CHAPTER 3

Outlook and Policy

THE PRINCIPAL QUESTION on the economic outlook for 1973 is not whether, but how fast, output and employment will expand. For policy, there are two issues. The first is to find and implement the set of policy actions which will maximize the likelihood that the economy will move to its full potential level of output and employment. The second is to do so in ways that will serve both to eliminate the vestiges of the post-1965 inflation and to place the economy squarely on a sustainable path of subsequent non-inflationary growth.

This is an ambitious set of policy goals, but there is a good prospect of achieving them, or at least approaching them closely. The year ahead is the first in a long time in which there is reasonable hope of closing in on full prosperity without serious inflation and without war.

For this to become a reality rather than just a hope will require full cooperation from business and labor. It will also require coordinated policy actions by the Administration, the Congress, and the Federal Reserve System. The economy will be approaching the zone of its potential by the end of the year. Such an economy requires a disciplined balancing of conflicting short-run interests in order to ensure that the common prosperity, which benefits all interests, can be sustained without interruption.

The central need is to balance the speed of expansion against its durability, but in the context of 1973 this problem has many other dimensions: The allocation of output between uses dictated by the Government and those dictated by the private sector; the balancing of the need for allowing free operation of market mechanisms for determining individual prices and wages against the continuing need for restraint on the average level of prices; the division of emphasis between minimizing unemployment in the short run and minimizing it more permanently.

GUIDES TO OVERALL ECONOMIC POLICY

The basic mandate for policy set forth in the Employment Act is to achieve "maximum employment, production, and purchasing power." The question of the precise meaning of those goals was left unresolved when the Act was passed in 1946 and has remained open ever since.

In the early 1960's a judgment was put forward that maximum employ-

ment for that time would be achieved when 96 percent of the labor force was employed, which meant 4 percent unemployed. Paralleling this estimate was a calculation of "maximum output," usually called potential GNP, which was conceptually the output that would be realized if the economy were operating at full employment. Estimates of potential GNP, at constant prices, were actually derived by assuming that the potential level of output was equal to the level of actual output in mid-1955, and that it would increase at a trend rate based on underlying changes in population, the proportion of the population that would be in the labor force, hours of work, and productivity. The trend rate was adjusted from time to time to reflect changes in the underlying variables. The benchmark period, mid-1955, was selected because it appeared to reflect most of the characteristics associated with noninflationary full employment, including an unemployment rate close to 4 percent (the actual rate of unemployment for the second and third quarters of 1955 was 4¼ percent).

These estimates of maximum employment and potential output were not considered to be either immediate or permanent guides to policy. In fact, policy in the early 1960's recognized that too fast a push to maximum employment or potential output could be dangerous. At the same time the 96 percent employment rate, or 4 percent unemployment rate, was considered to be an "interim" goal, which might be changed later as a result of improvements in labor markets or other developments.

These judgments applied to conditions expected in the early 1960's. In retrospect, the standard they suggested seems to have been in the correct zone: Steady noninflationary expansion did raise the rate of employment to 95½ percent and the ratio of actual to potential output to 99 percent by mid-1965, and both rates might have risen somewhat further or could have at least been sustained without generating inflation, had the normal course of events not been disrupted by the subsequent rapid rise in defense spending and the associated budget deficits.

The standards are a less reliable guide to policy for the 1970's than they were for the 1960's. Large and unpredicted changes have taken place in the nature, composition and behavior of the labor force, employment and unemployment, as well as in the length of the workweek. Also the economy itself has been through the worst and most prolonged period of price and wage inflation since World War II. These changes have important implications for the guidance of policy.

Given that our knowledge of the interrelation between the levels of output, employment, and prices at "maximum employment" is incomplete, it would be preferable to think of each objective, not in terms of a single value but as a range of values. Furthermore, the behavior of the economy in the near future will be determined not only by whether it is operating below or above some numerical potential output or below or above some target rate of employment, but also by the speed and manner with which it approaches the range of its potential levels. Against the background of recent inflation-

ary history it is necessary to give the economy reasonable assurance that policy will not repeat the fiscal errors which ignited the inflation in the first place. Too fast a dash for a numerical target of potential would rekindle inflationary expectations and behavior that might make the potential itself unattainable, and would make it unsustainable if attained, whereas a more gradual approach which allows for the sensitivity of wages and prices to expectations would make the potential not only attainable but sustainable.

The Government can neither precisely predict what maximum employment or maximum production will be nor can it precisely control the level of actual employment or production. What the outcomes should be and will be depends upon private behavior—upon the amount of work and production that people want to do on realistically achievable terms—as well as upon public policy. The contribution of public policy is to create conditions in which people can reach their desired employment and production goals through feasible behavior in the market. One aspect of this contribution is that the total demand for output in money terms should be sufficient so that people who want to work can find work without an unrealistically large departure from accustomed and expected patterns of wage behavior.

