PUBLIC POLICY IN ACTION

Agricultural Extension Service
Blacksburg, Virginia

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"Inflation Still a Danger"

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(Copy)

Blacksburg, Virginia
November 9, 1951

Dear Son,

We have already talked about how price guides production and distribution in our economic system for satisfying human wants. I must now answer your question as to why Professor Paarlberg considers himself a "Devil's Advocate." It is because he thinks that a free price system, designed for satisfying human wants, can also be relied upon to guide the production and distribution of guns, tanks, and other materials of war; materials which, I believe you will agree, are not on any individual's list of human wants.

Many people do not share the Professor's opinion that an economic system designed for peace-time operation can be made to work equally well in a war-time situation. They think a few modifications are necessary to allow for production of goods and services which do not satisfy human wants. This causes the Professor to defend his "Heresy."

When war comes in the front door, freedom flies out the back. We want individual freedom as well as price freedom. But are you free to decide whether or not you will serve in the army? Once you are in the army, how much freedom do you have?

The Professor suggests that consumers should be priced out of the market. Should the government, which is one of the most important consumers, be priced out of the market for materials needed to make weapons of war? For example, right now the relation between the production of machine tools and orders for them is 1 of production to 24 of orders. Can we let price decide who gets how much of machine tool production?

So it is with labor. In wartime, everybody has a job. Labor is in a superior position to hold out for more and more wages. Labor is most likely to do so when the goods and services they have to buy keep going up in price. Higher and higher wages will not bring forth proportionately more workers. Can we do without wage controls? A wage is a price, too--the price paid for services.

Of course, this does not mean that every wage and every price needs to be controlled by government, or that controlled prices should be fixed once and for all. It will depend on how much war we have and the relationship of a particular industry to defense production--or perhaps I should say on how much peace we can preserve. Perhaps the "Key to Economic Freedom" lies in peace.

In order that you may consider both sides of the price control question, I am enclosing a copy of a criticism of Mr. Paarlberg's paper by George L. Mehren, who is Associate Professor of Economics at the University of California, and now on leave to work for the Office of Price Stabilization. This was prepared for presentation recently at the American Farm Economic Association meeting at Guelph, Canada in reply to Mr. Paarlberg's paper, which was also presented there under the title, "Production and Distribution Problems Under Direct Price Control."

From what these two Professors have said, plus the questions I have raised above, I believe you can see that it is important that you and I and others who sit on the "Board of Directors" obtain all the facts we can before arriving at a decision as to what is the best course for our country to pursue. With this in mind, let's get back to our "Board of Directors" meeting and take a look at some more of the items on Uncle Sam's financial statement.

Now that we are generally clear on what Gross National Product is, the next important item we find on the financial statement is labeled "National Income, $289.2 billion." From the statement itself we can see that National Income is arrived at by making certain deductions from Gross National Product.

	Fiscal 1952 (Billions)
Gross National Product (at current prices)	$ 340.0
Less:	
Capital-consumption allowances	24.0
Indirect business tax and nontax liability	26.0
Business transfer payments	0.8
Plus: Subsidies less current surplus of Government enterprises	0
Equals: National Income	$ 289.2

From the discussion of the Joint Committee in the course of their explanation of why they think inflation is still a danger, we learn the meaning of the terms used in making these deductions.

The production of all the goods that were added into Gross National Product requires that a large amount of money be tied up in such things as factories, mills, machines, buildings, and homes for employees. These are called Capital Goods. In the course of a year these undergo a certain amount of wear and tear which we call depreciation. As these things wear out, they have to be replaced.

Besides that, fires, floods, storms, and explosions destroy a certain amount of such equipment needed to produce other goods. These losses by wearing out and destruction have to be subtracted from Gross National Product because the replacement goods were counted into Gross National Product when they were produced. Deductions for this wearing out of our productive plant are called Capital Consumption Allowances. The Joint Committee estimated that for fiscal 1952, $24 billion worth of Capital Goods would be consumed by use and by losses.

Another thing the Committee says must be subtracted from Gross National Product is that part of the price of goods which was made up of taxes. Sales and excise taxes are shifted from manufacturers to consumers of the goods by

adding the taxes into the price. If we don't deduct from Gross National Product the value of these taxes, we will have a double count because, you remember, taxes were added into Gross National Product under "Cost of Government Purchases of Goods and Services" and again in the price of the products. The amount of these Indirect Business Taxes is estimated by the Committee at $26 billion.

