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BY THE COMPTROLLER GENERAL

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Report To The Chairman, Joint Economic Committee

OF THE UNITED STATES

The Council On Wage And Price Stability Has Not Stressed Productivity In Its Efforts To Reduce Inflation

Efforts to improve productivity should play a substantial role in Federal programs to moderate inflation.

Despite congressional concern that the Council on Wage and Price Stability focus on productivity improvement to reduce inflation, the Council has not actively encouraged productivity improvement. The Council believes it can best stimulate productivity by reducing inflation and has directed its efforts to monitoring wages and prices and reviewing Government regulatory actions.

By not directly encouraging productivity improvement, the Council has neglected an effective mechanism for reducing inflation.

GAO recommends that the Council place more emphasis on its statutory responsibilities to focus attention on the need to increase productivity as well as to stimulate productivity in the design and monitoring of the wage and price standards.

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FGMSD-81-8

OCTOBER 16, 1980

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-200368

The Honorable Lloyd Bentsen
Chairman, Joint Economic Committee

Dear Mr. Chairman:

This report is in response to your April 9, 1979, request that we review various issues related to national productivity. You asked us to review how the wage and price standards administered by the Council on Wage and Price Stability could be modified to stimulate productivity. As agreed with your office, we expanded this to include a broader review of the Council's efforts to encourage productivity improvement as an anti-inflation mechanism.

We concluded that efforts to improve productivity should play a substantial role in Federal programs to moderate inflation. The report states that the Council on Wage and Price Stability should place more emphasis on its statutory responsibilities to focus attention on the need to increase productivity and to stimulate productivity in the design and monitoring of the wage and price standards, and should play a substantial role in national productivity policy as part of the effort to control inflation. In addition, the Council should report on particular productivity problems that identify Government remedial actions and should provide wage and price exceptions for programs that are documented to improve productivity.

The Council on Wage and Price Stability formally commented on a draft of this report. The Council expressed strong disagreement with the tone and conclusions of the report. We made some revisions and additions based on the Council's comments, but we did not change our basic conclusions and recommendations.

A staff study on productivity sharing programs in the private sector, examined as part of this review, will be issued separately. In addition, we will shortly issue a report on the effectiveness of the Council's wage and price standards.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. Then we will issue it to interested people and give copies to others on request.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CHAIRMAN,
JOINT ECONOMIC COMMITTEE

THE COUNCIL ON WAGE AND PRICE STABILITY HAS NOT STRESSED PRODUCTIVITY IN ITS EFFORTS TO REDUCE INFLATION

D I G E S T

By not doing more to encourage productivity improvement, the Council on Wage and Price Stability has not taken full advantage of an effective anti-inflation mechanism.

Not only does the rate of productivity growth affect the rate of inflation, but the rate of inflation affects the rate of productivity growth. Specific actions to enhance productivity growth should therefore play a substantial role in any efforts to moderate and control inflation.

The Council's enabling legislation and subsequent amendments, as well as other statements by Members of Congress, demonstrate continued congressional concern that the Council focus on productivity improvement as part of its efforts to reduce inflation. While the Council acknowledges that improved productivity could be an important factor in controlling inflation, it has not actively encouraged productivity improvement through its wage and price standards or by identifying and suggesting actions that Federal agencies could take to stimulate productivity.

The Council believes it can best encourage productivity improvement by reducing inflation. As a result, it has directed its efforts toward programs to design and monitor the wage and price standards, and review Government regulatory actions.

GAO found that the Council made limited efforts to minimize the negative effects of the wage and price standards on productivity, but did not use the standards as a mechanism to stimulate productivity. (See p. 12.)

(FGMSD-81-8)

The price standard does not provide a clear exception for productivity-improving capital investments that would enable a firm to know if it qualifies for an exception before it applies. (See p. 13.)

The pay standard provides productivity exceptions only where the increased productivity is (1) clearly tied to demonstrable improvements in the diligence of workers resulting from work rule changes in union contracts or (2) pay tied directly to physical productivity measures such as piecework or sales commissions.

These exceptions exclude nonunion employees from obtaining productivity-based pay due to productivity-improving work changes. They also exclude productivity sharing programs, which have been found to improve productivity, reduce operating costs, and serve as an anti-inflation technique. (See p. 15.)

The Council also failed to recommend or encourage Government actions to help improve productivity as part of the Government's overall anti-inflation policy. In its required productivity report to the Congress, the Council discussed in general terms Government policies that affect productivity but provided no specific recommendations. (See p. 20). As a member of the National Productivity Council, the Council has not used its position to suggest actions the Productivity Council or others could take to encourage productivity improvement. However, the Council has been effective in suggesting improvements in the regulatory process which could have a positive effect on productivity. (See p. 21.)

This approach does not place sufficient emphasis on the Council's statutory responsibilities regarding productivity.

RECOMMENDATIONS TO THE AGENCY

The Council on Wage and Price Stability should place greater emphasis on its statutory responsibilities to focus attention on productivity and consider the need to stimulate productivity in monitoring wages and prices. The Chairman, Council on Wage and Price Stability should:

- --Provide an exception from the price standard to permit financing capital investment programs from profits or profit margin allowances in an amount no greater than the demonstrable increases in productivity. (See p. 25.)

- --Provide an exception from the pay standard for productivity programs that are documented to improve productivity at a rate equal to or greater than their costs in terms of increased payments to employees.

- --Prepare reports on particular productivity problems and recommend appropriate Government actions--similar to the Council's work on Government regulation.

- --Develop an agenda for the National Productivity Council citing specific ways Federal agencies can encourage productivity as part of the effort to control inflation.

RECOMMENDATION TO THE CONGRESS

The Congress should amend section 5 of the the Council's enabling legislation to specifically require that the Council's periodic reports to the Congress

- --identify actions the Council has taken and plans to take to focus attention on the need to improve productivity and to encourage private sector productivity as a means of reducing inflation and

- --demonstrate what the Council has done to encourage and stimulate productivity through the wage and price standards.

AGENCY COMMENTS

The Council on Wage and Price Stability formally reviewed a draft of this report. The Council expressed strong disagreement with GAO's view of the Council's legislative mandate and GAO's related conclusions. (See app. I.) As a result of the Council's comments, subsequent meetings with Council officials, and additional information not previously available, GAO changed the general tone of the report and more fully recognized how the Council considered productivity in the design of the standards. The basic conclusions and recommendations were not changed. GAO's response to more specific criticisms is in appendix II.

Contents

CHAPTER 1

INTRODUCTION

As requested by the Chairman, Joint Economic Committee, we examined how the Council on Wage and Price Stability has addressed the issue of productivity improvement as an anti-inflation mechanism in its wage and price standards and in its position in economic policymaking.

The Council on Wage and Price Stability Act was passed in August 1974 to replace the mandatory wage and price controls initiated by President Nixon. The act established the Council on Wage and Price Stability to, among other things,

--monitor wages and prices,

--review and recommend action to reduce the inflationary effects of Government programs and policies, and

--focus attention on the need to increase productivity in both the public and private sectors.

From enactment in 1974 until October 1978, the Council had the limited role of monitoring and analyzing inflationary conditions in Government and the private sector and providing the President with recommendations. The act specified that nothing in the act authorized the continuation, imposition, or reimposition of any mandatory economic controls with respect to prices, rents, wages, salaries, or corporate dividends.

THE PRESIDENT'S VOLUNTARY ANTI-INFLATION PROGRAM

On October 24, 1978, President Carter announced a three-pronged anti-inflation program to (1) encourage voluntary wage and price restraint in the private sector, (2) reduce the inflationary effects of Government regulatory actions, and (3) relieve inflationary pressures on the economy through sound fiscal and monetary policies. The President's action was prompted by the probability that inflation would not moderate soon and the effect this would have on upcoming collective bargaining agreements, foreign confidence in the U. S. economy, and inflationary psychology. The Council on Wage and Price Stability was given responsibility for the first two elements of the program.

To enable the Council to carry out its expanded responsibilities, the Congress amended the Council on Wage and Price

Price Stability Act on May 10, 1979, to extend the Council's existence until September 30, 1980. Also, the fiscal 1979 appropriation was increased from $1.7 million to $6.9 million, and $8.5 million was appropriated in fiscal 1980 for 233 more permanent positions.

