

2. The wage-price guideposts are based on sound and fundamental economic principles, although the 3.2 percent guide for average annual wage increases set by the Council of Economic Advisers in 1964 is not wholly noninflationary.

I think that this point is not recognized, even by a good many economists. So, even if average wage increases were held to 3.2 percent, we would still get some upward peak in the general price level.

(a) Part of the increases in average hourly labor compensation, and in real product per man-hour in the private economy, is due to relative shifts of workers from lower paying to higher paying occupations and industries. Since these increases have been obtained through shifts, they are not available for increasing wage rates in given occupations and industries.

The farm-non-farm shift alone has added about 0.3 percentage points to private economy productivity in recent decades, and I have estimated elsewhere that probably at least half of a percentage point of the productivity rise has been due to all shifts. This part should not be included in the noninflationary guide.

(b) The sharp increases in farm productivity, which are part of the 3.2 percent, have not been fully passed on to consumers in relative price declines of farm products due to governmental farm price support programs. Hence, a wage guidepost based on productivity in the entire private economy, including agriculture, tends to have an inflationary bias for this reason.

(c) Specific allowance is not made in the Council's formula for changes in capital productivity, and in the probable or desirable rate of return on capital.

In an article which Professor Sato of the University of Hawaii and I wrote for the December 1963 American Economic Review, we demonstrate mathematically that real average hourly labor compensation can go up by more than the increase in so-called labor productivity to the extent that the rate of return on capital rises by less than capital productivity or, conversely, that real average hourly earnings can go up by less than productivity to the extent that the rate of return on capital rises by more than capital productivity (weighted by the ratio of nonlabor to labor income).

I might say that over the cycle, during the expansion phase, as profits rise from a below normal rate of return to a normal rate of return, this increase is greater than the rise in capital productivity so that real average hourly earnings usually rise by less than productivity. As Mr. Sheahan noted in his book, real average labor compensation did rise by something less than the guidepost from 1961 to 1965 for this reason. However, secularly, from peak to peak over a number of business cycles, we have the reverse effect historically; that is, the rate of return on capital has shown no particular trend, whereas capital productivity has risen, and this has tended to augment the rise in real average hourly labor compensation compared with productivity by about 0.2 percentage points a year.

(d) In point of fact, even when average wage increases were within the 3.2-percent guideposts in the early 1960's, there were modest increases in the general price level as measured by the Consumer Price Index or the implicit price deflator for the private GNP, slightly more than 1 percent, which I think bears out the theoretical point I make that 3.2 actually is not wholly noninflationary.