Specifically, in the current situation we believe these guides mean that the money value of output should rise at a rate which, with reasonably expectable price and wage behavior, would reduce the rate of unemployment to the neighborhood of 4½ percent by the end of 1973. The rise of money gross national product (GNP) would be about 9 percent from the end of 1972 to the end of 1973. This does not imply that in present circumstances 4½ percent is necessarily the floor to the unemployment rate. It does imply a belief that a more rapid expansion of the economy within 1973 would endanger the further reduction of the inflation rate that is desirable, and would do so despite the continuing price and wage controls program. However, if, as a result of cooperation with the controls system or for other reasons, prices and wages rise less rapidly than is assumed here, the increase in money GNP suggested for the year would permit output and employment to rise more and unemployment to fall further.

Policy beyond 1973 will have to be adaptable to developments during the year. However, in the absence of evidence to the contrary, a sustained period of uninterrupted expansion would provide the optimal background for maximizing both employment and price stability. To this end, the appropriate policy goal in the ensuing period would seem to be a steady increase of money demand (money GNP) at a rate consonant with the potential growth rate of the economy and reasonable price stability. Again, this would not imply that the unemployment rate of 4½ percent assumed to have been reached by the end of 1973 will not decline further. If, with 4½ percent unemployment, there is the pressure of an excess supply of

labor the average rate of wage and price increase would be lower and the rise in employment relative to the labor force would be higher, leading to a further reduction of the unemployment rate.

A further reduction of the unemployment rate in 1974 and beyond to even lower levels would be assisted by labor market policies, including manpower programs, which effectively reduce the relatively high level of frictional and structural unemployment that has typically been experienced in the United States.

It is worth repeating that the policy goal is a condition in which persons who want work and seek it realistically on reasonable terms can find employment. The Government must make two kinds of contribution to the achievement of this goal. First, it must maintain reasonable stability in the overall rate of economic growth so that the efforts of individuals to find work are not frustrated by erratic changes in the conditions on which work is available. Second, it must seek to eliminate obstacles that prevent willing workers and willing employers from getting together, insofar as these obstacles can be overcome without excessive cost. When the condition that persons who want work can find it through serious search is met, the rate of unemployment as we measure it will not be zero. What it would be we do not know. Undoubtedly the number would change from time to time. But it is the condition which is important, not the statistic.

FISCAL AND MONETARY POLICY

The path of the economy suggested above calls for slowing down the rise of money GNP, which was about 11 percent during 1972, to about 9 percent during 1973 and to a steady rate less than that thereafter. This desired shift to a slower rate of increase of money GNP would be assisted by a shift of the budget—from a position in which the unified budget would be in deficit at full employment to a position in which it would be in balance at full employment. In fact, the strength of the private demand forces in the economy, described below, argues that this shift in the budget position is essential to avoid an inflationary pace of expansion. The desired subsequent steadiness of the rate of increase of money GNP would be assisted by keeping the budget in a position of balance at full employment, unless there later appears clear and strong evidence that developments in the private sector call for greater fiscal stimulus or restraint. Constancy in the relation between full-employment receipts and expenditures provides approximate constancy in the Federal contribution to economic expansion. The constancy of the contribution is only approximate because the impact of the budget on the economy depends on its composition and total size as well as on the size of the deficit or surplus. However, constancy of the balance at full employment is the best single guide to a budget policy that neither pushes the economy above its desired growth rate nor holds the economy below it. In any case, the rule

that expenditures should not exceed the revenues that would be collected at full employment is essential to bring home the requirement that Government should not spend money for things it is unwilling to ask citizens to pay for. The circumstances of 1973 are appropriate for getting on to that track.

A gradual slowing down of the expansion of money GNP to a steady rate consistent with the long-run potential growth rate of the economy and reasonable price stability is also an appropriate goal for monetary policy. This is likely to require a slower increase of the supply of money and credit than was proper when the main objective was to encourage a quickened economic expansion in an environment of substantial unused resources.

There is, as far as we are aware, little explicit disagreement with the proposition that the budget should be brought into a position of full-employment balance for fiscal year 1974. The threat to the achievement of full-employment balance is not that the country or the Congress will decide against it but that congressional procedures will be incapable of carrying out a policy to do it. Congress, under present practice, makes hundreds of separate decisions affecting expenditures but does not decide at any point in the process what total expenditures should be. Lacking the discipline that would be imposed by recognition of a limit to total spending, Congress tends regularly to authorize and appropriate too much money, constantly straining the ability of the Executive to keep spending under control.

