The Heritage Foundation Backgrounder

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AN ANALYSIS OF THE CARTER ANTI-INFLATION PROGRAM

THE ISSUE

One of the few sounds that has been heard above the rumble of rising prices is the angry cry for an inflation policy. The past redistribution of wealth and the promise of future income distortions have prompted a unanimous and relentless clamor for action. President Carter's response to the call was presented October 24, 1978, in the form of voluntary wage and price controls and government restraint.

Even before the announcement, the program had generated considerable criticism from both labor and business leaders. Many are skeptical about the effectiveness of a voluntary program. Some believe that "voluntary" is merely a necessary prelude to mandatory.

The Administration itself does not hold a great deal of hope for the effectiveness of the program. Although the official target is a 1.5 percent cut in the inflation rate, a more realistic figure is one-half of one percent.

Inflation promises to be a most redoubtable foe. Next year's major wage contracts, in trucking, auto industries, and oil, among many others, threaten to boost the wage-price spiral into orbit. The Federal Reserve has persistently exceeded its stated money supply targets. The decline of the dollar, itself in part inspired by inflation, has contributed to the decline in purchasing power through higher priced imports. The dismal productivity performance, pushing up unit labor costs, promises to exert even more upward pressure on prices.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

BACKGROUND

The currently voluntary wage and price controls are actually Phase II of the "deceleration" program announced last April. In that version, business and labor were asked to hold increases below the average of the previous two years. The Administration, in an attempt to lead by example, limited government white collar increases to 5.5 percent. Promises to limit budget deficits and inflationary regulations were also part of the package.

Enforcement was practiced through the gentle art of suasion, or jawboning. As attested to by the current situation, the "deceleration" program was a failure.

THE PRESENT PROGRAM

The present voluntary program, retroactive to October 1, calls for annual wage increase ceilings of 7 percent. This standard, applied to executive, union, and non-union pay, also includes fringe benefits. Cost-of-living adjustments would be considered pay increases and are subject to the guidelines. Multi-year contracts must average no more than 7 percent a year. Existing contracts are excluded. Union wage contracts above 7 percent are permissible if accompanied by work rule changes which reduce costs. Those earning less than four dollars an hour will be exempted from the stricture.

The package also contains a "Real Wage Insurance" proposal designed to make the wage guideline more palatable. Should the inflation rate exceed 7 percent, workers who have accepted wage contracts of less than 7 percent would receive the difference between the inflation rate and the 7 percent standard in tax rebates. This proposal, however, must first obtain congressional approval.

Prices, while not tied to a specific figure, are to be held at least one-half percentage point below the 1976-1977 average increases. This is very similar to the Phase I guideline. In practice, this will limit increases to a 6 to 6.5 percent range.

Those firms which benefit from substantial cutbacks in labor settlements are expected to cut prices by more than one-half percent. Firms facing oppressive costs will be permitted to increase prices accordingly, but profit margins are to remain the same. There is, however, a 9.5 percent ceiling, on each product, regardless of cost.

The Council on Wage and Price Stability will monitor developments on a day-to-day basis. There will also be periodic reviews

of large corporations. To carry out these tasks, a staff increase of 100 to 200 is required. Many of these have been drafted from existing agencies. The 400 largest corporations also have been requested to make available to the Council on Wage and Price Stability weighted indices of all manufactured profits. This request is enforceable by subpoena.

Enforcement of the voluntary standards is in the hands of the Office of Management and Budget. This will also necessitate a staff increase. Firms bidding on federal contracts over five million dollars, must demonstrate, in advance, that they are operating within the guidelines. Offenders are expected to be hit by a loss of federal purchases and construction contracts. The OMB controls purchases of $80 billion. The White House is also expected to use the power of public censure to promote compliance.

