T. CONGDON

The Counter-Inflation Programme: Can it Work?

Mr. Congdon of Nuffield College, Oxford, examines the Government's counter-inflation strategy. He concludes that the Programme is certain to break down and that the only real question is how long this will take.

Inflation is the most difficult economic problem confronting the government at the present time: it is important, therefore, to consider the likelihood of success of the current Counter-Inflation Programme and to judge it from the viewpoint of economic viability, not from that of political astuteness. The government could justify the Programme on social grounds in that it obliges the trade unions to behave responsibly in a context which can be seen to be fair and just, or on the grounds that, whatever the scepticism felt about its outcome, there was no alternative to a formal prices and incomes policy. These claims may be accepted. But that does not vitiate an appraisal of its workability in more or less strict economic terms.

The points to be made will relate specifically to Phase Two of the Programme. Phase Two will be replaced by Phase Three in the autumn, but this does not mean they are obsolete. They are valid for any policy which does not acknowledge the sectoral heterogeneity of the economy. By concentrating on Phase Two the discussion is given targets for criticism and acquires a definite focus. The analysis should be of greater assistance in the formulation of Phase Three if conducted in concrete policy-related terms rather than in abstractions of greater or less generality.

The Programme as developed so far reflects a notable sensitivity to the particulars of economic behaviour. In an Appendix to the White Paper (Cmnd. 5205) of January 1973, difficulties in the application of the policy to the separate categories of manufacturing, services and distribution were acknowledged by the inclusion of separate provisions for each. In 'The Prices and Pay Code: A Consultative Document' (Cmnd. 5247) of February 1973, paragraphs 50–74 of the main body of the Paper were devoted to a detailed statement of the way the policy would apply to particular sectors. Paragraph 64 referred to 'Water Undertakings'; paragraph 70 to 'Hotels and Catering Enterprises'; paragraph 138 envisaged a distinct Construction Panel to examine the special problems of the building industry. In the White Paper (Cmnd. 5267) of March 1973, the section on 'Particular Sectors' was expanded to thirty-eight paragraphs.

A MISUNDERSTANDING OF THE ECONOMY?

This sensitivity to detail has been accompanied by a praiseworthy responsiveness to criticism. For example, the government has modified successive policy documents to answer points made by the Confederation of British Industry. Cmnd. 5247 reduced the record-keeping requirements of firms with a turnover of less than £1m, and recognised the principle of easements for low profit or loss-making concerns. But, on March 1st, the Director-General of the CBI sent a letter to all CBI members asking for information about grievances they might still have and setting out further objections to the policy proposals as they then stood. For instance, the stipulation that 50 per cent of pay increases be absorbed was felt to discriminate against labour-intensive businesses. This argument was appreciated by the government, and paragraph 41 of Cmnd. 5267 read, 'Enterprises are required to absorb 50 per cent of allowable cost increases arising from increases in labour costs . . unless the share of labour costs as a whole in their total costs exceeds 35 per cent.' A half-page table setting out the meaning of this qualification was added in an Appendix.

It may seem strange, therefore, to base a criticism of the policy on the assertion that it reflects a misunderstanding of the nature of a dynamic industrial economy. However, that is what will be done here. The crux of the matter is not that the economy is too complex to be controlled by the heavy-handed, over-precise 'dirigiste' methods implied by a literal interpretation of the policy documents, serious though the difficulties of practical implementation will prove to be. The misconception is more deep-seated. To expose this misconception, consider the rationale for the simple arithmetic of the policy, that profit margins on sales must not exceed the average level in the best two of the previous five years, and that increases in pay must not be greater than £1 per week plus 4 per cent. The

productivity of the economy as a whole is now believed to be rising at about 4 per cent a year. Consequently, increases in pay of the same amount (with the £1 a week thrown in as a token attempt to reduce differentials) and restrictions on profits make it impossible for incomes to rise significantly faster than output, and this should lead to a reduction in inflation. This reasoning overlooks the fact that the national productivity rise of 4 per cent is an average of the productivity rises of many different industries. Some industries' productivity grows more quickly than 4 per cent; others more slowly. There are provisions in the policy which appear to meet this difficulty. If costs fall because of, say, an exceptionally favourable improvement in productivity, the Price and Pay Code will empower the Price Commission to enforce lower prices.

