THE ECONOMICS OF WAGE CONTROLS

K. HOLDEN
D. A. PEEL
J. L. THOMPSON

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K. Holden
Senior Lecturer in Economics
University of Liverpool

D. A. Peel
Professor of Economics
University College, Aberystwyth

and

J. L. Thompson
Senior Lecturer in Economics
Liverpool Polytechnic

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THE ECONOMICS OF WAGE CONTROLS

Also by K. Holden, D. A. Peel and J. L. Thompson

MODELLING THE UK ECONOMY
EXPECTATIONS: Theory and Evidence

To Jennifer, Janet and Margaret

Preface

This book is intended as an introduction to the economics of wage and price controls (or incomes policies) for undergraduates taking courses in macroeconomics and the labour market. The first chapter reviews the historical experience of controls in a number of countries. In Chapter 2 the ways in which economists assess the impact of conventional incomes policies are considered along with the empirical evidence relating to their success. Recently different forms of tax-based incomes policy and arbitration methods have been suggested. These are analysed in Chapters 3 and 4. The economics of indexation are presented in Chapter 5 and some policy conclusions discussed in the final chapter.

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K. Holden
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J. L. Thompson

Contents

1 Recent Experience with Wage and Price Controls

1.1 INTRODUCTION

Since the end of the Second World War, various western governments have attempted, by legal restraints or moral persuasion, to influence the way in which aggregate wages and/or prices change. Such actions are known as incomes policies or wage and price controls. In this chapter we review the recent experience of a number of countries in order to provide the background for the assessment of conventional incomes policies in Chapter 2. First, in section 1.2 we examine the attempts to impose wage and price controls in Germany in the thirties, under the Nazi government. Next we consider the postwar experience of incomes policies in the United Kingdom, the United States, New Zealand and Australia and conclude with references to studies of other countries.

Wage and price controls have generally been invoked at times when governments believe that either the rate of inflation is too high or it is increasing too rapidly. The intention is to reduce inflation directly by operating on wages and prices: if prices are fixed there is no inflation. Indirect methods of controlling inflation, such as by deflating aggregate demand or reducing monetary growth, are thought to be more costly, in terms of lost output and higher unemployment, by advocates of controls (see, for example, Layard, 1982; Meade, 1985).

1.2 HISTORICAL REVIEW

The idea that governments can control the absolute or relative level of wages and prices has a long history. Schuettinger (1982) refers to the Egyptian government controlling the grain crop 5000 years ago and the Code of Hammurabi imposing rigid controls over wages and prices in Babylon around 2000 BC. Schuettinger reviews controls in Ancient Greece, the Roman Empire, Medieval Europe, the early days of Canada and the United States, Russia after the revolution, Germany in the thirties and during the First and Second World Wars. Here we will not duplicate all that material but instead consider what happened under the

Nazi regime in Germany. This time is of particular interest because the state had enormous powers at its disposal to make a prices and incomes policy effective in contrast to the countries considered below which are democracies, the activities of whose governments are constrained by their legal systems.

Economic policy in the Third Reich is discussed by Brittan and Lilley (1977), Schweitzer (1964), Lurie (1947), Schoenbaum (1967) and Schuettinger (1982). After the Wall Street crash of 1929 American loans and investment in Germany stopped and at the same time the demand for German goods overseas collapsed. The German economy entered a severe depression. In 1931 emergency decrees were issued which would allow the government to control prices. The banks were taken over by the government and currency controls were imposed to stop the mark collapsing. Unemployment rose from 1.3 million in September 1929 to 2.3 million in March 1930 and to over 6 million in March 1932. In the elections of July 1932 the National Socialists won 230 out of the 608 seats and, following much political manoeuvring, Hitler was appointed Reich Chancellor in January 1933. A four-year plan was announced involving government works using initially voluntary and, after 1935, conscripted labour. This was financed partly by higher taxes, partly by increased government debt and also by printing money. The money supply increased by 70 per cent between 1933 and 1938. The increase in economic activity put pressure on prices and wages. In earlier periods prices had been set by cartels. The government strengthened these by giving them legal powers to fix and enforce prices and the 'Law of Compulsory Cartels' of 1933 allowed the authorities to extend any cartel to include extra enterprises. The government also took a more direct role in supervising the cartels. The result was that many prices were directly controlled and the monopoly position of the cartels was strengthened.

