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## COUNTER-INFLATION MEASURES : THE U.K. PRICE CODE DURING STAGES II-V

### Introduction

In the Winter and Spring of 1971 the Conservative Government in the U.K. decided that the only way to deal with the problems facing them ( higher unemployment and not very cooperative trade unions) was to expand economic activity. This was done by pouring large amounts of money into the economy. "The upshot was that while the economy did expand and while unemployment did fall, the balance of payments got severely worse and prices were rising rapidly"<sup>1</sup>. In these circumstances, "having promised not to repeat what they had described as the failure of Labour's statutory policy, and having apparently no original ideas of their own, the Government began to look abroad for possible remedies"<sup>2</sup>. The Phase II price controls of the Nixon government were found to have worked reasonably well in the U.S.A. since October 1971, preceded by a ninety-day wage/price freeze. "Since the Americans had been doing roughly what we wanted to do, senior civil servants were packed off to the United States to discover what they had done and how they had done it"<sup>3</sup>. For this reason, it is to be noted that the U.K. Price Code bears striking similarities with Phase II of the U.S. price controls (October 1971—December 1972). However, it needs to be pointed out that this blind copying of the U.S. control was put into operation in the U.K. without consideration of the underlying difference in the rates of inflation, productivity growth, accounting practices and level of economic activity. Unlike the U.K., productivity deduction in the U.S. were more flexible and were implemented

with reference to the trend of productivity published by the Price Commission for each four-digit standard industrial classification product line<sup>4</sup>. A large number of companies in the U.S.A. were using the LIFO system of inventory valuation. There was much stricter adherence on the wage side of the control. Current and expected rates of inflation were much higher in the U.K. than those experienced in the U.S.

Another point to note was the difference in timing. The American control system was working in a rather slack economy (and was withdrawn in December, 1972, when economic activity was beginning to increase) with a fair amount of spare capacity, "whereas we introduced our controls when our economy was zooming upwards"<sup>5</sup>.

In June, 1972, a period of general restraint was called for in connection with prices and wages by the Conservative Government then in office. This call had little, if any, effect and on November 6th, 1972, a total freeze (Stage I of the counter-inflation measures) on prices, pay, dividends and rents, was applied, whilst the legislation which included the first Code (Stage II) was drafted.

The Counter-inflation Act, 1973, was enacted on March 22nd, 1973, and Stage II came into operation affecting pay and dividends from April 1st, 1973, and prices from April 29th, 1973. Stage II was intended to last for six months and it was replaced accordingly by Stage III in early November, 1973, continuing in essence the same objectives and principles of the controls.

Sharp increases in the prices of raw materials and oil, and what Barbara Wootton called "a winter of industrial discontent", preceded the downfall of the Conservative Government in February, 1974. Certain modifications were made to the Stage III Code controlling prices and profits by the Labour Government in May, 1974, but it was not until December 20th, 1974, that it was replaced by Stage IV. In the meantime, in June 1974, the Pay Board was abolished and the Pay Code ended thereon. Stage IV was not replaced by Stage V Code until August, 1976. The original Price Code was due to expire in March 1976, but in response to the soaring inflation the Government took power, in the Remuneration

Charges and Grants Act 1975, to reinforce the £6 per week increase pay policy and to continue the Price Code powers until July 1977. Stage V was running parallel to the second year of pay restraint and in one sense was the end of the line but not the last one. At the time of writing this thesis wide ranging discussions and intense negotiations between the concerned parties, CBI, TUC, Retailers' Consortium and the Government, was already under way about the nature and scope of the price controls after July, 1977. It should be mentioned here that after serial runs extending over four years, price control was being considered as "an essential part of economic management in mixed economy"<sup>6</sup> like Britain.

### **The Price Code : Its Objectives, Nature, Scope and Administration**

The programme for controlling inflation was introduced in April, 1973, with the following objectives :

- to maintain a high rate of growth and to improve real income ;
- to improve the position of the low paid and pensioners ; and
- to moderate the rate of cost and price inflation.

