EFFECT OF GOVERNMENT PURCHASES ON PRICES IN WAR AND PEACE

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DR. KRESS: General Holman and gentlemen: The work of the Procurement Branch enters a new phase today. We have progressed through lectures and seminars which have developed the interest of the several military services in the problems of procurement as to organization and policies, the coordination of procurement, under current legislation and the legal aspects thereof, as well as the intricacies of government contracts. With this background, we are now ready to attack the larger problem of the relationship of procurement to the civilian economy with all the attendant problems of economic stabilization.

We have as our speaker this morning a man who is most qualified to speak on the subject, "Effect of Government Purchases on Prices in War and Peace". He is qualified because he began his work in the field of price control with the establishment of the National Defense Advisory Commission in 1940. This was the commission in which Leon Henderson was in charge of price stabilization. With the establishment of OPA, Dr. Johnson held a succession of offices throughout the whole war period and was one of the keymen constantly called into consultation by the Price Administrator on problems of policy. At the present time he is Director of the Economic Stabilization Division of the National Security Resources Board and is again in the forefront of policy planning for any new emergency. Dr. Johnson pleaded the press of his office when I asked him to address you, but readily consented when I pointed out that you had need of his background to help you face the problems which are ahead.

It is a pleasure to introduce to you Dr. G. Griffith Johnson.

DR. JOHNSON: General Holman and Gentlemen: The subject that I have been asked to discuss this morning, "Effect of Government Purchases on Prices in War and Peace," is obviously a very broad one. It covers in its wider aspects the whole impact of war on our economy, and yet it extends to the types of problems which the average procurement official meets in his particular area. The general outline which I should like to follow is to discuss initially the most important factors which govern the effects in wartime of government purchases on prices, to indicate the type and scope of stabilization measures which are necessary to offset or minimize those effects, and finally to talk about some aspects of the relationship between these stabilization measures and direct procurement pricing operations.

The effect of government purchases on prices in war and peace depend upon a number of factors. The first one is obviously the size of those purchases in relation to the aggregate output of the economy. Prior to the thirties and except for periods of major war the size of the Federal Government's purchases was so small relative to the total output that they were not important in determining the level of activity or of prices.

With the development of the expenditure programs during the thirties they became more important, and with the advent of the growing defense expenditures following 1939 they became the most important factor in determining the levels of activity, of prices, of employment, and so on. At the present time they are also probably the most important factor in the picture. In wartime, of course, where they may account for as much as 40 to 50 percent of the total output, and where the main objective of a war economy is to divert materials or supplies to the Government, government purchases are obviously the controlling factor.

The second factor governing the effects of government purchases on prices is the level of economic activity, the extent to which unemployment and unused plant capacity exist. To the degree that additional government demand can be superimposed upon nongovernment demand by increasing employment and by raising total output, the effect of additional government purchases on prices and economic activity is generally salutary. This was the case in the period preceding World War II, where the growing requirements of the defense programs were met out of rising output rather than by taking it away from the civilian share. On the other hand, in a situation where the factors of production are fully employed or almost fully employed, an increase in government requirements must obviously force a reduction in the share going to civilians and business. Unless appropriate stabilization measures are taken under such conditions, the impact of government purchases on prices will tend to generate a useless inflationary spiral.

A third factor governing the effect of government purchases is the method of financing those purchases. As a rule of thumb--not very accurate, but still roughly so--the extent to which such purchases are financed by a budget deficit will tend to measure the degree of over-all inflationary pressure which is generated and the higher money incomes which result. Whether or not a sizable expansion in incomes and prices is desirable depends upon whether there are unemployed resources which can be pulled into production.

Finally, the fourth factor is the type of goods purchased by the Government and the relation of purchases to the supply and demand situation in the particular field. Expenditures for military goods, for example, tend to bear heavily in the field of metal durable goods; and such expenditures may have a pronounced impact on prices in that field well ahead of the time when government expenditures as a whole tend to generate inflationary pressures. It might be noted that this aspect is peculiarly important at the present time, and it was the first area in which dangerous pressure emerged following 1939.

The general measures which should be taken to offset the effects of government expenditures on prices depend upon the particular conditions which exist at the time as indicated by the four factors just mentioned. Their significance can be illustrated by contrasting the situation in the period leading up to World War II with the situation which would exist if we were to have a war emergency under conditions similar to the present.