But it is not only that industries vary with respect to their long-term productivity records; they also benefit differentially from short-term increases in demand. In the first part of the article the harmful short-term implications of the policy will be analysed; and only in the second part will its long-term repercussions for economic growth be discussed.

THE SHORT TERM PROBLEM

In order to develop fully the argument that short-term demand changes are not easily accommodated by the policy, the case of a firm the demand for whose product increases by, say, 20 per cent in a year will be discussed. This figure is clearly much above the figure for the growth of aggregate demand and it will be necessary to find out if this is a special case. It will be shown later that it is far from being a special case.

At the same price, the firm is able to sell 20 per cent more than before. Its total receipts are equal to wages plus profits. If it wishes to take advantage of the increase in demand the 20 per cent increase in receipts implies a 20 per cent increase in wages and profits. Suppose that profit margins are at their 'reference level', and so are meant to be constant. (The 'reference level' is the highest level permitted under the current legislation. It is equal to the average level of the best two of the last five years.) Then the wage bill must rise by 20 per cent.

There are three main ways in which this rise may take place. First, all members of the current labour force may receive the £1 plus 4 per cent to which they are entitled. However, this clearly would not take up the total increase in the wage bill.

Second, the current labour force may work for longer hours or with greater intensity, thus qualifying for overtime or payment-by-results supplements to their previous income. Both forms of supplement are permitted by the legislation, but no increases in the rate of overtime or payment-by-results are to be allowed. It seems possible, then, that workers may not want to work harder because the incentive of extra pay is muted.

Third, the labour force may be enlarged. This possibility has, of course, been foreseen by the government. In paragraph 144 of Cmnd. 5267, it is stated that 'New recruits to existing jobs should not be paid more than those they replace or more than the rate paid currently by the employer concerned for the same job.'; paragraph 145 runs, 'The rate for new work should not be more than the current rate paid for the same or most nearly similar work by the same or other employers. Where rates vary in different localities, the rate paid should not be more than the rate in the same locality.' For a firm there are two sources of new labour – the unemployed and the workers who can be induced to leave other jobs in existing firms. The government's condition may be respected for labour which has been unemployed. It is not necessary to offer wages above the generally prevalent level to attract them back into employment. But the government is, quite rightly, determined to lower unemployment and therefore to eliminate this source of new labour. What, then, about workers who have jobs elsewhere? Here the government's requirement cannot be met. Changing jobs is a troublesome and expensive business, and workers will be reluctant to do so unless offered a significant financial incentive. But the policy specifically precludes this – 'The rate for new work should be not more than the current rate paid for the same or most nearly similar work . . .'

SUPPLY AND DEMAND REVISITED

It may be contended that this does not exhaust the choices open to the firm. Perhaps the firm is hoarding labour, and the result of the increase in demand is that the labour force is utilised more effectively. This is equivalent to an improvement in productivity, or a lowering of costs, and the policy states that the appropriate response is an equal reduction in price. There are two main objections. First, if the firm lowers price, quantity demanded will again increase. The irony of the situation may be noted: demand has increased but a lower price is recommended. The Government's Programme

represents, it might be said, not merely a rejection of market-force dogmatism, but a violation of the laws of demand and supply. Second, the reason why businessmen take on extra orders or try to satisfy a demand for greater sales is that they desire maximum profits. If they are compelled to lower price whenever demand increases, and an opportunity for higher productivity and profitability emerges, they evidently have no incentive to satisfy the greater demand. There is nothing complicated in this argument: it says that a firm will not lower costs if someone else is to gain from the cost reduction. The government's perhaps legitimate indifference towards economic theory is complemented by a curious confidence in business altruism.

