Drastic measures

A history of wage and price controls in the United States

Hugh Rockoff

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1. The debate over controls

> The seemingly obvious remedy for the wage–price spiral is to regulate prices and wages by public authority. In World War II and the Korean War in the United States demand pressed strongly the capacity of the labor force as well as that of the industrial plant. . . . During both conflicts the wage–price spiral was successfully contained by controls.
>
> John Kenneth Galbraith, 1967

> Price and wage controls waste labor, both because of the distortions in the price structure and because of the immense amount of labor that goes into constructing, enforcing, and evading the price and wage controls. These effects are the same whether controls are compulsory or are labeled "voluntary."
>
> Milton Friedman, 1979

The challenge of inflation

One of the most important debates on economic policy in recent years has concerned wage and price controls. For over a decade, the non-communist world has suffered a chronic inflation which has disordered economic life and crippled attacks on unemployment and poverty. Traditional remedies have proved costly when not ineffective, and there are few observers who would dare predict that the problem will abate soon. Inevitably, the hope emerges that order might be restored by bringing the power of the state to bear on wage and price decisions. But just as inevitably, warnings arise that the cure will be worse than the disease. Bureaucracy, inefficiency, evasion, and corruption, it is said, will become the identifying features of the controlled economy. Clearly, if the participants in the debate are correct, the stakes are high.

Right now, of course, the focus of public debate is on other means of dealing with inflation. Decreasing the rate of growth of the money supply – the conservative approach to monetary policy – may have some impact on the rate of inflation and the level of unemployment, but it will not alter our economic and social structure in a fundamental way. Similarly, the debates on fiscal policy, whether, for example, to decrease the level of government spending and whether to do so by decreasing the government's deficit or the level of taxation, ultimately concern marginal changes in the structure of our economy.

But this is not so with wage and price controls. Introducing controls would profoundly alter the relationship between the government and the private sector, producing far-reaching changes in the economic and political life of the nation. While the current debate is not centered on these controls, they are likely to emerge as a major consideration in the years ahead. In the past twenty-five years controls have remained consistently popular with the general public, and when inflation has accelerated they have become popular with government officials as well. In 1971 these pressures caused an administration to impose controls that was, on purely ideological grounds, strongly opposed to them.

The term *wage and price controls* covers a broad group of policies, only some of which will be considered here. Sometimes the term refers to the control of a price in a single market or sector – in medieval times, for example, the price of bread. This type of control has important consequences, but it is generally not aimed at controlling inflation, the upward movement of the general level of prices. Nor is it likely that individual controls could provide this effect. Controls on prices in individual markets, if successful, are likely to divert purchasing power to other markets, and cause prices in those markets to rise somewhat faster. For this reason controls of this sort are not discussed in the following chapters.

The term *controls* is also used on occasion to refer to a variety of measures that seek to control the general level of prices, but that rely on moral suasion, or other limited forms of enforcement. An example is the guidelines for wage and price increases employed by the Kennedy administration, or the similar policies attempted by the Carter administration.[1] These measures were aimed at controlling the general level of prices, and might legitimately be included in a history of controls. I have chosen to exclude them largely because in retrospect they seem to have been relatively ineffective. Closely related to these measures are the proposals made by a number of economists for penalizing wage and price increases or rewarding restraint. This set includes the Tax Based Incomes Policy proposed by Wallich and Weintraub, which would penalize firms which granted wage increases above a guideline, and the numerous offshoots and descendants of this proposal.[2] This class of policies is not treated at length in the narratives simply because there are few historical precedents. Although some of the episodes discussed – for example, the period of selective controls at the beginning of World War II, and the period after VJ day – will be of interest to students of these policies.

Beyond these limited forms of controls are temporary wage and price controls applied over a wide range of goods and services, backed by the judicial power of the state, and aimed at combating inflation in an emergency. There are several examples of this sort of control in the American experience, and it remains in the public mind as one of the key alternatives to current policies. Focusing the historical narratives on these cases enables us to examine in some depth a series of highly varied episodes. To take one example, in some cases controls began with an across-the-board freeze covering virtually all prices. In others, controls began with a program aimed at a large subset of "strategic" prices. This is an important difference and represents a choice which will probably be faced if controls are again adopted.