Another deduction we must make is for Business Transfer Payments. Examples of these include donations by businesses to charitable organizations. We subtract them to avoid duplications, because these gifts to charity are already covered in the prices of goods which we added into Gross National Product.

Subsidies paid out by government to business firms make up a part of the cost of producing goods, and are therefore added in after subtracting any profit the government has made on any commercial enterprises it may operate.

After making these adjustments, the Joint Committee estimates a National Income of $289.2 billion in fiscal 1952. This compares with an actual National Income at an annual rate of about $277 billion for the last quarter of fiscal 1951 (last April, May, and June).

We could get National Income in still another way. We could add up all the income received by businesses and individuals. This would give us the same figure.

Next, we need to take a look at consumer income and consumer supply, but I've got to stop now and get some Outlook material together for a meeting Ken Peterson is having in Rockingham County. He has a lot of poultry up there and wants to know what prices are going to be next year. I don't know, of course; but I won't tell him that. There are some things we do know, tho' that always helps us guess.

Enclosed is your allowance for the rest of November.

Regards, Dad

(Copy)

Richmond, Virginia
November 15, 1951

Dear Dad,

Wow! Your OPS friend certainly picks the Professor's bones pretty clean. I'm afraid I didn't quite understand a few of his statements, but I get the idea that there are two sides to this question all right. Paarlberg certainly has a marvelous style of writing. He had me convinced. It's funny the National Livestock Producer's Association didn't distribute Mr. Mehren's speech, too.

I see Truman predicts government expenses of $90 billion in fiscal 1953. Maybe we had better keep Mehren on the job for a while yet, just in case.

I finally decided to get the red cold-fire cap, but when I went back for it the fellow had only one left and wanted $7.00 for it. I told him that if it was as valuable as all that, he'd better wear it himself! Thanks for the allowance. See you next week--get the turkey ready.

Bye' now, Your son

DISCUSSION OF

"PRODUCTION AND DISTRIBUTION PROBLEMS UNDER DIRECT PRICE CONTROLS"

By

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This is not an easy paper to review. The author revels in deviating from the orthodox herd, whose views on inflation are held to be blind acceptance of blind dogma. The paper is larded with scholarly allusions -- although the author seems not to know that the Devil's Advocate does not defend heresy but rather contests against sainthood. There are medical and historical analogies -- even references to the dramatic arts, to college football, and to aviation -- not clearly applicable to the problem addressed here. There is gross disregard of the difference between inflation with slack and inflation with full employment. There is a remarkable disregard of the actual scope of current price stabilization, of the methods used and of the orientation of price control to production needs. There is an elementary discussion of the functions of relative prices, well applicable with reasonable general price stability but quite meaningless in the frenzy of general price explosion such as prevailed late in 1950.

To some of the points in this paper we may stipulate agreement: that defense production is a major goal; that inflation is in some senses symptomatic -- although even the author will agree that inflation is a cumulative process in which worsening of the symptom engenders further illness; that most defense costs must be met currently; that price stabilization is neither the single nor even the best method to control inflation.

There are many statements in this paper which are attractively formulated and often partly true. The total impact is not persuasive to me. On the last page, there are three short summary statements purporting to encompass Mr. Paarlberg's entire case. I am unable to accept any of these.

First, Mr. Paarlberg holds that maximum production and not inflation control is the real problem -- that the benefits of inflation are dogmatically underrated and the damage therefrom exaggerated by self-interested professional economists with fixed incomes. Apparent failure clearly to understand the determinants and the impact of inflation is general throughout the paper. The "chief charge . . . against inflation" is not that it reduces levels of living. To assert that "another way . . . [to control inflation] . . . is to let prices rise, thereby pricing consumers out of the market" is a fallacy in reasoning from the particular to the general. With general price stability, an increase in the price of a particular commodity will usually decrease its sale. A rise

1/ These are the personal views of the writer and are not necessarily those of the Office of Price Stabilization.

in general prices will not restrict the sale of commodities in general. Most economists consider that enhancement of the aggregate price level engenders enhancement of aggregate money income. Rising general prices can restrict total consumption only if wage distribution were rigidly controlled through forced allocation of wages to groups with consumption propensities lower than those of wage earners. This method of dampening inflation is surely impracticable in the present American economy. Further, such wage control in the "national melodrama" must be quite as objectionable to Mr. Paarlberg as that "fair haired hero, . . . Price Freeze." Inflation is a price-income-price spiral. Rising money income without significant income redistribution does nothing to constrict total demand.

