

## CHAPTER 3

# Uses of the National Output

## INTRODUCTION

**B**Y ANY USUAL MEASURE, AMERICA ENTERS THE 1970's a wealthy nation which is growing wealthier at a rapid rate. Per capita national income in 1969 was about \$3,400 and had increased in real terms about 40 percent since 1959. It is expected to increase 20 percent more by 1975.

Despite this, or perhaps because of it, Americans are becoming acutely aware that being rich and growing richer does not solve all of our problems. The realization that we expect more than the economy can produce, productive as it is, points the way to the real problem, which is to make sure that the output is used efficiently to meet our most important needs. There is a growing sense that the limited national output is not being used in this way.

The focusing of increased attention on how the national output is divided comes after a generation in which it had seemed that the country could make a quantum jump in available output that would dramatically improve the quality of life. In fact, for a time this was true. During the 1930's, when the Nation was producing far below its economic capacity, we expected that our needs could be satisfied by the return of production to reasonably full employment. During World War II, when the economy actually operated at capacity, private citizens could foresee a large increase in the output available to them after the war.

Later, in the 1950's and early 1960's, many people were impressed with the possible contribution that a "small" increase in the annual rate of economic growth—from 3 or 4 percent to 5 or 6 percent—would make to providing the output available for every kind of purpose. "Faster growth" became the source from which all new claims on the national output would be met. But in time this was seen to be largely an illusion. The basic full-employment growth path of an economy is not readily raised by any of the policy instruments that we now know about. The country could count on sustained growth to increase its capacity for doing many things. It could not count on being able to boost the growth rate at will to support every new claim.

Although the necessity to confine total uses of output to a growing but limited productive capacity is becoming more recognized in principle, it tends to be ignored in practice. This is obvious in Federal Government policy involving claims on resources. Even when the economy is operating at fairly full employment it is possible to increase Government expenditures, to reduce taxes, and to finance Government borrowing by monetary expansion. This may seem to provide an escape from the limitation on resources and the necessity for hard choices that all individuals and State and local governments face. But in fact it does not. All it does is let inflation choose which demands are satisfied and which are not. A mature people can find a better way to make these choices. The basic problem is to make better decisions about the uses of the national output. This chapter discusses the role of the Federal Government in this process.

The attention given here to the Federal Government's role in allocating the national output may seem excessive for a nation committed to a free-market, decentralized economic system. The idea that the Federal Government must make hard decisions to allocate the limited resources within its own budget is commonplace. The idea that it does or should influence the allocation of the output of the entire economy is not. However, the Federal Government does have an important influence on decisions about the use of resources in the private, as well as the Government sector. Perhaps that influence should not be as big or as detailed as it is. Nevertheless a large influence exists, and much of it is inevitable or desirable or both. This influence should be recognized, its effects appraised, and decisions consciously made to achieve the effects that are preferred.

In 1969 the Federal Government purchased and used, mainly for defense, 11 percent of the gross national product. The remainder, except for a small amount of net exports, was used for personal consumption, for private investment, and for State and local government purposes. The Federal Government was a major influence in the division of the remainder among these three categories and within them. While it purchased only about 11 percent of the national output for its own use, it collected about 20 percent of the national output in taxes and social insurance contributions. It returned the difference to State and local governments in grants, to households in transfer and interest payments, and, since there was a budget surplus, to private capital markets for investment through repayment of Government debt. Grants to State and local governments to finance purchases (as opposed to transfer payments) were about 13 percent of their purchases. Federally financed transfer and interest payments to persons were equal to about 11 percent of consumer expenditures. The funds supplied by the Federal surplus to capital markets and available for private investment were 6 percent of gross private domestic investment. The relative amounts of these flows, and the taxes used to raise the revenues, substantially affected the division of the available output among these three broad categories.

