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U.S. GENERAL ACCOUNTING OFFICE
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Statement of Harry S. Havens
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Before the Subcommittee on Commerce,
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Summary of
13220

We are pleased to have this opportunity to present our views to you concerning the effectiveness of the Council on Wage and Price Stability. As you know, we are engaged in an extensive review of the Council and its role in the President's anti-inflation program. Our study will cover all phases of the Council's operations; we expect to complete our work this summer.

AGC00571

In your December 20, 1979 letter you asked us to address a series of questions concerning the Council's efforts to limit price increases for crude oil and petroleum products. According to the Bureau of Labor Statistics, the average retail price of gasoline rose 52 percent last year while the retail price of home heating oil increased 62 percent. These increases accompanied the largest increase in the Consumer Price Index in more than 30 years.

These increases, and the further price increases in January and February, raise questions about the effectiveness of the President's anti-inflation program in general and the effectiveness of the wage and price standards issued by the Council in particular. Do they apply to the oil industry? If they do, did the industry comply with them last year? If there was widespread compliance, how was the massive increase in oil prices possible? If there was not, why has the Council been so slow in detecting this fact and responding to it?

See attachment

You have asked us these questions and a number of others about the Council and its standards. I would like to submit our full responses for the record, and, with your permission, will summarize them for you.

The Council on Wage and Price Stability was established in 1974 with broad authority to review and analyze activities which threatened to increase individual prices or the overall rate of inflation. In October 1978 President Carter gave the Council the further responsibility of implementing a program of voluntary wage and price standards. Let me emphasize that these standards are voluntary; the Council does not have the legal authority to enforce them. However, the Council can and does publicize the name of companies which it determines to be in noncompliance and they are barred from bidding on certain Government contracts. During the past year and a half, the Council and its staff have spent most of their time defining, interpreting, and monitoring the standards.

According to most criteria the standards of the Council failed to restrain oil product prices in 1979. Prices rose more than 50 percent for most of these products and profit margins increased substantially. Certainly, the Council's goal of a decelerating rate of price increase was not met in the oil industry in 1979.

Our inquiry--based on extensive interviews with the Council's staff, a review of the standards, and an analysis of published data on energy prices--revealed that the failure could be traced to limitations in the standards' coverage, monitoring, and enforcement.

COVERAGE

The price standards do cover the oil industry, but not all parts of it. By far the most important exclusions are (1) the domestic production of crude oil, and (2) imports of foreign crude oil and refined products. Thus, the large price increases in OPEC oil are excluded from the standards. There are practical reasons why these exclusions were made. The Council can not influence the production and pricing decisions of OPEC. Moreover, the domestic price of crude oil and the price at which American companies import crude from their foreign affiliates are subject to Department of Energy (DOE) regulation. However, as a result of the exclusions, the acquisition cost of petroleum to American refiners is not covered by the price standards. During the first year of the anti-inflation program (that is, from the third quarter of 1978 through the third quarter of 1979), the increase in the cost of crude accounted for much of the increase in the retail prices of oil products. In the case of gasoline and home heating oil, this fraction was approximately 60 percent. Therefore, even if there had been total compliance with the standards, there would still have been large increases in these prices.

Where the standards do apply, they cover compliance units rather than individual product prices. A compliance unit is either a company or a division of a company. In most cases it produces a variety of products. Consequently, the standards apply to a group of products rather than to separate products individually. Moreover, in the oil industry almost all firms are on some form of margin standard. This means the standards do not apply directly to their prices but instead to the average spread between their selling prices and some measure of their average costs. Individual margins can increase for some products if they are matched by reductions in the margins earned by other products sold by the same firm. Even when the compliance unit is limited to the company's refining and marketing operations, this kind of variation is possible since the typical refinery produces a range of products. This approach differs from DOE regulation which has in the past and, in the case of gasoline, still does apply to specific products.

In summary, ~~our~~ the inquiry revealed that the incomplete coverage of the standards, and the way they are applied would have permitted substantial price increases, even if there had been total compliance. However, there are reasons to question whether compliance was complete.

MONITORING

The Council's staff is not large enough to monitor all the firms in the oil industry. In fact, we found that only four staff members are assigned to monitor oil company compliance, and they necessarily limit their attention to the largest firms--those with gross sales in excess of $250 million. This excludes the vast majority of wholesalers and retailers and the smaller refineries. Although the standards apply to those companies, the Council does not have adequate resources to monitor their compliance. The aggregate data suggest that many of them have not been complying. For example, (according to the Council's own calculation), the retail-wholesale margin for gasoline rose 81 percent from the third quarter of 1978 through the third quarter of 1979.