The Price Code set out the guidelines for the control of prices and charges and specified the obligation of those who were concerned with the determination of prices and charges. It also set out general principles relating to prices. These general principles were :

- to limit the extent to which prices may be increased on account of increased costs, and to secure reductions as a result of reduced costs ;
- to reinforce the control of prices by a control on profit margins while safeguarding and encouraging investment ;
- to reinforce the effects of competition, and to secure its benefits in the general level of prices.

The Code applied to the prices of all goods and services supplied to the United Kingdom home market, unless they were specifically excluded. Paragraphs 5 to 11 of the Code defined these goods and services whose prices were exempted : major exemptions were the

prices of exports, prices paid on the first sale into the U.K. of imports ; goods and services such as coal and steel, covered by international agreements ; prices paid to producers at home and overseas for fresh foods ; rent, rates and insurance premiums.

### *The Price Commission*

The Price Code was administered by the Price Commission. This was an independent agency set up under the Counter-Inflationary Act, 1973, which defined its powers, functions and obligations. The Commission was charged by the Act with ensuring that the provisions of the Price and Pay Code relating to prices and charges were implemented. Operational guidelines were provided by Statutory Orders.

The membership of the Commission was limited under the terms of the Act to twelve. It had eight members with a Chairman and a Deputy Chairman. The Price Commission had a London Headquarters and fourteen Regional Offices, consisting of a staff of approximately 700 towards the end of Stage IV. It started with ten Regional Offices in April, 1973, with a staff of about 400. Although its main function was to administer the Price Code, it also examined and reported on particular prices and charges referred to by Ministers.

The Commission was required to submit quarterly reports to the Secretary of State for Prices and Consumer Protection on the operation and effects of the Price Code.

### **Development of the Price Code from Stage II to Stage V**

The primary control mechanisms of incurred allowable cost-justified price increases and the regulation of profit margins introduced in Stage II remained unaltered throughout the successive stages. Of course, during its evolution important changes were incorporated to reflect changing conditions in the economy. But as inflation continued unabated, most of the emphasis was increasingly placed on the objective of moderating the rate of cost and price inflation. Substantial technical changes were introduced in Stage V to reflect the recommendation of the Inflation Accounting Committee<sup>7</sup>.

In the following pages we provide, firstly, important details of the Price Control framework as operated during Stage II. Secondly, we trace the major changes in the Code over the successive stages.

In order to administer the system of control embodied in the Code, the Price Commission developed two broad frameworks. These were :

1. The administrative framework ; and
2. The substantive framework.

### **The Administrative Framework**

The administrative provisions were those which determined how effectively the Code was applied to ensure that its provisions are complied with. All firms, whatever their size, were expected to comply with the Price Code. To ensure this, various legal obligations were imposed on firms, according to their size and the nature of their business. These obligations include :

- notifying price increases to the Commission before they are made ;
- periodically reporting profit margins and other information about prices to the Commission ;
- maintaining records of profit margins and details of price increases, which the Commission may check.

The table below sets out the division of firms by size and type, in accordance with which Price Code obligations might be identified. Particulars of the three categories are set out below. The figures related to total sales in the home market by the enterprise as a whole for the most recent year of the account.

This classification remained unaltered until Stage V when for Category II of both manufacturers and services the lower limit to prenotification of price increases was raised to £10m. and £7m. respectively. It should be noted here that inflation was not only pushing Category II companies into Category I but also brought smaller companies within the prenotification field during the earlier stages of the Code.

Stage II	Category I pre-notification and reporting	Category II Reporting	Category III Record-keeping
	£ million	£ million	£ million
Manufacturing, mining, public utilities, transport, postal services and tele-communications.	Over 50	5-50	—
Wholesalers, retailers and other distributive trades	—	Over 10	0.25-10
Services	Over 20	5-20	0.25-5
Construction	—	Over 10	1-10
Professional Services	—	Over 0.5	0.1-0.5
Banks, finance houses or similar enterprises.	—	( gross sterling deposits on 30th March 1973 )	( outstanding balances or leasing sales

The obligations of firms in various categories and undertaking various activities were as follows :

1. Category I enterprise/unit were required to pre-notify increases in prices, giving full information as per pro-forma supplied, at least 28 days before the date proposed for such increases and obtain the Commission's approval.
2. All firms in Category I and Category II were required to establish reference levels for each profit margin unit and to make quarterly returns to the Price Commission of their net profit margins and the reference levels to which they related.
3. Distributors in Category II had additionally to give information in their periodic returns about the gross profit margin achieved in the period covered by the return, together with particulars of the level of gross profit margin to which it related.