At the other extreme lies a permanent system of controls and rationing. This policy, too, lies outside the American experience, and in any case, would have few adherents as a potential cure for inflation. Few Americans would be willing to stand indefinitely the reduction in economic freedom that is implicit in such a policy.

When Americans debate the need for controls, their discourse can be likened to that over some new and potent drug. Advocates of the drug generally have the simpler case. They tend to emphasize the ability of the drug to alleviate an important symptom of the disease. The case for a new narcotic, for example, will emphasize the drug's ability to alleviate pain, and perhaps the corresponding freedom to employ drastic means of treatment. The critics of the drug, on the other hand, tend to emphasize long-term and indirect effects. The new narcotic might produce a dependency. When its use was stopped, the patient's suffering would actually be worse than before, and the narcotic might produce harmful side effects.

In the same way, the advocates of controls tend to emphasize the direct effects on current prices, while the critics emphasize the potential for a price explosion when controls are removed and such side effects as the development of black markets. In the debate over a new drug the issue is seldom whether the benefits or the side effects exist in the first place, but rather over the extent of the benefits and the seriousness of the side effects. It is the same in the debate over controls. Few economists would deny, for example, that controls are likely to create some black markets. What separates the advocates from the critics of controls is a different intuition about the potential extent of these effects.

The parallel between the debate over a new drug and over controls weakens when one examines the processes through which the debates are resolved. The medical profession can rely on scientific experiments to delineate with some precision the dimensions of the benefits, costs, and risks associated with a particular drug. This may not end the controversy completely – physicians may evaluate benefits and costs differently – but the likelihood of a genuine consensus is real. Economists, however, cannot experiment. The best they can do is to turn to the economic historian for an account of "natural experiments" with controls. For this reason phrases like "controls have never worked" and "we did it in World War II, and we could do it again" recur again and again in the ongoing debate over controls. Yet, surprisingly, few economic historians have addressed themselves to the history of price controls and even fewer have done so from the vantage point provided us by modern tools of economic analysis. With a few exceptions, the "natural experiments" with controls in American history have not been subjected to careful, critical examinations. It is the purpose of this book to fill this gap in our knowledge.

The case for temporary controls

Despite widespread opposition to permanent wage and price controls, a consensus exists among mainstream economists that in the right circumstances temporary controls can make a positive contribution to the fight against inflation.[3] This possibility exists because of the role of expectations in the inflationary process. Suppose that after a long period of expansionary monetary policy, with prices rising at ten percent per year, a new policy of slow monetary growth is adopted. Inflation would not stop instantaneously. Instead, because decision makers still *expect* inflation, they would continue to raise prices. Labor unions would seek contracts containing wage increases to cover the inflation they expect, and businessmen would raise their prices spurred by the fear of rising costs and confident that their rivals were taking similar actions. The result, in the short run, would probably be a severe recession. Eventually, rising inventories and falling sales would persuade businesses to reduce their price increases, and the economy would return to full employment with a slower rate of inflation. But in the interim the costs would be heavy. It is unlikely, moreover, that a democratic government would be able to stay the course. The more likely result would be the abandonment of the restrictive monetary policy.

