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WAGES AND PRICES

HENRY HAZLITT
The New York Times

THE subject of my address has been set down on this program as " Wages and Prices ". That subject is so broad, and has so many facets, that it could well occupy an entire book. In a short talk of this kind I am compelled to confine myself arbitrarily to only a few of the problems involved in the relationship of wages to prices.

I shall be obliged to take certain basic principles for granted, without presenting the arguments for them; and, although they are quite traditional principles, it may be helpful if I begin by at least confessing what they are. In the view of Ricardo and his disciples, prices were determined by wages. More broadly, prices were thought to be determined by all costs of production, but costs of production were thought of as consisting ultimately of costs of labor. The " Austrian " school reversed this view. It held that prices were determined by marginal utility and that wages were determined by prices.

Such short statements enormously oversimplify the problem; but I may indicate here that my own analysis is based on the so-called " Austrian " view. The value of the product determines the value of the elements that go to make up the product. The case is likely to be clearest if we assume a free economy and take, for example, the salaries of motion picture actors. Why does X draw a salary of $200,000 a year, while Y, who plays supporting rôles, gets only $50,000, and Z, an extra, gets only $5,000? Most people recognize immediately in this case that it is because X has the biggest " box-office appeal ". More people will pay more money to see him in a picture than will pay to see Y or Z. The producing company can afford to pay X his high salary because it can sell its picture for more to exhibitors; they in turn can afford to pay more for the picture because they know that a larger public will pay to see it. It is

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because they know (or believe) that the public is ultimately going to pay it that the producers are ready to " advance " X this salary, on the same principle that a publisher advances a promising author part of his expected royalties. X's salary, in short, depends upon, and is derived from, what he contributes to the total value of the product. It is what the picture sells for that determines what X is worth.

It is so, in the last analysis, with all other salaries and wages. The value of the workers' services is derived from the value of the products they help to create. This is the doctrine and the meaning of productivity.

In other words, wages are not low in China and high in the United States because Chinese employers are niggardly or American employers generous. Wages are not low in China because the Chinese employer " follows a low-wage policy " or high in the United States because the American employer " follows a high-wage policy." Wages are low or high because of the marginal productivity of the worker.

To put the matter in another way, the employer is a sort of middleman or broker between worker and consumer. What he can pay for labor is determined by what the consumer is willing to pay for the final product into which the labor enters; and wages cannot be excessively boosted, or profits excessively curbed, by either governmental or union action, without discouraging either the ultimate consumer or the employing middleman and thus endangering employment.

It is not difficult to reconcile this view of the matter with a theory that postulates a close relationship in the long run between prices and costs of production. It is not true that costs of production directly determine prices. What a commodity *has* cost to produce does not determine its market value, but what it *will* cost to produce may determine whether or not it will be made, or how much of it will be made. Thus present demand affects future supply; and thus there is a constant tendency for price and marginal cost of production to equal each other, though not because one directly determines the other.

With this very brief theoretical outline out of the way, we are prepared to discuss some of the practical problems that arise in the relationship of wages and prices at the present moment.

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We are now in an inflationary period. Pressure for higher prices is caused in part by continued wartime shortages of consumer goods and by accumulated consumer demands. More importantly, it is caused by a huge increase in the monetary medium and by policies that tend to bring about a still further increase. The volume of money and bank deposits has more than tripled since 1939. A policy of artificially low interest rates, combined with a continuing budget deficit, keeps increasing the volume of credit. Yet we are trying to " combat inflation ", not primarily by dealing with these causes, but by putting legal ceilings on wages and prices—or at least by putting ceilings on prices.

The executive orders under which we now operate are in many respects conflicting and ambiguous; but, in spite of apparent contradictions, it would not be unfair to describe our present economic policy as one of trying to hold the price line while allowing wages to remain practically free from controls. The federal government has even encouraged, if it has not virtually ordered, a general wage increase in the neighborhood of 18½ cents an hour.

Now can we really expect to " hold the line " on prices while permitting wages to go wherever competition or collective bargaining sends them? Obviously, the result of such a policy, if persisted in, must be to wipe out altogether the profits of marginal firms, or the profits on particular items, so that those items will go out of production and those firms will go out of business. The result, in short, if the policy is carried far enough, must be both to reduce production and to create unemployment. This result may be delayed or disguised for a while in an inflationary period like the present. Greater demand tends to bring greater volume of production; greater volume of production usually tends to reduce unit costs, and it may allow net profits to remain high even with unchanged or higher unit costs. But if the policy of boosting wages and holding prices is carried sufficiently far, it must eventually disorganize production and lead to unemployment.