If the budget is not to be a perpetual menace to economic stability, better congressional procedures will have to be created for making a deliberate decision about total spending. That is why the President has urged the Congress to establish a rigid ceiling on fiscal year 1974 expenditures before it passes any other spending legislation this year. The President has also urged the Congress to act on its own initiative to reform its expenditure-deciding process. In fact the problem is now more recognized in Congress than it has been for many years and there have been encouraging moves there to deal with it.

We also need to consider whether the future conduct of fiscal policy could be improved if Congress were to develop expeditious procedures for temporary, limited changes in the level of particular taxes. Such changes could take the form of a temporary, 1-year, positive or negative surcharge rate on personal and corporate income taxes, or additionally a temporary, 1-year shift in the rate of the investment tax credit. Both suggestions have been advanced with some regularity over the past two decades, and while they raise many difficult questions it is also generally agreed that we cannot be complacent about our existing instruments for the conduct of fiscal policy.

Basic changes in the structure and level of tax rates do and should require extended discussion. At the same time, experience has shown that the proper conduct of macroeconomic policy may sometimes call for a prompt and effective shift in the overall balance between the flow of Federal receipts and expenditures. Temporary and prompt changes in tax rates, which do not

alter the basic structure of taxes, may provide an efficient way of accomplishing such required shifts.

Government Expenditures

The shift to full-employment budget balance by 1974 can be accomplished either by raising tax rates or by restraining the rate at which expenditures rise. The Administration has a clear preference for the latter.

The conceptual basis for arriving at public expenditure decisions is fairly straightforward. In general, public expenditure is justified when both of two conditions are met: If a desired result can be achieved at less cost by public rather than private spending *and if* the expenditure yields benefits which (adjusted for their timing) are greater than their costs, measured by the value and timing of the alternatives that have to be foregone in order to finance the outlays required.

In practice, there are formidable difficulties in arriving at sound public spending decisions. For many expenditures, reliable estimates of benefits and costs are not available. Many decisions have spending consequences that stretch years beyond the point at which the decision itself is made; over this period, circumstances, priorities, costs, and benefits may and do change. The proper management of public spending therefore requires the continuous reevaluation of prior decisions from which current spending flows as well as the careful evaluation of new decisions. Furthermore it is instructive to gain perspective by referring to a rough guide such as the fraction of total output which flows through the government sector.

The United States has now been through a period of substantial growth of government expenditures, both absolutely and relative to the size of the economy. In making a comparison with the size of the economy it is useful to abstract from fluctuations in the level of actual output around its path of potential growth. To this end, the data shown in Table 20 relate the level of government spending and its major components to the level of potential GNP. Separate figures are shown for the Federal Government (including grants to the State and local level), the State and local sector (excluding Federal grants) and for all levels of government combined.

Excluding defense spending, the ratio of government expenditures—Federal and State and local—to potential GNP rose from 14 percent in 1955 to 23 percent in 1971. Defense spending fluctuated relative to GNP but was much lower at the end than at the beginning of the period. During these years, potential GNP, measured in nominal dollars, nearly tripled.

The share of the Federal portion in total government civilian spending also rose rapidly between 1955 and 1971. In 1955 Federal civilian spending was 6.6 percent of potential GNP compared to 7.4 percent for State and local spending. Over the 16-year period the Federal share rose twice as fast as the State and local share. By 1971 Federal civilian spending was 12.4 percent of potential GNP as against 10.5 percent for the State and local sector.

TABLE 20.—*Government expenditures as a percent of full-employment GNP, selected calendar years, 1955–71*

[Percent]

Type of expenditure	1955	1960	1965	1968	1971
Total government					
Total	24.5	25.3	27.1	31.6	30.2
Defense related [1]	10.4	9.0	8.7	10.3	7.3
Civilian	14.0	16.2	18.4	21.3	22.9
Education, health, and welfare [2]	8.5	10.1	11.7	14.1	15.9
Natural resources [3]	1.2	1.2	1.3	1.4	1.1
Commerce, transportation, and housing	1.8	2.1	2.3	2.5	2.4
General government and net interest	2.5	2.8	3.0	3.4	3.5
Federal Government [4]					
Total	17.1	17.3	17.9	21.2	19.7
Defense related	10.4	9.0	8.7	10.3	7.3
Civilian	6.6	8.2	9.2	10.9	12.4
Education, health, and welfare [2]	3.7	4.7	5.4	6.9	8.3
Old-age and disability	2.1	2.9	3.4	4.3	4.8
Other	1.6	1.8	1.9	2.6	3.5
Other civilian	2.9	3.5	3.8	4.0	4.1
State and local government [4]					
Total civilian [5]	7.4	8.0	9.2	10.4	10.5
Education, health, and welfare [2]	4.8	5.4	6.4	7.2	7.7
Other civilian	2.6	2.6	2.8	3.2	2.8

[1] Consists of national defense, space research and technology, and international affairs and finance. Negligible amounts of State and local expenditures for these functions are included in Federal expenditures.
[2] Consists of education, health, labor and welfare, and veterans benefits and services.
[3] Consists of agriculture and agricultural resources and natural resources.
[4] Federal expenditures include and State and local expenditures exclude Federal grants.
[5] See footnote 1.