Besides providing the Council with more time and resources, the amendment extended the act's original charge to focus on productivity improvement. The amendment directed the Council to

--consider the need to stimulate productivity in monitoring wages and prices and

--review its policies for promoting productivity and report its findings and recommendations to the Congress by July 1, 1979.

<u>The wage and price standards</u>

The Council set standards for wage and price increases, and requested business and labor to voluntarily adhere to the standards. Separate pay and price monitoring offices were set up within the Council to monitor compliance with the ceilings or standards. The objective of the standards was to reduce the rate of increase in wages and prices.

The price deceleration standard published by the Council for the first program year (Oct. 24, 1978 through Sept. 30, 1979) requested firms to limit the average increase in prices of all goods and services to 9.5 percent or one-half percent below the firm's average annual rate of increase for the base period years of 1976 and 1977, whichever was lower. Firms unable to comply with the price standard either because they were unable to calculate their average price increase or because of uncontrollable price increases in purchased goods and services, were given the option of meeting a two-part profit margin limitation.

--The firm's program year profit margin should be no higher than the average profit margin for any two of the company's last 3 fiscal years before October 2, 1978. 1/

1/The Council defines profit margin as the ratio of profit to net sales and/or revenues.

--Program-year dollar profits should not exceed base year profits by more than 6.5 percent plus any positive percentage growth in physical volume from the base year to the program year.

The price standard further provided that the Council could grant a firm an exception from the price deceleration standard or the profit margin limitation in cases of extreme hardship or gross inequity.

The first-year pay standard provided that the annual increase in average pay rates should be 7 percent or less for each employee unit. 1/ The pay standard was revised in March 1980, to a range of from 7-1/2 to 9-1/2 percent. The Council allowed exceptions to the pay standard in the following situations:

--Employees earning $4 or less per hour in straight time hourly wages as of October 2, 1978.

--Pay rate changes in one employee unit that have been regularly linked to pay rate increases of another group that were agreed to before October 24, 1978.

--Pay rate increases traded for work rule changes that result in demonstrable improvements in productivity.

--Increases in pay necessary to attract or retain employees in jobs that are affected by an acute labor shortage.

Under both the pay and price standards, the Council allowed exceptions for firms in cases of undue hardship or gross inequity. The Council defined undue hardship as a situation that seriously threatens the financial viability of a company and defined gross inequity as any situation that, in the Council's judgement, is manifestly unfair. Firms could request an exception to the pay or price standards from the Council under the above provisions.

On November 1, 1979, the Council issued revised price standards for the second program year. The revised standards established a 2-year ceiling on price increases which was limited to the lesser of (1) the rate of price increase for the base period years of 1976 and 1977 or (2) 19 percent. It

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1/Firms were asked to identify three employee units: (1) employees covered by collective bargaining agreements, (2) management employees not covered by a collective bargaining agreement, and (3) all other employees.

also limited the growth in dollar profits to 13.5 percent over the 2-year base period. Issuance of the second year pay standards was postponed pending receipt and consideration of recommendations from the President's Pay Advisory Committee, a group composed of representatives of business, labor, and the public.

Although all business and labor groups were expected to comply with the standards, monitoring of compliance by the Council was limited primarily to

--firms with annual sales of $250 million or more or at least 5,000 employees and

--collective bargaining agreements affecting 5,000 or more workers.

Firms that fell into the above categories were required to provide certain financial and other data to the Council so it could determine compliance.

The wage and price standards are considered voluntary in that there are no legal penalties for noncompliance. However, the President indicated that he intended to use the Government's power and influence to promote compliance. For example, as of February 15, 1979, firms seeking Federal contracts in excess of $5 million were required to certify compliance with the standards. Those firms unwilling to do so would not be eligible for Government contracts.

Council efforts to reduce the inflationary effects of Government regulatory actions

The Council's authorizing legislation charged the Council with determining the extent to which Federal programs and activities were contributing to inflation. The Council directed this effort through its Government Programs and Regulatory Reform Office which reviews new or proposed regulatory actions. The Council also participates in the Regulatory Analysis Review Group--an organization of representatives from the major economic and regulatory agencies of the executive branch. As part of the President's anti-inflation program, the Council's efforts in this area were expanded by increasing its resources.

The Council participates in economic policymaking

The Council on Wage and Price Stability is part of the Executive Office of the President. The Council's Chairman is also the President's inflation advisor and is a member of the Economic Policy Group and the National Productivity Council. The Council therefore plays an important role in economic policymaking.

PRODUCTIVITY GROWTH AND INFLATION

The recent decline in productivity of the country's non-farm private business sector has been the greatest since the second World War. At the same time, the inflation rate has reached unprecedented highs. Economists generally agree that these two phenomena are intimately related.

Productivity can be defined as the physical relationship between resource inputs (capital, material, and labor) to outputs of goods or services. When the output of goods and services increases faster than input, productivity is increasing. The greater this difference, the greater the rate of productivity growth. If, for example, output increases 6 percent while input (such as hours worked) increases only 3 percent, then the rate of productivity growth is 3 percent. If, however, output increases only 3 percent and input increases by 3 percent then the rate of productivity growth is zero.

Inflation is defined as an increase in the general price level, usually measured by some index of prices such as the Consumer Price Index 1/ and/or the Implicit Price Deflator for Gross National Product. 2/

In the simplest case the relationship between productivity growth and inflation is an arithmetic one--for example, we saw that if output increases 6 percent and the input of hours worked and other inputs increase only 3 percent then productivity would increase by 3 percent. If hourly compensation and the payments for other inputs increases by 7 percent then the price level, and thus the inflation rate, would increase by 4 percent.

If, however, as was just discussed, output increases by only 3 percent and input of hours worked and other inputs increase by 3 percent, then productivity growth would be zero.

1/The Consumer Price Index is a fixed weight index which tracks the increase in the prices of a typical market basket of goods and services that might be purchased by urban skilled or semiskilled workers.

2/The Implicit Price Deflator for Gross National Product measures the price behavior of all goods and services produced.

If, given zero producitivity growth, hourly compensation and the payment of other inputs increased by 7 percent then the rate of inflation would be 7 percent. If the rate of productivity increases and the rate of increase in hourly compensation and payments to other inputs were the same, the rate of inflation would be zero. In other words, for any given rate of increase in hourly compensation and other inputs, the higher the rate of productivity the lower the inflation rate.

The relationship between productivity and inflation exists for the entire Nation. As the tables on page 7 illustrate, real hourly compensation 1/ is very closely related to labor productivity and may be inversely related to hourly compensation.

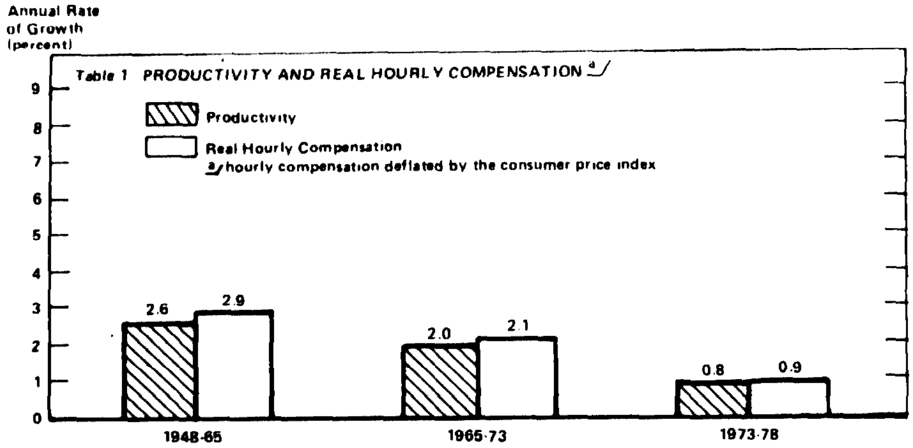
Productivity and real hourly compensation had their highest rate of growth between 1948 and 1965 when hourly compensation grew at its lowest rate. Between 1973 and 1978, hourly compensation grew at its highest rate while productivity and real hourly compensation were at their lowest. Moreover, this data shows that, as in the previous example, when the rate of productivity growth is high, for any given increase in hourly compensation, the resulting rate of inflation will be lower.