Federal decisions also influence the division of the output within these categories. The Federal Government not only provides the States and

localities with billions of dollars in grants, but it provides these grants through hundreds of separate programs for specific purposes. The taxes it collects from households and the transfers it pays to them come from and go to particular classes of persons, and thus affect the distribution of income and the composition of consumer spending. Taxes levied on specific items, such as automobiles or alcoholic beverages, also affect what is consumed. Facilities and services provided by the Federal Government stimulate private consumption or investment expenditures that are complementary with them or curtail private expenditures that are competitive with them. For example, Federal expenditures on highways encourage private expenditures for automobiles and trucks.

## THE DECISIONMAKING PROCESS

The Federal Government has a large and pervasive influence on the allocation of the national output. Its decisions in this role fundamentally affect the national welfare. There can be no single, scientifically determined "best" allocation of the national output. Differences of interest, value, and opinion among people are inevitable, and they are not of a character that can be resolved objectively. They must, however, be reconciled, and it is the function of the political democratic process to do this.

Given the distribution of interests and the location of powers to make decisions, there is still much that needs to be done to reach better decisions—to make sure that as far as possible the consequences of decisions are known and are taken into account as they are made. Decisionmakers need to know the longrun as well as the immediate results of what they do, and the indirect as well as the direct results. They need to see the options that are open to them, and there must be an opportunity for differing viewpoints to confront each other. The effort to improve decisionmaking has a long history, in which the establishment of the modern budget, the consolidation of the Appropriations Committees in Congress, the development of the Executive Office of the President, and the creation of the Council of Economic Advisers were milestones.

## THE LEVEL OF DECISIONMAKING

One basic requirement for good choices about the use of the national output is, of course, that they should be made at the right level and by the right people. The mere size of the Federal Government will influence the division of decisionmaking between it and the non-Federal—private, State, and local—parts of the community. There is a strong case for holding down that size in order not to load responsibilities on the Federal Government beyond its capacity to discharge them, as well as for other reasons. The character of the Federal activities is probably as important as their volume in determining the location of decisionmaking. For example, Federal tax policy inescapably influences the total amount of

consumption expenditures by private households, but some kinds of taxes go further and influence the composition of consumption. Similarly, the Federal Government probably cannot avoid influencing the total rate of private investment, but different Federal policies can involve more or less Federal influence over the character of the investment.

The problem of the appropriate level of decisionmaking has become critically important in the relations between the Federal Government and the States and localities. The amount of Federal financial assistance to the lower levels of government has grown markedly in the postwar period. This growth has raised the question whether the Federal Government should be a neutral supplier of funds or should attempt to determine how States and localities use these funds, and their own. Undoubtedly there is room for some Federal intervention in the decisionmaking process. However, grants for highly specified purposes have reached a degree of detail which is neither necessary nor efficient.

The Administration has proposed to alter the Federal-State-local relationship by instituting a system of revenue sharing, through which the Federal Government would supply funds without dictating their use. In addition the Administration has asked for authority to consolidate some of the innumerable specific grant programs when they relate to similar functions. In these ways it is hoped to improve the overall decisionmaking process.

#### **BUDGETARY BALANCE AS DISCIPLINE**

Balancing the Federal budget has long been a symbol and instrument of discipline in Government decisionmaking. The requirement that if some expenditures are raised others must be cut or taxes must be increased has forced Government officials to count the costs of expenditures. In recent years the Nation has become more sophisticated about budget deficits and surpluses. It has learned that the size of the surplus or deficit will and should vary with economic conditions. It is now learning that the longrun average size of the surplus or deficit should be determined by the amount of savings it is desired to make available for private business and housing investment in total. But this does not reduce the relevance or value of the budget-balancing discipline.

Once the appropriate longrun average size of the surplus or deficit has been determined, that goal should not be changed except upon reconsideration of the longrun objectives. Shortrun fluctuations in private demand will sometimes require offsetting temporary changes in tax rates or Federal expenditures. And the size of any specific year's surplus or deficit will inevitably depart from the target level as a result of economic fluctuations, even with tax rates unchanged and expenditures at longrun levels. But achieving the desired average budget position over a period of years means that on the average expenditures can grow only as fast as full-employment revenues.