Note.—Expenditures are on a national income accounts basis.
Detail may not add to totals because of rounding.

Source: Department of Commerce.

For all levels of government, the largest increases were recorded in spending for education, health, and welfare purposes. Total spending for such purposes rose from 8.5 percent of potential GNP to 15.9 percent, and Federal spending rose from 3.7 percent of potential GNP in 1955 (about $15 billion) to 8.3 percent in 1971 (about $93 billion). A large part of the rise was in spending connected with social security programs for the aged and disabled, although other forms of spending for education, health, and welfare functions also rose rapidly.

The rise in the share of Federal civilian spending in the United States has accelerated since the mid-1960's along with the large increase in the number and scope of social programs. Many of these were introduced without any firm estimate of how effective they would be in solving the problems to which they were addressed or how much they would cost in the long run. At the same time there has emerged the need for new social programs, especially in the field of pollution abatement.

The continued existence of large social problems alongside a greatly expanded volume of government expenditures designed to correct these problems is not a strong argument for devoting a still-larger share of the

national output to similar government programs. On the contrary, it is an argument for close scrutiny of these programs to discover whether they can be justified by their results. Such a scrutiny, carried out by the Administration, has led to decisions to cut back many programs, even though total Federal spending, after the cuts, will still be rising by about $20 billion a year. Making these cutbacks in less effective programs will provide budget room for consideration of more effective programs later as the growth of the economy expands the Federal revenue.

PRICE AND WAGE RESTRAINTS IN PHASE III

The purpose of budget and monetary policy is to help the economy achieve sustainable expansion along the growth path of potential output. One necessary condition for achieving this objective is the avoidance of policy errors which risk the re-emergence of generalized demand-pull inflation. A second condition is that the risk of inflation related to cost-push and expectational factors should also be minimized. Inflationary expectations and behavior left over from the country's experience since 1966, even though reduced in 1972 from previous heights, have not been completely eliminated. The self-interest of both business and labor calls for restraint and hence can be expected to lead to an even more durable winding-down of inflationary patterns than the economy has already achieved. However, the reciprocal abatement of the rate of wage and price increases is a delicate and complex process that can be upset through unrestrained behavior by particular sectors of the price-wage spectrum. To avoid the risk of such disruption, it is necessary to maintain a system of direct wage and price restraints in 1973.

Although temporary continuation of controls in 1973 is necessary, the condition of the economy and of the controls system have pointed to the need for substantial changes in the program. Two things are critical. One is to restrain and, if possible, reverse the rapid rise of food prices. The second is to moderate the degree of detailed supervision and mandatory enforcement in the system in order to preserve the self-restraint which has been the essence of the progam.

In 1972 food prices rose much more rapidly than other prices. The reasons for this, and the steps taken to curb the food price increase, are described in Chapter 2 and its supplement. By the end of 1972 adverse weather conditions had further reduced the food supply in prospect for 1973. Moreover, it began to appear that these uncontrollable adversities were superimposed on an agricultural policy which, although less restrictive than it had been, still leaned too far in the direction of limiting output and stocks relative to the rising domestic and foreign demand. This was especially true for meat, where the programs adopted in the early 1960's had made a major change in the way farmers could use their cropland. Whereas previous programs had placed limits on actual acres of crops produced, and allowed other areas of land to be used for livestock grazing or production of minor crops,

the new programs utilized a new concept. They restricted the production of major crops by paying farmers to idle a portion of the acres previously used in crop production. In return for the payment, the idle acres had to be planted to soil-conserving crops and could no longer be used for livestock grazing or other crop production during the most productive part of the year. This change had the effect of slowing the rate of growth of meat production after 1965. With strong growth in demand for meat in 1972, prices rose rapidly.

Arresting the rapid rise in food prices is a key element in the 1973 stabilization program, both because of the direct importance of food in family budgets and because of the possible link between food prices and moderation of wage increases. Accordingly, the revision of the Phase II program included major steps to restrain food price increases in addition to what had been done in 1972.

During January 1973 the Administration took a number of strong measures which will have an important impact on food supplies and food prices, although with some lag. These include:

1. Suspension for 1973 of mandatory acreage set-aside requirements under the wheat program.

2. Disposal of Government-owned stocks of grains, except for minimum reserves, to be completed promptly.

3. Termination of Government loans, effective May 31, 1973, on farmer-owned stocks of grains from crops of 1971 or earlier years.