Even with the large, integrated oil companies, where the Council does attempt to monitor compliance, its ability to do so in a timely fashion is questionable. The companies submit a quarterly report to the Council showing revenues and costs for their compliance units, but these data are highly aggregated, and they are based on the companies' interpretation of the standards. The Council has no audit capability, and currently does not verify the data submitted to it. Since all of the major oil companies are on some form of margin standard, the Council staff cannot detect noncompliance simply by observing price increases in the industry. It must also observe data on costs, and, consequently, it must wait for the information submitted by the companies. This means there is an inevitable delay between the time noncompliance occurs and the time the Council staff detects it, if it detects it at all. It is only within the last month that the Council has found sufficient evidence to identify eight refiners as probably out of compliance with the standards during the first year of the anti-inflation program, and, to date, only one of the major oil companies has been publicly identified as out of compliance.

ENFORCEMENT

Our inquiry revealed that limited coverage and incomplete monitoring are sufficient to explain why the standards failed to prevent the rapid increase in oil prices last year. However, even with broader coverage and more complete monitoring, the Council would still have limited power to enforce the standards. When President Carter announced the standards in 1978, he stated that the Federal Government would use its procurement powers to enforce them. As we testified last year, there are many practical and legal difficulties limiting the effectiveness of this sanction, and in the past year no company, to our knowledge or that of the Council, has been denied a Government contract for failure to comply with the standards.

The staff of the Council informed us that its only effective sanction is the harmful publicity attendant on a finding of non-compliance. Although this may be a credible deterrent to a large retailer or a chain of supermarkets, we wonder about its effect on the major oil companies. They have been receiving bad publicity for years. If the Council finds them in noncompliance, it may simply confirm what people already suspect. Bad publicity is an effective deterrent only if the company believes it will change public perceptions in ways that can harm the company.

For example, Mobil is the only major oil company the Council has identified as being out of compliance. In the week after the Council announced its finding, the price of Mobil's stock rose 6 percent on the New York exchange. There is no current evidence that the finding of noncompliance will reduce Mobil's sales or profitability in the future.

In summary, the Council's price standards failed to prevent increases in the prices of oil products because they were limited in coverage, they were only partially monitored, and the Council lacked effective sanctions to compel compliance.

<u>COWPS REPORT ON PETROLEUM PRICES</u>

I would like to turn my attention briefly to another issue of interest to the Subcommittee. A little over two weeks ago, the Council released a Staff Report entitled "Petroleum Prices and the Price Standards," and we have been asked to comment on this report. In our opinion, based on our own examination of the available public information used by COWPS, the aggregate figures presented in the report on petroleum costs, prices, and margins appear reasonable. We also have no argument with the Council's discussion of the world oil market

In many ways the report supports much of the testimony we have given here today. For example, in its analysis of the increase in the retail price of gasoline it finds that about 57 percent can be accounted for by higher costs of crude oil which are not covered by the standards. An additional 27 percent of the increase occurred in the distribution and marketing of gasoline which the Council either does not monitor or does not cover. Thus, according to the Council's own figures, only about 15 percent of the total increase in the price of gasoline fell within the area which their standards might be expected to influence.

There are two related areas in which we feel the report has shortcomings. First, its major conclusion appears to be that only a very small part of the run-up in the prices of petroleum products, or even in refiners' margins, is due to noncompliance with the Council's standards.

However, despite this conclusion and the Council's role as inflation watchdog, no suggestions are advanced concerning ways of bringing the standards to bear on skyrocketing energy prices. This may not be practical, but in this event the Council should at least spell out the reasons why more effective measures can not be taken.

Among other things, you asked us to comment on differences between the final report and an earlier preliminary draft of which you provided us a copy. In the earlier draft, COWPS did speculate on a few ways in which oil company profits might be shifted from refinery operations to production and exploration activities, thereby removing them from the the purview of the standards. If such shifting occurred, its effect would be to increase oil company profits without raising refinery margins, giving the appearance that most of last year's profits were earned overseas. It should be noted that both the Department of Energy and the Internal Revenue Service have some responsibility to control these kinds of cost and profit transfers, and the preliminary draft report included no evidence that such shifting occurred.

The report also attempts to explain the rather substantial increase in refiners' margins as revealed in the aggregate data concerning oil industry costs and prices, and to reconcile this finding with the rather small amount of noncompliance that the Council estimates occured based on reports submitted to it by the oil companies. We have no reason to doubt the Council's accuracy in reporting the figures received from the oil companies even though we have not been permitted to examine those reports. At the same time there is a large disparity between the Council's direct estimate of the extent of noncompliance, which accounts for only about 1 percent of the total increase in the retail price of gasoline, and the increase in refiners' margins revealed by the aggregate data which is almost 15 times larger. It may be true that only a small part of this increase resulted from noncompliance, but we have not been able to verify this using the data available to us.

CONCERNS ABOUT RECENT INFLATION

The Council's inability to do very much about oil product price increases raises deeper issues concerning the Council's mission and responsibility. I would like now to turn to those issues.

In January wholesale and retail prices surged upward again. If the monthly rate continues, inflation will approach 20 percent in 1980. Looking closely at the composition of the price increases, the inflationary picture does not look good. The increase occurred despite a drop in food prices. If one ignores food (as the Council prefers to do when food prices are rising) the rate of increase is even higher. Energy prices rose substantially in January, but the acceleration in prices was not limited to energy. It was widespread throughout many sectors of the economy.

