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Economic Policy

Inflation, Price Stops and Price Controls

by Professor Karlheinz Kleps, Linz *

It has been quite obvious for several years already that the attempts to achieve the aim of price stability are running into the greatest difficulties. While the rates of inflation are escalating in almost all countries, it is becoming increasingly clear at the same time that the authorities endeavouring to stabilise the level of prices are faced by problems of great complexity.

The efforts which are being made to stabilise the prices remind one more and more often of the behaviour of addicts who have recourse to ever stronger drugs in the foolish belief or desperate hope that they can escape their problems in this way. The resemblance is most striking in the use being made of the instruments available to the state for its *incomes policy*. What was originally a policy with one-sided application to wages is now directed at *all* relevant incomes, whether wages, salaries, social or occupational pensions, profits, dividends, rents or interest income. The aim must necessarily be to exercise a simultaneous and, if possible, equiponderant influence on the prices, and even to regulate them, in line with the general objectives of the stabilisation policy. In this endeavour the mildest method, that of "moral persuasion" of industry and trade unions, was everywhere the one to be applied first, until the governments sooner or later reached the strongest antidote, namely orders for a *general stop on prices and wages* combined with official controls and sanctions.

Stop and Control Measures

Such stop and control measures, which in socialist countries naturally form part of the repertory of central administrative direction of the economy, are an abrogation, in full or large measure, of the functions of orientation, guidance, adjustment and control which would otherwise be performed by freely moving prices and wages. There can be no doubt therefore that they are inconsistent with the basic concept of the market economy — a fact not seriously disputed anywhere. That no fewer than 19 of the 24 OECD countries (including Yugoslavia) nevertheless used them in recent years to combat inflation shows that (leaving

Yugoslavia aside) these countries are apparently no longer capable of carrying out the tasks of economic policy by relying exclusively on measures which are in conformity with a free market system. The responsible authorities have on the evidence of their own statements always been aware of this inconformity. There is all the more reason then to ask what concrete objectives they wish to achieve by their drastic interference especially with the market price mechanism.

The partial price stops and price ceilings which have been applied for a long time in individual sections of the economy (e.g. in housing) and the ensuing control measures were mainly determined by considerations related to social and/or structural policy. In contrast, the motive for general price stops and price controls in the interest of stability appears on closer inspection to be threefold:

Policy Objectives

☐ When authorities decide to apply the emergency brake in their price policy they always stress that their main aim is, on the one hand, to sound the alarm and urge price discipline for the future and, on the other, to gain time for germane negotiations with interested parties and/or for the preparation of comprehensive stabilisation programmes.

☐ As it is not difficult to see the connection between a general price stop and the subsequent trend of wages, it may be assumed that where a general wage stop is being imposed only after some delay the earlier price stop was intended to create the requisite political and psychological

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atmosphere for the following second step. To go by past experience, the relationship between government and trade unions at the time seems to play in this respect as important a role as the bargaining position and power of the labour organisations and the different views prevailing among the public about price and wage stops.

□ Such interference with the process of price determination enjoys wide-spread popularity, which can certainly not be said of restrictive state intervention in wage settlements. Especially general price stops are widely approved, in particular in the sections of the population which count themselves among the victims of inflation and have no experience of previous measures of this type or a sufficient grasp of the interconnections of prices and wages. That not only economic but in larger or smaller measure non-economic considerations (the wish for popularity) give rise to general price stop orders and price controls is therefore most likely.

General Problems

Naturally, nobody in a position of responsibility is likely to say openly that either of the two latter motives influenced a decision in favour of such intervention. The use made of the two instruments under discussion in the past and their efficiency in relation to the supreme and cardinal aim of stabilising the price level indicates however whether such motives have been at work and to what extent that has been the case¹.

Past experience with experiments involving price stops and price controls in the interest of a stabilisation policy shows that in most instances they have fallen far short of what was expected. And that is not the only objection which can be raised against them. Indeed, as far as this particular argument is concerned, one could, as is sometimes done, console oneself with the thought that in countries which abstained from such experiments the rate of inflation has also increased in the meantime. The real problems inherent in such *tampering with symptoms*² on closer inspection seem to lie much deeper and to go in part far beyond the short-term aspects of the stabilisation policy.

¹ Cf. Oscar-Erich Kuntze, *Preisdirigismus in Europa — Symptomkuren oder Therapie, Zufall oder Menetekel?* (Price dirigisme in Europe — Tampering with symptoms or therapy, a chance accident or the writing on the wall?), in: *Ifo-Schnelldienst*, No. 12, March 22, 1972; and Karlheinz Kleps, *Preisstopverordnung und Preiskontrollen — Bisherige Erfahrungen* (Price stop orders and price controls — the experience to date), in: *WiSt — Wirtschaftswissenschaftliches Studium*, 2nd year (1973), Issue 1, p. 39 seq.