4. Suspension of all remaining export subsidies for foods, applying to chickens, flour, and lard.

5. Permission for acreage diverted from crop production under Government programs to be used for grazing animals under arrangements to be agreed upon with the Department of Agriculture.

To help assure that the agricultural policies of Government are consistent with the anti-inflation objective, administrative actions of the Department of Agriculture affecting food supplies and prices will hereafter be subject to review by the Cost of Living Council (CLC). The CLC Committee on Food has been set up to discharge this function as well as to review or initiate other policies and proposals that may affect food prices. This can lead to a progressive reorientation of agricultural policy to the needs of the 1970's.

As in Phase II, mandatory controls will be continued on food processing and distribution. Large food processors will be required to comply with previous regulations, including prenotification and approval of cost-justified price increases. The limitations on retailers' margins established under the Phase II system will remain in force, except for minor administrative changes. Pay units in the food processing and retailing industries will remain under mandatory pay control.

Concern with the food price problem in 1972 led the Cost of Living Council to ask the National Commission on Productivity to undertake a study on ways to improve productivity and reduce costs in food production and distribution. The study, which has now been transmitted to the CLC for its consideration, contains numerous suggestions for both Government and private action. A Food Industry Advisory Committee, drawn from the private economy, has been established to advise the CLC on matters relating to food costs and prices. One of its main functions will be to assist in carrying out recommendations for raising productivity arising from the recently completed study.

Three other sectors of the economy, in addition to food, will receive special attention under Phase III.

(a) *Medical care.* Mandatory control of prices and wages remains in force in the health industry. The Cost of Living Council Committee on Health will review Government activities significantly influencing health-care expenses. A Health Industry Advisory Committee composed of private citizens will advise the CLC in this area.

(b) *Construction costs.* The Construction Industry Stabilization Committee will continue to operate as under Phase II to restrain wage increases in that industry. Construction prices are subject to reduction if scheduled wage increases are reduced.

(c) *Interest and dividends.* The Committee on Interest and Dividends will continue its efforts to obtain voluntary cooperation in holding down dividend payments and interest rates.

Outside of these particular areas, the main effort of Phase III is to bring about private action on wages and prices consistent with the goal of slowing down the inflation rate without imposing unnecessary burdens on the economy. These burdens, described in Chapter 2 as they related to Phase II, included administrative costs for the Government and the private sector, interferences with productivity and production, obstructions to the normal conduct of business and collective bargaining, weakening of incentives to investment, and a feeling of inequity on the part of some. Although surprisingly small during 1972, these burdens were becoming more serious and there was every reason to believe that they would become still more serious as the control system continued and as the economy moved closer to its potential.

These costs or burdens of the system were not essential for its basic objective. The objective was not to force prices and wages to conform in every particular case to precisely defined standards laid down by the Government, nor to obtain advance approval for every private action. The objective was a certain average degree of restraint. But prior to August 1971 private decisions had been made for a long time in a highly inflationary atmosphere. With that background, spontaneous wage and price decisions in 1972 could have come out a long way from the requirements of price stability, even

given a general desire to cooperate in the fight against inflation. Thus the ability of the Government to monitor private behavior and enforce reasonable compliance with the requirement of price stability had to be developed and demonstrated. Therefore, the situation of Phase II required prenotification, precise standards, and omnipresent enforcement. The conditions at the opening of 1973 permitted and—if the system was to survive and succeed—required a relaxation of these forms of the system. This is the basic philosophy of Phase III.

The President has established a goal of getting the rate of inflation down to 2½ percent or less by the end of 1973. The Cost of Living Council has set forth standards of price and wage behavior which are consistent with the achievement of this goal. These standards are essentially the standards of Phase II, with some modifications on the price side which are noted below. The CLC has authority to change these standards. In considering modification of the pay standards the CLC will have the advice of a Labor-Management Advisory Committee composed of leading private citizens.

Compliance with these standards is expected to be initially and generally voluntary. The program will be self-administering, in the sense that private parties can calculate the application of the standards in their own cases. The experience under Phase II, and the regulations and definitions developed under it, were invaluable in making this possible. Businesses and collective bargaining units will not be required to notify the Government in advance of price or wage increases. The largest economic units will be required to submit quarterly reports to the Cost of Living Council, which will permit the CLC to assess their behavior relative to the requirements of the anti-inflation goal. Moderate-sized economic units will be required to maintain records for the same purpose. The parts of the economy not required to submit reports or maintain records will be surveyed from statistical and other information and are expected to follow the same standards.

When the Cost of Living Council believes that there have been, or are about to be, price or wage increases that are not reasonably consistent with the objectives of the program it can take action to stop them. Among other things, it can, if it considers it appropriate, issue an order under the authority of the Economic Stabilization Act setting a ceiling on specific prices or wages. This order might be temporary, pending a hearing. While the order is in effect, transgressing it will be a violation of the Act and subject to its penalties. In determining whether price or wage increases are not reasonably consistent with the objectives of the program the CLC will be guided by the standards it has issued.

