PRODUCTION AND DISTRIBUTION PROBLEMS
UNDER DIRECT PRICE CONTROLS

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WHAT I have to say here will assume an economy in the present state of partial mobilization.

The country appears convinced that the number one economic problem is to stabilize prices and prevent inflation. This thought has become so thoroughly ingrained in our thinking that many have ceased to question it. It is a part of our economic doctrine.

In the early days of the Church, a complete code of religious doctrine was handed down to the laymen. There were some unbelievers who were called to account for their heresy. These unbelievers were permitted to have a spokesman to defend them. Since this spokesman was supposed to represent the powers of evil, he acquired the highly descriptive title, "The Devil's Advocate."

Similarly, today, the fear of inflation and an enthusiasm for price control have become a part of our economic doctrine. There are some who do not subscribe to this doctrine; I am among them. I should like to be the Devil's Advocate in defense of my own heresy and that of others.

Some will say that in view of political considerations, direct price controls are inevitable and that economists therefore should accept them and figure out how best to make them work. This is a view which I cannot accept. I recognize the need for synthesizing the view of the economist, the sociologist, the political scientist, the diplomat and the military expert at the policy level. I object to the idea of embarking on a policy based on political or other considerations and then asking the economist to rationalize and expedite this policy. I shall attempt to distill the economic considerations out of the current ferment; if too strong a drink comes out, the policy-makers can cut it with the appropriate amount of water. But let us not mix other disciplines with economics at the analytical level.

Flexibility Needed, Not Stability

First of all, in my judgment the number one economic problem is not that of controlling inflation, but of maximum production for the rearmament effort and for the economic well-being of our citizens. If we lose out to the enemies of freedom, it will not be because the price index showed a rise of a few points. The primary economic problem is to keep our economy flexible to meet the changing needs brought on by domestic and international developments. This can't be done with prices frozen,
any more than my car can be kept on the road with a locked steering wheel. The key word is not stability; it is flexibility.

**Inflation Is a Symptom**

Let us look at the chief charge leveled against inflation—that it reduces the buying power of the people and forces them to accept a lower level of living. It is certainly true that if we devote 20 percent or some other large percentage of our energy to the destructive efforts of war, we will have fewer useful goods and services to enjoy. How is this reduction in the level of living to be brought about? There are only three ways to do it:

One way is to take the money away from the people, either by taxing them or by requiring them to buy bonds.

Another way is to ration them and thereby limit the amount of goods they can buy.

Still another way is to let prices rise, thereby pricing consumers out of the market. These price rises may need to be supplemented by restrictions on the production of certain consumer goods which are not essential to the rearmament effort.

All three methods will achieve the purpose which is essential if the rearmament program is to go forward—reduce the level of living of the people and thereby transfer men and supplies from civilian uses to the rearmament program. The only question is whether this is to be done by a high level of taxation, by an arbitrary rationer in Washington, by the impersonal operations of a freely fluctuating price system, or by some combination thereof.

The real culprit responsible for the reduced level of living is the war effort; inflation is merely a symptom. Prices are to the economic body about what the temperature is to the human body. The human mechanism consists of various organs: the heart, the lungs, the liver, and the stomach. If something happens to one or the other of these organs, the temperature rises and is recorded on the thermometer. Similarly, the economic body consists of many parts—labor, agriculture, industry—each with its own supplies and demands. If something happens to the supplies of or demands for these commodities, the change is registered in the price.

A doctor could set the thermometer at 98.6 and think that therefore he had cured the patient. Similarly, we can freeze prices as of a certain date and think that we have cured whatever ailed us. A fixed thermometer would be a handicap to a doctor who is puzzled about how to diagnose and prescribe; a fixed price is a handicap to an economy which is trying to find out what to produce and consume.
Inflation is a good scapegoat; attributing our difficulties to inflation is a good way to draw attention away from the real cause of prospective reductions in the level of living—the rearmament effort. But let us not be so naive as to think that if we halt inflation we will be able to avert the reduction in the level of living brought about by rearmament.