In the situation described above, temporary wage and price controls could have a therapeutic effect. By persuading businesses to act in a manner consistent with the more restrictive monetary policy, controls would reduce the costs of transition and increase the credibility of the new policy.[4]

Even such a staunch advocate of the free market as Milton Friedman has spotted one case in which he believes that temporary controls served this purpose:

> I know of one empirical case in which it did work – the case of Argentina. One year back in the 1960's a government was determined to end an inflation – a rare event in Argentina! It was very substantial, not your moderate kind of inflation. . . . They announced a new monetary policy which was going to be very strict and they accompanied it by a temporary fixing of prices and wages. By altering people's expectations, and cutting off the tendency for wages to rise in line with anticipated inflation, they did succeed in rather substantially reducing the rate of inflation with relatively little cost in the way of unemployment. Needless to say, this was a temporary success.[5]

Temporary controls of this sort, to put the matter differently, communicate useful information to decision makers in the private sector. If total demand per unit of output were being increased at only five percent per year, while decision makers were raising costs and prices by ten percent, it would be important for decision makers to be aware of these relationships. But few businessmen would really understand or care about a statement to this effect. An equivalent statement that prices can (should or must depending on the law) rise at only five percent per year would be widely understood and would be acted upon by the private sector's decision makers.

The special conditions underlying this case can be seen in Figure 1.1. Here the path of the fundamental determinant of the price level, money per unit of real output, is shown by the bottom line. The break at time t_0 shows the adoption of a restrictive monetary policy. In the absence of controls prices would follow the path shown by the topmost line. The break in this line at t_1 reflects the onset of a recession, the result of prices and wages being carried by momentum to a point inconsistent

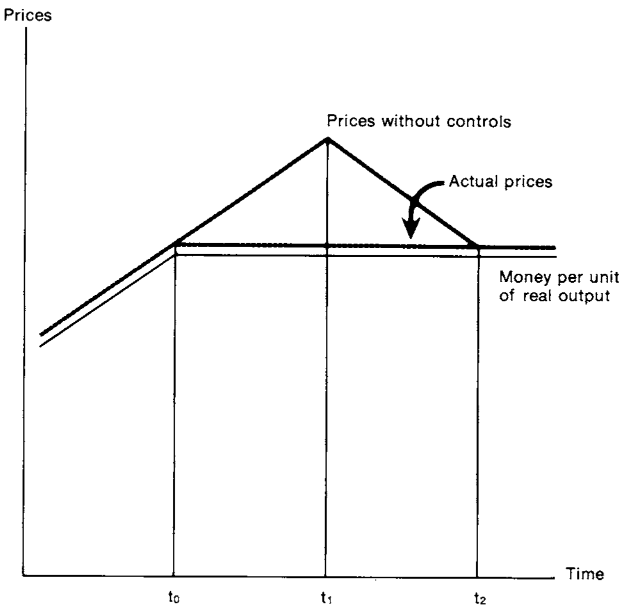

Figure 1.1. Price controls with monetary restraint.

with the fundamental conditions of demand. With controls, on the other hand, the price level would follow the middle line, thus minimizing the costs of transition to the final equilibrium at t_2 when controls are removed.

The scenario sketched in Figure 1.1, however, is only one side of the coin. If controls are not used in conjunction with a restrictive monetary policy the result could be a price explosion when controls were removed. This possibility is sketched in Figure 1.2. In this figure controls are imposed at t_0 but money per unit of output, shown by the middle line, continues to rise rapidly. In the absence of controls prices would follow the topmost line, but with controls they follow the bottom line. Thus, when controls are removed at t_1 prices rise more rapidly for a time until they return to the new equilibrium.

In this latter scenario the sole effect of controls has been to convert a relatively constant rate of inflation into a variable one. One of the basic assertions in the case against controls is that political considerations make this scenario inevitable. The imposition of controls, it is argued, frees the monetary authority to increase the money supply, perhaps even faster than before, in order to satisfy critics concerned with high