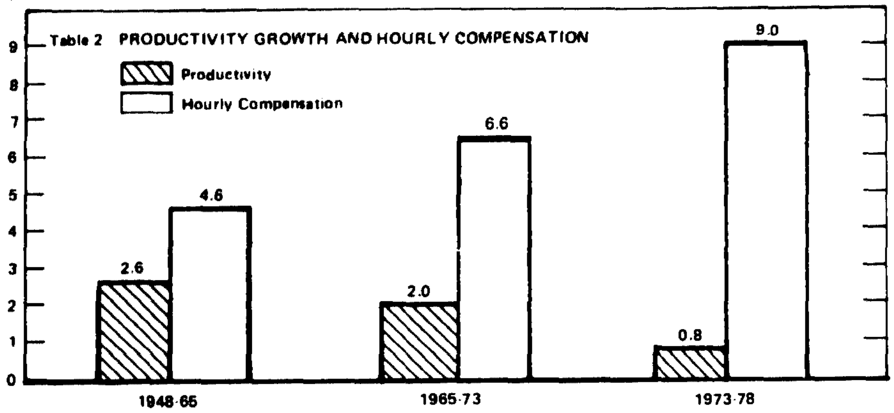
The general relationship between productivity and inflation is that increases in hourly compensation that are not matched by increases in productivity will result in increased unit labor cost and thus contribute to inflation. Differences in basic production relationships, such as changes in quality, differing rates of price change for labor and nonlabor resources, as well as cyclical influences, can destroy the arithmetic symmetry of the relationship between productivity and inflation. Changes in the variables do not, however, destroy the general nature of the relationship. For example, recently the price of energy increased more rapidly than hourly compensation. This is in marked contrast to the period between 1948 and 1973 when the price for energy increased at a much lower rate than did hourly compensation. The effect of this change in relative prices should encourage business to substitute relatively less expensive labor for relatively more expensive energy resources. A substitution of this kind would normally have the effect of reducing labor productivity.

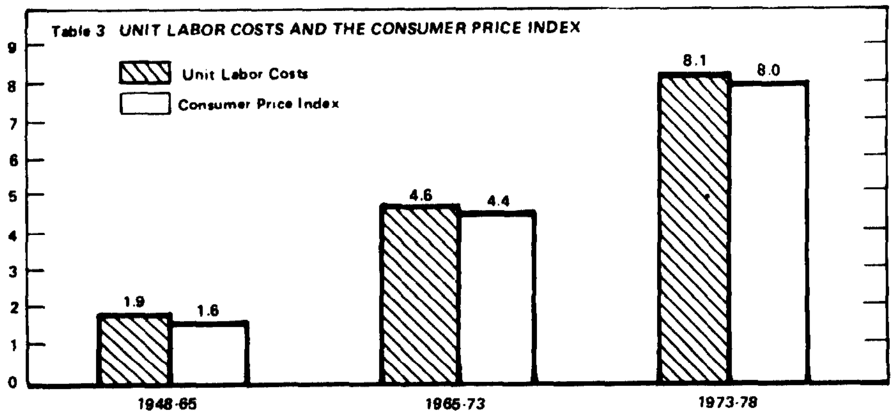
It is becoming appreciated that a decline in productivity not only increases the rate of inflation, but increased inflation also reduces productivity. Unfortunately, economists have been unable to measure the extent of the effect that increases

1/Hourly compensation deflated by the consumer price index.

PRODUCTIVITY AND INFLATION







Source: Bureau of Labor Statistics, Working Paper 87, January 1979 in inflation have on productivity. The major reason for this inability to measure the effect is that inflation has its impact on productivity indirectly rather than directly, primarily through an adverse effect on savings and investments.

In its midyear report on the economic outlook for 1979 and 1980, the Joint Economic Committee recognized that a solution to our stagnating economy and double digit inflation lies in the adoption of policies that will result in the growth of U.S. productivity. The Committee's 1979 report warned that unless the Nation's productivity accelerates, the average American is likely to experience a decline in the standard of living in the 1980s. The 1980 Economic Report of the President predicts that despite the efforts of the Council, inflation will remain high in 1980, and productivity growth will be very limited.

In discussing the role of productivity improvement in controlling inflation, a word of caution is in order. Many of the activities normally associated with productivity improvement, such as capital investment, are thought to occur over a substantial time period. Many of the activities aimed at controlling inflation such as wage and price monitoring are aimed at a shorter period. While productivity enhancement and inflation control are normally complementary, there can be instances in the short term where conflicts between these objectives arise. For example, increases in prices above the prescribed standards would normally be opposed on the grounds of increasing the rate of inflation. It can be the case, however, that temporary price increases, even when above the established price standard, might ultimately reduce the rate of inflation. This could occur if the revenues derived from the price increase are used to finance an investment program which, over the long term, improves productivity enough to allow for eventual price reductions.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this review, based on a request by the Chairman, Joint Economic Committee, was to evaluate the Council's efforts to encourage productivity growth through its voluntary wage and price standards and through its position in economic policymaking. The Council's enabling legislation requires it to focus attention on the need to improve productivity and consider the need to improve productivity in monitoring wages and prices. This statutory responsibility has been strengthened by continued congressional concern about the Council's work in encouraging productivity through the wage and price standards and in its other activities. Our work did not include an assessment of the Council's effectiveness at either monitoring wages and prices or reviewing Federal regulatory activities; that is the subject of a separate GAO review (PAD-81-2).

We reviewed legislation and the legislative history pertaining to the Council on Wage and Price Stability and held discussions with Council officials to determine how they viewed their productivity responsibilities and what they were doing to meet them. We also examined all of the Council's publications regarding the wage and price standards and its other activities.

Officials of firms nationwide were interviewed to discuss their views of the Council on Wage and Price Stability and their experience with and views of productivity sharing 1/ and other group producitivity and incentive programs. Fifty-four of the firms were selected from a list of 78 firms believed to have productivity sharing programs and 18 firms said to be considering such programs. The firms were selected to represent various sizes, types of industries, and experiences with productivity sharing programs. We also interviewed nine firms which did not have productivity sharing programs but did use other worker motivation programs, such as improving the quality of working life, labor-management committees, and incentives based on engineered standards. These firms were identified through a review of applicable literature.

In order to obtain cooperation, we assured participating officials that their names and the names of their firms would be confidential. Pledges of confidentiality were considered necessary because firms often desire to maintain a low profile about their programs and because many of the firms view their programs as giving them a competitive advantage, or believe their productivity sharing programs may put them out of compliance with the wage and price standards.

The detailed results of our field work will be the subject of a staff study on productivity sharing programs to be issued separately.

In addition to our field work, we conducted a roundtable session with business and labor leaders, economists, and others knowledgeable in the area to discuss the Council, inflation, and productivity.

1/Productivity sharing programs are group incentive programs that determine group performance by formulas measuring improvement from an established base period. Savings which result from exceeding the base period standards are generally shared between the company and the participating employees.

CHAPTER 2

THE COUNCIL ON WAGE AND PRICE STABILITY HAS NOT USED ITS WAGE AND PRICE STANDARDS AS A MECHANISM TO STIMULATE PRODUCTIVITY

The Council on Wage and Price Stability has not used its wage and price standards as a mechanism to stimulate productivity despite continued congressional encouragement. Also, the Council only made limited efforts to minimize the negative effects of the wage and price standards on productivity.

The Council's actions reflect its view that productivity improvement is a long term goal that can best be addressed by reducing inflation rather than through Government actions specifically directed at encouraging productivity improvement.

The Council's approach to productivity has resulted in its missing opportunities to directly and positively encourage productivity as part of its efforts to control inflation.

THE COUNCIL MADE LIMITED EFFORTS TO REDUCE THE NEGATIVE EFFECTS OF THE STANDARDS ON PRODUCTIVITY

The Congress recognized the effects the standards could have on productivity and therefore required the Council to consider the need to stimulate productivity in monitoring wages and prices and in determining compliance with the standards and to review the standards in terms of their effect on productivity.

In developing and implementing the wage and price standards, the Council made limited efforts to reduce the negative effects of the standards on productivity by including certain features that would not discourage productivity improvement.