Inflation and Production

It is sometimes thought that a rising price level cripples the productive plant of a nation and therefore hampers the rearmament program. On the contrary, a rising price level is a powerful stimulus to increased production. When prices rise enterprise is encouraged. Debts are easy to pay. Inventory values rise, modernization goes forward. Business ventures pay out. The tremendous production of World War II was accomplished while the price level was doubling. In time of war, the price system has always invoked a certain amount of inflation as a stimulus to production and a deterrent to consumption.

Is Inflation Followed by Deflation?

Another charge against inflation is that a price rise must inevitably be followed by a price decline; the rise may be pleasant, but the collapse is painful. This notion is based on the idea that there is a sort of normal for the price level and that prices somehow have to fluctuate around that normal. This we have believed for a long time; it is implicit in the concept of “normal agricultural value” for farm appraisal, based on the period 1910-14. “What goes up must come down,” we say, much satisfied with our wisdom.

But a study of history shows that there is no normal for the price level, that what goes up may stay up. After World War I, Spain’s prices leveled off at several times prewar, and stayed there. After World War II, prices in the United States were two or three times prewar, and I personally doubt if they’ll ever come back to the 1939 level.

As a matter of fact, there is the great likelihood that if we succeed for a time through direct controls in holding down prices we will have inflation later, when we take off controls. This occurred after World War II. In other words, if we impose price controls and at the same time keep pouring out more and more buying power we build up a larger and larger inflationary lake behind the weakening dam of price control. Inflation comes when the dam breaks or the flood gates are opened. We may fear to open the gates, and so continue to live in regimentation.

There is no assurance that if prices rise now, they must fall later. Neither is there any assurance that holding them down now would keep them from rising later.
Some people are afraid that unless we have price ceilings, prices will "go through the roof" and we would have runaway inflation such as Germany experienced in 1923 and Greece during World War II. I have studied many inflations in many lands covering a period of many years—the inflations of Austria, Russia, Hungary, China, Italy, Germany, Greece, and our own country during the Revolutionary War. I know of no record of any nation that underwent runaway inflation so long as its productive plant was intact. The only examples of runaway inflation that I know of occurred in countries ravaged by war, torn by revolution, or laid waste by some great disaster. Here again, inflation was a symptom of a more deep-seated cause.

It is a matter of interest that many of the countries which have undergone runaway inflation have done so in spite of a system of ceiling prices.

How Much Inflation Can We Stand?

How much inflation can a country stand? There are three different levels: the psychological level, the political level, and the economic level, each successively higher than the former. Much of the present confusion comes from failing to distinguish between them.

The psychological level is the one at which people start to complain about the rising prices. This is a very low level; an increase of a few cents a pound in the price of beef.

The political level is somewhat higher; it is the level at which the complaint about rising prices becomes sufficiently great so that Congress will do something about it. Maybe a rise of 10 percent in a year's time will bring about this reaction.

Finally, there is the economic level, the level at which the country's production is really harmed. I don't know where this level is, but it is very high. The doubling of our price level during the war was an aid to production, not a handicap. After World War I, Finland's price level was 10 times prewar, and she was prosperous enough to continue paying her war debt.

Inflation affects different classes of people differently, as everyone knows. Farmers find that their prices rise and costs lag; they like inflation. Laborers find that wages rise and jobs are plentiful; they like inflation. There is one important group which suffers during inflation—those on fixed salaries. Unfortunately this group includes newspaper editors, radio commentators, Congressmen, and professors of economics. These people talk and write all out of proportion to their numbers or importance, and are responsible for much of the furor about the evils of inflation. They find inflation harmful to themselves and generalize from their own experience.

A good measure of the reaction of the people to inflation is their be-
behavior at election time. A satisfied electorate will not "change horses in
midstream," when the people are in distress they "turn the rascals out." In
the 30 presidential elections since price data became available there
have been only two occasions when people failed to maintain a party in
power on a rising price level; with prices falling, there have been only
two occasions when they failed to "turn the rascals out." Truman's elec-
tion in 1948 was an upset in terms of the Gallup Poll, but not in terms of
the price level.

To summarize, I doubt that the dangers of inflation are sufficiently
great to cause us to scrap the price system and go in for direct controls.