In 1939, and even in 1941, we had a very substantial volume of unemployment and unused plant capacity. As defense expenditures increased in the years following 1939, a considerable upward movement of prices was stimulated. This upward movement facilitated pulling into employment the unused capacity and the unemployed people which previously had been present in the economy. Furthermore, at no point in this period immediately preceding World War II was the size of government purchases sufficient to require a reduction in the volume of goods and services going to the civilian economy. In fact, the increase in aggregate output made possible by the slack which had existed was sufficient, even at the peak of the war, to cover all military requirements and still permit a volume of goods and services for consumers which was greater than that which had existed in the prewar period. In other words, the average civilian had a higher standard of living during the war than he had had before.

Now, at some point in, say, the latter half of 1941 or early in 1942 the stage was reached where additional general price increases and rises in income levels served no further purpose in generating additional output; this was the point at which firm and comprehensive stabilization measures should have been taken. There is some disagreement as to just when this point was. My own feeling is that it came in the latter half of 1941 and that we would have done well to have taken more comprehensive price, wage, and other control measures, especially higher taxation, at an earlier point than we did.

In contrast to this pre-World War II situation, a war emergency today would involve fundamentally different conditions and considerations, and would require, I think, a fundamentally different approach. Economic activity is already straining available resources. Any substantial growth in government purchases would require, particularly in the hard goods field, a substantial decline in the goods and services going to civilians. In a future war it is probable that the Government "take," so to speak, would have to be a significantly larger part of total output than it was in World War II and that a very substantial decline in goods and services available to consumers would be required. In other words, the standard of living of the average civilian would have to decline, perhaps sharply, in a war under present conditions. At the same time, however, the money incomes of civilians would tend to increase by reason of such factors as overtime payments, the employment of people who are not normally in the labor force, and so on. Thus consumers as a whole would have more money with which to buy fewer goods, and as a consequence a war under present conditions would present us with the rapid development of enormous inflationary pressures.

There are, of course, other differences between the pre-World War II situation and that of today. World War II is estimated to have cost in the neighborhood of 350 or 400 billion dollars. Owing to the higher price level we now have, another war on a similar scale would cost well in excess of five or six hundred billion dollars. Since some price increases would undoubtedly occur and since a future war might well involve a much more total effort on our part and possibly also some onshore destruction, the cost of another war might well exceed the incomprehensible magnitude of a trillion dollars. Yet we would be starting out with a situation where our public debt and money supply have already been inflated by the last war and our price and income levels are similarly inflated. It seems clear that without drastic measures to prevent further general price increases and to prevent an undue rise in money supplies, incomes, and so on, our entire financial and social system might easily be threatened, not only after the war but during the war itself.

I mention these aspects to emphasize the seriousness of the situation with which another war would present us. We would have to take, as I say, immediate and drastic action, and time would not be available for the gradual development of stabilization measures, as it was in the period preceding World War II. I think in the absence of such quick and comprehensive action the developments in prices and wages would be beyond anything we have heretofore experienced.

I scarcely need to discuss the serious effects of inflation. They are pretty well-known. But I should like to emphasize one point in particular. People frequently make the error of emphasizing the importance of effective stabilization in terms of the postwar effects or the postwar results which would otherwise occur. I think this is important, to be sure; but of even greater importance is the fact that the economy cannot operate efficiently during the war period itself unless a reasonable degree of stability is preserved. Thus an effective stabilization program is a vital part of the war program, and its success becomes as much a matter of moment to the Military Services, for instance, as to any other part of the Government.

I might merely mention some conditions which the average procurement official would face if we allowed a pronounced inflationary movement to occur. He would find, for example, a rapid deterioration in the efficiency and moral of workers and businessmen. This would inevitably result in extensive work stoppages, interruptions in the flow of materials, and speculative hoarding which would tend to reduce supplies. He would find it impossible to construct cost estimates with any degree of certainty. He would find it impossible to make contractual commitments without having extensive escalation clauses or contingency allowances, cost-plus contracts, or similar measures, all of which would tend to make it necessary to resort to pricing pretty much on a cost-plus basis. There would be no possibility of incentive pricing, because the changes in costs and the profits to be derived from speculative activity would be far greater than any incentive which the Government could provide. In other words, it would be impossible to establish and operate an allocation system, production scheduling, and the other controls that go along with a war economy.

Now, to prevent these consequences, the Government has to undertake and put into effect a stabilization program. This program would consist of the following types of measures: heavy taxation, heavier than anything we have had; monetary policies and credit controls designed to prevent an undue increase in the money supply and its spending, and to immobilize increases in the public debt; measures to increase the volume of private savings, which may have to be compulsory rather than voluntary; direct measures to stabilize income rates, such as price and wage controls; and measures to govern the distribution of essential consumer goods.