This brings us to a wider problem. If we grant that we cannot boost wages and hold the price line, is it not at least possible under present conditions, it may be asked, to hold the line on both wages and prices by direct government ceilings?

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It will be found on examination, however, that this is posing the problem as if it were primarily concerned with the interrelationship of prices considered en bloc with wages considered en bloc. But this is a false way of looking at the real problem we have to deal with. We really have to consider the relationship of each price to each wage rate. Further, we have to consider the interrelationships of thousands of prices with each other, and the interrelationships of thousands of wage rates with each other. For each of these relationships affects production. Each of these relationships affects the relations between supply of and demand for particular products. If we take as our base the prices or wages of some past period—of January 1941, for example—we must take over at the same time the complex interrelationships of thousands of individual prices and wages which were determined by the particular supply and demand conditions of that particular month and year. But those supply and demand conditions no longer exist. Any effort, therefore, to preserve or petrify the interrelationships based on them must distort and disrupt the present structure of production.

Price control itself inevitably does this. Price ceilings that are held below the level to which the forces of a free market would bring them tend to encourage consumption and to discourage production, thus bringing about shortages. If I were to elaborate upon this point, I should get into the general question of price control, which is beyond our present subject. I am bound to mention the general nature of the consequences of price control, however, in order to emphasize the enormously more complicated problems raised when we consider the interrelationships of wages and prices as well as of wages to each other and of prices to each other.

This brings us to another problem that has been much discussed of late. From the Office of War Mobilization and Reconversion there leaked out a few months ago figures, never officially sanctioned, purporting to show with some qualifications that industry could " afford " to raise wages by 24 per cent. At the same time the Department of Commerce put out a report, later retracted, which declared that " present cost-price relationships are such throughout industry that a basic wage increase is possible without raising prices "; and that the automobile indus-

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try in particular could grant a 15 per cent increase " without adverse results in the first post-war year . . . and a further increase of 10 per cent . . . for 1947."

Now it is not my intention here to analyze the figures which purportedly led to these conclusions. I should like rather to raise the broader question whether trustworthy calculations of this sort are possible at all—especially with the very limited data that even government bureaus are likely to have. I do not think, in fact, that over-all estimates of this type can be either trustworthy or useful. Prices and wages, in the first place, are always specific; they do not consist of " levels " or averages. Over-all averages can, of course, be approximately calculated or abstracted from selected prices or wages. But it is quite invalid to use such averages, in turn, to try to calculate what a specific wage or price ought to be. The problem of the level of a particular wage or a particular price, or of its relationship to thousands of other wages and prices which it affects and which affect it, is always a specific problem. It cannot be answered in terms of the general price " level " or wage " levels "; it cannot be answered in terms of *averages* at all. These mass over-all calculations completely ignore the fact that any " average " advance in wages would affect each industry and each firm to a different extent and in a different manner. No statistician could predict the effect of a given general wage increase unless he knew not only the over-all profits of industry but the profits of each industry and the distribution of those profits as among particular firms—as well as scores of other constantly changing facts than no one mind does know. The folly of the government's encouraging, recommending or ordering an increase of 18½ cents an hour in each wage, regardless of the particular existing wage to which that increase is added (especially at the same time as the government pretends to be " holding the line " on prices, or allowing " only a bulge, and not a breakthrough "), ought to be too obvious to require serious analysis.

This attempt to treat wages and prices in terms of over-all averages has led to some queer conclusions. A few months ago the Secretary of Commerce was reported to favor a 15 to 20 per cent wage increase, provided prices were not increased more than 3 per cent. This calculation seemed to be based on some notion that wages constitute only one fifth or one sixth of

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costs of production or of sales prices, and that a 15 per cent increase in wages would require only a 3 per cent increase in prices for everything to come out even again. If that were so, our problems would be enormously simplified; for if such a fixed relationship existed, we could increase wages, say, 150 per cent and prices only 30 per cent; or wages 1,500 per cent and prices only 300 per cent, and labor would always come out better off both relatively and absolutely.

It is clear, unfortunately, as soon as we make the figures large enough, that the proposition reduces itself to a mathematical absurdity. For the last fifteen years or so, "labor" has consumed, it has been estimated, about 75 per cent of the national product. But if labor is now consuming 75 out of every 100 units of production, then with a 150 per cent increase in wages to a 30 per cent increase in prices it could consume 187 out of every 130 units—which, as Euclid would say, is impossible.

