Review of Political Economy,
Volume 20, Number 4, 569–593, October 2008

Routledge
Taylor & Francis Group

The Theory of Price Controls:

John Kenneth Galbraith's Contribution

STEPHANIE LAGUERODIE* & FRANCISCO VERGARA**
*University of Paris (Paris-Est), France; **Association pour la diffusion de l'économie politique, Paris, France*

> Price controls didn't work in World War I, when they began as 'selective'; they didn't work in World War II, when they were 'comprehensive' . . . price controls *have never worked*. (Murray Rothbard, 1995, emphasis added)

> In World War II . . . we controlled or sought to control all prices . . . the General Maximum Price Regulation was put into effect in April of 1942, and *it worked*. (John Kenneth Galbraith, 1980, emphasis added)

ABSTRACT *Price controls have always aroused controversy. Before the Second World War, most economists saw them as either impossible to implement or unwise. Even during wartime it was widely believed that prices should remain as free as possible. Many economists saw benefits to price controls during the war, but also identified numerous costs to these controls. They also tended to favor limited price controls, applying to only those goods needed to fight the war. John Kenneth Galbraith was generally sympathetic to price controls during the war. He too supported limited controls, but then changed his mind and supported more extensive price controls during the Second World War. After the war, inflation tended to reappear long before full-employment was reached, even when production and employment were falling. From his wartime experiences, Galbraith tried to draw lessons for peacetime inflation. He proposed price and wage monitoring for a few hundred big companies and the unions with whom they negotiate.*

1. Introduction

Since the time of Adam Smith, one question that has raised great passion and controversy among economists is that of government control over prices. Are certain prices so special that government control over them is justified? Can particular circumstances sometimes warrant a more extensive control over prices?

Correspondence Address: Francisco Vergara, Association pour la diffusion de l'économie politique, Paris, France. Email: vergajofra@aol.com

ISSN 0953-8259 print/ISSN 1465-3982 online/08/040569–25 © 2008 Taylor & Francis
DOI: 10.1080/09538250802308950

These questions are of special interest for at least two reasons. First, they raise issues that appear again and again throughout history. Who is not worried today about the price of health care and a university education, or about the impact of rising food prices? Who is not concerned by the fact that exclusive reliance on fiscal and monetary tightening, as a way of containing inflation, can hurt the most vulnerable and slow down an economy?

But the subject is also of interest because the author we are commemorating, besides having had extensive experience in the practice of price controls (from 1941 to 1943), also wrote a book that makes important contributions to this debate (Galbraith, 1952).

1.1. The Classical Economists on Price Controls

Before we get to Galbraith, let us recall that the classical economists (from Adam Smith to A.C. Pigou) were not doctrinaire *laissez-faire* advocates when it came to the question of price controls. Smith did not believe that the free movement of prices is always and everywhere the best policy. He thought that the government should ensure that education is provided at a low price, affordable to all. 'For a very small expense the public can facilitate, can encourage, and can even impose upon almost the whole body of the people the necessity of acquiring those most essential parts of education. The public can facilitate this acquisition by establishing in every parish or district a little school, where children may be taught for a reward so moderate that even a common labourer may afford it' (Smith, 1776, Vol. 2, p. 785).

Smith also believed that, in the England of his time, too much of savings were being squandered in harebrained schemes and that a low legal maximum on the rate of interest (an important price if there ever was one) could improve the allocation of resources by making lenders prefer sober investors over reckless ones 'who alone are willing to pay high interest': 'Where the legal rate of interest, on the contrary, is fixed but a very little above the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors' (Smith, 1776, Vol. 1, p. 357).

As for Pigou, after a detailed discussion of several examples of successful price controls drawn from British war-time experience, he draws some rather positive conclusions: 'The fixing of *maxima* for a number of particular prices . . . helps a government to hold back the ultimate threat of galloping inflation. . . . Government restriction of particular prices is not then a policy either foredoomed to failure or necessarily futile' (Pigou, 1941, p. 118).

1.2. What is meant by Price Controls

'Price controls' does not necessarily mean government imposition of some precise price at which given commodities must be bought and sold. This is just one option among many. By 'price controls', authors like John Kenneth Galbraith meant a wide variety of policies by which market prices that are causing problems can be modified or influenced. Price controls are thus a palette of measures among which the policy maker can choose according to the particular problem he wishes to solve

or alleviate. In some cases it will be a legal maximum on a given price (as proposed by Smith for the rate of interest), in others a legal minimum (as the minimum wage), sometimes a minimum price at which the government promises to buy and a maximum at which it promises to sell (as for certain agricultural commodities), sometimes a temporary price freeze, and sometimes a maximum or minimum for price changes. This is probably why the plural word 'controls' is often used.

The fundamental idea behind price controls is that if the free movement of certain prices produces very bad consequences (as during a mobilization for war), or if it makes it impossible, or very difficult, to attain some important national goal (like full employment without inflation or access to food for everyone), it is legitimate to keep an eye on these prices and eventually do something that makes the situation better. Most economists agree on this point, but then many go on to exclude price controls from the policy options that are on the table. Not Galbraith (1951, p. 15), who believed that 'we cannot exclude from use any weapon that is necessary ... it would be reckless to decide in advance that price controls should not be used'.

Price controls are, of course, only part of the solution, and often just a temporary expedient to buy time while a more comprehensive policy to solve the problem is being put in place. To be effective, they generally have to be part of a package that includes accompanying measures to ease the pressure of prices. And this package must evolve with particular circumstances. Galbraith was always clear about this. In 1941, for example, he writes about the war mobilization effort: 'Reasonably full use of resources without serious inflation can be achieved, but ... we shall need *a portfolio of measures* appropriate to different stages in the expansion process' (Galbraith, 1941, p. 84, emphasis added). Nearly 40 years later, referring to peacetime anti-inflation policy, he expresses the same sentiment: 'Controls on wages and prices in the highly organized sector of the economy are not ... the whole answer ... But they are *part of any complete strategy*' (Galbraith, 1980, Introduction, n.p.).

The different methods by which a government can bring about compliance with the price policies it chooses can also be very diverse – ranging from exhortation and moral pressure to legal restraints and penalties, tax incentives, selective liberalization of imports for particular commodities, or selling of government strategic stocks.

In this larger sense, such policies are actually much more common than one would believe, though they are not usually called 'price controls'. Open market operations by the Federal Reserve, for example, can be considered as such a policy since it is clearly intended to modify the interest rate that arises from the market. New York Stock Exchange circuit breakers (by which trading is halted when the Dow Jones falls more than 10%) and price limits (which prohibit trading at prices below a pre-set limit during a price decline) are other, less well-known ways of not allowing the free movement of prices to cause havoc. Governments also use regulatory policy instruments, created to increase competition, in order to obtain lower prices by threatening companies with investigations, litigation, disrepute and eventually fines and even dismemberment. Finally, public utility fees, and the price of many government services are, of course, often controlled.

1.3. What is not meant by Price Controls

As often happens with words, the expression 'price controls' has become associated, in many people's minds with crude and counterproductive measures that eventually make things worse. If the price of cereals becomes too high, for example, a government that imposed an excessively low, non-remunerative selling price on farmers, would probably discourage them from increasing food production. Price controls are also not a policy to be applied in isolation, all by themselves. A city government that just froze house rents (in face of a housing shortage), without doing anything else, would eventually find itself with all sorts of undesirable secondary effects and would probably not achieve its end of promoting affordable housing. Such unwise forms of price controls have undoubtedly been imposed by local and general governments afraid of popular discontent, but they have never been proposed by economists like Galbraith. Nevertheless, it is such measures that libertarian authors, from Frédéric Bastiat to Friedrich Hayek, love to argue against.

This is probably one of the reasons why the word 'controls' has a negative connotation, and why it would be wise to find some other expression. Galbraith was perfectly aware of this: 'I have used the word "control" in the past so that no one would think there was an easy-escape from firm government responsibility. I now propose that we try a new designation, and speak of . . . Incomes and Prices Policy' (Galbraith, 1978, p. 109). Even better, we can use a much less controversial expression and speak of 'monitoring prices'.