The extent to which these various measures are used depends, of course, upon the extent of the impact of government purchases on the economy at the time. In a war emergency under present conditions, however, there can be little doubt that we would have to use all of them and use them in a more drastic form than in World War II. This means that the various measures have to be fitted into a more integrated program than we had last time. It also means that there would have to be a far greater effort and cooperation by all parts of the Government as well as the public in general.

Now, in connection with the design and administration of a stabilization program there are a few points which I should like to discuss briefly. The first one, which has already been noted but which I think deserves to be emphasized again, is the fact that it would be necessary to act very quickly and comprehensively under present economic conditions. The inflationary problem would be immediate and the pressures would be greater than any we have seen.

In the second place it is important, I think, to keep in mind that a stabilization program and the various measures that have to be taken impinge directly on the ability of consumers and businessmen to earn money, to buy goods, and to act as they normally act in peacetime. It is the avenue by which most of the economic hardships of a wartime economy are transmitted to the average individual. Thus an effective stabilization program is as much a matter of politics as it is of economics. We can draw up the finest plans in the world for an effective wartime stabilization program and they will have no effect unless they meet with the approval or at least the acquiescence of the major groups in the country. The basic strategy of stabilization, therefore, must be to devise a relationship between profits, wages, farm receipts, and other types of income which is maintainable and which is satisfactory to the various groups in the community. Once this balance is achieved, it must be maintained by uniform standards and policies throughout all aspects of the war effort.

In this connection it should be noted, I think, that procurement officials have a major responsibility in determining the level of profits throughout a wide area of the economy. It is important that they recognize their position in this respect and attempt to achieve results which are in line with general stabilization policies. Unless there are such uniform standards and treatment of the various income groups, any stabilization program is bound to be seriously undermined.

Third, it will be necessary to go much further in the direction of formulating and implementing integrated programs in various commodity fields than was done in World War II. Such programs should arrange for the coordinated use of stabilization, production, distribution, procurement, and other controls to accomplish unified objectives. From the stabilization standpoint the most important examples of this are a wartime food program and a wartime textile and apparel program. But there are other examples as well in the industrial field, such as lumber, building materials, and so on. In such programs military set asides and other procurement practices are a vital part.

In general, we would have to go a great deal further than we went in World War II in coordinating the use of stabilization controls and other measures such as production, allocation, and procurement activities. There are some things which have to be done for effective stabilization which simply cannot be done unless other types of instruments such as production controls are available. On the other hand, there also should be a wider recognition on the part of officials in the production and procurement areas of the limitations of price and wage adjustments in accomplishing specific tasks. I think this probably was the greatest source of conflict, disagreement, and to some extent frustration in the last war. Generally speaking, adjustments in prices cannot be used to govern the type, quantity, or distribution of products in the industrial field. This is not to say that there are not some situations in which price incentives are useful; but, generally speaking, they are much more limited in scope and type than was frequently believed by those charged with production and procurement responsibility in World War II.

In this connection I remember a not unusual type of incident that arose with respect to lumber supplies in the last war. One of the procurement services, together with appropriate representatives of the War Production Board, descended on OPA to complain that ceiling prices on a particular type of lumber which they needed were impeding procurement, and they requested a price adjustment. After considerable pressure had been exerted, the OPA granted the price increase. Within a few weeks there was another delegation from another procurement service, together with representatives of the WPB, which complained that the price increase had diverted lumber from a material which they needed for their purposes, and asked for a compensating price increase. The fact of the matter, I think, is clear--that there was not a sufficient supply of lumber for all purposes, that price adjustments could not in the nature of the situation be used to allocate the supply or to determine the price which should be paid, and that the only effective method of handling the situation was by the use of direct allocation measures, combined if necessary with mandatory orders. In the much tighter situation which would develop in any future war, it seems clear that the Government would have to be prepared to make much further use of direct physical controls--production scheduling, allocation systems, mandatory orders, and so forth--in order to obtain the desired flow of material and products by types and amounts. Much time and frustration would be saved by an early recognition of this and by better development of a coordinated program in the commodity field to accomplish the desired results.

Finally, I should not like to have the above comments construed as indicating an opinion that there is no place for monetary incentives in a war effort or that stabilization programs cannot be sufficiently flexible to provide such incentives where they are necessary. On the contrary, I should think that a primary objective of a stabilization program should be not only the maintenance of monetary incentives in wartime, but also the shaping of them into forms most conducive to a successful war effort.