An example of the type of pressure that will occur was reported in the Wall Street Journal (October 20, 1978). To ensure sufficient resistance to the upcoming Teamsters' contract negotiations, the ICC, at the Administration's behest, has warned trucking firms that cost increases may not necessarily be passed on in higher rates. On the labor side, the Washington Post (October 24, 1978) reported that the Administration is studying alternative methods of computing wages paid to privately-employed labor working on federal projects.

A less controversial aspect of the program is President Carter's proposal for government restraint.

The Administration has pledged to minimize the inflationary effects of government regulation. To accomplish this, a "Regulatory Council," composed of inflation specialists and representatives of selected independent agencies, such as OSHA and the EPA, has been established.

The program also includes a plan to limit the 1980 budget deficit to $30 billion. The proposed 1979 deficit is an estimated $40 billion. An additional element is a partial freeze on hiring. No new positions are to be created and only 25 percent of existing vacancies are to be filled.

ANALYSIS

The Administration's plan to limit the role of government promises to have a positive impact on inflation. Barry Bosworth, director of the Council on Wage and Price Stability, estimates that regulation accounts for three quarters of one percent of the current inflation. An evaluation of the inflationary aspects of future regulations is a step in the right direction.

The promise to cut the budget deficit, while still only a promise, bodes well for the future. It implies less government spending and will permit the Federal Reserve to pursue a more

restrictive monetary policy. However, the proposed "Real Wage Insurance" might, if enacted, have a significant effect on the size of the deficit. Rebates, if the inflation rate exceeds 7 percent, could be substantial, particularly since federal workers, now limited to wage increases of 5.5 percent, are to be included.

The outlook for the wage and price controls is not so optimistic.

Wage and price controls function, primarily, by squeezing profit margins. Increased costs are not passed on in higher prices, but rather absorbed through a decrease in profits. The objection to the voluntary, or any future mandatory wage and price controls is that by squeezing profits, controls endanger the future of the economy. Price increases are not eliminated under this policy, merely postponed. Wage and price controls also unfairly and inaccurately cast business and labor in the role of the originators of inflation.

PROFITS

Profits perform a critical and vitalizing function in our economy. When retained, profits finance expansion and research. When distributed, profits offer inducement for investment and, consequently, growth. The prospect of diminishing profits threatens not only the return to corporate shareholders, but also the degree to which our economy can expand.

The imposition of wage and price controls is, particularly at this time, a dangerous policy. Profits are, and have been for several years, below their historical post-war levels. Furthermore, the current reports dramatically exaggerate the true level of profits. Finally, due to the nature of the inflation process, prices lag behind cost increases.

HISTORICAL LEVELS

There are a variety of conflicting theories to explain the recent decline in secular prices. There is, however, no dispute that profits have indeed fallen. Profits, as a percentage of national income, exceeded, sometimes substantially, the 10 percent level in every year from 1946 through 1969. Since that time, profits have never surpassed 10 percent. In fact, the percentage sank as low as 7.5 and 7.6 in 1974 and 1975 respectively. (See chart on page 5.)

The seriousness of the situation is actually understated in both government-compiled statistics and corporate earnings statements. Standard accounting practices fail to adequately compensate for the effects of inflation on capital equipment replacement and the cost of inventories.

CORPORATE PROFITS AS PERCENT OF NATIONAL INCOME

Year	Yearly Average
1945	...
1946	9.2
1947	11.4
1948	13.3
1949	12.7
1950	14.2
1951	14.0
1952	12.4
1953	11.8
1954	11.6
1955	13.6
1956	12.4
1957	11.6
1958	10.2
1959	12.2
1960	11.4
1961	11.0
1962	12.0
1963	12.3
1964	12.9
1965	13.6
1966	13.3
1967	12.1
1968	12.0
1969	10.6
1970	8.5
1971	9.0
1972	9.6
1973	9.3
1974	7.5
1975	7.6
1976	...

Source: *Business Conditions Digest*
September 1976

George Terborgh, in a study for the Machinery and Allied Products Institute, has found that the reported $77 billion in profits for 1977 was, in real terms, only $43 billion. To arrive at this figure, Terborgh adjusted the rate of depreciation to more closely reflect the cost of replacement. He also increased inventory consumption charges from historical to current costs.