The Functions of Price

It has become increasingly fashionable to doubt or deny that price can
allocate resources or guide consumption. This is in spite of competent
research to the contrary, and in spite of a rather efficient pattern of pro-
duction and consumption which could have come about in no other way.
One who doubts that price can guide production and consumption is an
economic agnostic, like a physicist without a law of gravity or a theologian
without a Deity. We have become so engrossed in some of the finer points
of economic doctrine that we have largely forgotten economic lesson
number one. We economists have been concentrating on end runs, double
reverses and mousetrap plays instead of studying the fundamentals of
blocking and tackling. Here are the functions of price as I see them:

Prices serve three functions. They tell us what to produce, they guide
commodities through the channels of trade, and they tell the consumer
what and how much to consume. If the price of hogs increases relative
to corn, the farmer recognizes the consumer's request for more pork,
and he responds accordingly. If the price of eggs rises in New York
relative to Philadelphia, the egg trade recognizes the call for more eggs
in New York and diverts eggs to the high priced outlet. The consumer,
with her market basket on her arm, chooses food on the basis of price.
If steak is high she buys hamburger, and if both are high she buys
beans. One hundred fifty million people vote on their prices. Everybody
serves on the committee that determines market prices, and serves with-
out pay.

What happens when we hold these prices below the market level?

First, the consumer recognizes this as an encouragement to increase con-
sumption, and cleans off the shelves.

Second, the farmer recognizes this as a sign to reduce production. So a
shortage develops, and the scant supply must be rationed. This may not have
been contemplated at the time the ceiling price was set, but given time, it
follows as the night follows the day.

Finally, with artificially lowered prices, production continues to lag and
subsidies must be resorted to.
Ceiling prices, rationing, and subsidies are the three-legged stool of an economy which endeavors to hold prices below the equilibrium level. A stool will not stand for any length of time on one or two legs, but needs all three.

In England they understand this better than we do, for they have been at it longer. They fix prices, ration, and subsidize agricultural commodities pretty well across the board; they have had to do this to make the system work. We will have a similar experience if we stay with it long enough. If we won’t let the price system function we shall have to step in and do the jobs that the price system formerly did for us.

In the first act of the national melodrama, Price Freeze is the fair-haired hero who would save Little Nell from the villain, Inflation. But in Act Two, he must request the aid of that low character, Rationing, and in the last act the two of them must beg the help of that ugly fellow, Subsidies. If the audience knows all this and still wants to pay to see the show, well and good. But they had best not cheer too loudly or too early, when Price Freeze makes an entry.

The American citizen needs to know that he can’t have artificially low prices (which he considers desirable) without rationing and subsidies (which he considers undesirable). It is a package sale. We do not know this, hence our enthusiasm for price control. The first effect of price control is to permit us to buy at a low price, which all consumers like. This continues so long as the momentum of our past production pattern will carry us. Then we get in trouble, and need to ration and subsidize. In time we feel the full impact of the program and are likely to kick it out. This cycle took about four and a half years under OPA.

Management Under Price Control

The job of management is to put together land, labor, and capital in an efficient manner so as to produce the goods and services asked for by the consumer. Prices are the critical items in these decisions. Prices tell the manager which products the consumer wants. Prices of land, labor, and capital tell him how much of each he should use in producing the commodities that are asked for.

When prices are fixed, the chain of command is broken. How can the manager tell whether the consumer should have beef or butter? If the price is effectively fixed all the manager can do is give heed to the fixed price. If prices of hogs and corn are fixed at a relationship favorable to hogs, management can only expand hog production in response to this fixed price until suddenly the country runs low on feed.

Prices may be calling for the proper product at the time they are frozen, but they don’t stay that way. Along comes a short crop or a changing need, and the old ceiling is no longer the right one. Changes
are not made in time; it takes an administrator a long time to make up his mind that the ceiling is wrong, and still longer to correct it.