4. These returns had to be 'reconcilable' with annual accounts. The Commission required that as and when the year's account of Categories I and II enterprises ended, such reconciliation should be provided along with the next periodic return.
5. Firms in Category III were not required to submit regular returns, but they were required to keep records containing the same information as Categories I and II firms. Duly authorised officers of the Price Commission could call for the production of these records to ensure that the Code was being observed.
6. Distributors in Category III were also required to keep records of their gross profit margins from period to period, and of the level of gross margin to which they related.
7. Firms falling below the limits of Category III were not obliged to pre-notify, report or record price increases. They were, nevertheless, expected—and could be required—to comply with the Code.

The Commission could take up with Categories I and II enterprises any excess revealed in a periodic return, and after considering seasonal, and other distorting factors, might have required prices to be reduced, unless the return contained information demonstrating that full corrective action was being taken. It was the responsibility of the firm concerned to take any necessary corrective action. Category III enterprises, in the same situation, were to be ready to give information to any authorised official of the Commission.

The 'unit' of a company to which profit margin control applied, could have been one of three alternatives. These were :

- (a) The enterprise as a whole.
- (b) The separate types of activity,
- (c) A 'split' into separate constituents, companies or subdivisions, subject to the Commission being satisfied about the basis of the split.

#### *Mixed Enterprises*

It should be noted here that a unit for net profit margin control could be different from the one for pre-notifying price increases. Where the activities of an enterprise were not confined to manufac-

turing, distribution, or the provision of services, but included more than one of these, each of the activities could be treated separately for all the purposes of the Code, including the calculation of net profit margins, provided that adequate accounts could be made available for each of them.

#### *Changes in the Administrative Provisions of the Code between Stage II and Stage V*

In Stage III, Category II enterprises had been brought into the pre-notification field with a pre-notification period of 14 days. For Category I enterprises, a flat four week, without any scope for extension by the Commission, was permitted. This change was important because firms could implement price increases on average more quickly. In Stage III, the Code permitted the continuation of splitting but the circumstances in which a group could be split was more clearly defined. It was required that at the time of splitting reference levels were to be established both for the group and for the individual units.

It was suggested that as a result of these changes the intensity of control on the whole field was likely to be reduced<sup>8</sup>. In Stage III, it was indicated, the Commission's function became one of "intervention" to stop unjustified price increases and to cut down those which were excessive.

The Commission no longer approved price increases and there were no "approvals" to announce<sup>9</sup>.

#### *Frequency of Price Increases*

In Stage III it was required that a product should not be increased in price within three months of a previous price increase on any related product. In its place, the Stage IV Code provided that a firm might not increase the price of a product unless at least three months had passed since the implementation of the last price increase for that product. But there were certain exceptions to the rule (paras 29a, 29b and 29c) which allowed price increases within three months, provided the permitted increase was at least 10% if the cost of materials and fuel in the product accounted for 75% of its total cost, or the permitted increase was at least 5% in conjunction with materials, etc. cost of 50% of the total cost. Price increases under special provisions

of the Code, e. g. margin safeguards and investment reliefs, were not affected by the three-month rule. Stage V of the Code provided for continuation of this rule.

### *Category III Firms—Registration*

The most important administrative change that had been introduced in Stage IV affected Category III firms. They were required to send to the Commission's headquarters before 1st March, 1975, particulars of their names and addresses, the names and addresses of any subsidiaries, and the U. K. sales in the latest complete year of accounts for each activity, including those of subsidiaries.