It is now time to examine the evidence. Are increases in demand of the magnitude of 20 per cent in one year common in British industry today?

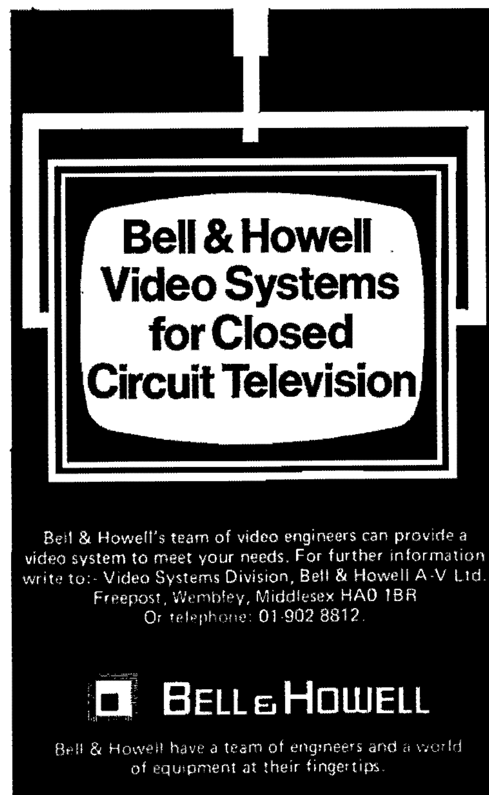
The demand for consumer products may be considered first. The volume of food, textiles, tobacco and other necessaries sold does not fluctuate much from year to year. However, sales of more durable and expensive items do vary considerably. For example, the value of sales of television sets to the British market was £29m. in the second quarter of 1971 and £58m. in the fourth quarter of 1971, a doubling in less than a year. In part this reflected seasonal factors, but in the second quarter of 1972 the figure had climbed again to £62m. It might be said that this was abnormal and was due to the introduction of colour television. But, between the second quarter of 1971 and the second quarter of 1972, the value of radio sets sold jumped from £2·968m. to £3·510m., a rise of nearly 20 per cent. Again it might be said that these figures are symptomatic of the general consumer boom inaugurated by the 1972 Budget. But, between 1970 and 1971, the value of sales of motor bikes rose from £17m. to £27m.; of record players from over £24m. to over £34m.; and of electric irons from under £5m. to £6·4m. Or, to look at an earlier year and to stress that economies have declining as well as expanding industries, it may be noted that sales of electric shavers for the home market from £3·4m. in 1968 to £1·9m. in 1969.

VARIABILITY OF DEMAND

Perhaps these figures relate to comparatively unimportant items. However, if more significant components of consumer demand are considered, the picture does not need to be modified. An illustration is provided by the current booming market for cars. In the first quarter of 1971 an average of 91,000 new cars per month were registered; by the fourth quarter the figure had climbed to 132,000. Although there was a slight fall to 121,000 a month in the first quarter of 1972 this was still nearly a third higher than a year before. Subsequently the number of new registrations has risen to best ever levels. In textiles, too, the same variability is to be found. The production of man-made fibres fell from 44·6m. kilos in 1970 to 36·6m. kilos in 1971. But production between January and November 1972 was 29 per cent up on production between January and November 1971.

Clearly, therefore, whatever the relative constancy of the overall growth figure, individual production units within individual sectors of the economy are subject to large fluctuations in demand. Moreover, this evidence of volatility is strengthened by a similar examination of demand and production indicators for investment industries.

The 20 per cent figure on which the hypothetical example was based is not, therefore, in any way unrepresentative. The bad habits that governments and economists have slipped into – of looking solely at aggregates when framing economic policy – have caused them to misunderstand the economy's workings and to devise remedies, which,



whatever their validity at the economy-wide level, are either futile or pernicious in their consequences for particular industries or firms. Looking at aggregates, the Keynesian approach is most rewarding if there is heavy unemployment and *all* industries can increase production without difficulty if demand increases. But, in a fully employed or nearly fully employed economy, only *some* industries can do this; others may have reached capacity. It is necessary, then, to look at the components of the aggregate figures. This is no problem; the figures presented above are taken from the CSO 'Monthly Digest of Statistics' and the DTI's 'Trade and Industry'; they are readily available to government advisers and civil servants; however, their implication seems to be persistently and obstinately overlooked.