Perhaps even more distressing is Terborgh's calculation of the value of retained earnings. Based on 1972 dollars, retained earnings declined from $28 billion in 1966 to $7.9 billion in 1976. At the same time, real GNP in 1972 dollars increased from $981 billion to $1.27 trillion.

The profit distortion is further exacerbated by the federal tax system. The effective rate on real profits, as determined by the Terborgh study, has increased from 42 percent in 1966 to 56 percent in 1976. The result is even less real profits for retention and distribution.

Another factor constricting profits is the inflation process itself. Demand pull inflation is transmitted initially through the cost of raw materials, then labor, and finally prices. Firms, which respond to excess demand by first increasing output, drive up the cost of raw materials and labor. These costs are then later reflected in prices. Higher prices prompt cost-of-living increases and the wage-price spiral is under way.

The essential element is that most firms do not anticipate rising costs but rather react to them with a lag. A wage and price freeze will leave many firms with cost increases already incurred but not yet reflected in prices.

The immediate future brings with it even more pressure on profits. The exclusion of already existing contracts from controls, when coupled with the expectations of future inflation, promises to promote substantial cost-of-living increases. Wage contracts at large companies, settled in the first six months of 1978, were at a 10 percent annual rate. These contracts, in turn, serve as models for 1979 negotiations. In addition, many wage contracts overestimate the rate of productivity, thus pushing unit labor costs higher than expected. President Carter has rejected suggestions that the January increments in the social security taxes and minimum wages be postponed. These developments cloud the dismal profit picture even further.

Ironically, the Economic Report of the President for 1978 states that a purpose of the Administration's tax proposal was to increase after-tax profits and spur investment. The recent tax bill sent to the President contains several provisions to assist business and boost capital spending. The need for more capital spending had been a constant theme among businessmen, politicians, and the press

in the past few years. Yet with the wage and price controls, the Carter Administration abandons this target and instead follows a completely contrary course.

The Administration's about-face is both unnecessary and ill-advised. Wage and price controls will at best only delay inflation. The oft-repeated dictum that "wage and price controls treat the symptoms, not the disease" is true.

(A study by Robert L. Schuettinger and Eamonn F. Butler, Forty Centuries of Wage and Price Controls, to be published by The Heritage Foundation in November 1978, chronicles the history of wage and price controls from ancient China to the present. Some common characteristics seem to be shortages, black markets, and occasional political upheavals.)

CONCLUSION

Inflation is, above all else, a monetary phenomenon. Continually rising prices are caused by excessive increases in the money supply, whether inspired by expansive or accommodative Federal Reserve policy. The cure, therefore, lies in following a restrictive monetary policy.

Adherents of the cost push school of inflation claim that monopolies and labor unions are the source of inflation. That implies a certain degree of power. The question is, if these monopolies possess such power, why haven't they exercised it earlier? It would be a most irrational decision to postpone achieving the optimal price or wage.

Furthermore, there is no evidence to indicate that business or labor unions have recently gained, or are now gaining monopoly power. This makes it doubly difficult to ascribe inflation, defined as continuously rising prices, to monopolies constantly pushing up costs.

An unfortunate by-product of this theory has been the widespread popular belief that business and labor are the perpetrators of inflation. The use of wage and price controls not only encourages this misconception, but also diverts attention from the true source of inflation, the government.

President Carter's wage and price control program is based upon a cost push theory of inflation. To attempt to cure a demand pull inflation with cost push tools is similar to performing surgery with a hammer rather than a scalpel. The most probable result will be a bludgeoned patient.

The Carter Administration is hoping for a one-half percent decline in inflation. This can be achieved, at least on a temporary

basis, but only at an enormous cost. To jeopardize the future of the economy for a slight, fleeting, recision of the inflation rate is a dangerous and desperate policy.

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