However, the balance of trade had been deteriorating since 1931 because of the general reduction in world trade. By 1934 reserves of gold and foreign exchange were almost exhausted and strict import controls were imposed. In February 1934 German importers were allowed to spend 50 per cent of the amount of foreign exchange they had spent in 1931. By May 1934 this was reduced to 5 per cent. The shortage of imported goods raised their prices. At the same time new methods of cost calculation were approved which allowed some cost increases to be passed on. While world prices rose by 1.6 per cent between 1933 and 1936, the official price index in Germany rose by 7 per cent, despite the attempts to hold down prices. Low relative prices of agricultural products led to reduced farm output because of the movement of labour to towns, so that, for example, butter was in short supply in 1935.

When the Nazis took power they dissolved the trade unions and in 1934 the Labour Regulation act was passed which banned strikes and lockouts. The government set up Labour Trustees to set minimum wages, subject to the official policy of keeping most wages at their 1933 level. Legally employers could pay more than this but did not do so. The result was a decline in real wages between 1933 and 1937. In 1934 laws were passed placing restrictions on the movement of labour. Workers in agriculture were not allowed to move into urban areas. While initially such restrictions were to prevent unemployment they became part of a more general policy of state control. From 1936 all workers had to have a 'work book' which acted as an identification document and gave the state details of the individual workers' qualifications and experience. With the expansion of the economy, as a result of government works and rearmament, intervention increased. Workers could not be hired without approval of the regional labour offices. Even with these controls skilled workers were in short supply in several industries by 1936.

Pressure for wage and price increases was building up so in November 1936 a general wage and price freeze was imposed. Some flexibility was permitted in pricing and many government contracts were based on cost agreements. Shortages continued and wage ceilings were used by Labour Trustees to prevent competitive bidding for skilled labour. Between 1933 and 1939 wage rates were almost unchanged in money terms, increasing from 78.5 *Pf.* per hour to 79 *Pf.* per hour. Earnings rose because of increases in the number of hours worked and a shift towards piece-rate payments.

A second four-year plan was announced in the autumn of 1936 with the intention of making Germany entirely self-sufficient in food and industrial raw materials. This reduced unemployment so that by 1938 full employment prevailed. New labour reserves were opened up by the conquest of Austria, Sudetenland and parts of Czechoslovakia. These were incorporated into the German work force. Labour shortages became a serious problem and threatened Hitler's military plans. The final steps to prevent the free movement of labour were taken in 1938 when a decree was passed ordering all workers to take a new job if required. As a further step towards removing labour shortages, those leaving school were directed into apprenticeships useful to the state. Even with all these powers to direct labour, skilled workers continued to be in short supply at the fixed wage rates.

The conclusion from the experience of Germany in the thirties is that wage and price controls resulted in shortages of labour and goods. Moreover, despite all the attempts by the state to control economic activity, the work-force reacted to fixed wages by moving to areas of the economy where rewards were highest (i.e. from farms to factories and from fixed wages to piece-rate payments).

1.3 THE UNITED KINGDOM

Since the end of the Second World War there have been a number of incomes policies in the United Kingdom; in fact between July 1961 and May 1979 the only time there was no form of incomes policy in operation was from July 1970 to July 1971. Details of the various policies are provided by Ingham (1981) and Fishbein (1984) with Flanagan, Soskice and Ulman (1983) and Dean (1981) providing summaries for parts of the period. The exchange rate was fixed from 1949 to 1967 and there was a belief in some quarters that an incomes policy would allow the simultaneous achievement of stable prices and a higher rate of growth (and lower unemployment) than could be achieved by fiscal or monetary policy alone.

Two features of the UK economy are important: the industrial relations system and the role of the public sector. In the postwar period the system of wage determination has been for basic rates of pay to be negotiated for each industry between employers' federations and national unions. This is then followed by local negotiations between small groups of workers, represented by the shop steward, and their supervisors. Since the late sixties there has been a move towards plant-wide and company-wide bargaining, but the national negotiations still have an important function in setting the mood for the local negotiations.