1.4. Galbraith's Book

In *A Theory of Price Control*, Galbraith recalls his experience as President Roosevelt's price controller during the Second World War, and tries to draw some lessons that could serve for other, less extreme, circumstances. The book marks an important turning point in the author's life. Its lack of impact upon the economic profession made him realize that if he wanted to influence policy, it was better to write directly for the larger public and not waste time trying to convince other economists: 'I decided that henceforth I would submit myself to *a wider audience*' (Galbraith, 1981, pp. 174–175, emphasis added).

Galbraith thought *A Theory of Price Control* was one of his best books. None of his other publications, he tells us, combines his theoretical knowledge with practical experience to such a degree (Galbraith, 1981, pp. 174–175). This opinion is shared by some of his critics. George Hildebrand, who reviewed the book for the *American Economic Review*, recognized that Galbraith: 'brings to the task a fortunate combination of high level administrative experience, and awareness of the main theoretical issues' (Hildebrand, 1952, p. 987). Yet Hildebrand (1952, pp. 988–989) then adds the familiar arguments: 'price controls do not prevent inflation. They hide it . . . they threaten the survival of a free society . . . they are not likely to work . . . if by a miracle they were to work, the resulting distortions would make little economic sense'.

For Milton Friedman, another great opponent of price controls, this book makes Galbraith: '*the only person* who has made a serious attempt to present a

theoretical analysis to justify his position [a position favorable to price-controls] . . . I happen to think that the analysis is wrong, but at least it is a serious attempt to provide a basis for a point of view' (Friedman, 1977, p. 12, emphasis added).

Friedman would have us believe that price controls have only been proposed by 'practical' men who made no attempt at theoretical justification (with the exception of Galbraith who tried a theoretical argument but got it wrong). In this he is perfectly mistaken. Some of the sharpest economic minds have written on the subject and provided plausible arguments in favor of price controls based on economic theory.

The First World War had just ended when Frank Taussig (1919) published his 'Price Fixing as Seen by a Price-Fixer,' an account of his experience as President Wilson's price controller during the conflict. Two years later, in 1921, Pigou gave his own opinions based on his experience in Great Britain, dedicating a chapter of *The Political Economy of War* to the issue of price controls. At the beginning of the Second World War, Pigou rewrote his book (1941 [1921]) taking into account his reflections on the subject during the inter-war period. Then there was John Maynard Keynes (1940), who published *How to Pay for the War*, a powerful pamphlet criticizing the *laissez-faire* policy adopted during the First World War and proposing that something very different be done this time. Finally, Michal Kalecki also addressed these issues.[1]

The US entered the Second World War two years after Great Britain (in December 1941) but, due to the massive expenditures related to preparation for war, inflationary pressures appeared earlier. The problem attracted the attention of Alvin Hansen (1941), whose opinions were close to those of Keynes. Hansen's views led Galbraith to respond with a critical comment in which he disagreed with Hansen and Keynes (Galbraith, 1941). At the end of April 1941, President Roosevelt put Galbraith in charge of price controls, where he remained until May 1943. In the latter 1940s, Galbraith published several articles drawing from his experience.

The discussion on price controls does not end with the Second World War; each time that inflationary tensions reappear, so too does the debate over controls. At the start of the Korean War, Tibor Scitovsky *et al.* (1951) wrote a tract, *Mobilizing Resources for War*, for the Rand Corporation. This work analyzed the interrelationships between inflation and war efforts, and reviewed the different anti-inflationary policy options. A few months later Galbraith published *A Theory of Price Control*, in which he summarized his experience and thinking on the subject (Galbraith, 1952). The subject of price controls comes back again under Presidents Kennedy, Johnson, Nixon and Carter.

2. Price Controls in Time of War

Before we focus on Galbraith's contributions to the debate on wartime controls, it is useful to look at some different opinions on anti-inflation policy and price controls that were expressed during the Second World War.

[1]Kalecki (1997) contains a collection of his articles on these subjects.

2.1. The Timing of Price Controls

Before the Second World War began, it was widely believed that, because of the high unemployment and excess capacity inherited from the Great Depression, inflationary tensions would not arise as soon as they had during the First World War, but only *after a while*, as full-employment was approached and excess capacity disappeared. So, if price controls (or some other anti-inflationary policies) were required, they would not be necessary right away. Here is how Mordecai Ezekiel (1939, p. 1), a prominent economist in the Roosevelt administration, put it: 'This is one of the subjects on which economist generally, I believe, do agree ... If you have some unused capacity in your economy, the result of borrowing is not to put heavier pressure upon what you are already producing but rather to call forth more production. You then may borrow, get increased production for war purposes, and yet not drive up the price level'.

However, contrary to expectations, inflation started *immediately*. In the UK, four months after war was declared, wholesale prices rose by 27%, and the cost of living by 10%, even though unemployment had hardly fallen. In the US, inflation shot up from a yearly rate of 3% (in July 1940) to 15% (in July 1941); but unemployment was still above 10%, and the US would not enter the war for another five months.

Keynes and Galbraith gave different (but not necessarily opposed) explanations for this unexpected phenomenon. Keynes provided a macro explanation, Galbraith a micro one. Let us start with Keynes.

To carry on an important war (as opposed to a short military expedition), Keynes argued, a country could not *draw on its stocks* of ammunition and war material; rather, it must *expand its production* of these items. The labor force necessary for expanding war production could only come from the ranks of those already employed elsewhere (in branches producing civilian goods), or from the ranks of those who are not employed. In both cases excess demand for civilian goods appears *immediately* – no matter how much unused capacity there is. In the first case, excess demand arises because the production of civilian goods is reduced, in the second case excess demand arises because the number of wage earners increases without more civilian goods going to the market. As Keynes (1940, p. 8) put it: 'Even if there were no increases in the rates of money-wages, the total of money earnings will be considerably increased by the greater number of men engaged in the services and in civilian employments ... It follows that the increased quantity of money available to be spent in the pockets of consumers will meet a quantity of goods which is not increased'.

Excess demand then appears immediately, no matter how far we are from full employment and full utilization of capacity; so whatever anti-inflationary policy the government decides on, it must begin right away. 'This analysis of how inflation works is fundamental. ... But it is not yet understood by everyone ... During the last war I was in the treasury. But I never, at that time, heard our financial problem discussed along these lines' (Keynes, 1940, p. 70).

Kalecki was not very clear on this subject at the beginning of the war. In June 1940, he writes: 'The fundamental problem of the war economy is ... to prevent a violent rise in prices, which is bound to come, since the *productive resources are*

limited' (Kalecki, 1997 [1940], pp. 7–9). A year later, he assimilated the point made by Keynes: 'The problem of inflation arises in wartime because the volume of employment is maintained or even increased, whereas the output of consumption goods falls considerably' (Kalecki, 1997 [1941], p. 20). The fact that productive resources are 'limited' no longer enters into the argument.

In the case of Kalecki, his first (erroneous) formula had little influence on what he proposed. He in no way used it as an argument for postponing government intervention until full capacity use was reached. On the contrary, he favored rationing and price controls from the very beginning of the conflict, seeing them as a way of preserving the interests of the working classes and sharing the burden of the war more equitably.

Galbraith's alternative explanation comes in critical comment on Hansen's (1941) paper 'Defense Financing and Inflation Potentialities', where Hansen estimates that output and employment in 1940 were running at roughly 80% of potential capacity and concluded that 'the fear of inflation is exaggerated'. 'In taking account of inflation potentialities, the situation differs from that of the first World War ... there is very large productive capacity ... we approach the problem of preventing wartime inflation from a stronger vantage ground than in the first World War' (Hansen, 1941, p. 6). His argument was that, during mobilization, inflation can enter the system for *two different reasons* – because of bottlenecks and because full employment has been reached. Each type of inflation required a different policy to counter it. As full utilization of resources is approached, it may be useful to control prices. But if the price of a given commodity starts rising because of a bottleneck, the only sound policy is to concentrate efforts on 'breaking the bottleneck'; it would be wrong to block the corresponding price increase and thus deprive oneself of 'the important weapon of specific price increases where these may help eliminate bottlenecks' (i.e., by attracting capital and labor): 'If we succeed in avoiding, or at any rate in holding to a minimum, bottleneck inflation ... we shall finally encounter, *as we approach full employment*, the problem of general inflation' (Hansen, 1941, p. 6).