THE LONG-TERM PROBLEM

The criticisms of the Counter-Inflation Programme that have been advanced so far relate to its unsuitability as a corrective for short-term demand fluctuations. The further objection that it will stunt long-term growth patterns will now be developed.

It has been observed that substantial changes in demand are frequently found at the firm and industry level. These are found in the short-run, but permanent long-run changes are also far from insignificant. Permanent restructurings of demand are of two kinds – those which reflect differences in income elasticities of demand; and those which reflect differences in productivity growth rates. Attention may be focussed on the second kind.

Suppose that productivity is increasing in an industry, and that the price of inputs is constant. Then unit costs must be falling. If competitive conditions prevail, and price equals unit cost, it follows that the quantity of the industry's product demanded will increase, and the size of the increased depends on the elasticity of demand. The industry will be able to maintain the same labour force only if the increase in quantity demanded (i.e. production) is equal to the increase in productivity – if, in other words, the elasticity of demand is one. This argument would have to be qualified in a growing economy because of the effect of income elasticities of demand and because other industries' productivity will also be improving, making it necessary to study the relative price movements of several products rather than the absolute price reduction on one product. However, it is possible to make some conjectures. Since it is unlikely that all price elasticities are equal to one it is highly probable that differences in productivity growth rates between sectors, industries and firms will necessitate reallocations of labour. Further, the amount of structural adjustment required will depend on the dispersion of demand elasticities. How is this adjustment to be achieved?

Changing from one job to another is an expensive matter for the individual concerned; and labour turnover is costly for businesses affected. To compensate the individual he must receive an increase in income; and it is not clear that a sufficient margin of incentive is provided by the '£1 plus 4 per cent' formula. It must be emphasized also that the sectoral adjustment under consideration is much more troublesome to the worker than the inter-firm movement within the same employment category needed to accommodate short-run demand changes.

If the reallocation of labour is deterred, structural change, a central and integral part of the growth process, is prevented. In this way the growth patterns of the economy will be disrupted.

PRODUCTIVITY AND THE PROGRAMME

The argument so far has assumed that productivity improvements continue, irrespective of the framework of incentive or disincentive imposed by the government. But, with the present prices and incomes policy, it is doubtful if the framework of incentive continues to be neutral. There are three main points.

First, the policy, as already noted, punishes productivity improvements in certain circumstances by enforcing corresponding price reductions. An incentive of some sort survives, nevertheless. If a firm lowers costs and as a result its prices fall by more than those of other firms in the same industry, it should increase its share of the market. Although margins cannot increase, a higher turnover should produce higher profits. The power of the remaining incentive depends on two factors – the elasticity of demand for the firm's product; and the likelihood that other firms in the industry can match its cost and price reductions. In an industry where demand is highly inelastic the benefits of productivity advance may be much less than now before the policy was introduced.

The other side of the coin is the threat to slow productivity-growth firms contained in the provisions for cost increase absorption. If a firm has 35 per cent of its total costs accounted for by labour costs, increases in such costs cannot be passed on in price rises to the full extent. Only half of them can be transferred to the consumer. If it can be

accepted that wage increases of the 6–8 per cent order are to be inferred from the '£1 plus 4 per cent' formula, this means that firms must achieve a 3–4 per cent productivity improvement to maintain profit margins. This is, admittedly, the average figure for industry. But it is precisely because it is an average that it is wrong to apply it. It is customary for some firms to exceed the figure; it is also inevitable that some firms will not attain it. The government might say that the policy is sound because it will penalize the laggard firms; this is extremely foolish; it is simply not to be expected that the rate of technical progress in the pottery industry will rival that in microelectronics; it is in the nature of different products to have different technological and productivity records; nothing can be deduced from this about the adequacy or inadequacy of management. Those industries and firms which cannot, no matter the pressures, achieve the 3–4 per cent figure, must suffer a deterioration in profit margins if they pay the same wage increase as industry in general. If they do not, they may lose employees.