The fallacy which gives rise to this belief that a wage increase could be safely imposed on the economy substantially greater than the accompanying price increase is that of looking only at the direct wage costs of a specific trade. In the automobile industry, for example, the direct wage costs at the assembly plant may be less than a third of the total costs; and this may lead to the conclusion that a wage increase of 30 per cent would require to offset it a price increase of, say, only 10 per cent. But the falsity of this is apparent as soon as it is recognized that the other costs of production of the automobile industry—the costs of raw materials, of rent, of transportation, of selling—"break down" in turn largely into wages paid by *other* industries. And a general wage increase would raise these indirect labor costs in each industry as well as its direct labor costs.

If the labor income of the country represents approximately 70 to 75 per cent of the total income of the country, as has frequently been estimated, then an increase of 30 per cent in wages, it might more reasonably be deduced, should ultimately reflect itself in an increase of 20 to 22 per cent in prices. While the over-all mathematics of this is better, I do not think that even this sort of calculation is very useful. Like the other over-all kind of calculation we have been discussing, it ignores the specific realities of the situation. One might make the abstract

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objection, for one thing, that if the relative purchasing power of profits were cut down in this way marginal producers would desert the ranks of employers and entrepreneurs and would join the ranks of employed labor. But the real objection to this method of measuring wage-price relationships is of another nature.

If we discuss the problem more realistically, this type of over-all calculation is seen to be extremely dubious. If in an otherwise free market the wage of some powerful union group is forced above the equilibrium level, the main result may not be a corresponding rise of prices of the product which that union makes. The main result may be unemployment. Even if a price rise is the immediate result, the price advance restricts the market for the product, restricts the volume of sales, reduces production and therefore reduces employment.

At the moment we have a very unusual economic situation. We have a volume of money and credit that would doubtless sustain higher wages and prices than at present exist. These levels are kept down to a certain extent by governmental controls—though (when we consider quality deterioration, black markets, and reduced production) not quite to the extent that government statisticians calculate. But even under existing conditions, it should be clear that inflation is not caused, as is so often supposed, by an upward "wage-price spiral". The causation, in fact, is the other way round. It is the monetary inflation and a shortage of goods that make the wage-price spiral possible. We could not, for example, have had an upward wage-price spiral in 1932. If we had tried it we should only have increased unemployment. It is precisely because we did try artificially to bring about an upward wage-price spiral in 1933 and 1934 through the N.R.A. that we prolonged our unemployment and depression. At the present juncture, it is true, governmental encouragement of a wage increase acts *politically* as an inflationary factor, by bringing later pressure for a sufficient price rise or monetary inflation to make it work. But this does not mean that a wage-price spiral is the basic economic cause for inflation.

The basic cause for inflation is to be looked for on the monetary side. Government price and wage controls cannot cure inflation; they merely tend to prevent production from going into the channels where there is the greatest consumer demand. They

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reduce production, if not always in terms of tonnages, at least in terms of utilities to consumers. If we are to combat inflation we cannot do so through wage and price ceilings, but only by dealing with the fundamental monetary causes of inflation.

To sum up, the main proposals and theories now prevailing with regard to wages and prices are the product of political expediency rather than of scientific study. If we try to hold down prices while permitting wages to go wherever competition or collective bargaining sends them, we must eventually disorganize production and create unemployment. Even if we try to hold the line on both wages and prices by direct government ceilings, we must still distort the structure of production and create shortages. It is a delusion to suppose that all wages can be raised by some given percentage without affecting prices, or affecting them only to some negligible extent. We cannot cure inflation by trying directly to prevent a wage-price spiral, but only by dealing with the causes of inflation, which are basically monetary. If we deal with those causes, then we can safely leave wages and prices to seek the levels to which the forces of a free market send them.

Finally, we can do most to clarify our economic ideas, not by returning to medieval concepts of " just " prices or " just " wages, but by maintaining the modern concept of functional prices and functional wages. The best prices are not the highest prices, but the prices that stimulate the largest volume of production and lead to the largest volume of sales. The best wages are not the highest wages, but the wages that lead to full employment and the largest possible payrolls. The best profits are not the lowest profits, but the profits that encourage the most persons to become employers and to provide jobs. Prices, wages and profits must be thought of together. Only when we have achieved the best balance among them can the economy function at its fullest. If we try to force one of these elements out of relationship to the others, we must reduce production and hurt everyone—and sometimes most of all the very groups we are most eager to help.

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Remarks by the Chairman

Chairman Ransom: As I announced at the beginning of the meeting, we regret very much the absence through illness of Mr. John W. Scoville. Next we shall turn to discussion of the addresses of the morning, and we shall have the benefit of the experience of one of the best known of American trade unions, a militant union which has solved through arbitration and through all sorts of friendly relations many of its own problems in relation to employers.

I have the pleasure of presenting, from the Research Department of the International Ladies' Garment Workers' Union of the American Federation of Labor, Dr. Broadus Mitchell.

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