Galbraith starts his criticism by diplomatically suggesting that the comments he is about to make are 'supplementary to rather than at issue with' Hansen's arguments. But then he questions not only the relevance of Hansen's main distinction but also his main proposal: 'Professor Hansen distinguishes between rising prices associated with specific bottlenecks and rising prices associated with an approach to full employment ... I am not sure that complete rejection of the distinction would not be wise' (Galbraith, 1941, pp. 82–83). After more than ten years of Depression, parts of the economy that can speedily expand production and those that would rapidly experience bottlenecks are so intermingled that any distinction between the two is purely academic: 'Full employment will have little or no relation to the appearance of inflation ... the important decisions in price policy and fiscal policy will have to be made *long before full employment is reached*' (Galbraith, 1941, p. 83, emphasis added).

It seems only fair to mention Bernard Baruch here. Baruch identified speculation as a third argument for starting price controls *immediately*. Once the fear of war appears, businessmen anticipate that certain commodities will be in short supply, and their price will rise. The perception that prices are likely to rise

makes them bid up the price of existing stocks and future contracts for these commodities. Prices thus start rising even before the excess income related to war production (of which Keynes speaks) comes into existence (Adams, 1942, pp. 111–142).

2.2. Which Anti-inflationary Policy?

Economists may have agreed that war mobilization produced excess demand and inflationary tensions, but there was little agreement concerning what should be done about these problems. It is here that Galbraith's most original contributions to the question of price controls are to be found. But to understand them it is necessary to know what others thought about this issue.

The first policy that usually comes to the mind of a trained economist when faced with excess demand is to let the market restore equilibrium. This is what the free movement of prices is supposed to do.

Even if the price mechanism does this in times of peace, there are several arguments against relying on it in times of war. Importantly, it takes too much time. As Mordecai Ezekiel (1939, p. 9) wrote: 'If you wait for a high price to encourage manufacture to expand … you may lose a great deal of lives before that profit motive has brought the material needed'. To extend a famous remark by Keynes, we could say that, if we rely on market forces in times of war, we would be dead 'in the short run too'. Pigou (1941, pp. 70–71) says essentially the same thing: 'In an intense international conflict, *delay is extremely dangerous*. Time is of the essence of victory … commandeering enables the transition from peace production to war production to be effected much more speedily … The molding of industry into the shape proper for war needs therefore to be helped forward by direct government coercion'. Likewise, Tibor Scitovsky *et al.* (1951, p. 139, emphasis added) wrote: 'The market mechanism takes time – sometimes a considerable length of time – in effecting adjustments to changes in supply or demand conditions. In fact, the slowness of the market mechanism was the main argument advanced in World War II in favor of direct controls'.

Another argument against relying on the free movement of prices is that when war mobilization takes place, excess demand arises not only for military goods but for civilian goods also (for the reasons explained by Keynes). If prices of civilian goods rise, the profits from making these goods will attract investment away from military production, which is exactly what one wanted to avoid. As Seymour Harris (1945, p. 30) noted: 'uncontrolled prices may well result in the movement of labor and capital to industries which can be dispensed with in war-time'.

A last argument is that, during a war effort, the free movement of prices *will not* restore equilibrium. As Keynes put it: 'the Government having taken the goods, out of which a proportion of the income of the public has been earned, there is nothing on which this proportion of income can be spent … if prices go up, the extra receipts simply swell someone else's income, so that *there is just as much left over as before* … that is an arithmetical certainty' (Keynes, 1940, p. 61, emphasis added). And Keynes comes to the conclusion, a position later challenged by Galbraith, that: 'Some means must be found for

withdrawing purchasing power from the market ... *This is the only way*' (Keynes, 1940, pp. 8–9, emphasis added).

Withdrawing purchasing power: taxes versus savings. It seems there are only two ways of withdrawing excessive purchasing power from the market. The first is raising taxes, what Scitovsky *et al.* (1951) call the 'pay-as-you-go system'. It consists of financing current military expenditures by current taxes. As Pigou (1941, p. 73) explains, this system has practically never been relied on: 'in a war on a great scale, it is generally agreed that a policy of finance through taxation alone, however excellent it might be in theory, is in practice out of the question, for the simple reason that *people would not stand it*' (emphasis added).

This is one reason the founders of political economy often favored such a policy – they wanted the people to feel, in their pockets, the cost of the unnecessary wars their sovereigns chose to wage. But here we are supposing that the war is justified and necessary, so the task of the economist is exactly the opposite. It is to make the pain of financing the war as imperceptible as possible.

A second way of withdrawing purchasing power is by increasing savings. Voluntary savings can be increased by patriotic propaganda, by increasing incentives to save, by making consumption more difficult, etc. But there is a big problem with this approach. 'The defect in a voluntary plan, of course, is that its magnitude will necessarily be small compared with what might be achieved by a compulsory plan' (Hansen, 1941, p. 6).

There is another way 'voluntary' savings can deliver funds that the government requires for its military needs – it is by allowing inflation. Keynes brilliantly shows that this is a hidden way of transferring income from those who 'try to spend it' to the hands of those who 'will save it'. He explains how this comes about: 'allowing prices to rise ... merely means that consumer's incomes pass into the hands of the capitalist class' (Keynes, 1940, p. 6). What happens to this income, since the goods on which it could eventually have been spent on have been taken by the Government? What will the capitalists do with it? '[P]art of this gain they would have to pay over in taxes; part they might themselves consume thus raising prices [of consumer goods] still higher ... the rest would be borrowed from them, so that *they alone*, instead of *all alike*, would be the principal owners of the increased National Debt' (Keynes, 1940, p. 6, emphasis added). 'Thus it is quite true that, in the last resort, the amount of saving necessary to balance the expenditure of the Government (after allowing for the yield of taxation) can always be obtained by "voluntary" savings. But whether this is a good name for it is a matter of taste. It is a method of *compulsorily converting* the appropriate part of the earnings of the worker ... into the *voluntary savings* (and taxation) of the entrepreneur' (Keynes, 1940, p. 69, emphasis in original).

In sum, Keynes and Hansen both believed that voluntary savings (apart from the unjust type just described) would be the better way to finance wars. The problem, however, is that people do not seem to be up to the task of saving voluntarily; so Keynes and Hansen both propose *forced savings*, although they disagreed on the name. Keynes called it 'deferred wages'. These would be placed to the credit of their owner 'as a blocked deposit in a friendly society or ... in the Post Office Savings Bank carrying interest at 2.5%' (Keynes, 1940, p. 44). Hansen (1941, p. 6) preferred to call it 'a tax on payrolls' deducted from wages

that would be credited to the wage earners 'in the form of a blocked postal savings account'.

Galbraith's 'disequilibrium system'. Galbraith was not convinced by the Keynes–Hansen policy of across-the-board withdrawal of purchasing power. He was afraid that it would produce undesired side effects. First, by withdrawing purchasing power to reduce inflationary pressures where there are bottlenecks (rubber tires and scrap aluminum, for example), we also reduce purchasing power where there is abundant idle capacity (food and tobacco). It is a method of reducing demand for 'scarce goods needed by the army' that also reduces demand for 'non-scarce goods used by the people'.

Second, excess demand has a stimulating effect on production that it would be a mistake to eliminate:

> reducing the amount of spending too soon [as Keynes proposes] ... would remove a very desirable pressure for expansion of capacity ... If we wait for full employment before reducing the volume of spending [as Hansen proposes] we shall already have had a good deal of inflation ... we must avoid premature reduction of spending. It is not something to be done at the first sign of inflation. It is not clearly desirable even when inflationary tendencies become relatively wide-spread, for at such time, if my analysis is correct, there will still be important unused resources. (Galbraith, 1941, pp. 83–84)

We should control prices right away! As such, 'this control ... will check inflation without hampering expansion or curbing the consumption of commodities or the use of services which are plentiful. In short, the real burden of the armament effort can be reduced by price controls' (Galbraith, 1941, p. 84).