Inflation results whenever the total demand for goods and services exceeds the supply available at a constant price level. Under these conditions prices rise because buyers are willing to pay more rather than do without desired goods, and sellers are able to raise their prices without losing customers. Price stability requires that demand and supply grow at the same rate. During the past fifteen years, demand has consistently grown more rapidly than supply, producing inflation. It will continue until the growth of demand is in line with the growth of supply. Supply stimulus, demand restraint, or a combination of the two can be used for this purpose. An increase in supply would not only be helpful in reducing inflation, it would also raise real incomes. However, at a time when the dollar value of gross national product is increasing at an annual rate in excess of 10 percent, no feasible increase in supply can by itself end inflation. Demand restraint is also needed.

Bringing inflation under control is obviously complicated by the fact that some key prices--most notably the price of imported oil--are established through a political process, rather than in competitive markets. Despite this, however, bringing our general rate of inflation down requires that overall demand be constrained. Doing this is further complicated by the fact that after inflation has continued for some time buyers and sellers come to expect it. Sellers raise their prices in anticipation of rising costs, and workers seek wage adjustments to preserve their purchasing power. If wages do not keep pace with prices, consumers can reduce their savings in order to maintain their standard of living. Excess demand is still driving prices upward, but the usual symptoms of excess demand--tight markets, longer delivery times, and declining unemployment--are not observed because the anticipatory price increases forestall them. Nonetheless, the inflation can still be traced to the imbalance of demand and supply, and demand restraint is still required to end it.

Under these conditions the initial effects of demand restraint are likely to fall heavily on output and employment. The rationale for the wage-price standards was that they could reduce this impact by transferring it immediately to prices and wages. If they had worked as intended, inflation would have decelerated without a recession. But the precondition for the success of the program was prior demand restraint. As it turns out, that precondition was not satisfied and the program failed. It will continue to fail until the growth of aggregate spending is checked.

The real question today is whether action to date--primarily by the Federal Reserve System (Fed)--has been sufficient to provide that check or if further action is needed.

In October the Federal Reserve System announced that in the future it would conduct monetary policy in terms of a target rate of growth for bank reserves rather than a targeted level of short term interest rates. We are encouraged by this development and the persistence of the Fed in pursuing the policy. This promises to bring the growth in the supply of money under control if the new policy is maintained over the long term. It is perhaps the most significant anti-inflation step in several years. However, it will not immediately reduce the rate of inflation nor is it likely to succeed over the long run unless other steps are also taken.

No single tool of economic policy--no matter how powerful it may appear to be--should bear single-handedly the burden of bringing inflation under control. What is needed today is a careful orchestration of all the tools which can help solve the problem. That sort of orchestrated policy response has not yet emerged.

Projected Federal expenditures in fiscal year 1980 are already running $30 billion higher than forecasted a year ago

The projected deficit is $10 billion higher. If current trends continue the budget will be significantly less stringent than originally intended. Fiscal discipline is essential for a successful long run effort to control inflation. Without it the Federal Reserve System will find it very difficult to pursue a monetary policy aimed at reducing inflation.

Last year the productivity of the American worker declined for only the second time since World War II. Since 1973 the growth of productivity has been too slow to permit significant gains in real income for the average worker. Real wages have stagnated. Without a rising level of productivity, price stability will require wage and salary cuts for some workers. Thus, efforts to increase productivity also are an essential element in an orchestrated set of policies for dealing with inflation

Monetary restraint, fiscal discipline, and efforts to increase productivity, if pursued diligently can eliminate inflation. They will not do so overnight, but we didn't arrive at this situation overnight either; if they are seriously pursued they will break the inflationary psychology and, in time, restore reasonable price stability. They have worked in other economies, and there is no compelling reason to believe they will not work here.

Recent inflationary pressures, however, also raise the consideration of mandatory wage and price controls. Some observers believe that direct action limiting prices and wages is needed.

Wage and price controls--by themselves--do not have a very successful record as an anti-inflation measure. Guidelines often fail from the outset, as the current policy has failed. Even if controls meet some temporary success, they are followed by an outburst of price increases when the controls are lifted. It is interesting to note that no democratic country has followed a permanent policy of wage price controls. Furthermore, those countries which have imposed them have always abandoned them.

Given this record it is difficult to be enthusiastic about controls. As a general proposition, they can only be useful if they are part of a much larger package of measures to deal with the underlying causes of inflation. They cannot substitute for the longer term policies which are essential ingredients for a successful anti-inflation program.

In the past fifteen years the Federal Government has not been willing, except temporarily, to take the steps needed to end inflation. We sincerely hope that in the current crisis the Federal Government can find the resolution to do what is needed and to persist in it until this problem is ended.

My colleagues and I would be happy to address any questions you may have.