The Council's limited treatment of productivity in the price standard

According to the Council, the price standard was designed to be effective with a minimum loss of efficiency and to avoid the dampening of investment incentives. In support of its statement, the Council points to the following:

--Unlike the price controls of the 1970s, the Council's price standard applies to the average rate of price change across all product lines of a company. Companies are free to adjust relative prices in response to changing market conditions so long as they meet the overall deceleration objective. The Council considers this freedom to adjust relative prices to be essential to avoid distortions and shortages, which could seriously damage productivity incentives.

--If companies meet the price deceleration goal, no limitations are placed on profits. This encourages firms to take cost-reducing actions, with the resultant profits available for investment and capital accumulation--a major determinant of productivity growth.

--If companies cannot meet the price deceleration goal due to significant uncontrollable cost increases, they may use a profit margin exception.

The Council stated that while the price deceleration standard does not dampen incentives to improve productivity, surges in raw material and energy prices have forced many companies to use the profit margin exception. In fact, only about one-third of the firms are reporting to the Council under the price deceleration standard.

The profit margin limitation standard, which most firms reporting to the Council use, lacks the productivity incentive features found in the price deceleration standard and may reduce the ability of firms to finance productivity enhancing capital investments and still comply with the standards.

<u>The Council's limited treatment of productivity in the pay standard</u>

The initial pay standard issued by the Council called for pay rates to increase by 7 percent or less overall. The primary change in the second program year was to change the pay standard to a range of from 7-1/2 to 9-1/2 percent. In its June 1979 "Compendium," the Council stated that "the pay standard does not vary across industries or by firms depending on industry-specific or firm-specific productivity changes." Two reasons are provided: (1) Because productivity is difficult to measure, the existence of a general productivity measure would create a significant loophole, preventing the effective limitation of pay rate increases; (2) The disparities between productivity growth rates across industries are due to the greater potential for productivity improving innovations in some industries and are not attributable to differences in the diligence of workers involved.

In establishing the pay standards, the Council provided an exception from the standards when productivity improvement was clearly and directly measurable and when it was clearly tied to demonstrable improvements in the diligence of workers. This allowed more traditional incentive systems, such as piece-rate systems and sales commissions, to qualify under the standards.

Firms may also request an exception from the pay standard under the hardship or gross inequity exceptions if they believe pay or bonus systems should be excepted from the standards.

THE WAGE AND PRICE STANDARDS HAVE NOT BEEN USED TO STIMULATE PRODUCTIVITY

Although the Council on Wage and Price Stability provided some consideration for productivity in the standards (particularly in the price standard) and provided some exceptions for productivity, the Council failed to use the standards to encourage productivity improvement by firms seeking compliance with the standards.

The Council's exceptions for productivity improving capital investments are unclear

The Council's failure to use the standards to encourage productivity is illustrated in its not providing an exception from the standards for capital investment programs intended to improve productivity. First-year standards permitted a profit margin exception because of a firm's inability to calculate its average price changes or because of uncontrollable price increases in purchased goods or services. Firms with abnormally low pretax profits during the base period 1/ which were forced to adopt the profit margin exception were unable to improve their profitability. This occurred even though their low profits at the time may have resulted from productivity-enhancing capital investments or research and development expenditures. This condition also applies to firms that experienced abnormally low pretax profits during the base period for other reasons and may have required the income generated from a greater profit margin to finance productivity-enhancing capital investment programs.

An official at one firm that was forced to use the profit margin limitation said the company had tried to improve

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1/The base period is defined as the best two of the three fiscal years ending before October 2, 1978.

operations by starting a major 5-year capital investment/ productivity improvement program in 1974. The program reduced pretax profits during the 5 years. This period, however, included the base period established for determining the profit margin limitation. The firm's profit margin limitation under the standards is therefore considerably more strict than it would have been had it not embarked on a capital investment/ productivity improvement program. The firm considers its treatment under the standards to be unfair and believes the Council's policy penalizes it for attempting to improve productivity.

Council officials have pointed out that such a firm could have applied for an exception under the hardship and gross inequity exceptions. However, the conditions acceptable to the Council to qualify for such an exception are unclear. According to several business consultants and attorneys we spoke to, the unclear criteria for exceptions causes firms to hesitate applying for a hardship or gross inequity exception for their productivity improvement programs. No such exceptions were granted under the first-year price standard. Firms want to know whether or not they meet the criteria for an exception before applying. We believe that the conditions acceptable to the Council as qualifying for an exception should be clear enough that firms have a good understanding of their ability to meet the specified conditions before they apply.

The Council's second year price standard provided an additional productivity exception for certain capital investment programs. The Council decided to amend its procedural rules "to permit modifications of exceptions on a case-by-case basis for documented extraordinary improvements in productivity that are demonstrably attributable to unusual capital-expenditure programs."

This exception is also unclear and does not provide criteria for firms that consider applying for it. The conditions acceptable to the Council as qualifying for a productivity-enhancing capital program should be clear and explicit enough so that firms know if they meet the specified conditions before they apply.

The Council recently provided adjustments to the gross margin standard for petroleum refiners that, according to the Council, will partially compensate for productivity improving investments. It is considering similar adjustments for other industries.

Limited exceptions for pay increases based on productivity improvement

As stated earlier, the Council provides productivity exceptions to the pay standard only where the increase in productivity is directly measurable and where it is clearly tied to demonstrable improvements in the diligence of individual workers. According to the Council, this occurs when

- --pay rate increases are traded for work rule changes in union contracts that result in demonstrable improvements in productivity or

- --an employee's pay is tied directly to physical measures of the employee's industriousness, such as piecework and sales commissions.

The Council granted 18 exceptions to the first-year standards from October 1978 through December 1979 for firms in which contractual work rule changes were made. We found that they tended to be for changes in work hours, job assignments, and job scheduling rather than actual changes in the work process. For example, several exceptions were granted for firms and unions that had agreed to increase their workday a few minutes, reschedule vacation and holiday leave, or change job classifications. The number of firms benefiting from the exception for piecework pay or sales commissions is unknown because firms were not required to apply to the Council for this exception.

The contractual work rule exception is limited to union firms. The Council maintains that nonunion firms do not have to "buy out" productivity-inhibiting work rules since employers establish work rules in these firms. This can lead to nonunion employees making the same productivity improving work changes as union employees, but not having their productivity-based pay increase excepted from the standards the same as increases paid to union employees.

Fifteen of the firms we interviewed cited an apparent bias toward labor unions in the standard. The main example given was the exception for contractual work rule changes which is available only to unionized firms since nonunion shops have no contractual work rules. We found no adverse reaction to the exception of piece rate and sales commission payments.

Many of the firms we interviewed that had productivity sharing plans were critical of the Council's decision to not provide an exception in the pay standard for such programs.

No exceptions for productivity sharing programs

Productivity sharing programs, which the Council refers to as group productivity incentive plans, determine group performance by formulas that measure improvement from an established base period. Savings which result from exceeding the base period standards are generally shared between the company and the participating employees.

The Council's rationale for not providing an exception to firms with productivity sharing programs was the difficulty it perceived in identifying productivity improvements clearly attributable to the programs, as opposed to those that would have occurred without the program. The Council stated in its August 7, 1979, "Issue Paper" that "these difficulties would make monitoring such plans difficult and create a potential loophole."

The Council made it clear that any exception for group incentive plans would be based on only the increased physical effort of employees. This would mean that the plan would not reward productivity improvements due to new capital equipment, changing technology, or any other influence other than workers' performance.

Since a key goal of group incentive plans is to encourage workers to recommend and accept new capital equipment, technology, and work procedures, and share in any resulting increases in productivity, the Council's position places most productivity sharing programs--such as the Scanlon, Rucker, and Improshare plans and their variations--outside the standards. The Council's failure to provide an exception for bona fide productivity sharing plans is viewed by some firms and business consultants as evidence that the Council is not emphasizing productivity improvement as a means of reducing inflation and is in fact discouraging productivity improvement.

Information obtained from the 36 firms with productivity sharing programs, as well as comments from roundtable participants, offered ample evidence of the ability of such programs to improve productivity, reduce operating costs, and serve as an effective anti-inflation mechanism. Information from seven firms with productivity sharing plans operating for at least 5 years showed an average savings of almost 29 percent of work force cost for the most recent 5-year period. Individual firms' average savings ranged from 13.5 percent to 77.4 percent over the 5-year period. For the 24 firms with productivity sharing plans furnishing financial information, savings averaged 16.9 percent of work force cost.