That was Galbraith's main message, and it is what the United States did under his (and Leon Henderson's) guidance. In 1947, looking back with well deserved paternal pride (for both the system and the name it goes under), he writes:

> During the second World War, the United States ... developed a system for mobilizing economic resources that, by commonly accepted standards of performance, proved highly satisfactory ... [this system] I have termed the *Disequilibrium system* ... an aggregate of money demand substantially in excess of the available supply of goods and services ... was a distinctive and pervasive feature of the system (not an unfortunate or evil by-product) ... I have used this disequilibrium of demand and supply to name the system as a whole. (Galbraith, 1947, pp. 287–288, emphasis added)

To be fair, we must recall that Kalecki opposed across-the-board withdrawal of purchasing power a year before Galbraith. He feared that it was a policy that unnecessarily reduced the consumption of things that were not needed for the war effort: 'reduction of enjoyment of services releases little in the way of raw materials and labour ... If somebody's compulsory savings are made by ... reducing his dwelling space, or giving up the cinema – he does not, indeed, contribute much to the war effort' (Kalecki, 1940, pp. 7–9). He also feared that Keynes's policy would burden the poor more than the rich. The rich, he says, can comply with the 'forced savings' that are required by reducing their 'voluntary savings', without restraining their consumption. The poor don't have voluntary savings, they can only comply by reducing their consumption: '[we should]

establish a certain maximum for the consumption of the rich before compulsory saving is imposed on the poor' (Kalecki, 1940, pp. 7–9).

2.3. The Scope or Coverage of Price Controls

It was also widely believed, at the beginning of the war, that price controls (if and when they eventually became necessary) need not be comprehensive – they should only concern specific commodities. According to the consensus opinion, Galbraith (1980, p. 5) tells us in his book: 'price controls would be applied [only] to *commodities which the war had placed in especially short supply*' (emphasis added). Keynes also seems to have seen no extensive role for price control: 'some measure of rationing and price control should play a part in our general scheme ... [a list of] *a limited range of essentials* ... should be drawn up and the Government ... should do their best to prevent any rise in an index number based on the cost of these articles' (Keynes, 1940, p. 57, emphasis added). The idea that price controls should be limited to specific items was shared by Galbraith (1941, p. 84): 'in the areas where resistances develop, as they are now developing, we shall need *specific price controls* ... these *specific price controls* must be the major reliance' (emphasis added).

Both theoretical and practical arguments were advanced for the scope of price controls. The more laissez-faire authors wanted to disturb the mechanism of freely moving prices as little as possible because they believed this mechanism would direct resources towards their most efficient uses (Anderson, 1938, pp. 3, 16; Enke, 1942, pp. 842–843). For this reason, among others, Ludwig von Mises (1945, 1949) argued that controls should be minimized lest they set a precedent and jeopardize the future of economic freedom and private property.

Galbraith was not impressed by such laissez-faire arguments, in large part because he did not see the need for comprehensive price controls. As Leon Henderson (Galbraith's boss) explained before the House Committee on Banking and Currency, on 17 September 1941: 'ceilings on 75 to 100 of the principal commodities and fabrications would be sufficient' (Barber, 1996, p. 142).

The prevailing idea was that if (and when) the supply of a given commodity became problematic the authority supervising prices should step in, study the market in question, and propose a specific solution. One of the first problems encountered were rubber tires: 'By the summer of 1941, prices of lumber, scrap metal, some textiles ... were under the pressure of rising military and civilian demand. As the prices rose, we published schedules setting out the maximum permissible [price] levels' (Galbraith, 1981, p. 136).

But it rapidly became evident to Galbraith that they were on the wrong path. The number of commodities posing problems skyrocketed; and although the Office of Price Administration expanded its personnel, the task of studying a growing number of markets for problematic commodities and proposing a well thought out price schedule for each of them, quickly became impossible. The politics of 'piecemeal control' (as Baruch and Harris called it) soon became unworkable:

> each price fixing action took time; costs had to be obtained, meetings held and the results deliberated ... The work in understanding issues in dispute, establishing ceilings, according hearing and appeal to interested and aggrieved parties,

> staffing and otherwise managing the enterprise and answering to the Congress, press, and public, was to be the most intense effort of my life ... we began to realize for the first time what an unreasonably large number of products and prices there were in the American economy ... I began to accept that *I had been very wrong*. (Galbraith, 1981, pp. 136, 164, emphasis added)

And the problem seemed destined to become more serious over time. If the price of commodities for which excess demand appears first (tires, lumber, scrap metal) gets fixed, they stop rising; but the excess income still exists and simply chases the remaining (and less numerous) commodities. As Harris (1945, p. 93) explained: 'Once the government has restrained prices ... over a significant part of the economy, the pressure of excess demand became more serious, for the area over which excesses of purchasing power could be spilled was gradually being reduced'.

There was clearly a dilemma. Letting the market determine prices would lead to inflation, but the government seemed unable to set prices with promptitude and competence. Yet if only some of the prices were fixed, it just made the problem worse for the price of the remaining commodities.

Towards general price controls. The solution came in the form of the General Maximum Price Regulation (GMPR) of 28 April 1942, which imposed a ceiling on all prices. Starting from that date, no seller would be allowed to charge, for the same item sold to purchasers of the same class, more than the highest price he had charged during the month of March 1942.

The new regulation reversed the earlier design for price control policy. In the earlier system, the burden of proof had been on the Office of Price Administration: if it wanted to impose a maximum price on a particular commodity, it had to give a well thought out argument for doing so. Now the *onus probandi* would be on the particular seller: if he wanted to raise his prices and charge more than he had during March 1942, he had to give a convincing reason for doing so. Controls over prices and wages became the rule; freedom from such regulation became the exception. The new regulation made no pretense to deal with particular disequilibria. According to testimony by Chester Bowles to Congress, overnight the prices of 8 million products were fixed (Harris, 1945, p. 22).

There had, of course, been voices dissenting from the previous consensus that controls were only necessary on the price of some goods. Baruch (who was chairman of the War Industries Board during the First World War) long opposed the path that Galbraith and his colleagues were following. Testifying before Congress in 1941 he warned: 'I do not believe in piecemeal price fixing. I think you have first to put a ceiling over the whole price structure ... and then adjust separate price schedules upward or downward, if necessary, where justice or governmental policy so require' (Baruch, 1960, p. 287). George Adams (1942, pp. 111–142) has given an excellent account of the objections to Baruch's opinions, and the answers he gave.

In his memoirs, Galbraith recalls how Baruch's propositions had been received at the time:

> We were horrified. All economists were horrified. An economist without a price system is a priest without a divine being ... We had spent our lives learning

> about prices and teaching others how they rose to encourage needed production; how they fell to discourage unneeded production ... Under the Baruch plan all of this admirable mechanism would be in limbo ... We could not accept the Baruch system. (Galbraith, 1981, p. 134)

Rostow (1942, p. 486) confirms this: 'The majority of economists ... opposed such wide and drastic action.'