Let me try to give several examples along this line. The stabilization program must, I think, envisage an over-all growth in the volume of money income of civilians despite a decline in what those incomes can buy. Now, such a growth of money income, of course, makes the stabilization job much more difficult, but it is the only way that the maximum effort required in a total war can be obtained. Thus, additional pay for a longer work week is, I think, desirable as a method of stimulating additional effort on the part of workers. Somewhat higher wage rates are desirable in some war industries in order to compensate for the non-monetary disadvantages of shifting to employment in those industries and as a method of attracting into employment people who are not ordinarily in the labor force. Similarly, profits are necessary in wartime also, and such proposals as a 100 percent excess profits tax tend to be self-defeating in this respect. A marginal increment of income is as necessary in wartime as in peacetime. Stabilization programs, I think, have to be reconciled to the fact that they should primarily attempt, not to prevent any rise in income, but to achieve stability in income rates.

Similarly, the theoretical idea that you can finance a war by taxation is equally in error. It cannot be realized in practice. A tax burden large enough to do this would simply destroy all marginal incentive. Actually, however, political limitations are far more likely to be the governing factor than economic limitations. So as a practical objective I think we should seek to get taxation as high as politically possible in wartime.

There are also cases where incentives must be used in specific areas to accomplish specific tasks. Generally speaking, as I said, adjustments in prices and wages and other stabilization measures are not suitable instruments for this purpose, as indicated by the lumber example. They cannot accomplish the fine adjustments in production, in the flow of materials, in the shift of manpower, and so on, which are required to carry out specific production programs in wartime. For example, if it is desired to eliminate a certain production operation, either to conserve materials or manpower, the obvious way to do it is by direct prohibition. If it is desired to reduce production or employment in particular areas, the best way to accomplish this result is by limitation orders which directly specify the desired level of production or employment. To attempt to accomplish the result by adjusting relative prices or wages is not only administratively impossible, but also discriminatory against the workers or businessmen from whom a certain amount of production is still desired; and the degree of curtailment which will follow from adjustments in prices or wages simply cannot be ascertained in advance with any precision.

The same reasoning applies in those cases where it is desired to divert additional resources to the increased production of a particular product. To make use of stabilization instruments to accomplish objectives of this sort not only involves insuperable administrative and cost accounting difficulties, but it is an almost certain guarantee that the results desired will not be achieved with the necessary precision. The attempted use of stabilization instruments for such purposes also greatly undermines the program as a whole.

Nevertheless, there are situations where price and wage adjustments and other types of monetary incentives must be used simply because it is not feasible to resort to direct production or distribution controls. In such cases stabilization measures can provide only general incentives which tend to produce the result desired, and that may be the best that can be hoped for. An obvious example of this is agricultural production. Short of a system of direct controls over the two or three million farmers, which I think most people would consider impracticable and self-defeating, the only way to implement production goals in agriculture may be, in part, to try to create monetary incentives which will influence farmers in the direction that you want them to go. Even in the agricultural field, however, much can be accomplished through the use of direct measures to influence production. Thus, in actual operation a wartime food program should be an integrated program in which production, price, and distribution controls are administered in a coordinated fashion.

The obvious danger in this situation, as in all situations where special monetary incentives have to be provided, is that the desired incentives will always be created by an increase in income rates, thereby inviting a continuing rise in inflationary pressures and a gradual undermining of the income balance that we have pointed out is the essential basis of a stabilization program. Such a result is not, however, necessary. The incentives which are important in such cases are the relative incentives, and they can be created and changed while operating within a stable average of income and price level.

While the farm situation is the most important and perhaps the most obvious instance where adjustments in prices may have to be relied upon to accomplish production or distribution goals, there are others as well. They generally arise in cases where the number of productive sources, the number of producers to which direct physical controls would have to apply, is so great that it simply is not feasible to undertake such controls; it is not worth the effort that would have to be expended. This is certainly one of the more difficult facets of the stabilization program the exceptions which must be made from general standards in order to accomplish results which in most industrial fields would be accomplished by direct production or allocation measures. The use of exceptions along this line is a matter of judgment, and it is important that all parties concerned use great restraint in resorting to adjustments of this character.

I have dwelled at some length upon this problem of the use of monetary incentives in wartime because it is one of the more critical areas in the operation of a stabilization program and perhaps one which impinges most directly on the activities of procurement agencies.