### *Pay Policy*

Major amendments to the Stage IV Price Code (effective from 8th August, 1975), had been made to give effect to the policy contained in the White Paper, "The Attack on Inflation". (Cmnd. 6151, published 11th July, 1975).

The amendments provided that an enterprise should not under any provision of the Code reflect in its prices any part of an increased pay settlement arising after 11th July, 1975, where that was in excess of the pay limits of the White Paper. This prohibition applied to all provisions of the Code and to enterprises of all categories, including the nationalised industries. The disallowances of settlements infringed on the limits applied to the whole of the increase and not just to the excess over and above the limits to a minimum of 15% of total costs.

Firms in Category I and Category II had imposed on them the obligation to submit information on pay settlements. The Commission referred this information to the Secretary of State for Employment. Where the Secretary of State for Employment certified that a pay settlement was outside the limits, the Commission excluded it in the calculation of a permitted price increase.

In Stage V, no increase of 2% or less (either in isolation or cumulated with previous increases) over the level established at 1st August, 1976, needed pre-notification to the Commission. Profits were to be reported and monitored over periods of 12 months, instead of 3 months. Sanctions against payment of remuneration in excess of

pay limits introduced under the pay policy during Stage IV were also continued in Stage V.

### The Substantive Framework

The substantive provisions determine the stringency of the Code. They had two 'prongs'. One stemmed from the 'allowable cost regime' and the other from limiting "margins". Manufacturing and service business were covered by both prongs, whereas distributors needed to satisfy only the limits to "margins", (gross as well as net).

The main elements of control in this category were :

1. The "allowable cost regime".
2. Net profit margins for manufacturing and services.
3. Gross and net margins for distributors.
4. A "reference level" for limiting margins.

The "allowable cost regime" was based on the net result of increase in certain elements (not all) of cost per unit over some base date or the date of the last price increase. In Stage II, the main non-allowable costs were increases in depreciation, advertising and part of the labour cost. Since Stage III, depreciation had become an allowable cost.

"Net profit margin" meant the margin of conventional net profit but before deducting tax expressed as a percentage of sales, or turnover.

The "gross margin" was the difference between what the distributors received from sales during any period of time and the amount paid to suppliers for the goods sold during that period expressed as a percentage of turnover.

The net margin was the gross margin minus the distributors' operating costs expressed as a percentage of turnover.

For manufacturers, the "reference level" margins were generally to be the average level of net profit (per cent) in the best two of the last five years of accounts of the unit/enterprise preceding 30th April, 1973. (In Stage V, companies were given an option of the best two out of eight years prior to 31st July, 1976). There

were provisions for modifying the base period for profit margin calculation and also for calculating reference levels where profits were low or where the firm had been substantially reconstructed.

If the calculated reference level margin produced a "return on capital" of less than 5% in such cases the net profit margin which needed to produce a return of 5% might be treated as reference level. The figure was 8% and 10% for Stages III and IV respectively. Capital was defined as the net assets employed, excluding borrowing on which interest was deducted in arriving at net profit.

A description of how the two prongs work in restraining price increases is presented below :

#### *Costs and Prices*

Prices which were within the control could not be increased unless there was an increase in total cost per unit output. No increase could exceed the increase in total costs per unit.

When there was an increase in total costs per unit, only those increases defined in the Code as "allowable cost increases" could be taken into account in arriving at the permitted price increase, and these would be subject to a "productivity deduction" where appropriate. With limited exceptions prices could not be increased in anticipation of cost increases.

If the unit cost of any product had fallen, the Code required the firm to reduce its price.

#### *Base Date*

Application of the "allowable cost regime" as the basis for price increase, required the calculation of unit cost of product or service in question at the *base date*. The base date for this purpose was 30th April, 1973, or the date of any subsequent price increase. Where a firm adopted a base date earlier than the date of its last price increase for a product, it had to take into account in calculating the new price all the price increases made since the base date. These unit costs had to be calculated on the basis of output

In two "representative periods", one before the base date and one before the price increase date.