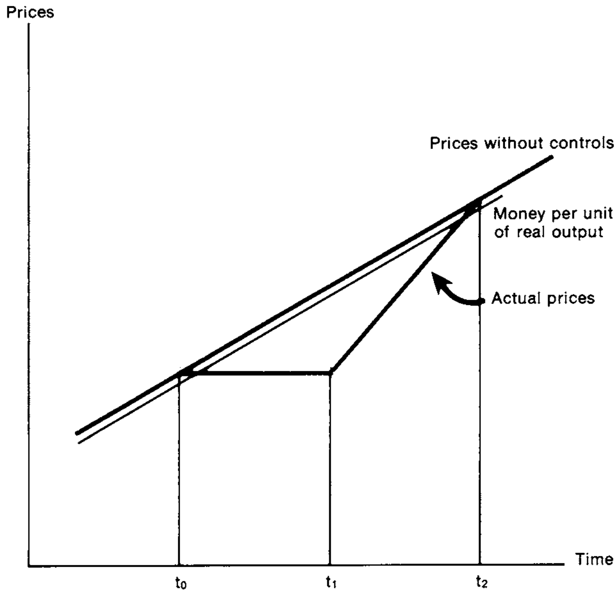

Figure 1.2. Price controls without monetary restraint.

interest rates or unemployment. Thus, one of the central questions in the following narratives is whether the price explosion model of temporary controls is as inevitable a picture of reality as the critics of controls claim it is.

The costs of controls

What dissuades most economists – even those who accept the first scenario as possible – from advocating temporary controls, is the belief that the costs of controls will be so great that even a substantial reduction in inflation could not justify their use. The most obvious of these costs is the large government bureaucracy required to administer and enforce controls. References to huge bureaucracies abound in the writings critical of controls, but no attempts to measure with accuracy the bureaucracies that have administered controls, or to forecast the bureaucracies needed in the future, accompany the arguments. In the following narratives, I will provide the reader with a description of the bureaucracies that have, in the past, administered controls so that he or she can decide whether the governmental apparatus would indeed be too costly.

This question is more complex than it appears to be on the surface. For one thing, the task of administering and enforcing controls was often divided among a number of agencies. Indeed, the question of which administrative tasks flowed from the attempt to control prices and which resulted from other constraints imposed simultaneously is often a difficult one to answer without an appeal to economic theory. Not all of the bureaucrats who administered controls, moreover, were government employees. Controls created bureaucracies internal to the business sector, which interpreted and applied the rules and responded to the government's demands for information. In wartime, the typical case, volunteers were used to help enforce the rules. The size of the bureaucracies cannot be appreciated, moreover, unless they are understood within the context of the economies in which they worked. The size of those economies, the extent of the inflationary pressures, and the degree of patriotic compliance all must be considered before a judgment can be reached about the bureaucratization likely to flow from a new attempt to impose controls.

Even if this bureaucracy were very small, however, the critics of controls would argue that they prevent the price mechanism from allocating resources efficiently. Demand and supply, they contend, are in constant flux. If there exists a surplus of one commodity and a shortage of another, then the price of the good in short supply will rise relative to the other. Resources will be attracted to the production of the good in short supply and demand for it will be choked off. Controls prevent this adjustment process from working automatically, thus lowering the real income of the community. This proposition, that a free price system allocates resources with maximum efficiency, is in fact the central proposition of modern economics. The work of most economists specializing in microeconomic theory could be described as specifying the conditions under which this proposition holds, or fails to hold.

As usual, Professor Friedman has put this point with the greatest force.

> The reason suppressed inflation is so disastrous, . . . is that the price system is the only technique that has so far been discovered or invented for efficiently allocating resources. If that is prevented from operating, something else must be substituted. What do we substitute? It is always some kind of clumsy physical control.[6]

Given that this argument is central to the debate, it is surprising that the discussion has been carried on in terms of anecdotal evidence. It is not hard to find cases during periods of price controls in which controls clearly interfered with the efficient allocation of resources. I will examine many of them in the narratives that follow. But a long list of these cases is not likely to convince the skeptic. Allocative mistakes are also constantly being made in a free price system simply because businessmen must predict the future, and they can do so only imperfectly. The real question, the skeptic will say, is whether the volume of misallocations is greater under controls than under free markets – and if it is greater, how much greater. This question cannot be answered without recourse to an examination of aggregate statistics. The skeptic wants to know how large total output was in relation to total inputs under controls. Did this ratio rise or fall? Were other things happening in the economy that might have influenced this ratio? These are difficult questions to answer and this perhaps explains why so few advocates or critics of controls have plunged into the aggregate data. It is almost as if the participants in the debate have been afraid to put their cherished beliefs to the acid test.