² One can speak of tampering with symptoms at least in those cases in which the extra time allegedly wanted to prepare a stabilisation programme tackling the causes of the problem of inflation in conformity with the needs of the market and economic system is being wasted or not put to proper use.

If there is a leakage before a price stop or price controls are officially announced — and there is one almost invariably — a final burst of inflation will be let loose by a government's intention to take such steps: the prices of all goods and services will be pushed up once more to the very limit (*dissemination effect*). Pace and finish of such a final spurt primarily depend on existing defects in competition and on the resultant market positions of the suppliers. Among the "winners" in this race will be not only the competitors who hold a dominant market position or come to an arrangement with other competitors ahead of the imminent price stop but the government which may adduce the final burst of inflation, which it has started off itself, as an additional reason for a price stop. It will find it all the easier to claim it as such if the public at large does not perceive the causal connection and sees in the intervention a manifestation of "law and order".

The goods on offer are to a more or less significant part imported in the form of raw materials, semi-manufactures or finished products. If the *prices of imported goods* continue to advance after a stop has been imposed on domestic prices — and in the absence of a world-wide stop on prices and costs this will certainly happen — two alternatives will present themselves in theory:

Prices of Imported Goods

□ The government can include the import prices in its price stop. That however can be done only by reimbursing either the foreign exporters or, more simply, the domestic importers from public funds for the difference between the domestic prices subject to a price stop and the import prices which go up further. Since such additional government spending must be matched by extra revenue, taxation will have to be increased either by raising the taxes on most incomes which will certainly give rise to compensatory wage and salary demands, or by putting a heavier tax burden on industry. In either case the result will be the same: a commensurate increase in the costs of the domestic suppliers who however will no longer be able to pass them on to the consumers by raising their prices. In so far as they are also unable to absorb the resulting increase in costs by improving their productivity, *unemployment* will follow as an inevitable outcome, and this will be the heavier the longer the price stop is kept on under the described conditions.

□ Clearly, an attempt to solve in this way the problem of a continuing rise in import prices is as unacceptable as an embargo on imports. So the government will have to exempt the prices

of imported goods from the domestic price stop. The first deviation from a general price stop however by no means resolves the dilemma, for a large part of the imports consists of raw materials and primary products which are absorbed into domestic manufactures: if their prices rise, so will the production costs of the latter. The producers of such goods will therefore be entitled to apply for higher selling prices and their applications will have to be passed on grounds of non-discrimination and also because of the threat of production cutbacks and unemployment. To prevent at the same time that dearer raw materials and primary products are used as an excuse for more than proportional price increases for finished products made from them and stocks of previous cheaper imports and thus for evasion of the price stop, the government will be compelled to engage in detailed *price costing and auditing* exercises before applications for higher prices are passed in part or full. This is a point which leads directly to the next general problem.

Growth of the Bureaucracy

Once the price stop is in force, the authorities will very soon be *swamped by applications to raise prices*. Their number will depend on the extent of economic integration with the outside world and be augmented by such other applications as can be justified on grounds of rising wage costs, heavier tax charges (e.g. to cover additional administrative expenses) or even qualitative improvements. These applications will all have to be checked.

The need for such checks which will turn the original price stop increasingly into a system of price controls is bound to require an *extension of existing or establishment of new official bodies*, for until the opposite is shown convincingly to be true, the administrative apparatus must be assumed to be carrying a full work load by virtue of its previous duties. How else could the growth of bureaucracy — everywhere claimed to be necessary or unavoidable — seem to be plausible? Enlarged or new official bodies put in charge of controls ensuing from the price stop are bound to involve the state in extra expenditure. Staffs taken on for this purpose cannot simply be laid off when price stop and price controls end and may thus be regarded as a *first structural consequence* of the interference with the price mechanism. This aspect of economic and social policy has beyond question generally received far too little attention although it has a bearing on almost all economic and social measures.