### *Related Product Pricing*

Where price increases were being made on a range of related products a firm did not have to relate the price increase for each product within the range closely to the cost increase for each product if it had not been the practice to do so. But this did not permit excessive loading of price increase on to the price of one product within the range. Moreover, where the permitted percentage increase was not applied uniformly to the whole range, the weighted average price increase made on the selling prices of products within the range could not exceed the percentage that would have been allowed by cost increase of an individual product. In Stage V the "two times rule" limited this to a maximum of twice the average; e.g. if the average increase for the range was 2%, the price of an individual product could be increased by a maximum 4%.

### *Allocation of Costs to Controlled Prices*

In the case of an enterprise selling the same product at home and abroad and also selling some products which were not controlled, a 'fair division' of costs between the controlled and uncontrolled portions had to be applied and consistently followed.

### *Margin Control*

Under the margin control prices had to be determined so as to secure net profit margins (for distributors gross as well) that did not exceed the margins of the reference level period.

If the reference level was exceeded the firm must either delay further price increase or make price reductions.

### *Calculation of Permitted Price Increase\**

Para. 21. The maximum permitted price increase had to be arrived at as follows :

- (i) calculation of the change in total cost per unit and allowable cost increases per unit (as reduced by the productivity deduction) between the base date and the date of the price

\* Illustrated with numerical examples on 36.

- increase ; cost increases which had already been reflected in prices had to be excluded ;
- (ii) expression of allowable cost increase per unit as a percentage of total costs per unit at the base date ;
  - (iii) application of the resulting percentage to the selling price at the base date in order to establish the new permitted price level.

### *Productivity Deduction*

In order to ensure that the benefits of increased productivity were passed on to the consumers, enterprises were required to absorb 50% of allowable cost increases arising from increases in labour costs per unit. If the share of labour costs as a whole, within total costs, exceeded 35%, the maximum absorption was limited to 35%. Manufacturing productivity was increasing by 8 or 9% during Stage II and was decreasing during Stages III and IV. However, in Stage IV, productivity deduction was reduced from 50% to 20%. There was a tapering provision which allowed deductions up to a maximum of 35% for capital intensive operations and a minimum of 7% for labour intensive operations. Capital/labour intensity was determined by the proportion which labour cost was related to total costs. In view of declining productivity, the deductions became effective absorption of labour cost increases which were increasing at a rate of about 25% on an annual basis during Stages III and IV. With decline in productivity continuing the provision with limited transitional exception, was abolished in Stage V.

*Stocks:* In calculating the cost of current production or sales per unit of output, enterprises, during Stages II to IV, were required to adhere to the practice which they consistently followed for the treatment of such costs for pricing purposes. With almost universal application of the FIFO principles of inventory valuation the implication of this provision was that an increase in the value of ending inventory over beginning inventory, due either to increase in volume or prices (stock appreciation) would result in undercharging of the current cost of production. Although some tax relief was being provided for stock appreciation following the April 1974 budget, until the introduction of Stage V, this provision remained unaltered for the purpose of price control.

In Stage V, firms were given two options : first, for the purpose of computing increases in their allowable costs, the cost of materials currently consumed could be calculated on the basis of the latest contracted price. Second, a deduction could be made from profits of any increase in the value of stocks in the relevant period reduced by 30%; i.e. 70% of the stock appreciation could be deducted.

#### ALLOWABLE COST PRICING

Cost Items	Base date	Case I	Case II
	£ per unit	£ per unit	£ per unit
Labour	23.70	26.07	26.07
Materials, fuels and power	60.80	66.88	66.88
Depreciation and other fixed costs	11.00	12.10	[11.00]
Non-allowable	4.50	4.95	4.95
<b>Total Costs</b>	<b>100.00</b>	<b>110.00</b>	<b>108.90</b>
Cash Margin	9.29	9.21	9.11
Price	109.29	119.21	118.01
<b>Percentage Margin</b>	<b>8.50</b>	<b>7.73</b>	<b>7.72</b>

**Assumptions :** only 80% of the labour cost increase is allowable.\*

Case I : 10% cost increase ;  
no volume change or increase in productivity.

Case II : As Case I, but with 10% volume growth.