Lest the reader think, however, that I intend to offer merely another dull recitation of statistics, let me explain now that I will also examine the black market. You should now be imagining otherwise law-abiding citizens slinking off to some deserted part of the city to buy goods at prices above those fixed by law; goods that cannot be had at the official price change hands in a dark alley, providing a script that holds equal fascination for the layman and the economic historian. This image also constitutes a major theme of the case against controls. What good are price controls that hold down an official index of prices if the "real price," meaning the black market price, is rising even faster than before? Indeed, even if inflation correctly measured is slowed by controls, is it worth the destruction of the social fabric implicit in the creation of a large black market? This fear is separate and distinct from the fear that controls will reduce economic efficiency. To the contrary, black markets may offset the negative impact of controls on productive efficiency. Suppose that the controllers have set the relative price of some good too low and that production has been curtailed as a result. One remedy is for the controllers to recognize their mistake and raise the price. An alternative, albeit a less efficient one, is for the producers to supply their product to the black market.

Although the term *black market* usually conjures up the sort of midnight transaction described above, this sort of thing has actually been less important than more mundane ways of evading controls. Some examples will provide a sense of the range of potential evasions. A simple one is the elimination of sales. If the price controllers attempt to freeze price tags as of a certain date, and demand continues to rise, the natural reaction of sellers will be to eliminate traditional discounts or regular sales. This action effectively raises the price to buyers that had previously taken advantage of sales or discounts. More irritating, and more significant, is the reduction of quality. There are two ways to raise the price of a candy bar, to take an example from World War II: either raise the price of the bar, or reduce its size or use inferior materials. In either case, the amount of money the consumer must pay for a standard amount of candy will go up. Under controls there is a tendency for increases to take the second, hidden form. These examples convey some sense of the enormous possibilities for evasion, and in the narratives to come these examples will be multiplied many times over.

Stories about black markets, even carefully verified stories, and even lists of dozens of stories, will not, of course, provide a sufficient reason for rejecting controls. Shoddy business practices occur under free markets, and most laws are evaded to some extent. The question at issue is whether evasion is likely to occur on such a scale as to make controls an unattractive alternative. In the case of black markets, however, the problems involved with measuring and assessing the effects of controls are magnified by the clandestine nature of the black market. Transactions that stand outside the law seldom find their way into official statistics. The one type of quantitative evidence which is available is the number of violations brought before the courts. This type of evidence will be explored at length. But frequently we can only guess at the relationship between the number of violators charged with illegal activity and the true volume of such activity.

Suppression of the black market is likely to require rationing, some form of quantitative allocation imposed by the government. If rationing is widespread, consumers are likely to find the constraints on their economic freedom irritating. This cost of controls, although not measurable in dollars and cents, has often been cited. The extent to which controls require rationing is thus also a major concern of the following narratives.

The imposition of controls means that considerable power is shifted to the government, either to the controllers themselves or to the legislature which sets the guidelines under which the controllers work. Ultimately, it is this shift of power which raises the most serious questions about controls. How will legislatures respond to their new powers? Will they set reasonable guidelines that permit the controllers to discharge their duties in an equitable way, or will they respond to the overtures of special interest groups by providing privileges and exemptions? The dangers, moreover, go beyond the corruption of the legislature to political freedom itself. Will the media be free to attack the government when the prices they receive and the costs and supplies of the resources they use are under government control? Indeed, will anyone feel free to oppose a government when the price and wage authorities determine his or her income? In effect, it is this danger to political freedom, I believe, which leads most economists to oppose permanent wage and price controls. Since I share their concern, I am pleased to report here that while the following narratives do raise serious questions about the legislative response to controls, they fortunately do not provide examples in which our basic political freedoms have been violated.