The Price Commission and the Pay Board will no longer operate in Phase III, but many of their functions will be performed by Price and Pay Divisions of the Cost of Living Council. Rent control, which had already been cut down to cover about 30 percent of rental units, is terminated in Phase III, because it leads to costly evasions, enforcement is difficult, and housing market condi-

tions have significantly improved. The total number of personnel assigned to the program will be reduced from about 4,000 to about 2,000. Relieved of the necessity to process a large flow of advance notifications, and to administer rent control, this staff will be adequate to maintain an effective option for the Government to intervene to assure achievement of the anti-inflation goal. The President has asked for a 1-year extension of the Economic Stabilization Act, which would otherwise expire on April 30, 1973.

One significant change has been made in the standard for prices. As in Phase II, prices may be increased only to reflect cost increases. These cost-based price increases are then subject to one of two further limits. First, the average increase in a firm's prices may not exceed 1.5 percent in a year; if this standard is observed the firm's profit margin will not be limited. Second, if a firm's average price increase exceeds 1.5 percent that firm may not exceed its base period profit margin. Thus, a firm is given the opportunity to exceed its base period profit margin if it does so by increasing productivity, without raising prices by more than 1.5 percent. The base period for calculation of the allowable profit margin is slightly altered by permitting the inclusion of fiscal years ending after August 15, 1971.

The essence of Phase III is that the Government retains the enforcement ability and authority necessary to the Nation's anti-inflation objective while leaving the private sector the maximum possible freedom to pursue productivity, efficiency, and collective bargaining.

THE OUTLOOK FOR 1973

The U.S. economy will expand substantially in 1973. All major components of demand will rise strongly except for residential construction and Federal purchases. Aggregate demand for goods and services will rise by about 10 percent, from an estimated 1972 level of $1,152 billion to about $1,267 billion in 1973.* The real increase is projected at 6¾ percent with an implied increase in the GNP price deflator of 3 percent. This projection of GNP prices is compatible with the objective that the rate of inflation, as measured by the consumer price index, be reduced to 2½ percent or less by the end of 1973. Civilian employment is expected to rise more rapidly than the civilian labor force, reducing the unemployment rate to the neighborhood of 4½ percent by the end of the year.

The course of the U.S. economy, at least through the first half of 1973, will be dominated by expansive forces already in place at yearend 1972. Business investment has developed a strong forward momentum, stimulated by both the fact and the expectation of expanding orders, sales, and profits. The ability and willingness of consumers to increase their purchases has been augmented by the large increase in social security benefits in the fourth

*Given the path of money GNP in 1972, an increase of 10 percent between the average level in 1972 and the average level in 1973 is consistent with an increase of 9 percent from the end of 1972 to the end of 1973.

quarter of 1972 and their incomes will be augmented again early in 1973 by Federal pay increases. The financial position of the State and local government sector, stronger than it has been in many years, will be strengthened further by both current revenue sharing payments and retroactive payments for 1972.

Given these expansive forces the probability is that the economy will maintain a very high rate of real growth over the first half of 1973. After midyear, the economy will be significantly closer to the zone of full potential output, and it is both probable and desirable that the rate of expansion will and should abate toward its sustainable long-run path.

The outlook for the major components of expenditure on GNP in 1973 is discussed in the following sections.

Business Fixed Investment

The Council expects the rise in business fixed investment to continue on its strong upward course and to increase by 14 percent from 1972 to 1973, about the same as the rise from 1971 to 1972. The last time two successive annual increases of this magnitude occurred was in the mid-1960's. A substantial part of the earlier increase took place before the rapid buildup of the war in Vietnam. The foundation for the large increase expected in 1973 has already been laid. The rapid expansion in 1972 has generated increased requirements for capacity expansion and has also provided business with a substantial part of the funds required for capital goods purchases: In addition to rising profits, the actual and potential availability of funds has been augmented by liberalized depreciation provisions, the investment tax credit, and the restraint on dividend increases, as well as by favorable financial conditions in the markets for debt and equity capital. This year's strong economy will sustain investment plans that have already been made and, indeed, will probably lead to their upward revision.

Several indications of forward investment commitments were noted in Chapter 1. Additional evidence can be found in the strong buildup in unfilled order backlogs held by producers of capital goods, which were 14 percent larger in November 1972 than a year earlier. Recent months have also seen a pronounced step-up in construction contract awards for factory building, which had been lagging for several years.