For example, one manufacturing company had 2,000 employees under a productivity sharing plan that saved an average of 24 percent of work force cost 1/ in the last 5 years with annual savings ranging from 20 to 35 percent. Another manufacturing firm with 215 of its 225 employees covered by a productivity sharing plan averaged a 14-percent savings in work force cost over a 5-year period with an annual range of 11 to 18 percent.

Many of the firm officials interviewed were unaware of or confused about the Council's treatment of their plans in the first-year standard. Officials of seven firms believed their productivity sharing plans were exempt from the standard because their plans predated the effective date of the first-year standards. Six firms were not aware of the Council's policy requiring firms to apply for an exemption because increases in incentive bonus payments are considered along with increases in wages and fringe benefits as subject to the ceiling of the pay standard (now 7-1/2 to 9-1/2 percent).

The monitoring of productivity sharing programs should not be more difficult than monitoring other aspects of the voluntary wage and price program. The Council can require a strict reporting requirement for firms desiring a pay standard exception for their programs. Where these programs are in operation, management generally keeps extensive records. This is required by the productivity sharing program's objective: to share documented productivity gains. These records should enable firms with bona fide productivity sharing programs to document their existence and results.

While we do not suggest that only excepting productivity sharing programs from the standards will have a significant effect on our Nation's lagging productivity, such an action would encourage firms and employees to improve their productivity in order to increase wages and profits.

The Council recently recommended that an exception be provided for group productivity sharing plans. However, the wording of the proposed exception would not permit most firms with productivity sharing programs to qualify. To be effective, such an exception must be written to allow sharing plans that can demonstrate productivity increases to qualify. Although the Council is responsible for the standards, the recommendation is under consideration by the Council's Pay Advisory Committee.

1/Work force cost includes salaries, wages, and fringe benefits but not productivity sharing bonuses.

SUMMARY

The Council on Wage and Price Stability has not used the wage and price standards as a mechanism to encourage productivity as well as constrain prices. Despite continuing congressional concern and the stated statutory responsibility that the Council consider the need to stimulate productivity in monitoring wages and prices and review its policies with regard to promoting productivity, the Council has made no significant changes.

Council officials advised us that they have been trying to revise the standards to reduce their adverse effect on productivity. If the Council considers productivity more in the wage and price standards, this will go a long way toward satisfying congressional concern about the standard's negative effect. The Council would also be adding an effective technique to its efforts to control inflation--productivity improvement. To date, however, little has been done.

CHAPTER 3

THE COUNCIL HAS NOT EFFECTIVELY ENCOURAGED PRODUCTIVITY AS AN ANTI-INFLATION MECHANISM

Despite continued congressional concern, the Council not only failed to use its wage and price standards to stimulate productivity, but also did little to identify and encourage other Government actions to improve productivity.

The Council's actions in the area of productivity reflect the belief of Council officials that productivity can best be improved by reducing inflation rather than through specific Government actions directed at productivity improvement.

In a legislatively required report to the Congress, the Council acknowledged that productivity growth is important to the economy, but did not believe there was anything more the Council could do to improve it. The report also did not contain any specific recommendations for what it or other agencies should do to improve productivity.

The Council has not used its position on the National Productivity Council to identify and suggest actions the Productivity Council or its member agencies could take to encourage productivity improvement as an anti-inflation mechanism.

On the positive side, the Council has exercised leadership in the regulatory process to change or eliminate regulations that are not cost-effective or that needlessly add to inflation.

THE COUNCIL HAS NOT ACTED TO ENHANCE PRODUCTIVITY GROWTH DESPITE CONGRESSIONAL ENCOURAGEMENT

The Council's enabling legislation requires that it "focus attention on the need to increase productivity in the public and private sectors of the economy." This charge was expanded in a 1979 amendment to the Council's enabling legislation requiring it to

--consider the need to stimulate productivity in monitoring wages and prices and

--review its policies on promoting productivity and report its findings and recommendations to the Congress by July 1, 1979.

The Congress in 1980 again demonstrated its desire for the Council to expand its work in productivity. The House and Senate have passed legislation that would require the Council to establish an office to address productivity issues.

These existing and pending legislative requirements have been reinforced by numerous expressions of congressional concern that productivity enhancement should play a substantial role in anti-inflation policy.

Our examination of the Council's structure, activities, and allocation of resources shows that the Council has given priority to wage and price monitoring and strongly supported the review of Government regulations. In contrast, the Council's activities in areas directly related to encouraging productivity growth as a mechanism to reduce inflation have been unfocused and limited.

The Council maintains that actions to encourage productivity growth--such as reducing inflation, changing tax policies and regulations, and providing more support for research and development--require a major restructuring of the economy and generally affect productivity only after a timelag. The Council also points out that many of the actions needed to support productivity growth require changes in areas where other agencies have primary responsibility. For these reasons, the Council has not considered direct actions to encourage productivity as a useful part of its activities and it has not made recommendations to other departments and agencies.

The Council has stressed that it views productivity enhancement as a complimentary activity in controlling inflation. To the extent that inflation can be controlled and Government regulations can be made more cost effective, productivity will be improved. While this is true, so is the contrary; improved productivity will reduce inflation.

Although Council officials have on numerous occasions correctly stated that the inadequate rate of productivity growth is hindering attempts to reduce inflation, the officials have not recommended that specific actions be taken to improve productivity.

THE COUNCIL'S REPORT TO THE CONGRESS ON PRODUCTIVITY OFFERED FEW NEW INITIATIVES AND NO NEW SOLUTIONS

The Council's legislatively required report to the Congress on productivity issued July 24, 1979, concentrated on the importance of productivity growth to the economy and analyzed the causes of the Nation's productivity problems. However, the report provided few new initiatives and no specific recommendations for how it or other agencies could help solve the Nation's productivity problems.

The 1979 amendments to the act directed the Council to review its policies with respect to the national interest in promoting productivity growth, including the need for flexibility in determining compliance with the pay and price standards, and to provide a report of its findings and recommendations to the Congress by July 1979. The report findings drew attention to the role that productivity plays in the Nation's economy, in inflation, and in the standard of living. The report also focused on many of the factors causing the productivity slowdown, such as intersectional employment shifts, composition of the labor force, capital/labor ratio, and Government regulation, and acknowledged the disagreements of economists over other factors influencing the productivity slowdown.

The Council's recommendations for solving the productivity problem primarily described actions already taken or being taken. Also, the Council offered no new solutions to promote productivity through policies to encourage capital accumulation, Government regulation, research and development, the Council's own involvement in the National Productivity Council, or the Council's monitoring of the wage and price standards.

For example, the report noted that while capital investment is increasing, much larger increases would be needed to significantly improve productivity growth in the future. However, the recommendations made to encourage increased capital investment were either nonspecific or dealt with actions completed or under way as shown below.

Recommendations	Status
Reduction in corporate tax rate	In Revenue Act of 1978
Investment tax credit	In Revenue Act of 1978
Future reductions in corporate taxes could be carefully designed to stimulate investment	Nonspecific
Accelerated depreciation on capital	Nonspecific
Savings to accommodate investment needs	Nonspecific

Loosened regulations for interest rates on savings accounts	Administration and the Council have supported these reforms

In regard to its wage and price standards, the Council simply restated its earlier actions to reduce their negative effect on productivity and stated it would consider some additional actions.

THE COUNCIL DID NOT USE ITS POSITION ON THE NATIONAL PRODUCTIVITY COUNCIL TO FOCUS ATTENTION ON PRODUCTIVITY

Despite the Council's recognized productivity responsibilities, it has not used its position on the National Productivity Council to focus attention on productivity. As a member of the Productivity Council, the Council on Wage and Price Stability limited its participation to a single presentation on the relationship between productivity and inflation.

The National Productivity Council was established on October 23, 1978, by Executive Order 12089, to coordinate and promote Federal programs to improve productivity in the public and private sectors. One reason the Productivity Council was established was the President's recognition that "one of the major factors fueling inflation is slow productivity growth in our country."