In an economy not close to full employment, a mild and gradual and unanticipated rise in prices is stimulating to enterprise and to production. This is not now nor will it soon be the kind of problem to which economic stabilization is addressed. There was a drastic speculative inflation a year ago. There are now firm defense commitments which almost certainly assure heavy inflationary pressure in the near future. Even without full-scale war, such inflation if uncontrolled will be neither mild nor gradual nor would its continuance be long unanticipated. Anticipated price increases induce withholding goods from use. The more critical the defense need the stronger would be the incentive to hold for further price increases. Rapid general price increases are irregular among commodities. Inefficient producers are not weeded out. Labor, materials, and plants may be diverted from essential defense uses. Sellers will not make long term contracts necessary to efficient planning of production. Wage renogotiation will interrupt production processes. Speculative cunning is rewarded at the expense of productive efficiency.

Economists agree that in normal times the free market best allocates resources. However, such allocation is achieved through changes in relative and not in general prices. The functions of relative price changes are impaired or destroyed when price rises are sharp and foreseen and are feeding upon themselves. Mr. Paarlberg would be startled to observe the dislocation of relative prices disclosed by the freeze of January 26, 1951. He would apparently be surprised to know that a major function of the Economic Stabilization Agency is to repair these dislocations and to restore the effectiveness of relative price changes in guiding resource use. The freeze of January 26th was a distasteful necessity. Even so, inspection of the fifty-odd tailored regulations, as many supplements to the General Ceiling Price Regulation, the amendments to both, and other forms of regulation issued since January 26th would indicate beyond doubt that price stabilization is not price freezing. It is a continuous process of maintaining normal price relations as well as containing general price levels.

Mr. Paarlberg's disregard of the costs of inflation is amazingly cavalier. There is severe damage to national defense and to productive efficiency but there are also major social costs: impairment of the whole social fabric through destruction of middle class assets; creation of antagonisms from income redistribution; damage to saving propensities and to capital creation; deterioration of morale from elevation in national emergency of speculators to the top income strata.

Mr. Paarlberg's second claim is that inflation may better be controlled by methods other than price and wage controls. All agree that direct controls should be only a part of the total attack upon inflation but they are a necessary part in rapid mobilization. Effective direct controls encourage saving. They thus discourage speculative withholding and reduce the inflationary gap. Even if taxation and credit controls could substantially eliminate the inflationary gap, there would still be heavy and inevitable pressure in this full-employment economy for upward wage adjustments. We cannot in a mobilization economy afford the unemployment which we normally tolerate and which serves normally as a brake upon inflation. Presumably, indirect controls limit wage and other income pressures by restricting money demand to the extent that employers can neither afford higher wage payments nor reflect wage increases in higher prices. However, the principal buyer of many strategic materials is Government. Here no such indirect control of wage and income levels is possible. And income increases in these fields would surely spread through the rest of the economy in the absence of direct control. Mr. Paarlberg could fruitfully examine the changes during 1950 in prices of rifles, tanks, aircraft and other military equipment. He might well consider the implications of these price changes.

Thirdly, Mr. Paarlberg holds that direct controls will surely transform Americans into a nation of traitors, beggars, law-breakers, wheedlers, scroungers and special pleaders. I hold too high an opinion of Americans and of American government to concur in this view. Fairly devised and honestly administered, an efficient system of direct controls can be enforced with only minor and temporary loss of individual economic independence -- much less enduring and stringent than the loss of liberty from defeat by Communism. It is true that the public must understand the stabilization program and its obligations thereunder. I share Mr. Paarlberg's belief in democracy and his faith in the soundness of informed public opinion. The extent and impact of black markets in World War II has been greatly overplayed. Until June 30, 1951, techniques were available to control such black markets. The experience of our British allies demonstrates that intelligent and law-abiding nations can in fact endure prolonged control without destruction of moral fiber or personal liberty. And in doing so they can defend themselves.

I like controls no more than Mr. Paarlberg. I look forward to the day they can be lifted. Not long ago, all of us saw war. All of us now are in danger of a political force whose victory would mean far more serious results than price control. The American people have assumed terrible responsibilities in their attempt to contain Communist imperialism. These responsibilities require us to accept the burdens of mobilization. They require us also to prevent the inflation which could as surely destroy us as could military defeat.