According to the most recent Commerce Department survey, taken in November and December and published in January, businessmen were projecting a rise of 13 percent in their plant and equipment expenditures from 1972 to 1973. The survey also projected a rise of 13½ percent for manufacturing companies. These results correspond fairly closely with a similar survey conducted by McGraw-Hill in late October. The manufacturing increases extended to almost all major industries and were especially large in the durable goods sector. Investment by nonmanufacturing business is expected to continue its steady upward trend for a projected rise of 12½ percent, with larger than average increases in spending by public utilities and mining.

The Council's forecast for an overall rise of 14 percent is basically consistent with the rise projected in the anticipations survey for 1973. One reason for a slightly higher forecast is that investment demand is expected to be strong in certain sectors not covered by the plant and equipment survey, notably investment in agriculture, and among professional businesses. A second reason is that over the postwar period anticipations have tended to underestimate actual results during periods of strong expansion.

It is interesting to note that experience in 1972 was an exception to the general rule: Business spent less on new plant and equipment in 1972 than was projected early in the year by both the Commerce and McGraw-Hill surveys. It is highly unlikely that the shortfall was due to disappointments in demand; indeed, capital appropriations, new orders, and contract awards all increased as 1972 progressed. A possible explanation for the shortfall which occurred is that construction and equipment costs did not rise as fast as originally expected, especially for older projects that had been planned several years previously and had been reactivated after postponement during the recession.

Inventory Investment

The change in business inventories is expected to total $12½ billion in 1973, an increase of about $7 billion over last year's level of inventory accumulation. Considering the strength of the rise in output and sales in 1972, inventory accumulation was relatively low. However, stocks relative to sales at the beginning of 1972 were still a little high by historical experience. In addition, most sectors experienced few problems with delivery delays, and under such conditions a major shift in inventory policy was not likely. The combination of last year's strong upsurge in sales and the moderate rise in stocks has reduced the ratio of stocks to sales for manufacturing and trade firms combined to its lowest level since 1966. One structural element that will help add to inventory investment this year is the increased demand—stemming from some of the capital-intensive manufacturing industries—for heavy equipment with long production lead times.

Residential Construction

Residential construction expenditures are expected to rise only slightly from 1972 to 1973 and to decline somewhat in real terms. Housing starts are expected to edge down gradually throughout 1973, averaging 2.2 million units as compared to 2.4 million in 1972. In general the decrease in new starts will reflect cutbacks in some areas where overbuilding has occurred, some reduction in the backlog of demand as this is satisfied by the very large volume of completions expected in 1973, and somewhat less favorable conditions in mortgage markets than prevailed last year. The number of new nonfarm housing units—public as well as private—to be started under HUD-

subsidized programs is expected to exceed the 1972 level somewhat, even though new commitments under these programs are being discontinued.

The reduction in total starts is not expected to be severe because the underlying demand for housing—buttressed by strong formation of new households and replacement demand—continues to be very high. Furthermore, while some rise in interest rates may occur as a result of the strong upsurge in business activity, there is little possibility of the stringent financial conditions that led to shortages of mortgage funds in 1966 and 1969.

Government Purchases

Government purchases are expected to show mixed trends. State and local purchases are projected to rise by 12 percent, or by somewhat more than last year's 10 percent rise, due in part to the effects of revenue sharing. Many States and localities have indicated that spending increases related to revenue sharing receipts will take the form of capital projects, in which case the full impact of the new program on the economy will be deferred by the longer lags involved in planning and executing such expenditures. There will also be tax cuts from existing levels or the avoidance of tax increases that might otherwise have taken place in the absence of revenue sharing, and also some debt reduction. All of this may stimulate the economy but not in the form of higher government purchases.

Federal purchases of goods and services are scheduled to show little change from 1972 to 1973, which means a decrease in real terms. The year begins with a Federal pay raise for both military and civilian workers that is expected to add $2.2 billion a year to Federal payrolls, although part of this rise is expected to be offset by subsequent reductions in personnel.

Net Exports

Imports of goods and services are likely to exceed exports again in 1973 but the difference is expected to be narrower by about $2½ billion than was the case in 1972. The improving trend in the balance of trade that began in mid-1972 should continue through the coming year. Because the growth of U.S. output from yearend 1972 to yearend 1973 will be slower than it was in the preceding 4-quarter period, the demand for imports should rise less rapidly than during 1972. At the same time, economic growth in major industrial countries abroad is expected to be more rapid during 1973 than during 1972, and on this account the growth rate of demand for U.S. exports should show an improvement. Furthermore the slower rise in U.S. costs and prices relative to those experienced by our trading partners should increase the relative demand for U.S. products both at home and abroad. Finally, the positive long-run effect of the December 1971 currency realignment, which was offset by its perverse short-run effects on the nominal dollar value of our trade balance last year, can be expected to show up more clearly in 1973. However, the positive effects outlined above will be reduced by a continuing rise in net fuel imports.