The general picture of a stabilization program which would be required to meet the pressures of any future war thus emerges as a more difficult and drastic operation than the program we had in World War II. Quick action would be necessary, more drastic action; higher taxes; more rigid price and wage controls in the sense of not using the monetary incentives, wage incentives, and so on to the extent that we used them the last time; probably somewhat tighter procurement practices as far as cost analysis and profit margins are concerned; and a much greater reliance on direct production and allocation controls. Such a program obviously would require a greater cooperation on the part of all agencies, whether or not they were directly responsible for stabilization activities; and it would require a much better understanding of the issues and alternatives with which war presents us.

It is likewise obvious that the design of a stabilization program and its effective operation depend primarily on the psychology and understanding of the public as reflected, to a large extent, in the operations of political pressure groups. For this reason it is impossible to construct a blueprint for a wartime program with any reasonable assurance that it will actually be a practical plan. Major policy decisions, which are a prerequisite for formulating stabilization policies and programs, can be made only in terms of the political and economic situation at the time of the emergency. Thus it is impossible to say ahead of time under what circumstances the war will begin, or just what proportion of the total war cost can as a practical political matter be covered by taxation, or to what extent compulsory saving methods will be needed, or at what level of prices and incomes a satisfactory balance between income groups can be achieved, and so on.

At the National Security Resources Board, with the help of other government agencies and outside groups and consultants, we are attempting to prepare analyses of these problems and to develop improved techniques for doing the things that have to be done in wartime. But the principal hope for effective stabilization in a future emergency, in my opinion, must be a growth in understanding of the issues presented by a wartime economy on this front, and of the actual alternative courses of action with which public authorities are confronted. There are no pleasant alternatives in wartime but only degrees of unpleasantness and effectiveness.

I should like now to turn to some aspects of the relationship between general stabilization controls, particularly over prices, and the activities of government procurement agencies in wartime. I have already mentioned briefly the importance of an effective stabilization program to the operations of procurement officials. I should like to mention also some of the reasons why procurement pricing activities are important to the stabilization picture and the stabilization program.

In wartime, as I indicated, government procurement may require up to 50 percent of the total output. The pricing policies which are followed in this sphere do not directly affect the prices which civilians have to pay, the cost of living, and so forth; but they do have collateral effects which are of major importance. In the first place, procurement pricing policies tend to determine the profit share of national income for a wide area of the economy. Thus they can significantly influence the degree to which we have an inflationary rise in total income. Loose pricing policies can result in the bidding up of costs, the bidding up of prices of purchased goods and services; or, if such costs are controlled directly, as they probably would be, nevertheless loose pricing policies can weaken such controls by increasing the pressures upon them.

Moreover, if profit rates in government procurement are out of line with controlled rates in other areas, they can result in undue diversion of goods from the civilian to military areas. That seems like a desirable thing when the general objective is to get that diversion, but nevertheless in many areas a promiscuous diversion of resources from one to the other is not desired. This possibility is, of course, greatly reduced by the presence of strict allocation and production control; but nevertheless it can cause difficulties in the detailed operations within particular commodity fields, as was indicated by our experience in the last war in some cases. Loose procurement pricing policies can similarly cause a greater than necessary growth in the public debt and a dissipation of public funds.

Finally, most important of all is the role which they play in influencing the efficiency with which materials and manpower are used in war production. I know that the Services have devoted a great deal of attention and effort to this aspect of procurement; and the improvements which have been made, for example in World War II as compared to World War I, are certainly most heartening.

These general considerations are undoubtedly important; but what about the actual operating relationships between the procurement officials and stabilization officials? During the last war many persons on both sides of the fence will recall the conflicts and disagreements of opinion which occured. There were some on general issues, but primarily they occurred with respect to specific instances where one side felt the other side should do something it was not doing or vice versa. Looking back on the period with some perspective, however, both the historians for the Services and the historians for OPA have agreed that the results of the actions and relationships between the procurement services and the stabilization agencies were much more successfully and effectively handled than may have appeared in the heat of actual operations. I think it is important to note that most of the conflicts between the two arose in the early period prior to the so-called Henderson-Patterson-Forrestal agreement in September of 1942. At that time, in that early period, important costs, primarily wage costs, were not under control, or at least not under effective control, and the stabilization authorities were concerned about the effects of procurement pricing practices even in connection with such purely military products as airplanes, because such pricing was the primary available instrument for impeding rises in wage rates and other uncontrolled costs. This source of friction was for the most part removed when the system of stabilization controls was extended to include all major cost areas.