#### Price Calculation

Labour cost increase $2.37 \times .80 =$	1.90	1.90
Other allowable cost increase =	7.18	6.08
Total increase in allowable cost . . . . .	9.08	7.98
As per cent of total cost at base date : $P_i$	9.08%	7.98%
Base date price $(1 + P_i/100) =$	119.21	118.01
=	Permitted Prices	

\*In Stages 2 and 3 only 50% of labour cost increase was allowable.

*Depreciation:* For the purpose of allowable cost increases, depreciation was to be calculated in accordance with generally accepted accounting principles consistently applied by the enterprise concerned (Stages III and IV). In Stage V, firms were given two options: first, depreciation was allowed to be charged on the basis of a revaluation of assets if the revaluation was shown in their annual accounts. Second, in the absence of any general revaluation, a rise in depreciation charges based on historic cost, was allowed by a factor of 1.4. Changes in the treatment of stocks and calculation of depreciation were incorporated to reflect partially the recommendations of the Inflation Accounting Committee<sup>10</sup>.

### *Investment Relief*

The Code gave the Commission a degree of discretion in dealing with investment cases. The Commission could modify under defined criteria the application of provisions relating to allowable cost increases or to increases in total costs or to profit margins, in order to encourage and ensure investment financing out of profit to be generated by allowing price increases higher than those which would be allowed under the Code. The following were the criteria on which the Commission's discretion was to be used :

- (i) that expenditure on the proposed investment should begin within 12 months of the date of the price being increased or the profit margin limit being modified;
- (ii) that it should either not be possible for the firm to raise the funds for the project from other sources or, if possible, would reduce the prospective rates of return to unattractive levels;
- (iii) that during the 12 months ending 30th September, 1972, the enterprise should have absorbed cost increases to such an extent that profit margins were significantly reduced.

Given these conditions were satisfied, enterprises having the following characteristics could apply for price increase :

- (i) that it had net tangible fixed assets, excluding land and buildings, per employee, of more than £2,000 ;
- (ii) that it had plant or facilities for manufacturing a group of related products, of fixed value at original cost of at least £10 million ;

- (iii) that the capacity of this plant had seriously been under-used before 30th September, 1972, or before the base date; and
- (iv) that the rate of utilisation had since risen by  $12\frac{1}{2}$  percentage points.

In order to obtain price increases under investment discretion, firms in Categories I and II had to give the Commission 56 days notice of this intention.

The fiscal incentives to increase prices provided through investment relief were continued unaltered in Stage III, but the responses were insignificant. In Stage IV, the scope of the investment relief was widened and export sales were included. Paragraphs 79 and 80 of the Code entitled firms to raise their prices by amounts sufficient to allow them to recoup in a year, through higher profits,  $17\frac{1}{2}$  % (from May 1975, 20 %) of their expenditure on certain types of investment. Firms were required to monitor their actual expenditure on investment and firms in Categories I and II were also required to make certain returns to the Price Commission. At the end of the 12 months period those prices were permitted (provided they were not pitched at a higher level than was justified) to be maintained until the end of March 1976. Finally, in Stage V, the rate of relief was raised from 20 % to 50 % of outlay.

### *Profit Margin Safeguards*

Besides the investment relief provisions of Stage II, in Stage III the Code contained an important provision which would limit to 10 % the reduction in profit margins caused by the operation of the allowable cost or productivity deduction provisions on any unit of an enterprise. In Stage IV the price of any product or range of products could be increased to cover total costs per unit of output, plus a margin of 2 %. Or the price could be increased to secure a profit margin over total costs per unit of output of 70 % of the percentage profit margin on that product or product range at 30th April 1973, or at 30th September 1972, if the profit margin had fallen by 25 % or more between those dates.

In Stage V a minimum return of  $12\frac{1}{2}$  % on capital employed was provided for by raising the ceiling on net profit margins. The alternative safeguard expressed in terms of a margin on turnover

was raised from 2% to 2½%. The product margin safeguards were also raised to 2½% and 80% of base-date margin respectively.