Beyond that, expenditure increases in one area must be matched by expenditure cuts in another, or by increased taxes. In principle, every decision on Government expenditures should reopen the question of the desirable size of the surplus or deficit. In fact, Government cannot operate that way. The objectives served by the surplus or deficit, although important, are remote and indirect. These objectives will suffer if they are implicitly reevaluated every time an expenditure decision is made. In their day-to-day decisions about spending, Government officials need to be confronted with costs that are obviously and directly within their purview and responsibility. This means that they must at least count costs that appear in the form of tax and expenditure requirements to meet a given surplus or deficit target.

The budgetary discipline in the Federal Government can only be self-discipline. If the old symbolism of the balanced budget is losing its force, a new understanding of its value must replace it.

### TOWARD IMPROVING FEDERAL DECISIONS

Although a budgetary rule that requires the balancing of additional expenditures against additional revenues has an essential role in Federal decisionmaking, it is by itself far from a sufficient guide to the discharge of the Federal Government's fiscal responsibility. This rule tends to focus attention on the shortrun aspects of what are also longrun commitments. It forces the counting of costs, but it does not provide realistic information on what the costs are. It concentrates on choices among uses of the relatively small part of the national output that is within the budget without adequately revealing the effects that the choices will have on the larger part that is outside the budget.

This Administration has taken several important steps to improve decisions about the allocation of resources. The President established in July 1969 the National Goals Research Staff to identify alternative goals important to Americans and to study long-range social trends of significance for national policy. The Cabinet level Urban Affairs and Rural Affairs Councils and the Cabinet Committee on Economic Policy are interagency groups the President has formed to coordinate the development of policy. The Defense Program Review Committee, on which the Chairman of the Council of Economic Advisers and the Director of the Bureau of the Budget serve, helps to assure that the broad picture of total national resources and claims enters into the process of decisionmaking for defense.

As a further step toward improving the organization of the Executive Branch for making its major policy decisions, including those which importantly affect the allocation of the national output, the President established the President's Council on Executive Organization—the Ash Council.

In 1965, a new effort was inaugurated throughout the Government, in the planning-programing-budgeting system, to evaluate more objectively

the costs and benefits of existing and proposed programs. Building on this beginning, the Administration is now focusing economic analysis primarily upon major policy issues. By examining especially carefully the most important programs, scarce analytical resources are economized; thus analysis can penetrate further into the decisionmaking process. Potential savings from improved decisions can be large.

Analysis of the possible implications of proposed decisions before they are taken is, although speculative, obviously necessary. Equally necessary, and somewhat less speculative, is evaluation of the results of decisions after they have been taken. Persistent efforts to evaluate existing programs are necessary if the Nation is going to be able to do the new things it wants to do. One of the steps in this direction was the President's instruction to the Office of Economic Opportunity to establish a research and evaluation office capable of independent appraisal of Federal social programs affecting the disadvantaged. Evaluation of the results of Government programs remains one of the most urgent needs of Government as it seeks to make effective decisions about the use of resources.

Besides assessing the full costs and benefits of Federal programs, agencies must take into account the time pattern in which benefits and costs of programs occur. The Government, like private firms and individuals, must recognize that benefits are worth more if they occur today rather than tomorrow. Accordingly, agencies have been directed to apply a discount factor to all programs which have costs or benefits that occur 3 or more years in the future. Studies have been undertaken to determine the appropriate factors to use in this kind of calculation. In addition, explicit account is being taken of risks involved in public projects.