In 1970 the public sector accounted for 25 per cent of total employment according to *Economic Trends* November 1979. This was made up of 6.3 per cent central government, 10.5 per cent local government (including police, teachers, fire service, municipal transport) and 8.3 per cent public corporations (including gas, electricity, water, post office, railway and coal mining workers). The size of this sector and the fact that the government either controls or can strongly influence its level of wages means that even with free collective bargaining the government plays an important role in wage determination.

The 1948 Wage Freeze and 1956 Plateau

Following the end of the Second World War the Labour Party won its first general election in 1945. There were still widespread price controls and rationing and many products were unavailable or in short supply. When the economy switched to peacetime production the balance of payments position deteriorated and inflation accelerated, leading to an appeal by the government in January 1947 for higher productivity and, later that year, for voluntary wage restraint. As this did not occur, a wage freeze was announced in February 1948 in which the only exceptions were to be in industries with a shortage of labour. Prices would remain frozen and the wage freeze was to be compulsory in the public sector and voluntary elsewhere. Following discussions, dividends were also controlled, and the Trades Union Congress (TUC) supported the freeze at a special conference in 1948, and its annual conferences in 1948 and 1949. In 1950, however, the TUC rejected wage restraint because of rank and file discontent with the policy. There were three main reasons for this, according to Fishbein (1984); real wages had fallen between 1948 and 1950, the devaluation of sterling in 1949 was expected to raise prices, and the freeze had operated unevenly in that hourly paid workers received no increases while piece-work workers were able to raise their incomes by increasing output. It is generally agreed that the freeze reduced the rate of increase of wages and that much of its success came from the desire of union leaders to help the Labour government in the particular circumstances of the immediate post-war period.

The boom associated with the Korean War of 1950 and the relaxation of wartime price controls and subsidies by the new Conservative government elected in 1951, coupled with free collective bargaining, led to an increase in inflation in the early fifties. This was controlled by fiscal policy but the economic revival in 1955 further boosted inflation. The government introduced the Macmillan 'price and wage plateau' in March 1956. The nationalised industries and a number of private employers agreed not to increase prices. There was no arrangement to restrain wages directly but the assumption was that there would be less pressure for wage increases if prices were steady. The policy lasted until January 1957 when free collective bargaining was resumed.

The Pay Pause 1961–2 and Guiding Light 1962–5

The Conservative government continued free collective bargaining in the late fifties with a policy of deflating the economy as a means of keeping prices under control. An independent body, the Council on Prices, Productivity and Income (CPPI) was set up in 1957 to provide comment on economic policy, particularly concerning prices and wages. It proposed that, in general, there should be a link between changes in pay and changes in productivity. In its final report in 1961 the CPPI recommended some form of incomes policy to reduce inflation. There was a balance of payments crisis at this time and the Chancellor, Selwyn Lloyd, introduced a 'pay pause' which would freeze wages in the public sector and rely on voluntary support in the private sector. Existing commitments to increases could be honoured and the government was to try to develop a more permanent way of relating productivity increases and wage increases. The TUC opposed the pay pause and, because groups such as teachers and nurses suffered under it, while less popular but better organised groups benefited from it, the policy was largely ineffective and ended early in 1962. A new body, the National Incomes Commission (NIC) was set up with the job of investigating particular cases of proposed wage increases referred to it by the government. The NIC was intended to be independent of the government, employers and unions and was expected to encourage employer resistance to wage increases. A 'guiding light' allowing increases of between 2 and 2.5 per cent in wages was suggested for 1962, with further increases permissible where productivity increases were involved or where the industry was short of labour. The TUC did not co-operate with the NIC since there was no attempt to control prices. Early in 1963 the target rate of wage change was raised from 3 to 3.5 per cent. Along with the NIC, in 1962 the government set up the National Economic Development Council ('NEDDY'), chaired by the Chancellor of the Exchequer and with government, employer and union representatives. Since the unions were not participating in the NIC, the role of NEDDY became important as a point of contact with the government. Initially NEDDY was concerned with stimulating economic growth but in 1963 it published a report, agreed by the union representatives, acknowledging that wages, salaries and profits would need to rise less rapidly than in the past. The government presented an expansionary budget to encourage economic growth, which persuaded the TUC representatives on NEDDY to discuss the possibility of a voluntary incomes policy. In the end no agreement was reached but the crucial link between restraining wage demands and economic expansion was now established. The 'guiding light' policy ended with the election of a Labour government in October 1964.