The Productivity Council is composed of the heads of departments and agencies that have significant responsibilities related to productivity improvement in the public and private sectors. The Chairman of the Council on Wage and Price Stability is a member of the National Productivity Council.

The Council has not used its membership on the Productivity Council to address the effect the Federal Government has on productivity or to identify and suggest specific actions that Federal agencies could take to encourage and stimulate national productivity as a means of reducing inflation.

THE COUNCIL'S REGULATORY INTERVENTIONS SHOULD HAVE A POSITIVE EFFECT ON PRODUCTIVITY

In contrast to its very limited efforts in the area of productivity, the Council has exercised leadership in intervening in the regulatory process to assure that regulatory activities are cost effective and do not needlessly add to inflation. Our examination of a selected sample of regulatory reports prepared by the Council, together with our brief survey of actions of involved executive agencies, leads us to support the Council's contention that it has had some success in influencing executive agencies to minimize the compliance costs and improve the efficiency of their regulations. Reducing compliance costs and eliminating unnecessary regulations should have had a positive effect on productivity. This is important not only in and of itself, but also is illustrative of what can be done by the Council beyond monitoring wages and prices.

The Council's Office of Government Programs and Regulatory Reform is assigned the regulatory responsibilities. The Office, with a staff of 23, analyzes approximately 50 regulatory actions yearly, most of which are new or proposed.

Since Federal agencies issue about 6,000 to 7,000 rules or regulations annually--and hundreds of thousands already exist--the Council must determine which ones to review. The Council, therefore, concentrates on new rules or regulations which may be significantly detrimental to the economy.

The Council's Government Programs and Regulatory Reform staff also serves as the staff of the Regulatory Analysis Review Group. The Review Group was created by a Presidential directive to complement Executive Order 12044, which requires that regulatory analyses accompany all major proposed and final regulations when published in the Federal Register. The aim of both Executive Order 12044 and the directive establishing the Review Group is to improve the quality of Federal regulations. The Review Group is composed of representatives from the principal economic and regulatory agencies of the executive branch and is led by the Chairman of the Council of Economic Advisers.

The Review Group annually selects 10 to 20 regulatory analyses of proposed regulations for review. It may select analyses that appear inadequate or incomplete, raise policy issues of interest to several agencies, or suggest regulatory overlap or conflict between agencies. Further, the Review Group tends to select regulations in which the economic ramifications seem expansive.

As in the case of the Council initiated comments, reports submitted by the Review Group are advisory only. According to Council staff, however, the Review Group reports carry considerably more weight than those of the Council since they represent the opinions of the top economic policymakers in the administration.

SUMMARY

The Council has missed opportunities to stress productivity improvement as a mechanism to reduce inflation. In its legislatively required report to the Congress on productivity, the Council offered no specific recommendations to improve productivity. Also, the Council has not used its membership on the National Productivity Council to identify and suggest specific actions that Federal agencies could take to stimulate productivity.

The Council's activities in the area of analyzing regulations for their cost effectiveness and inflationary impact demonstrate how the Council can play an important role in coordinating actions within the executive branch. The Council's work in this area has contributed to both the anti-inflation effort and to productivity improvement. Similar efforts should be made to directly encourage productivity improvement.

By not undertaking such additional efforts to encourage productivity improvement, the Council has failed to use an important and effective technique for reducing inflation that the Congress has urged it to use.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

In the original Council on Wage Price Stability Act and in the 1979 amendments, the Congress charged the Council with the responsibility of focusing attention on the issue of productivity improvement as a means of moderating inflation. On several occasions, the Congress has reiterated its intent that productivity improvement play a substantive role in moderating inflation. This intent was recently reemphasized by the passage in the House and the Senate of an amendment to the Council's authorizing legislation which would require the Council to set up a specific unit to address productivity issues.

Through its public statements and activities the Council has made it clear that it views productivity improvement as a long term anti-inflation mechanism. However, the Council has directed its efforts towards legislatively mandated, short range anti-inflation programs of monitoring wages and prices and reviewing Government regulatory actions. Within its monitoring of wages and prices, the Council has failed to encourage productivity as an anti-inflation mechanism. The Council believes that success in moderating inflation through its two major programs will have a positive effect on productivity. We do not believe this approach sufficiently emphasizes the Council's statutory responsibilities regarding productivity.

The Council could have adopted a more positive stance toward productivity enhancement with relatively minor program changes. For example, the Council could have adopted a position that explicitly supported productivity improvement as a means of reducing inflation and incorporated this position in the standards. The Council also could have done more to identify and suggest actions Federal agencies could take to improve productivity as part of the anti-inflation effort. The Council on Wage and Price Stability feels that it has fully met its legislative responsibilities in the productivity area by considering the effects of its policies on productivity, intervening in the regulatory process, and making public statements on productivity issues.

Inflation has proven to be more persistent and detrimental than originally believed. The task of reducing inflation and securing price stability is likely to require fundamental changes in our economy and a national commitment for the foreseeable future. Since declining productivity is a significant factor in our inflation rate and productivity enhancement can contribute to the moderation of inflation and to economic stability, efforts to stimulate productivity should be an integral part of the effort to moderate inflation. Without integrating a strong productivity effort in the anti-inflation program, private sector initiative and incentive to actively participate in the Nation's fight against inflation may be impaired.

RECOMMENDATIONS TO THE AGENCY

The Council on Wage and Price Stability should place greater emphasis on its statutory responsibilities to focus attention on productivity and consider the need to stimulate productivity in monitoring wages and prices. Specifically, we recommend that the Chairman, Council on Wage and Price Stability:

--Revise the standards to provide an exception from the price standard to permit financing capital investment programs from profits or profit margin allowances in an amount no greater than the demonstrable increases in productivity. 1/

--Revise the standards to provide an exception from the pay standard for productivity programs that are documented to improve productivity at a rate equal to or greater than their costs in terms of increased payments to employees.

--Prepare reports on particular productivity problems and recommend appropriate Government actions. This would parallel the Council's work on Government regulation.

--Develop an agenda for the National Productivity Council citing specific ways Federal agencies can encourage productivity as part of the effort to control inflation.

RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress amend section 5 of the Council's enabling legislation to specifically require that the Council's periodic reports to the Congress

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1/On Sept. 19, 1980, the Council announced its interim final standards, effective Oct. 1, 1980, through Dec. 31, 1980. The revised standards include a provision that will allow firms extra credit in calculating their profit limitations so they can reap the benefit of any cost savings resulting from investments designed to increase productivity, such as new plants and equipment.

--identify actions the Council has taken and plans to take to focus attention on the need to improve productivity and to encourage private sector productivity as a means of reducing inflation and

--demonstrate what the Council has done to encourage and stimulate productivity through the wage and price standards.

AGENCY COMMENTS

The Council on Wage and Price Stability formally reviewed a draft of this report. In his letter to us, the Council's Chairman stated that the draft was seriously deficient in understanding, consistency, and in supporting its title and negative conclusions.

The Council believes that Government activities to enhance productivity fall under five broad, overlapping headings. These include

--restraining inflation;

--restructuring the tax system;

--direct, productivity-enhancing expenditures;

--reforming Government regulations; and

--analyzing and reporting on productivity growth trends and methods of effecting them.

The Council believes it is playing a leadership role in two of these areas--restraining inflation and reforming Government regulations--and believes it would be inappropriate for it to try to assume a leadership role in restructuring the tax system or making direct, productivity enhancing expenditures. The Council also believes it has been active in analyzing and reporting on productivity trends.

The Council's Chairman concludes that these activities are consistent with the Council's statutory responsibilities. He also stated that we distorted the Council's mandate with respect to productivity by implying that the Council has a legislative mandate to encourage private sector productivity and suggesting that the Council should assume responsibility for all aspects of the productivity problem.

As a result of the Council's comments, subsequent meetings with Council officials, and additional information not previously available, we changed the title and general tone of the report. We revised our statement that the Council had not met its legislative mandate to focus on and stimulate productivity to state that the Council should place greater emphasis on its statutory responsibilities regarding productivity. We did not and do not suggest that the Council should assume responsibility for all aspects of the productivity problem.