The solution of controlling all prices was not completely new, of course. Germany imposed a general price-stop in 1936, but it was largely believed to be a decision: 'taken by men who were intellectually incapable of weighing the alternatives ... to their unsubtle minds, it seemed the only way to prevent inflation' (Galbraith, 1952, p. 5). Whatever may have been the case with Germans, the method of using a general formula, instead of dealing with each individual price, had also been applied by the British, during the First World War, to commodities having great variety and numerous grades. Here is how Pigou (with evident approbation) described this practice:

> grades were often very numerous ... when there were a great many, it was thought better to rely, not on a schedule of maximum prices, but on a general order determining the relations between the prices that might be charged in the future and those that had been charged in the past ... sellers of machine tools [for example] were forbidden, except with the sanction of the Minister, to charge prices higher than they were charging in July 1915. (Pigou, 1941, pp. 119–120)

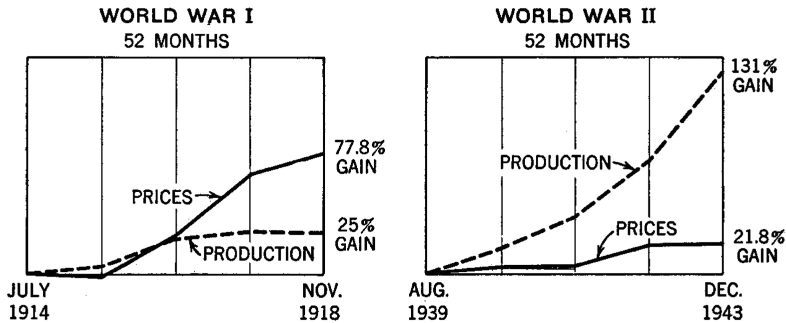
Finally, when general price controls were imposed by the Canadian government in the autumn of 1941 and these controls seemed to be working, the taboo was broken: 'I had been up to Ottawa – writes Galbraith – it was obvious that they were doing a better job of price stabilization than we were ... In March (1942) I confessed error' (Galbraith, 1981, p. 164).

In the end, Galbraith (1952, pp. 4, 7) tells us: 'all of the highly organized belligerents emerged with *comprehensive systems of price-fixing* ... Events had forced the step that economists, in the main current of economic theory, had so long viewed as unwise or impossible, or both' (emphasis added).

3. Why General Price Controls were Possible and why it didn't cause Chaos

As noted above, it was widely believed that it was beyond the ability of the government to develop a comprehensive and coherent schedule of prices to replace market prices because of the enormous number of goods, the great diversity of varieties and qualities, and the many different localities and circumstances in which production was carried out. It was also believed that, if the mechanism of freely moving prices were suspended, there would be catastrophic results.

The experience of the Second World War shows that nothing of the sort happened. All developed belligerent countries applied general price controls during the war but no country collapsed because of these controls. As for the US, from 1939 to 1944 its per capita GDP doubled in constant dollars (Madisson, 2003,



·Industrial production and prices of industrial goods in two world wars.
(*Source: Office of Price Administration.*)

Figure 1. Price and production during both wars for the first 52 months of the conflict.

p. 88), industrial production almost tripled, and it was possible to produce a massive amount of war material while at the same time increasing civilian living standards.

Drawing some lessons from war-time price controls, Harris (1945, p. 8) writes: 'Few will dispute the fact that price control in the United States has been effective. Those who do not agree need only compare the rise of prices in former wars – especially the first World War with those in the second World War – to be convinced'. He furnishes a graph comparing price and production performances during both wars for the first 52 months of the conflict (Figure 1). The large gains in output during the Second World War are clear from this figure. As Galbraith (1981, p. 171) put it: 'That so much could be accomplished with the market in partial suspense was deeply damaging to the established faith'.

This raises two questions. First, why the did the task of fixing thousands of prices and then enforcing compliance, a task that had been considered by most economists to be impossible, turn out to be less difficult than expected? Second, why didn't the suspension of the price mechanism cause chaos, as had so often been predicted?

3.1. How was it Possible

According to Galbraith, economists were not wrong in thinking that price controls would be (almost) impossible in a purely competitive market. Their mistake was in believing that the pre-war economy was still a competitive one, and that prevailing prices were mostly determined by free-market forces. Economists did not realize how American capitalism had changed, how widespread imperfectly competitive markets had become, and how relatively easy it would be to control prices in such markets:

> concentration in American industry had gone far beyond the current estimate or appreciation of the textbooks. Oligopoly ... was no longer the exception ... it

> was the rule. Where a few large firms dominated an industry, as they did steel, aluminum, oil, chemicals, pharmaceuticals and many others, *prices were already controlled* ... these markets lend themselves to price regulation to a far greater extent than had previously been supposed. (Galbraith, 1952, pp. 10–11, emphasis added)

The belief that many prices were already fixed, long before the war began, was not new. Most classical economists admitted this fact, but believed that such prices should be considered as exceptions to the rule. Institutionalists went even further; they considered these administered prices (as Gardiner Means baptized them) as part and parcel of their model from the very beginning (Goode, 1994, pp. 173–184).

Administered prices were not new to Galbraith. In 1938, when searching for the causes of the persistence of the Great Depression, he strongly suspected the culprit to be rigidity in the price of commodities like automobiles, steel, and cigarettes, which (unlike agricultural prices) refused to fall in face of reduced demand. It was clearly not the forces of supply and demand that were keeping these prices up, but some kind of market power possessed by producers (or, as he then calls it, 'jurisdiction over price'). He noted that: 'the sort of producer jurisdiction over price which is to be found in the automobile industry ... holds over the great range of American industry' (Dennison & Galbraith, 1938, p. 24).

Widespread price rigidity, which he (at the time) believed to be a curse that largely explained why the economy was experiencing great difficulty coming out of the Depression, was now seen as a blessing that would help win the war. The same economic forces and institutional arrangements that kept prices from falling during the Great Depression, could now be harnessed to stop them from rising during the war. As Galbraith (1952, p. 17) summarizes: 'I am tempted to frame a theorem that is all too evident in this discussion: it is relatively easy to fix prices that are *already fixed*' (emphasis added).

Galbraith tells us, in his memoirs, how shocked most economists had been when Bernard Baruch proposed a suspension of the mechanism of freely moving market prices. They had not noticed that the free-market price mechanism had already been suspended to a significant extent before the war. It had been suspended, not by any sudden government decree, but by the gradual extension of market power. George Adams (1942, p. 138) already saw that:

> the area in which prices are administered, rather than formed competitively in a free market, has been growing ... To move from a world in which many prices are fixed by private industry to a world in which many prices are fixed by Government ... is not so drastic a change as some critics of governmental price control have assumed.

It is easier to understand why comprehensive price controls are possible if we distinguish the three principal problems that such controls are supposed to encounter. The first is that of determining at what level (or inside what interval) we desire to keep different prices. As already noted, it was believed that this was an impossible task for government to perform in a modern economy. How could a government agency decide what the right price is for millions of commodities, produced

under millions of different conditions, and in as many different localities? And as we saw above, if a government agency tried to find the best price 'commodity by commodity' the task is endless. But, if it imposes the prices practiced during the month before, a complete set of prices already exists, and is ready to be used overnight, as a satisfactory starting point.

A second problem is that of the 'rationing mechanism' by which the allocation of commodities to different buyers will be performed. Since a government-imposed price will be lower than the market price, demand at that price will be greater than supply and not everyone will get all he wants. Those who are excluded will be tempted to secretly offer the producer more than the legal price, and a black market will develop, unless someone has the power to decide who will be deprived of the commodity and who will get to buy it. Since there are so many producers, buyers and commodities, it is impossible for a government agency to make these decisions (for the same reason that it was impossible for it to decide prices one by one).

In a purely competitive market (with a large number of producers and buyers), sellers do not know who their buyers are; so, even if they wanted to decide which buyers should be rationed and which should be served, they would have no way of doing so. In an imperfectly competitive market, it is otherwise. When there is imperfect competition, the government does not have to make these decisions – the sellers can make them. The seller knows his buyers so, if there is need for rationing, the seller is in a position to perform it:

> when the number of buyers is relatively small, or the number of sellers relatively small, or both . . . It is possible for sellers to allocate scarce supplies to specific customers . . . it is possible, and even rather easy, for sellers to give large, habitual, or otherwise favored buyers, preference rights to what is available and this is a very natural pattern of behavior . . . in the ideal case there is no supply left to enter a free (or black) market. (Galbraith, 1952, p. 11)

The government then doesn't have to create, *ex nihilo*, a bureaucratic apparatus to perform the rationing function since such an apparatus already exists. It just has to control and monitor it to make sure that this rationing function is performed in conformity with the war effort.