Black Markets

Most likely, prices would not be effectively fixed; there would be black-markets, gray markets, tie-in-sales, under-the-counter sales, kickbacks, upgradings, false counts, and short weights. These activities are viewed by some as outright violations of law and by others as an effort to reestablish the functioning of supply and demand. In a country like ours with a tradition of freedom and individual rights, nobody becomes very disturbed about two people getting together on a deal mutually satisfactory.

People display all sorts of reactions to violations of law. They'll help catch a kidnapper; they'll report a traffic violator, but won't try to catch him. What will they do and say about somebody who buys a piece of beef above the ceiling price? Many will ask "Where did you get it?" and "What did it cost?"

The cost of abiding by the law will be measurable in so much per pound whenever the farmer goes to market. For a certain percentage of people with firm respect and blind faith in law, the choice is easy. For another group—the greedy or the desperate—the choice is likewise easy. For most Americans, the choice is difficult. The prospect is not a bright one. Honesty and respect for law are virtues which are already frail enough so that one has no wish to see this extra burden and temptation placed on them.

Some people attribute difficulties of enforcement to incapable administration, to poor organizational setup, to excessively complex regulations, or to some special perversity of human nature. These changes may be partly true, but the difficulty lies deeper than that. It lies with suddenly declaring illegal operations which formerly were considered entirely moral and right. It asks a sudden changing of the value concepts with which people regard economic activity. Sociologists tell us that these changes come about slowly and only in response to some deeply felt need.

Would there be better compliance and a better job of enforcement in the years ahead than during World War II? We probably can't count on the degree of cooperation that existed then, when we were definitely at war and the people were behind the effort and in a mood to sacrifice. Furthermore, there is the possibility that the forthcoming effort might be of considerable duration, and the longer the period, the more the maladjustments that would have time to develop. What lies ahead may be a mile run, not a hundred yard dash. These two races should not be run in the same manner. A price freeze works better for the dash than it does for the distance.
An Alternative

Luckily there are alternatives to direct controls—taxes, which mop up buying power, and credit controls, which prevent the creation of new money. These take the upward pressure off the price level. If we had the courage to apply these remedies in sufficient degree, we could halt inflation and at the same time let the prices of individual commodities fluctuate freely.

I have tried to make these points:

First, that the real problem is maximum production of the appropriate goods and services, not inflation control. The beneficial effects of inflation have been much underrated, in my opinion, and the unfavorable effects much exaggerated.

Second, if a price freeze really comes—and what we've had now is not a real freeze but merely a cool spell,—then we become a nation of lawbreakers, wheedlers, scroungers and special pleaders. I am not saying that direct price controls will not work; I am merely saying that the cost of making them work might well be greater than the questionable benefits derived therefrom and greater than a free people would long tolerate.

Third, if inflation control is desired, there are better ways of accomplishing this objective than price freezes, namely, heavy taxation and credit control. We need not burn down the house to roast the pig.

I feel deeply about this because it seems to me that we economists have not done our job. We have not helped people to understand the workings of the price system, and this failure is about to cost us our liberty.

There is an intriguing phrase, "the point of no return." An aviator starts out on a mission with a certain supply of gasoline, and after a time may reach a point where he doesn't have enough gasoline to return to his base. This is the point of no return. Every flyer thinks carefully before he passes that point.

There can be, I think, a point of no return in economic affairs. We may start off on some mission, not too well conceived, and bumble about, issuing directives, patching the leaks and patching the patches until we pass the point of no return. Affairs will have then gone so far from equilibrium and the shock of return would we so great that we would lack whatever it takes to slough off the controls.

If we should pass the point of no return after a full appraisal of the advantages and disadvantages of our new position as compared with our old base, then we need have no grief. I believe in democracy and have immense faith in the soundness of informed public opinion. But if we embark on some program after considering only the short run implications and then find ourselves hedged about with unsuspected evils, so that we wish to return to our base but can't, that is a different matter. I feel strongly the need for economists to tell the public what's inside this hand-
some package labeled "direct controls." My guess is that if we were to go in for a full system of price controls and stay with it for 10 years, we would have passed the point of no return. Price freedom is the key to all other economic freedoms.

**DISCUSSION**

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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 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 is rigidly controlled through forced allocation of wages to groups with consumption propensities lower than those of wage

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