The Council Chairman's letter to us is in appendix I. Other comments made by the Council and our responses are in appendix II.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL ON WAGE AND PRICE STABILITY
WINDER BUILDING, 600 - 17TH STREET, NW.
WASHINGTON, D.C. 20506

July 14, 1980

Dear Elmer:

I appreciate the opportunity to respond to your draft report, "The Council on Wage and Price Stability is not Meeting Its Legislative Mandate to Stimulate Productivity," prepared at the request of Senator Lloyd Bentsen, on behalf of the Joint Economic Committee.

I regret to report that the draft has serious deficiencies of understanding, consistency and in the support it adduces for its provocative title and negative conclusions.

Perhaps the most basic defect of the draft is its failure to weigh the Council's efforts in the productivity area against what might reasonably be expected of such an agency, given its statutory mandate. I should make clear at the outset that we agree totally with your emphasis on declining productivity growth as a fundamental cause of inflation and on the importance of reversing that trend. The role that the Council can play in such efforts is, however, necessarily limited, since many of the key policy tools are under control of other agencies.

The things government must do to enhance productivity fall under a number of broad, overlapping headings. The first, in both the long and short run, is to restrain inflation. That will help create an environment conducive to productivity growth, in large measure by reducing uncertainty and restoring investor confidence, and thereby encouraging long-term capital investment.

The second is to restructure the tax system in such a way as to provide additional incentives to save and invest in technological, physical, and human capital.

Third, the government should undertake some direct, productivity-enhancing expenditures. An outstanding example would be support of basic research: without government support, there would be insufficient investment in basic research, because individual companies do not reap the full social benefits.

Fourth, there is the reform of government regulation and related structural improvements in the economy, including most prominently restoration and maintenance of the discipline of the competitive market. Leading examples of recent achievements along these lines are the elimination of inefficient regulation of trucking, more imaginative environmental policies such as the so-called "bubble" approach to controlling air pollution, and reduction of trade barriers. Reforms like these enhance competition and the pressures it imposes for continually improving efficiency, improve the economy's ability to adjust to unforeseen changes, and reduce the costs that socially necessary regulation imposes.

Finally, there is a continuing need to analyze and report regularly on productivity growth trends and on methods of affecting them. This responsibility overlaps all of the others.

It is clear that the Council is suited to play a leading, even a central role in some of these efforts, but can participate in others only as one member -- and in some of them a decidedly lesser member -- of the Administration's team of policy makers. In the anti-inflation effort -- the first on my list -- we bear primary responsibility for the wage and price standards; but in the formulation of monetary and fiscal policy we necessarily participate only as a member of the Economic Policy Group, on whose Steering Committee I sit in my combined capacities as Chairman of the Council and Advisor to the President. It would make as much sense to criticize the Council for not playing the leadership role in monetary and fiscal policy in combatting inflation, as the draft report's criticism of it for not playing an equally prominent role in all major aspects of the requisite attack on productivity.

It would clearly not make sense for the Council to try to assume any kind of lead responsibility for the second and third approaches on my list -- redesigning our tax incentives or planning government expenditure programs designed to enhance productivity. There is no way of bypassing or overriding the primary responsibility of such agencies as the Treasury Department and the Office of Management and Budget, except through an interagency organization like the Economic Policy Group.

We do, however, play a leadership role in the government's regulatory reform work -- the fourth critical plank in any productivity platform. Curiously, your draft report correctly characterizes the high priority and effectiveness of our regulatory reform work, yet at the same time concludes that (1) we accord low priority to productivity improvement; (2) our concern with productivity is only "short-term" in nature; and (3) that our productivity efforts are ineffective. One scarcely knows where to begin pointing out the fallacies in this set of propositions. There is ample evidence that regulation has been an important contributor to the American economy's lamentable productivity performance. This is true in important measure because it has all too often suppressed competition; and all too often imposed unreasonably heavy costs. Our fifty or so regulatory interventions each year -- which the report praises -- are directed at both of these evils. There could be no more fundamental, long-tun, important contribution to productivity than efforts such as these; so if we accord high priority to regulatory reform, and our efforts in this area are effective -- both of which points the report concedes -- then the three conclusions it makes that I have summarized above must be incorrect.

Finally -- to turn to the fifth kind of activity in the productivity area -- the report takes inadequate account of our compliance with our statutory mandate to analyze and report regularly on productivity growth trends. We have written a report to Congress on the subject; in addition, each of our regularly published Inflation Updates contains analyses of productivity developments; and members of the Council have testified several times before Congressional committees on this subject.

The foregoing assessment of the proper roles of the Council in a national productivity improvement effort is, I believe, consistent with the Council's statutory responsibilities. Our enabling legislation, as amended, makes clear that Congress intended us to "encourage price restraint," with due consideration to productivity improvement, rather than to establish and conduce a full-fledged program to improve productivity performance, in all its pertinent aspects. Moreover, as I observed at the outset, and as the report recognizes in individual sections but not in its conclusions, there is an increasingly well recognized connection between the establishment of a stable, non-inflationary economic environment and the enhancement of productivity growth.

This is not to say that there may not be conflicts in the short run between anti-inflation and productivity objectives. Indeed, the report's principal criticism of the Council seems to be its assertion that we pay inadequate heed to the possible adverse effects of our pay and price standards on productivity. We analyze this criticism at greater length in accompanying, more detailed comments. But I would like to make a few general responses to the criticism. First, the report appears to gloss over the difficult choices that may arise between these two goals. Second, it fails to recognize that basic features of the pay/price standards program -- most notably the application of the standard to average rather than individual prices, and the primacy of a price rather than a cost passthrough, profit margin standard -- are designed and implemented to ensure that the anti-inflation objectives are accomplished without seriously inhibiting efficiency or productivity growth. Third, it does much less than full justice to our efforts to incorporate productivity incentives in our pay standard. And fourth, its criticisms are based entirely on simple assertions, with little or no evidence adduced in support.

Given our various related responsibilities and, I believe, our success in meeting our objectives, I find it extremely puzzling, to say the least, that your report -- beginning with its title -- characterizes our efforts in the productivity area so damningly.

This is not to say that our pay and price standards -- designed to control inflation (and thereby to contribute to productivity) -- do not require constant reexamination, to minimize any adverse consequences, an effort in which we are continuously engaged. Nor is it to say that our work on productivity could not be expanded effectively, subject, of course, to budgetary constraints, and a recognition of which functions it would be sensible for us to undertake, which not.

In addition to this general response, I attach more specific comments on the draft report, along with a copy on which my staff has marked the statements we consider misleading or inaccurate.

Since our problems with the report are so numerous and fundamental, I am delighted to discover that our staffs have already agreed to get together to discuss modifications. I do urge you to encourage that process.

With best regards,

Sincerely,

Fred Kahn

Alfred E. Kahn
Chairman

Enclosure

Mr. Elmer B. Staats
Comptroller General of the United States
General Accounting Office
441 G Street NW
Washington, D.C. 20548

DETAILED COMMENTS

FROM THE COUNCIL ON WAGE AND PRICE STABILITY

AND OUR RESPONSE

Comment

GAO failed to understand that to the extent that inflation inhibits investment, anti-inflation and productivity objectives tend to be complementary rather than competitive.

Response

We understand and recognize that inflation inhibits productivity and so state in our report. We also point out, as the Council has stated, that declining productivity growth contributes to inflation. We differ in what should be done. We believe that the Council should take a more active role to encourage productivity growth (through the wage and price standards) as a mechanism to reduce inflation and by identifying and suggesting specific actions Federal agencies could take to improve productivity. While the control of inflation should eventually result in the improvement of productivity, there are actions that can and should be taken now.

Comment

GAO slights the Council's regulatory activities in GAO's overall assessment of the Council's work on productivity. While recognizing the Council's effectiveness in regulatory reform, GAO does not recognize the important role this plays in improving productivity.

Response

In our report we stated that based on our review of the Council's regulatory interventions, we supported the Council's contention that it has had some success in influencing executive agencies to minimize the costs and improve the efficiency of their regulations. We also state that "reducing compliance costs and eliminating unnecessary regulations should have a positive effect on productivity."

Regulatory reform can help improve productivity, but there is much more that can and should be done. We believe that the Council's apparently effective work in the regulatory area demonstrates what can be done in the area of encouraging productivity improvement as a mechanism to reduce inflation.