The third problem concerns the surveillance mechanism needed to police the system (i.e., to report eventual violators). In a competitive market, where there are many sellers and buyers, there are innumerable potential offenders to watch over. Each violation of the law will be small and very few people will be informed of it. Those who are informed (the violating seller and the violating buyer) have an interest in keeping it secret, so it will be relatively difficult and very costly to detect.

In a monopolistic market with big corporations, illegal actions are more important and known to a greater number of employees. Buyers who have been penalized (i.e., excluded) will be bigger and have an interest in, and the means to, investigate and disclose illegal actions: 'in the competitive market there is little hope that the buyer will police the price regulation imposed on the sellers; in the imperfect market, the market of administered prices, there is considerable chance that he will' (Galbraith, 1952, p. 15).

3.2. Why Price Controls did not Produce Havoc

The dominant opinion among economists, as Galbraith tells us, was that free-market prices are indispensable and should be disturbed as little as possible:

> Freely moving prices, as the first textbook lessons tell, are the rationing and allocating machinery of the economy. They keep demand for goods equal to what is available, they guide resources from less to more important uses. Obviously if prices are fixed they can no longer perform these functions ... At a minimum, the effect must be some malfunctioning of the economy; at a maximum, it might be chaos. (Galbraith, 1952, pp. 2–3)

Why didn't this happen? Several explanations have been given.

For many economists price controls had direct, negative effects on production because they distorted market signals and produced inefficiency in allocation. But their indirect, non-economic effects (through their impact on morale and patriotism, for example) were positive. Price controls helped convince people that their forced savings would not be eroded by inflation, that profiteering was being contained, that the burden of war was being more or less fairly shared. Had excess demand been withdrawn from the market by taxes, or had inflation eroded real wages and savings, or had wartime profits skyrocketed, it is not certain that unions would have respected no-strike agreements or people would have worked longer hours without complaining.

This is the way Keynes, who often writes of the waste and inefficiency he observed during the war, saw the problem; but Keynes believed that the indirect positive effects largely outweighed the direct negative ones. Economic historian Hugh Rockoff, in his 1984 book on the history of wage and price controls in the United States, expresses a view similar to Keynes (Rockoff, 1984, p. 139). However, 11 years later he seems to have changed his opinion. His later view is that the direct negative effects outweighed the indirect benefits. 'All in all, price controls made a limited and probably *negative contribution* to the speed and maximum degree of the mobilization' (Rockoff, 1995, p. 12, emphasis added).

Other authors also believe that the negative economic effects were relatively small. Scitovsky *et al.* (1951, pp. 122–123) suggest that the optimal prices that a competitive market is supposed to generate (those prices that should not be distorted), do not change very rapidly. So, if they are frozen for a short period of one or two years, the harm done (by directing resources to sub-optimal uses) is probably small.

Others argued that the initial prices were probably not optimal to begin with. This opinion is expressed by Scitovsky *et al.* (1951, Appendix II), which speaks of the theory of efficient allocation through free-market prices as a 'belief' belonging to the past: 'That all this is accomplished by the pricing system in the market economy *was believed* to be proved by the theory of perfect competition. *Today*, perfect competition is looked upon merely as a model of economic perfection of which our economy falls short' (Scitovsky *et al.*, 1951, p. 259, emphasis added). If the initial prices then were not optimal, there is no *a priori* reason for believing that government intervention distorts them; it could even make them 'better.' This was Galbraith's line of reasoning.

One of the main forces behind the free market argument is that if the government-imposed price is lower than the market price, less will be supplied by the producer. But this assumes that we are in a situation of pure competition and decreasing returns. With monopolistic competition and increasing returns, there is no presumption that if government lowers prices, less production will be forthcoming. As Pigou (1941, pp. 128–129) noted:

> authoritative limitation of the price that may be charged for a thing produced under competitive conditions is likely to check the output of that thing. With a thing produced by a monopolist ... price limitation, by preventing him from seeking his gain by high prices, may force him to seek it through large sales, and so may actually stimulate production.

Likewise for Galbraith (1952, pp. 22–23):

> many, if not most, of the economists actively associated with price control ... consciously or implicitly assumed that where large increases in production would be required, it would be at increasing cost ... In retrospect ... the number of manufacturing industries expanded at increasing cost was extremely small ... most industrial expansion during the war was at constant or decreasing cost.

4. Price Controls in Time of Peace

Keynes argued in the 1930s that recessions could be mitigated, and a higher level of employment maintained, by modulating government spending. Government programs during the war tended to confirm this theory by wiping out unemployment; but they also caused inflationary tensions that had to be neutralized lest they hinder the war effort.

Inspired by this result, the Employment Act of 1946 imposed upon the federal government of the US the legal obligation to promote 'maximum employment'.[2] It was widely believed, at first, that standard monetary and fiscal policy could achieve this goal without unleashing the inflationary tensions seen during the war, since the required stimulus would not have to be so massive. If demand could be increased without pushing it above what the existing capacity and labor force could cope with, high employment could be obtained without triggering inflation. This was a popular view in the years immediately following the Second World War. As Kalecki (1943, p. 323) put it: 'if Government intervention aims at achieving full employment but stops short of increasing effective demand over the full employment mark, there is no need to be afraid of inflation'. And as David Colander (1984, p. 33) points out: 'The lesson most economists learned from World War II was that Keynesian aggregate demand policy worked. The fact that the expansion of aggregate demand had been accompanied by major controls over wages and price ... was lost on the majority of the profession'.

[2]The exact wording was 'to promote maximum employment, production, and purchasing power'.

4.1. The Problem of 'Premature' Inflation

As often happens in economics, things do not turn out as expected. In the years following the Second World War, a sort of premature inflation (as Milton Friedman called it) appeared, an inflation that tended to spring up long before full employment was in sight. At first, economists blamed the specific circumstances surrounding each new bout of inflation. The price increases in 1946 were explained by the liberation of pent-up demand during the war. The second surge, in 1950, was attributed to the increase in spending related to the Korean War. When prices surged again in 1956, although the economy was in ordinary circumstances (the Korean War had been over for three years and public spending had been falling for four consecutive years), many economists suspected that there was a deeper underlying cause at work.

Paul Samuelson (1960), who was hoping for an unemployment rate of 3.5% to begin with (and for it to go below 3% once the right policies were in place) put it this way: 'instead of setting in only after you have reached overfull employment ... inflation may be a problem that plagues us even when we haven't arrived at a satisfactory level of employment'. Similarly, Robert Solow (1966, p. 42) identified a key policy difficulty. 'It is a fact ... wages and prices begin to rise too rapidly for comfort while there is still quite a bit of unemployed labor and idle productive capacity and no important bottlenecks. This tendency creates *a dilemma for public policy*' (emphasis added).

No one disputed the fact that restrictive fiscal and monetary policies could check inflation. But the pain was much greater than was expected. It seemed that an unemployment rate of 6%, 8%, or even 10% (unacceptable in the postwar years) was required. Some other way of containing inflation would have to be found, or it would mean the end of full-employment policy. In his January 1961 report to President-elect Kennedy on the state of the American economy, Samuelson (1961, p. 28) characterized the situation as follows: 'Economists are not yet agreed how serious this new malady of inflation really is. Many feel that *new institutional programs*, other than conventional fiscal and monetary policies, must be devised to meet this new challenge' (emphasis added).

What could these new institutional programs look like? Should some form of price controls be part of the solution? Should controls be extensive or limited? Should they be permanent or transitory? Should they be compulsory or voluntary?

4.2. Market-power or Excessive Money-supply?

Different explanations of this unexpected inflation were given and different policies were proposed for ending it.

While recognizing the role played by specific factors such as pent-up demand, bottlenecks, and military expenditure, Galbraith believed that there was a deeper underlying cause that explained this premature inflation. He pointed to the power that large corporations (and important trade unions) have to increase prices (and wages) even in the face of falling demand (and employment), a power that the rest of the economy lacked. If anti-inflation policy was to be effective, this market-power would have to be controlled.