While the two alternative product margin safeguards and the unit margin safeguard were mutually exclusive, none of these safeguards could be applied to cause the relevant unit net profit margin to exceed its reference level. Two entirely new provisions were incorporated in the Stage V Code. These were as follows :

- (i) *Interest* : Enterprises outside the public and financial sectors were given the choice of leaving interest out of account for virtually all purposes of the Code, including profit margin control.
- (ii) *Efficiency and Cost Savings* : In calculating changes in overhead costs, half of any future growth in output, both in export and home sales, would be disregarded, so that the firm would not lose the whole of the benefit of the lower costs resulting from increased output. The whole of any reduction in fuel costs per unit of output was also to be excluded in computing the allowable cost increase.

### Summary and Research Questions

The Code was a large body of rules applicable to all enterprises irrespective of differences in cost and capital structures, market conditions and numerous other differences with respect to costing and pricing practices.

The rules provided that all companies should stay within profit levels typical of the period prior to control and that manufacturing and service companies could increase their prices pro-rata to the increase in certain allowable costs, absorbing the non-allowable portions by accepting reductions in the profit level prior to control. In doing so, historic cost concept and conventional accounting systems were used as the only relevant base. This uncritical acceptance of the historic cost and conventional accounting premise ignored the fundamental methodological deficiencies of the accounting system which is traditionally geared to stewardship accounting and leaves certain costs, such as 'cost of working capital', equity capital, etc., unmeasured in the accounting process. Moreover, as has been

pointed out, the use of historic cost for the purpose of price control decisions resulted in the pegging of inflation by delaying the recognition of increased costs in prices. It can therefore be suggested that price control policies were based on two irrelevant premises—historic cost and the financial reporting context<sup>11</sup>. In this connection it must also be emphasised that no effort was made to consider the implications of some of the received financial theories, such as *discounted cash flows* and *capital asset pricing models* in formulating the policies of control. As to the system of unit cost-based price control operated, it had been recognised in the latest prices policy<sup>12</sup> that these were “complicated, inflexible and arbitrary”...“in some cases adversely affected efficiency and employment”. Therefore, the control over price increases by reference to costs was to be dropped in the next round, while selective controls of profit margins would continue.

Regarding the changes in the Price Code from one stage to the next, it appears appropriate to comment that the changes were made to reflect changing conditions, but they appear to have been lagging rather than leading. The toughest phase of control was exercised during Stages II and III when market conditions (1973-74) would have permitted higher prices to be realised, and relaxations were made in Stage IV (1975) when it served no useful purpose. On the nature and timing of these changes it would be worthwhile to reiterate Professor Hague's observation: “I think they [the Conservative Government under Heath] did all the right things, but at all the wrong times”<sup>13</sup>.

In the meantime, the main cause of which inflation is a symptom, money supply was allowed to grow rapidly until the end of 1974. As is well known, to expect pay restraint and price control to succeed without monetary restrictions, does not work<sup>14</sup>. In the U.K. there was virtually no pay restraint up to July 1975. Naturally, the only group in society to bear the brunt of the total mishandling was the corporate private sector. Therefore, the realities of high inflation and unemployment, reduction in output and investment and rising imports, were not totally unexpected.

Having summarised the Price Code and the problem, we need to address the specific issues with which this thesis is concerned. Despite all the changes and safeguards, profit margins, on the average,

declined by over 40% during the three years of control as estimated by the Price Commission. Two related questions may be asked : First, why did the manufacturing industries not utilise the safeguard provisions and investment reliefs if profit margins actually were 'eroded' in the way indicated above ? Second, did the margin that was controlled and actually realised represent a true measure of profit ? In this book we have attempted to provide answers to both these questions with special emphasis on the latter issue. The answer to the second question should be negative as we have already tried to show in Chapter 1, by establishing the relationship between conventionally-measured profit and earnings measured on a cash flow basis which will be dealt with more fully in Chapters 3, 5, and 6 of this book. The first issue is probably rooted in the time lags needed for industry to adjust to high and accelerating inflation, to which the price control regulations made certain contributions. Discussion and empirical evidence on this aspect appear in Chapter 4.

#### Footnotes

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