decline of 15 out of 23 Leading Indicators in October and 15 out of 19 in November, 1966.

SEYMOUR E. HARRIS, San Diego, Calif.

February 16, 1967.

Chairman PROXMIRE. This concludes the hearings this committee will hold on the President's Economic Report. We will have a number of other hearings this year, but this ends our formal public review.

The Joint Economic Committee stands adjourned.

(Whereupon, at 12:25 p.m., the committee adjourned.)