Friedman also believed in an underlying cause of inflation, and he also saw it as stemming from an abuse of power, but he pointed to political power as the culprit. According to Friedman, the deep underlying cause of inflation is always excessive growth of the money-supply: 'inflation is always and everywhere a monetary phenomenon ... I know of no exception to this generalization'. Since the money supply is controlled by government, inflation is the government's fault: 'In modern times, the government has direct responsibility for the creation and destruction of money. Since inflation results from unduly rapid monetary expansion, the government is responsible for any inflation that occurs ... the only effective way to stop inflation is to restrain the rate of growth of the quantity of money' (Friedman, 1966, pp. 18–25).

Friedman conceded that a corporation with market power could use it to raise its prices above the normal market level, but he didn't think this process could be repeated again and again. Market power might explain why some prices were higher than they should be, but not that they were rising: 'Insofar as market power has anything to do with possible inflation, what is important is not the *level* of market power, but whether market power *is growing* or not ... the degree of monopoly *has not been increasing*, this monopoly power *will not* and *cannot* be a source of pressure for inflation' (Friedman, 1966, p. 57, emphasis added).

Moreover, Friedman thought that the market power explanation had catastrophic political effects. It blamed 'the rapacious businessman and power-hungry labor leader rather than point to the government printing press as the culprit' (Friedman, 1966, p. 24). The policy of wage and price controls that follows naturally from the market-power explanation will not be effective: 'it does not eliminate inflationary pressure. It simply shifts the pressure elsewhere and suppresses some of its manifestations ... suppressed inflation is far more harmful, both to efficiency and freedom, than open inflation ... it encourages delay in taking effective measures to stem inflation, distorts production and distribution, and encourages restrictions on personal freedom' (Friedman, 1966, p. 18–24).

4.3. The Medical Analogy

According to Galbraith, monetarists saw inflation in the US as an infectious disease that had entered the healthy body of the market economy. It could be purged only by taking an appropriately bitter medicine. In an article for the *New York Review of Books*, he had called this 'the peristalsis theory' (Galbraith, 1982, p. 34). Inflation had crept in because of the erroneous policies of using public spending to push unemployment below its natural rate, and letting the money supply grow too fast. Inflation then became anchored in expectations because these erroneous policies had been followed for too long. If restrictive policies were imposed for a while, they would be painful but the infection would be defeated, and health would come back.

Galbraith disagreed completely with this analysis. For him, this new form of inflation was more like a chronic condition due to age. The root cause cannot be eliminated, but the unwanted effects (rising prices) can be contained. American capitalism had changed; it passed from a situation in which competitive markets prevailed to one where imperfect competition prevailed. Here was the

cause of inflation, and not the easy-money policies castigated by Friedman. Since the cause of inflation is not excessive money supply growth, the remedy cannot be restrictive monetary policy: 'In the industrial countries we can no longer control inflation by the designs – notably the monetary policy – that were appropriate to the classical market economy. Professor Friedman is not wrong; but he is right only for the last century' (Galbraith, 1983, p. 39).

4.4. The Ineffectiveness of Restrictive Fiscal and Monetary Policies

In an early paper, 'Market Structure and Stabilization Policy,' Galbraith (1957) gave both moral and economic arguments against the restrictive fiscal and monetary policies proposed by Friedman. There is, first of all, the painfulness and injustice of the policy because, if it works, it works by affecting the weakest and most vulnerable. But the main economic objection is that *it will not really work*.

The higher interest rates and lower global demand that are a direct consequence of these policies have opposite effects on the two different sectors of the economy. The smaller and weaker companies of the competitive sector reduce their prices when they are faced with lower demand, and they scale down their investment projects in face of higher borrowing costs. But the big companies of the monopolistic sector can maintain their prices in face of reduced demand, and they can continue their investment projects since they are less dependent on bank credit or are given preferential treatment by the banks: 'while inflation continues in the corporate half of the economy, there can be falling farm prices and a painful recession in the competitive sectors ... The practical conclusion is that inflation cannot now be arrested by fiscal and monetary policy alone unless there is willingness to accept a very large amount of unemployment' (Galbraith, 1977, pp. 195–196) .

By making the small companies of the competitive sector reduce their prices, restrictive policies can influence inflation but, by pushing more of them out of business, they increase the respective weight of the monopolistic sector, which was the cause of inflation in the first place. So restrictive fiscal and monetary policies camouflage inflation more than they cure it, and they end up making the situation worse for the next surge in prices.

Some form of 'price controls' seems necessary, and the permanent control of prices set by the monopolistic sector appears to be the natural solution. As Dunn & Pressman (2005, p. 185) explain: 'Galbraith accepted neither the monetarist solution to the problem of inflation nor the fiscal solution of Keynes, arguing that both fail to assimilate the consequences of institutional change in the industrial structure into the conduct of macroeconomic policy'.

5. The Return of Free Market Ideas

The political situation is very different now from that which prevailed at the end of the Second World War, and the US did not implement the policies that Galbraith proposed. Not everyone thought that the new goal America had set itself (maximize employment) had the same priority as the previous one – winning the

war. Even among those economists giving full employment high priority, many believed that there were other, less controversial ways of attaining this goal (reduction of the minimum wage, supply-side policies, deregulation of markets). The orthodox ways of reducing inflation, which had been discarded during the war (raising interest rates, reducing public expenditure, opening markets to cheaper foreign goods) did not seem so out of line any more. The success of wartime price controls had been forgotten, and they were again largely believed to be impossible or harmful for the economy.

Differences of opinion did not only fall along party lines. Here is how William Barber (1975, p. 150) describes the situation among economists surrounding Kennedy in the 1960s:

> a sharp division emerged over whether a government position on wage-price policy was needed at all . . . among those who accepted the need for an official position on wages and prices, the ranks divided on the form it should take. Should intervention be directed primarily toward wages . . . or should even handed treatment of both labor and management be adopted? Should the objective of policy be comprehensive coverage or should government involvement be reserved for selected sectors? Was it realistic to expect that without direct controls, potentially inflationary behavior could be policed?

Solow (1966) largely agreed with the market-power explanation of premature inflation. But he was skeptical about compulsory controls and was only willing to accept voluntary guidelines for wages and prices of the monopolistic sector. Samuelson (1975) was hesitant: 'When I hear my good friend of long standing, Ken Galbraith, speak about the merits of permanent price-wage controls . . . applied mainly to a few hundred large corporations and the few dozen unions they bargain with . . . I cannot help but wonder'. Four years later, in an article for the *Encyclopedia Britannica*, he was still hesitating: 'controls work rather effectively in the very short run, for three or six or nine months. But increasingly they become ineffective, inefficient, and inequitable' (Samuelson, 1979, p. 63).

The return of inflation after the war, and the question of what to do about it, set the stage for a long battle that eventually turned out to be a fight about the path that American capitalism would follow. Would it continue in the direction opened up in the 1930s by the New Deal and experiment in original forms of enlightened government intervention to solve economic and social problems? Would the US embark on a road more like that of the Scandinavian countries, or would it be tempted by a more free-market ideal of society?

Many indecisive skirmishes were fought. Kennedy and Johnson (and later, Jimmy Carter) had recourse to voluntary wage-price guideposts (Sheahan, 1967). In 1971, Richard Nixon surprised everyone by imposing a 90 day wage-price freeze (Weber, 1973) followed by several stages of selective controls. The consensus around the neoclassical synthesis began to disintegrate, and most strands of macroeconomic thought converged against all forms of government intervention, while monetarism made a remarkable, though short-lived, comeback.

6. Concluding Remarks

After the inauguration of Jimmy Carter in January 1977, the Fed began steadily increasing the Federal Funds Rate. It reached 15% in 1980 and remained at these high rates during Ronald Reagan's first two years in office. The US economy experienced two consecutive recessions and stagnated for four years (from 1978:4 to 1982:4); unemployment reached 10.8% before a recovery started. The US and the Western World entered a period of about 25 years of low inflation which may be ending now.

Economists are divided on why inflation declined after 1985, and especially when it declined after 1992. Some believe that Paul Volker's shock monetary therapy purged inflation from the system, and that central bank credibility has somehow kept it from coming back. Others believe that the growth of competition from European and Japanese companies, and then the influx of low-priced Asian commodities, neutralized the market power of big American corporations and trade unions that Galbraith blamed for inflation. Whatever the respective merits of these rival explanations, interest in them seems to be receding today as inflation has reappeared. And with the re-emergence of inflation comes the question of price controls.