Comment

GAO did not recognize that the pay and price standards were designed to be effective with a minimum loss of efficiency and to avoid dampening investment incentives. In addition, the Council pointed out that GAO focused on the fact that although the profit limitation exception may be modified for documented extraordinary improvements in productivity, the standard does not include precise criteria for the modification.

Response

In response to this comment, we added a section to the report discussing how the Council considered productivity in the design of the standards.

We stand by our criticism of the productivity modification of the profit margin limitation. The modification is available for "documented extraordinary improvements in productivity," but no criteria are provided. During our review, we found that firms want to know whether they have a chance of obtaining such a modification before applying for it.

Comment

The Council stated that GAO ignored the fact that the gross inequity and undue hardship exceptions are general provisions under which relief can be granted when precise criteria have not been worked out. The Council believes exemptions with clear criteria will evolve from the general exceptions. The Council stated that it has solicited suggestions for additional exceptions that will not undermine the effectiveness of the standards, but no suggestions have been received.

Response

While clear criteria for the gross inequity and undue hardship exceptions may evolve from the general exceptions granted, a program that is considered short term, as the wage and price standards are, should have clearer criteria for its available exceptions. We found that the unclear nature of the exceptions discouraged some firms from requesting them. Others did not believe they should have to request undue hardship or gross inequity exceptions for their productivity improvement programs.

Comment

The Council also believes that GAO emphasis on the profit margin limitation is misleading in light of the Council's efforts to adjust the standards so that firms can continue to comply with the basic price deceleration standard.

Response

We added a section to our report discussing the Council's design of the price deceleration standard and pointed out that this standard does not discourage productivity improvement. However, despite the Council's efforts to have firms comply with this standard, only about one-third of the reporting firms use it. The remaining two-thirds are on various modifications of the price standard that the Council agrees can provide productivity disincentives.

Comment

The Council states that GAO failed to recognize that the gross margin standard for petroleum refiners contains adjustments that at least partially compensate for productivity investments. The Council also indicated willingness to consider modifications to the adjustments that might more adequately compensate for such investments and noted in a July 8, 1980, report that "similar adjustments could be applied more generally."

Response

The Council's paper on the petroleum refiners' standards was issued 3 days before our draft was sent to the Council. We do not believe that the fact that the Council's gross margin standard for petroleum refiners contains adjustments that partially compensate for productivity investments affects the conclusions of our report.

We support the Council's willingness to consider modifications to the adjustments that more adequately compensate for productivity investments and to apply similar adjustments more generally. To date, however, this has not been done.

Comment

The Council questions GAO's criticism of the price standards for the Council's failure to provide adjustments to profit limitation exceptions in instances of abnormally low base period profits.

Response

In our final report we explicitly recognize that the base period is a 3-year period from which the best 2 years are used to determine the profit limitation.

We recognize that firms with poor base periods can request an exception under the undue hardship and gross inequity provisions. As we state in the report, firms are reluctant to use these exceptions because there is no criteria to determine what is acceptable.

Comment

The Council states that GAO's report is critical of the fact that the pay standard exception for productivity-enhancing contractual work rule changes applies only to unionized firms and does not recognize that nonunion shops do not have to "buy out" productivity inhibiting work rules, since employers establish work rules in these firms.

Response

We stand by our statement. Many nonunion shops have traditions and accepted work practices. Employers in such nonunion shops often find it necessary to compensate employees for changed work habits. The Council apparently now agrees with us because it recommended to the Pay Advisory Council that the exception be expanded to nonunion shops.

Comment

The Council stated that GAO misrepresented the Council's rationale for not providing an exception for group productivity incentives.

Response

In our draft report, we stated that the Council's rationale for not providing an exception to firms with productivity sharing programs was that these programs

--do not significantly increase aggregate productivity;

--reward all workers, regardless of individual performance; and

--use a performance standard often measured in dollars that may reward workers for an increase in revenue unrelated to production.

We based this statement on interviews with Council officials and on Council testimony. As a result of the Council's comments, we changed our explanation of its rationale to that provided in its August 7, 1979, "Issue Paper," which states that no exception was provided for group productivity incentive plans

> "* * * because of the difficulties of identifying productivity improvements clearly attributable to them, as opposed to improvements that would occur anyhow. These difficulties would make monitoring of such plans difficult and would create a potential loophole."

Comment

The Council believes GAO criticized the Council unfairly for not adopting a specific exemption for group productivity incentive plans. The Council had stated that it planned to propose such an exception but held off only because the Pay Advisory Committee indicated it wanted to study the issue and to propose a change later.

Response

The Council on numerous occasions stated that it planned to grant a certain exception or it would recommend to its advisory committee that a certain exception be granted. We recommend that the Council except bona fide productivity sharing plans from the pay standards since no such exception currently exists.

Comment

The Council questioned GAO's approach of developing information on productivity sharing plans and productivity by questioning firms that have such plans and through discussions with business and labor leaders, economists, and others knowledgeable in the area.

Response

The data available on existing productivity sharing plans is limited. Many firms consider their plans' existance to be proprietary information. Consequently, we developed our own data base of firms that had productivity sharing plans or had considered such plans. We obtained this information from consultants who implement these plans, researchers, productivity sharing plan associations, private productivity centers, and various business and labor officials. The firms interviewed were chosen to obtain a varied sample of types of plans, types of industry, firm size, experience with the plans, and length of time the plans were in place. We also interviewed officers of a number of large corporations that had not made use of productivity sharing plans. We do not claim the sample was scientific nor was it used that way. The interviews did provide us with a great deal of information on the actual operation of these plans. Much of this will be included in a staff study to be released later.

We conducted a round table to gather productivity experts, leading business executives, and major labor union representatives to discuss the Council's productivity activities and to obtain the roundtable participants' insights on the effectiveness of productivity sharing and other incentive plans. Again, while this session provided us with useful insights and information, it was not structured to be a scientific sample nor were the results used as such.

Comment

The Council also states that since only about 1,000 firms have productivity sharing plans, such plans must not be very effective. If they were very effective, the Council assumes the plans would be more widely adopted.

Response

The number of productivity sharing plans is but an estimate since no reliable count exists. While the number of these plans is apparently low in relation to the entire economy, there are indications that their use is on the rise due to high inflation and declining productivity. Many firms are now exploring methods to increase employee productivity and are willing to share productivity gains with their employees.

The usage of productivity sharing plans, however, is not the issue. We consider the Council's failure to except such plans from the standards to be an example of a missed opportunity for the Council to encourage productivity improvement as a mechanism to reduce inflation.

Comment

The Council states that GAO criticizes it without evidence for failing to use its position on the National Productivity Council to focus attention on productivity. The Council maintains that its activities are consistent with the National Productivity Council's broad mandate and points out that its Director attended three of the Productivity Council's four meetings.

Response

Our evidence for the Council's failure to use its position on the National Productivity Council to focus attention on productivity was based on interviews with Council on Wage and Price Stability officials and National Productivity Council officials and examinations of the minutes of National Productivity Council meetings.

We did not say that the Council on Wage and Price Stability's actions were inconsistent with the National Productivity Council's mandate. We simply stated that the Council has not used its membership on the Productivity Council to address the effect the Federal Government has on productivity or to identify and suggest specific actions that Federal agencies could take to encourage and stimulate national productivity as a means of reducing inflation.

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
WASHINGTON, D.C. 20510

April 9, 1979

Honorable Elmer Staats
Comptroller General
General Accounting Office
Washington, D.C. 20548

Dear Mr. Staats:

As part of my ongoing interest in issues affecting productivity, I would appreciate your staff reviewing two issues for me. They are not, in my opinion, of sufficient importance to warrant a GAO study; a brief examination of the questions and a report by letter only will be an adequate response.

The questions are as follows:

(1) How can the wage and price guidelines currently administered by the Council on Wage and Price Stability be modified to stimulate productivity gains?

(2) How can the operation of the Federal Patent and Trademark Office be streamlined to improve its operation at a reduced cost? I understand that much of its prior art research work is done manually rather than by computer. If so, substantial savings may be obtainable from automation of that office.

I appreciate very much your continued cooperation with my efforts on the question of productivity. Please call me if you have any questions, or have your staff call Mr. George Tyler at 224-5171.

Thank you.

Sincerely,

Lloyd Bentsen
Chairman

LB;gtb

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