Hence, because the policy has been worked out without respecting the sectoral heterogeneity of the economy, it removes incentives for fast productivity-growth industries and penalizes low productivity-growth industries. The net effect must be a reduction in the economy's growth potential.

RESTRICTING PROFITS

Second, by restricting profits, the government is stifling the principal source of finance for investment. In the short-run this may be immaterial. After the easy money conditions of the past two years firms have considerable liquid reserves available. But, over the longer-term, the situation could become more serious. Particularly noteworthy has been the effect of the policy on new issues on the London Stock Exchange. Because of the likely results for profits of the Counter-Inflation Programme, there was a steep fall in the value of shares in February and March this year. The low level of prices has discouraged new issues. Net domestic issues by quoted UK companies, after reaching record levels in the second quarter of 1972, had fallen to £77·1m. in November. In December they amounted to £50·5m.; in January 1973 to £21·7m.; and in February to £25·3m.

This is certain to have an impact on the ability of British industry to carry out the heavy investment required to avoid reaching capacity constraints if demand maintains its present rapid rise. The damage to confidence on the Stock Exchange has been exacerbated by the uncertainty of the time-period over which the measures will be operating. If a period of three to five years is foreseen, the consequences may be grave. To repeat the message – in a growing economy it is usual for some sectors to be expanding more rapidly than others. One reason for this is that profitability is increasing at different rates, and capital is transferred from decreasingly profitable to increasingly profitable industries. The Stock Exchange is the financial middleman in implementing the transfer of capital. But the present policy prevents the natural unfolding of disparities in profitability and curtails the effectiveness of the Stock Exchange in this role. In this way it freezes the inter-sectoral distribution of capital and obstructs the growth pulses of the economy.

Third, in the very long-run, the main aspect of economic growth is the development of new products and the invention of new technologies. Here the notion of a price change becomes at best misleading and at worst metaphysical. It is just not feasible to calculate the change in the 'price' of drying hair as a result of the introduction of electric hairdryers. There is no benchmark for an 'inflationary' or 'non-inflationary' price. It must be conceded that there is some acknowledgement of this problem in the Programme. In paragraphs 34 and 35 of the Green Paper it is stated that 'A reduction in quantity or quality is equivalent for the purposes of the Code to a price increase' and 'Quality changes in goods or services, quantity change in sales units, or artificial creation of new products should not be used as a means of avoiding the requirements of the Code'. But there seems to be no guidance about the pricing of new products which are genuine, and little awareness of the problems involved.

CONCLUSIONS

It is obvious that the objections to the Programme made in this section increase in force as the time-period under consideration is lengthened, and that the contradictions contained in it will manifest themselves more strongly as the years go by. The context of long-run economic growth exposes its weaknesses in a glaring way. The policy may work for a time; the dam will remain intact for a year, eighteen months or, perhaps, two years; eventually, there will be cracks in its structure, where sectoral pressures become too strong; and the dam will burst as sectoral difficulties become generalised throughout the economy.

The Counter-Inflation Programme is certain to break down. The only real question is

how long it will take. If the government wants to find an answer to this question, and if it wishes to make Phase Three a success, it would be well-advised to take account of the sectoral heterogeneity of the economy. It will not be a good policy unless it recognises that, even if the aggregate productivity-growth figure is 3–4 per cent, this figure is an average for industries with widely divergent productivity records. A crude policy may reduce inflation, but if it compounds the structural stresses and strains of a dynamic economy it will adversely affect economic growth. This is something which the present administration, if its public statements are to be believed, does not want to do.