Restraint under Labour 1964–70

Following the election, inflation was increasing because of the 1963 expansionary budget and there was a high balance of payments deficit. The NIC was abolished and a *Joint Statement of Intent on Productivity Prices and Incomes* was agreed by the TUC and the government, while a voluntary incomes policy with a 3 to 3.5 per cent norm continued.

The government created the Department of Economic Affairs which was to be responsible for increasing the long-term rate of growth. A National Board for Prices and Incomes (NBPI) was set up in February 1965 with the job of advising the government whether proposed increases in prices and wages were in the national interest. In April 1965 the government announced its Prices and Incomes Policy, a voluntary policy with a wage norm of 3 to 3.5 per cent and exceptional increases allowed for increased productivity, labour shortages, low pay and comparability. The TUC accepted the policy but wage and price inflation continued. Wages rose by 8.3 and 8.5 per cent in 1964 and 1965, while the corresponding figures for prices were 3.2 and 4.8 per cent. There was a balance of payments crisis in July 1965 which resulted in the government announcing legislation to make prior notification of wage and price increases to the NBPI compulsory.

The TUC acted to avoid government wage controls by setting up its own system for vetting proposed wage increases. However, a further balance of payments crisis in July 1966 resulted in the statutory *Prices and Incomes Standstill* which included a mandatory six-month freeze on all wages, prices and dividends, to be followed by a six-month period of severe restraint. At the same time the government imposed strongly deflationary fiscal and monetary policies. During the freeze period only productivity increases could justify any wage increase, and a particular feature was that any commitments to increases which had not been implemented when the policy was announced were also frozen. For the period of severe restraint (January – July 1967) the norm was again zero but productivity increases, low pay, labour shortages and comparability could all justify an increase in wages. Prices could only rise to cover tax and cost increases beyond the control of the firm. Between July 1966 and July 1967, unemployment rose from 1.3 to 1.8 per cent, hourly wage rates rose 2.8 per cent and consumer prices rose by 2.5 per cent. These increases were much lower than during the preceding year so to some extent the policy worked. No major union attempted to evade the freeze, the increase in wages for each group being 1 per cent below the previous settlement, and became effective in mid-1971. At the same time deflationary policies were adopted and unemployment rose to 3.5 per cent in 1971 and 3.9 per cent in 1972. There was also a voluntary commitment by the employers to restrain price increases to 5 per cent. The NBPI was abolished in March 1971. The 'n−1' policy had some success with postal and National Health Service workers in 1971 but the coal miners received a 20 per cent increase after a strike in 1972 which caused a national state of emergency to be declared and prolonged electricity cuts to be imposed. When the railway workers received a 13 per cent increase compared to their previous settlement of 9 per cent, the 'n−1' policy was dropped.

The Prime Minister attempted to reach a voluntary agreement with unions on pay and prices between the spring and autumn of 1972 without success. In June 1972 the pound was floated and since the money supply was growing at over 20 per cent per annum there was a danger of a rapid depreciation of its value. The government decided that an incomes policy was required and in November 1972 a ninety-day freeze of wages, prices, dividends and rents was announced and became known as Stage I of the policy. In April 1973 Stage II started with a target of £1 per week plus 4 per cent, subject to a maximum of £250 for any individual. As with the last Labour policy, the norm applied to groups rather than to each worker. Extra increases were permitted in the reduction of male/female pay differentials. A minimum period of twelve months was required between wage increases. Stage II lasted until November 1973 and was followed by Stage III which had a norm of the larger of 7 per cent or £2.25, and extra increases allowed for productivity agreements, working unsocial hours and to remove anomalies. There was also scope for 'threshold payments' or 'escalator' clauses whereby if the retail price index increased by more than 7 per cent over its October 1973 figure workers would receive 40p per week for each 1 per cent rise. A Pay Board and a Price Commission were set up at the end of 1973 with authority to control wages and prices. (Compare equivalent developments in the USA under the New Economic Policy 1971–4 in section 1.4 below.) The TUC refused to nominate trade union representatives to these bodies. The Pay Board had to be advised of any settlements effecting more than 100 workers and advance approval was required if more than 1000 workers were to be affected. Firms with fewer than 100 workers were required to keep pay records. If a settlement did not meet the requirements of the pay policy the Pay Board could reject it. Inflation continued in 1973 because of three factors: the drop in the