The uses of historical experience

While I have laid out the arguments over controls in terms of benefits and costs, it is clear by now that these cannot be reduced to strict numerical sums and added up to determine whether the net effect was positive or negative. The costs and benefits lie on different dimensions, so evaluations and comparisons require value judgments. There is not even agreement over how important it is to reduce inflation itself. The advocates of controls take it for granted that inflation is a destructive force worth going to great lengths to stop. The critics of controls tend to emphasize that once inflation is fully anticipated, people can protect themselves from its undesirable effects. Labor unions can negotiate higher wages or cost-of-living adjustments; lenders can protect themselves by charging higher interest rates. These and similar measures, the opponents of controls maintain, prevent the arbitrary redistributions of income which result when inflation is not anticipated.

The role of value judgments is even greater when comparing benefits with costs. Suppose that we knew that the rate of inflation could be cut from 10 to 5 percent at the cost of reducing aggregate productivity by two percent. Is that a fair bargain? People with different values would come to different conclusions. What a study of the historical experience can do is clarify the nature and extent of the costs and benefits. When, however, the historian weighs these costs and benefits, as I do in the following chapters, he must invoke his own set of priorities. That is why I have tried throughout to separate evidence from conclusions, so that readers can reach conclusions consistent with their own systems of values.

In reaching these conclusions, I think you will benefit from a careful study of the historical record. That record can do much to clarify the debate over controls because their history is surprisingly rich. Attempts to control wages and prices can be found in almost every epoch of recorded history. In ancient Babylonia the Code of Hammurabi fixed wages and prices in magisterial detail. In ancient Rome the most ambitious attempt was the Edict of the Emperor Diocletian issued in A.D. 301. This law specified maximum prices for a wide range of goods and services and provided the death penalty for violators. Severe as it was the Edict apparently failed, and became, so to speak, a dead letter (at least with the abdication of Diocletian four years later, if not before). Many centuries later, the revolutionary government of France tried repeatedly to maintain the value of its own rapidly depreciating paper money, the famous assignats, by fixing maximum prices. This experiment also failed, but this did not prevent other governments in other places from mounting similar attempts.[7]

Controls were also used in virtually every epoch of American history. They were frequently resorted to during the Colonial period and during the Revolutionary War. The Civil War, an episode in which one might have expected controls because of the severity of the inflation, was notably free of them. The exceptions were a few isolated attempts in the South. The absence of controls during the Civil War can be accounted for most easily by the ideological temper of the times. The prevailing economic philosophy was that of laissez-faire. In the North, particularly, the public and the administration looked on price increases as the inevitable cost of the war, a burden the public had to bear just like the far greater burdens on the men in uniform.[8] In later wars, however, America returned to wage and price controls to fight inflation. Democratic administrations during the World Wars and during the Korean War had little compunction about government interference with the market. During the Vietnam War the Nixon administration, which did have ideological reservations, resisted the call for controls for a long time, but eventually succumbed in August 1971.

These cases provide the substance of the following chapters. At first glance the association of each of these episodes with war might suggest that their relevance to the debate over peacetime controls is limited. We are inclined to dismiss wartime experiences as untypical, and hence irrelevant. But in several ways the wartime experiments with controls are ideal "natural experiments" with the type of controls that plausibly might be used in peacetime. For example, the wartime inflations were exacerbated by strong expectations of further inflation and by disturbances on the supply side – both of which are important aspects of the current inflation.

In describing these historical episodes I have tried to present a broad picture of controls and have relied on a wide variety of sources: traditional statistical series, numerous accounts written by former administrators of controls after their term of service, documents produced by the agencies controlling prices, newspaper and magazine accounts, court records and other official materials. In spite of this, I have undoubtedly made mistakes. My hope is that the gains in viewing the effects of controls in numerous circumstances, and in numerous forms, outweigh the cost of errors on details. Perhaps too, my broad-brush approach will stimulate my fellow economic historians to refine and correct the picture I have drawn. Even if it accomplishes nothing more, this book will have served a useful purpose.