Consumer Spending

Consumer spending is expected to rise approximately 9½ percent in 1973, exceeding last year's large rise of 8½ percent. However, the course of consumer demand within 1973 is not likely to be as rapid as it was within 1972. This difference between year-to-year and within-the-year movements reflects the fact that unlike 1972, the year 1973 starts off from a high base. For example, retail sales in December after seasonal adjustment were 4½ percent above the monthly average for all of 1972; the corresponding figure a year ago was 2½ percent above the 1971 average.

Personal income is expected to show another large gain from 1972 to 1973, with an expected rise close to that of last year. A large rise in employment and payrolls will be supplemented by the increase in social security benefits that became effective in the final quarter of 1972 as well as by new benefits that become effective in 1973.

Personal income is computed after subtracting personal contributions for social insurance. This year, increased social security tax rates and a higher taxable earnings base will reduce personal income by about $5 billion. Although the national income accounts record the entire amount of the tax rise beginning in the first quarter, it is important to note that the portion due to an increase in the wage base ($1.6 billion at an annual rate) does not, in actual practice, become effective until later in the calendar year.

Disposable income is expected to show an extremely large rise of 10 percent this year, exceeding the rise in personal income mainly because of the refunds of the overwithholding of 1972 personal income taxes. These refunds are expected to give a strong boost to cash income in the first half of the year, followed by a corresponding slowdown in the growth of spendable income after midyear. Some impact on consumption is expected from these refunds, but the greater part is assumed to affect personal saving, as seems to have been the case in 1972. Because of the heavy infusions of income in the first half of 1973, the saving rate in that period is likely to be very high but it should decrease as the year progresses.

Labor force and unemployment

The unemployment rate is expected to decline to the neighborhood of 4½ percent by the end of 1973. This projection is essentially based on the forecast that real GNP in 1973 will be about 6¾ percent higher than it averaged in 1972. The principal uncertainty involved in translating the projection of output into a projection of the unemployment rate is the growth of the total labor force (which includes the Armed Forces) over the course of the year.

In the mid-sixties it was widely assumed that the trend rate of growth of the labor force would rise to about 1¾ percent per annum and remain there through 1980. In fact the growth of the total labor force turned out to be much higher; over the last half of the 1960's it was close to 2¼ percent per annum. As a result, the total labor force is now far larger than the level

projected in 1965. The extraordinary expansion in participation rates ended in 1970.

In 1972, in spite of a strong expansion in employment opportunities, the growth of the total labor force was close to its long-term rate of 1¾ percent. The uncertainty for 1973, and beyond, is whether labor force growth will remain at this level. There are reasons to believe that it will, and that the extraordinary increases between 1965 and 1970 represent a one-time phenomenon, caused principally by the following factors:

1. The strong demand for labor due to the Vietnam mobilization and buildup increased labor force participation rates. In particular it drew large numbers of women and teenagers into the labor force because so many men were either in the Armed Forces or remained in college.

2. The fertility rate fell rapidly, causing fewer women to be out of the labor force looking after young families.

3. Because women generally have a lower median age at marriage than men there was a temporary excess of women when the first cohorts of the postwar baby boom reached marriageable age in the mid-1960's. Like the fall in the fertility rate, the "marriage squeeze" induced an abnormal increase in the labor force.

4. The introduction of 7-day and late night openings by many sectors of retail trade led to large increases in the availability of part-time work.

These factors do not seem to be still operating on balance to accelerate participation rates further, and it is therefore likely that labor force growth will now remain at its long-run trend rate of 1¾ percent. If it does, and the size of the Armed Forces remains close to present levels, the 4½ percent unemployment level forecast should be achieved.

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As always there are uncertainties. The projection of a 10 percent rise in money GNP between 1972 and 1973 is within the high side of the fairly narrow range being forecast by the majority of economic models and economists. The probability that GNP in 1973 will differ from its forecast value by more than 1 percent is extremely small.

The apparent consensus on money GNP for 1973 is due in part to the fact that many of the common foreshadowing data used are themselves stated in terms of expected dollar flows. There is less agreement about how the nominal increase will be divided between real growth and changes in the price level—because we have fewer insights on either of these components than we have for the total itself. The Council's projection of a 3 percent change in GNP prices is at the low end of the range now expected by private forecasters. It is based on three assumptions about the future: That the limit on federal expenditures proposed by the President for fiscal 1973 and fiscal 1974 will be met; that the rate of rise in food prices will be less than in 1972; that there will be a high degree of compliance with

Phase III standards, enforced as necessary by the Economic Stabilization Program. None of these is certain but the probability is high that all will be realized.

Notwithstanding the uncertainties, the economy in 1973 appears to be moving along a general path which gives it a better chance of reaching sustainable full employment than it has had in all but one or two years of the postwar period.