By recalling some of the discussions concerning price controls that took place during the Second World War, and with the full employment policy after the War, we hope to have given the reader some background to better understand this current debate. The same rival camps seem to be forming. On one side are those who see the worrisome price movements as precious information being signaled to us by the admirable forces of supply and demand, signals that should not be distorted. Others suspect, as Galbraith always did, not only that the forces of supply and demand sometimes produce destructive price movements but also that the price movements we are experiencing probably have a wider diversity of other causes than just supply and demand. Among the many suggested culprits in generating our current rising prices are market power, speculation, fear, and rumors. These were the causes that Galbraith recognized as stemming from the nature of mature capitalist economies. Likewise, Galbraith thought that neither the direction nor the degree in which prices move should be considered as sacred.

Each one of us can decide for himself whether the discussions to which Galbraith contributed, and his attitude towards dominant economic theory, are of value only for the historian or if they should be taken seriously by policy makers today.

References

Adams, G.P. (1942) *Wartime Price Control* (Washington, DC: American Council on Public Affairs).

Anderson, B. (1938) *Price Control in War Time, Course 1937–1938* (Washington, DC: The Army Industrial College), www.ndu.edu/library/ic7/L38b-030.pdf.

Barber, W.J. (1975) The Kennedy years, in: C. Goodwin (Ed.), *Exhortation and Controls: The Search for a Wage-Price Policy* (Washington, DC: Brookings Institution).

Barber, W.J. (1996) *Designs within Disorder: Franklin Delano Roosevelt, the Economists, and the Shaping of American Economic Policy, 1933–1945* (Cambridge: Cambridge University Press).

Baruch, B. (1960) *The Public Years* (New York: Holt, Rinehart & Winston).

Colander, D. (1984) Galbraith and the theory of price control, *Journal of Post Keynesian Economics*, 7(1), pp. 30–42.

Dennison, H.S. & Galbraith, J.K. (1938) *Modern Competition and Business Policy* (New York: Oxford University Press).

Dunn, S. & Pressman, S. (2005) The economic contributions of John Kenneth Galbraith, *Review of Political Economy*, 17(2), pp. 161–209.

Enke, S. (1942) Price control and rationing, *American Economic Review*, 32(4), pp. 842–843.

Ezekiel, M. (1939) *Price Control, Course 1938–1939* (Washington, DC: The Army Industrial College).

Friedman, M. (1966) What price guideposts? in: G.P. Schultz & R.Z. Aliber (Eds) *Guidelines, Informal Controls, and the Market Place* (Chicago: University of Chicago Press).

Friedman, M. (1977) *From Galbraith to Economic Freedom, Occasional Paper 49* (London: Institute of Economic Affairs).

Galbraith, J.K. (1941) The selection and timing of price controls, *The Review of Economic Statistics*, 23(2), pp. 82–85.

Galbraith, J.K. (1947) The disequilibrium system, *American Economic Review*, 37(3), pp. 287–302.

Galbraith, J.K. (1951) The strategy of direct control in economic mobilization, *The Review of Economics and Statistics*, 33(1), pp. 12–17.

Galbraith, J.K. (1952) *A Theory of Price Control* (Cambridge, MA & London: Harvard University Press).

Galbraith, J.K. (1957) Market structure and stabilization policy, *Review of Economics and Statistics*, 39(2), pp. 124–133.

Galbraith, J.K. (1977) The bimodal image of the modern economy: remarks upon receipt of the Veblen-Commons Award, *Journal of Economic Issues*, 11(2), pp. 189–199.

Galbraith, J.K. (1978) *Almost Everyone's Guide to Economics* (Boston: Houghton Mifflin).

Galbraith, J.K. (Ed.) (1980) Introduction to the 1980 edition, *A Theory of Price Control* (Cambridge, MA & London: Harvard University Press).

Galbraith, J.K. (1981) *A Life in Our Times* (Boston: Houghton Mifflin).

Galbraith, J.K. (1982) Recession economics, *New York Review of Books*, 29, p. 34.

Galbraith, J.K. (1983) Reaganomics: a midterm view, in: A. GitlowL. (Ed.) *Reaganomics, Meaning, Means and Ends*, pp. 27–40 (New York: The Free Press).

Goode, R. (1953) Mobilization economics, *Review of Economics and Statistics*, 35(1), pp. 87–92.

Goode, R. (1994) Gardiner Means on administered prices and administrative inflation, *Journal of Economic Issues*, 28(1), pp. 173–186.

Hansen, A. (1941) Defense financing and inflation potentialities, *Review of Economic Statistics*, 23(1), pp. 1–7.

Harris, S. (1945) *Price and Related Controls in the United States* (New York: McGraw Hill).

Hildebrand, G. (1952) *A Theory of Price Control by John Kenneth Galbraith, American Economic Review*, Vol. 425, pp. 986–990.

Kalecki, M. (1940) Scheme of curtailment of consumption, *Bulletin of the Oxford University Institute of Statistics*, 2(3), pp. 7–9.

Kalecki, M. (1941) Inflation, wages, and rationing, *The Banker*, 60(189), pp. 43–48.

Kalecki, M. (1943) Political aspects of full employment, *The Political Quarterly*, 14(4), pp. 322–331.

Kalecki, M. (1997) *Collected Works of Michal Kalecki*, Vol. VII (Oxford: Clarendon Press).

Keynes, J.M. (1940) *How to Pay for the War* (London: Macmillan).

Mises, von, L. (1945) Inflation and price control, *Commercial and Financial Chronicle*, 20 December. http://mises.org/story/1823.

Mises, von, L. (1949) War and the market economy, in: *Human Action: A Treatise on Economics* (New Haven: Yale University Press).

Madisson, A. (2003) *The World Economy, Historical Statistics* (Paris: OECD).

Pigou, A.C. (1941) *The Political Economy of War* (London: Macmillan).

Rockoff, H. (1984) *Drastic Measures: A History of Wage and Price Controls in the United States* (New York: Cambridge University Press).

Rockoff, H. (1995) *Price and Production Controls in World War II,* Departmental Working Papers 199602 (Rutgers University, Department of Economics).

Rostow, W.W. (1942) Price control and rationing: some aspects of price control and rationing, *American Economic Review*, 32(3), pp. 486–500.

Rothbard, M. (1995) Price controls are back, in: *Making Economic Sense* (Auburn, AL: Ludwig von Mises Institute).

Samuelson, P. (1960) Interview in December 1960 with *U.S. News World Report*.

Samuelson, P. (1961) Economic Frontiers, in: *New Frontiers of the Kennedy Administration: The Texts of the Task Force Reports Prepared for the President* (Washington, DC: Public Affairs Press).

Samuelson, P. (1975) Economic Policy – where is it leading? *Boston University Journal*, 1975(1), pp. 30–36.

Samuelson, P. (1979) The roots of inflation, in: *Encyclopedia Britannica, 1979 Book of the Year* (Chicago: Encyclopedia Britannica).

Scitovsky, T., Shaw, E. & Tarshis, L. (1951) *Mobilizing Resources for War: The Economic Alternatives* (New York, Toronto & London: McGraw-Hill).

Sheahan, J. (1967) *The Wage-Price Guideposts* (Washington, DC: Brookings Institution).

Smith, A. (1776) The Wealth of Nations, *The Glasgow Edition* (Oxford: Clarendon Press).

Solow, R. (1966) The case against the case against the guideposts, in: G.P. Schultz & R.Z. Aliber (Eds) *Guidelines, Informal Controls, and the Market Place* (Chicago: University of Chicago Press).

Taussig, F.W. (1919) Price fixing as seen by a price-fixer, *Quarterly Journal of Economics*, 33(2), pp. 205–241.

Weber, A. (1973) *In Pursuit of Price Stability; The Wage-Price Freeze of 1971* (Washington, DC: Brookings Institution).