There are, however, important sources of conflict between pricing and procurement officials which are likely to exist in any wartime situation. The first of these is obviously a lack of understanding and perspective on the part of any one group of people for the problems and difficulties of another group of people doing a somewhat different job. This is not confined to these particular relationships we are talking about, but occurs throughout any large organization such as a wartime organization and is one reason why we have to have centralized coordination and direction of a war effort.

More important, certainly more important as a source of conflict, is the fact that a pricing agency and a procurement agency approach the problem of establishing or adjusting prices in fundamentally different ways. A procurement official generally operates on a case by case basis, setting a price for a particular contract with a particular company. This is the only way in which the procurement function can generally be handled. A central pricing agency, on the other hand, establishes and adjusts ceiling prices on the basis of broad industry groups or products, and only in a very small proportion of instances treats with the price structures of individual companies. This, in turn, is the only practicable method by which a central pricing agency can function in view of the literally millions of individual prices which its activities have to cover.

Now, from this basic difference in approach between the two activities it follows that there are different standards which have to be applied. A procurement official, for example, can scarcely refuse to grant a profit on a particular contract in initially negotiating the price simply because the company involved is making profits on other contracts. Thus procurement pricing standards must be developed with that situation in mind. The central pricing agency, however, cannot as a general rule deal with particular products or even with particular companies or establish ceiling prices and profit margins on individual transactions. There are simply too many of them, and product cost accounting techniques are far from sufficiently developed to make that method feasible. Consequently, a central pricing agency must normally evaluate prices and profits on an industry or product basis, generally on an industry basis. This means that in wartime as in peacetime individual companies will have varying over-all profit rates and individual items, to the extent that costs calculable on such items will show widely different profit or even loss positions.

It is easy to see that in specific instances where these two types of approaches and the differing profit standards which flow from them come into direct contact, the conclusions which will be drawn as to the action required will tend to be markedly different. I am not sure, but I think that that was the principal explanation of the rather continuous flow of annoying disputes that occurred between the production and procurement agencies and OPA in the last war.

Another source of conflict is frequently a different evaluation of the usefulness of price increases to increase the production of specific items. A production control or procurement official operating within a particular commodity field frequently believes, usually with good reason, that a price increase on a specific item with which he is having difficulty will solve his problem and get the supplies that he wants. What he frequently fails to see, and what the stabilization official is normally impressed with, is that solving his difficulty in this way will merely tend to create difficulties elsewhere which will require compensating increases on the same grounds, since total supply is limited. Thus the widespread use of price increases to accomplish diversion of resources tends merely to degenerate into a self-defeating spiral.

On the other hand, there are instances where price increases as incentives can perform a useful and necessary purpose. During the last war the stabilization authorities were probably too reluctant to recognize such instances. I think in large part this was caused by the fact that stabilization programs generally had their backs to the wall throughout the entire period and the responsible officials were afraid to make any concessions which were not forced upon them.

A final possible source of conflict is the problem of the line of demarcation between the particular products over which procurement agencies and central pricing agencies, respectively, have pricing jurisdiction. I see my time is running short, but I would like to make a few comments on this particular question, because I think it is the foundation for a good operating relationship between the two activities. I think it can largely be solved by an objective analysis of the pricing problems presented by the individual industries or products. Assuming, as I think we must assume, a general agreement on the need for and general objectives of stabilization, the goal in determining the appropriate line of demarcation must be to accomplish pricing in the best and most feasible way.

If we keep in mind the different methods by which procurement agencies and the central pricing agency establish or adjust prices, the first rule is to examine the nature of the product being purchased by the Government and to determine for that product which is the best or most appropriate method to use. Thus it is clear that, for products like ships, airplanes, tanks, guns, and so on, the techniques available to the central pricing agency are simply not suitable for use, because of such characteristics as changing specifications and volume and other factors which greatly reduce the predictability of costs. An analysis along this line will clearly establish, I think, that the bulk of government procurement in wartime will be of the type for which negotiated pricing is the most suitable method to be used, and thus should be exempt from general price controls. This would include almost all strictly military goods together with their special parts and subassemblies.

It is with respect to the balance of procurement that difficulties tend to arise. This balance can be classified into two types: first, subcontracts and components; and, secondly, standard civilian-type items bought on prime contracts.

With respect to the first category, I do not think that any general rule can be suggested. I would suspect that in the majority of instances the average procurement official will not be in a position to exercise control over component prices and over prices on subcontracts for items not also being purchased on prime contracts. The central pricing agency would then have to devise such regulations as it can to accomplish this control. However, to the extent that it is feasible for procurement officials to operate in this area, they should be allowed to do so, free from general pricing regulations, simply because the nature of specialized components and fabricated items covered by subcontracts is such that they can more generally be priced effectively by direct negotiation. This does not apply, however, with respect to the area of basic materials and standard components, which, I think, should remain in the jurisdiction of the central pricing agency. In other words, with respect to this group it is again necessary to look at the nature of the transactions involved and to determine which method is most suitable.