In an economy with full employment and relatively low labour mobility the enlargement or establish-

ment of official bodies will encounter certain difficulties. Three different methods are being tried in practice for circumventing them as regards the *checking of prices*: First, as soon as it proves impossible to cope with the increasing number of applications for price increases within a reasonable time, certain sections of the economy are absolved from control (as was done in the USA and Sweden for instance). Secondly, very soon there is also a growing tendency to use (or rather misuse) the facilities for restrictive controls in regard to prices which are of relevance to price indices or of political significance. Thirdly, there is a growing inclination to simplify procedures in all other cases by confining the checks to an examination of whatever cost increases are shown to have taken place. This means however that the longer the price controls are kept on, the smaller is the incentive for producers to try to improve their productivity and lower their costs, until the incentive in the end disappears altogether. Instead, the producers find that it is in their interest to concentrate on proving as large cost increases as possible and negotiating corresponding price increases with the control authorities. In consequence it is now no longer the price mechanism of the market but the public authorities which determine the further structural development of employment and production — a *second structural consequence* of the interventionist price policy.

Inflation Backlogs

In as much as, despite the objections mentioned, the efforts to curb the general upsurge of prices by administrative means and to prevent by warnings of condign punishment that all business is swallowed up by a morass of black and grey markets prove successful, an *inflation backlog* will accumulate. Taking an overall view, this is fed by three sources: further wage and salary increases which the trade unions secure without an offset by corresponding gains in productivity, further increases in public spending which arise unavoidably from the interplay of economic, social and political interests and are financed by borrowing, and increased export earnings which result from the constantly widening price differential compared with foreign countries and are not either invested abroad or sterilised at home. The reservoir of inflation stored up in this way will, to judge from all previous experience, break when the price stop and price controls are rescinded, and the eruption will be the more violent the more effective the measures have been in achieving the objectives of the stabilisation policy, the longer they were applied and the more likely it is that the government will resort to them again in future. If applied "successfully", these

measures strengthen the case for returning to them later.

In an order which is predominantly of the nature of a market economy the decisive determinant of *investment activity*, one of the crucial prerequisites of economic growth is the prospect of profits. If prices are kept down by administrative action, and assuming further that the inflation thus held back does not seek an outlet in grey or black markets commanding unlawful higher prices, the earning of profits will thereafter solely depend on the course of costs and tax charges. Both however are almost certain to rise — the costs mainly because the wages have not (yet) been stopped, and the tax charges, if for no other reason, because money has to be found for the new or enlarged control authorities as well as further rising salaries and pensions. Incidentally, the activities of these authorities will by no means be confined to the tasks which have already been mentioned: they will, besides, have to check and fix prices for new goods and services.

Alternatives for the Government

If the authorities thus keep down the prices and do not allow the further rise in costs to be passed on, the government will sooner or later reach the point where it has to choose between the following three *alternatives*:

☐ A continuing rise in the number of firms which can no longer absorb rising costs and tax charges by appropriate rationalisation measures (many of which involve additional investment) as the interference with prices continues. The result will be production cutbacks, plant closures and *unemployment*.

☐ Constraints to prevent a further increase in costs to avoid mounting unemployment. But that means in fact that a *general wage stop* must be imposed. Moreover, the state will have to cut other expenditure in order to finance the further expansion of its control offices by alternative economies.

☐ If the second alternative also proves impracticable, the government will in the end have no choice but to *abandon the price stop and price*

controls. How far the dammed-up inflation will now break through depends essentially on the judgment and strength of those in charge. They must take effective follow-up measures, attacking the problem of inflation at its roots. Otherwise, as experience has shown on various occasions, the sorry spectacle of remedies being applied to symptoms only will most likely soon be re-enacted — with inflation on a worse scale than before.

Result and Conclusion

A price stop and concurrent price controls provide a relatively short span of time for the preparation of a comprehensive and effective stabilisation programme to correct a mistaken economic policy *provided* that at the same time a wage stop is imposed and public spending curtailed. Apart from that there is no economic or political argument which can be advanced for having recourse to what are in fact obsolete economic instruments for the purposes of price policy. All experience suggests that such tampering with symptoms — it is nothing else — is bound to fail and can give the public at large only a short-lived and deceptive impression of effectiveness unless cogent action can be taken quite early to combat the real causes of the problem of inflation.

Those who assert with increasing frequency that the problem of inflation and the abortive acts of price dirigisme are in the final analysis the reflection of deteriorating efficiency of the concept of the market economy, evidently overlook that the root causes of the problem — excessive demands by the various social groups, excessive expenditure by the state, monetary overexpansion and insufficient competitive pressure — do not concern some "invisible hand" but fall undeniably within the compass of the economic policy of the state. For this reason the problem must also be regarded as a result of faults or omissions in economic policy. From this follows, further, that the danger threatening the order of the market economy arises not so much from shortcomings in its operation as from the follies of its beneficiaries and the short-sightedness of those who bear official responsibility for it.

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