With respect to the second category, namely, standard civilian-type items bought on prime contracts, there is considerable difference of opinion. Some people believe that the procurement agencies should have pricing responsibility for all prime contracts regardless of what is bought, while others believe that on standard products prices should be subject to the maximum price regulations of the central pricing authority. The general reason for the latter position is that having two separate authorities, with quite different standards and methods, determining prices on the same items, depending on whether or not they are sold to the Government, tends to cause a great deal of confusion and discrimination, and, in addition, difficulties for that authority having the stricter standards.

Again, however, I do not think that any general rule can be drawn on this question. A useful approximation can be made by examining the nature of the technique which the central pricing agency is using with respect to the particular product in question. If the nature of the product is such that the central pricing agency can develop effective and detailed controls, such as dollars and cents ceilings, then it seems to me that the maximum price regulations of the central pricing agency should govern government contracts as well as other transactions. Obvious instances would be standard steel mill products and other basic materials, and important consumer items where it is desirable to have uniform pricing and adjustment policies. On the other hand, where by the nature of the product the central pricing agency is forced to resort to less effective methods of controls, such as formula pricing, there may be, in my opinion, real advantages in permitting the procurement agencies to operate free from maximum price regulations.

At any rate, as long as there are firm general controls over wage rates, basic material prices, and other important cost items, and as long as government procurement pricing operations do not conflict with important civilian programs, such as in food and clothing, it does not seem to me that this is a particularly important question from a general stabilization standpoint. The principal criterion, as I say, should be who can do the job best, with the least amount of administrative burden. I shudder, for example, when I think of the amount of time and effort which was spent on cotton duck pricing in 1944 and 1945 in both the Services and OPA. I think it seems clear from hindsight that OPA could have spent its time and effort in a much better direction.

It follows from these considerations that a satisfactory line of demarcation can be drawn between the operations of the procurement agencies and the stabilization agencies on the basis of an analysis of the problems presented by particular types of products. There will, of course, continue to be conflicts in day-to-day operations. These conflicts with one another are inevitable, but generally speaking they can be resolved as they were resolved in World War II, namely, by direct negotiation.

I should like to emphasize in closing, however, that the most basic consideration of all for this relationship as for all others, for the effective coordination of the entire war program is the development of a broader understanding of the issues involved, both in the determination of general mobilization policies and in actual operations within specific program or commodity fields.

DR. KRESS: I think the most conclusive thing to be said about Dr. Johnson's talk is that it was the lecture of an economists' economist. I am sure that his words will be poured over and studied long after he has forgotten having written them.

Dr. Johnson will answer your questions. He has fortified himself on the procurement side with the presence of Dr. Thomas B. Worsley, a former Army procurement officer and a member of the teaching staff of this College for three years. He is modestly sitting there in the corner. But I think you will notice from his closing remarks that Dr. Johnson probably won't need much help from Dr. Worsley.

QUESTION: The point has been brought out of the probable necessity of bringing into being effective controls with much greater rapidity than was done in World War II. Would you like to comment on the feasibility and the desirability of an initial freezing of prices, wages, salaries, and existing structure with great suddenness at the beginning, taking the view that the dynamics of it could be accounted for by revision in specific instances as may seem desirable thereafter?

DR. JOHNSON: I think that if we had a war emergency with economic conditions the way they are now, with the same inflationary pressures that there are at present, the only way you could handle the situation would be to move in very rapidly with an over-all freeze of prices. It just wouldn't be administratively possible to approach the problem from the selective standpoint. It would take too much time to develop selective controls. You would get, I think, an immediate upward price movement in important areas, primarily free market areas--agriculture, industrial materials, and so on--unless you did move very quickly. The only way you could move quickly is by an over-all freeze.

Now, that is true with respect to prices; but I think from the political and psychological standpoint you probably would want to move at the same time with respect to wages and salaries, although the urgency is not quite so great there, since wages and salaries don't move so quickly as prices do. So you could conceivably come along with a wage and salary freeze or some form of control a month later or two months later or something like that. But I think, generally speaking, it would be desirable to move in the whole area of income rates as soon as possible.

I might just mention that there are a lot of difficulties involved in a general price and wage freeze. I don't want to get into that in detail. I just want to assure you that it is by no means a simple matter and that it is only as a matter of desperation that we should undertake such an enormous administrative measure.

For example, if you were to freeze prices as of last week, there would be a lot of businessmen who actually would not know what their ceiling prices were. So that until you could straighten them out on a detailed basis in their particular area, in other words, give them a tailored control measure for that particular area, they would just be up in the air as to what their ceiling prices were. You have to move very rapidly with interpretations and refinements when you undertake a general freeze.

COLONEL McCULLOCH: That is an excellent exposition of control in a period of real emergency, but what about control in a limited emergency? The national situation being what it is, and the inflationary situation being what it is, it seems to me we have a lot of economic arguments in favor of immediate control. What do you think about that?

DR. JOHNSON: I think that to make what you might call a suggested program of economic action for next year, it would be necessary to start off with some assumption as to what, for example, the federal budget was going to be. If you assume that you have another five or so billion dollars of federal expenditures, most of which will be in the military and foreign relief areas, then I think the situation would look something like this: The general inflationary picture could be handled in large part in my opinion by tax methods, in other words, by a substantial increase in taxes, together with possibly some further monetary controls, although I don't believe that they are very important. But where the difficulty would arise would be in the metal durable goods area, where the situation is already tight, where inflationary movements are still going on. The primary impact of your additional government expenditures would be in the metals field.

Now, what measures would be necessary to handle that is, of course, one of the great debates that are going on at the moment. We at the Board, so far as our part in this discussion is concerned, have felt that immediate anti-inflation policy is a subject which the Council of Economic Advisers has been set up to deal with, a type of subject that is primarily in their bailiwick.

But it seems clear that some measures would have to be taken to assure that the Government gets what steel it needs. Whether that can be done by voluntary means or whether you have to move to mandatory control I think depends on an analysis of the steel balance sheet, so to speak. I couldn't say offhand that we will have to have one or the other. The same thing may be true with other short areas, like copper and lead and so on. But in terms of general control, the type of thing you are thinking about in wartime, it doesn't seem to me that an expansion of the government budget by five or so billion dollars requires consideration of what has been called the full panoply of wartime controls.

COLONEL McCULLOCH: The thing that concerns me, sir, is that in a period of limited emergency we talk about allocations and priorities to some extent. We talk about, for example, rent control. At the same time there is evidence of a fourth-round wage demand. I can't understand how we can intelligently apply controls unless we apply them across the board. Can we do that in time of technical peace and maintain the kind of government that we are operating under at the moment? Can it be done?

DR. JOHNSON: I think that is right. I would say for example that you can't have effective general price controls without having effective general wage controls. If you felt that the pressures were so concentrated in, we will say, the metal durable goods area that you had to move in with price control in that area, then I should think that over time they might not be effective unless you had some wage controls in that area. In other words, I think they go hand in hand in any situation where the pressures are heavy. If the pressures are not too heavy, I am not sure that you would have to go so far as formal wage control.

I gather that another aspect of your question was whether you could actually put controls over one part of the economy without putting them over other areas as well. Is that right?

COLONEL McCULLOCH: Yes.

DR. JOHNSON: I don't know. I think that in the short run you can, but I doubt very much if you could do that very long. In other words, I think it would be possible to put price controls in the area of basic materials for 1949, but I don't believe you could do that year after year. I am sure of one thing and that is that you couldn't satisfactorily put price controls on meats without going through practically the entire area of important agricultural products.

QUESTION: What consideration, if any, has been given to income adjustment in that group which will be inducted into the Armed Forces?

DR. JOHNSON: I have to answer that directly by saying that we really haven't given any consideration to that aspect, not because it is not important, but simply because we haven't gotten around to a great many parts of this picture. We know they are important, but we are fairly new at this planning operation.

QUESTION: Do you feel that a rigid stabilization program can be put into effect in time of war without some real draft of civilian labor?

DR. JOHNSON: I think that we can put into effect a more drastic program than we had in World War II. I don't think that it can be made completely rigid without having practically all important resources allocated, and that would include labor. I rather suspect that the national service legislation which the allocation of labor would involve is possibly the most drastic wartime control. Whether it is necessary or desirable will depend upon a number of factors, not the least important of which is public psychology and the willingness of the public to undergo such control.

GENERAL HOLMAN: Dr. Johnson, you have certainly driven home one point this morning and that is the fact that price control is a very practical problem and that practical answers will have to be found for all of these facets of that problem. We are deeply appreciative for your coming here today. You have given us a lot of food for thought. Thank you very much.

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