The Administration is seeking to formulate the larger choices it faces in the allocation of national output in the light of the competing options. Among the most important steps in this direction have been the inter-related studies conducted through the National Security Council and the Cabinet Committee on Economic Policy. These studies examined alternative defense strategies with their associated costs and alternative nondefense Federal programs. Various defense strategies were translated with rough accuracy into a large number of possible forces and budgets. Similarly, alternative nondefense Federal programs were developed. The studies revealed the probable effects of different combinations of defense and nondefense programs on private consumption, housing, other investment, and State and local expenditures, given the limit set by potential national output. These studies in the Cabinet Committee have also explored trade-offs among various nondefense programs within resources that will be available from continued economic growth and assumed reductions in defense expenditures. All of these studies have served as background for consideration of long-range revenue and expenditure decisions.

## FUTURE NATIONAL OUTPUT AND THE CLAIMS UPON IT

The last few pages have discussed mainly the budgetary *rules* and decision-making *procedures* that might improve Federal Government decisions. These decisions affect the use of the entire national output, as was pointed out in this chapter's introduction. The substance of the priorities problem is to allocate the future national output among alternative uses in a rational way that reflects decisions about national priorities. This tailoring of Federal decisions concerning allocation to a view of national priorities requires—

1. An estimate of what the future national output can be.
2. A view of the claims upon the national output—the things we would like to do with it—that are eligible for serious consideration.
3. A view of the policy measures that would be necessary to bring about satisfaction of some claims rather than others.
4. A decision about the claims to be satisfied and the policies to carry out the decision.

Step 4 in this process must, of course, ultimately reflect Government decisionmaking at the highest level. This section undertakes a tentative approach to the first three steps. No one can now confidently draw comprehensive and detailed conclusions on these first three steps. But even the rough and preliminary estimates presented here reveal much about the priorities problem confronting the Nation and establish the need for further efforts to analyze it.

Projections of available future output and the potential claims on it can move discussion of the priorities problem from vague and sometimes easily ignored knowledge to the concrete realization of just how limited the available output will be. First, a projection will be made of available output—GNP in real terms for the years 1970–75. Then visible claims on this output by consumers, governments, and business will be projected. Adding up these claims and comparing the total to available GNP will indicate the magnitude of the priorities problem. The projections will also provide a framework for discussing various policy alternatives that would meet various sets of claims on the output.

The principal objective of this section, therefore, is to estimate the claims against GNP and to show how different patterns of allocation of the GNP can be achieved. Since it is assumed throughout that the projected real GNP is in fact achieved, the only problem discussed here is how the GNP is to be allocated. The projected GNP can be achieved by any one of a number of different combinations or “mixes” of fiscal and monetary policy, which will differ in the allocation of the total GNP that results from them. In these terms this section is concerned with which mix will give a desired allocation of the total GNP. In the short run, this is probably an exaggeration of the choices available; the number of mixes consistent with economic stability may be more limited. But for the long run, which is the appropriate

context of this analysis, the assumption of a given GNP achievable with any of a large variety of policy mixes and resource allocations is reasonable.

Since the problem here is allocation of a projected real GNP as it moves along its growth path, the projections are made in constant 1969 prices. This does not imply any forecast about the price level; rather the assumption keeps the focus on the allocation problem.

#### POTENTIAL AND PROJECTED GNP

The output the economy would be capable of producing when operating at an unemployment rate of about 3.8 percent—called here potential output—is estimated to rise by about 4.3 percent per year in real terms. This results from projected growth of the labor force at  $1\frac{3}{4}$  percent per year, a decline in annual average hours of work per person of one-quarter of 1 percent per year, and an increase of output per man-hour in the total economy of 2.8 percent per year. Projected available output is assumed to be below potential from 1970 until 1972, as a result of policies to slow inflation, but to equal potential output thereafter.

The resulting illustrative projections of available GNP at 1969 prices are shown at the top of Table 13.

#### CLAIMS ON THE NATIONAL OUTPUT

To list uses of the national output which though desirable would exceed potential output is not difficult. But that is not the purpose here. The purpose is to present the claims that already exist. The largest part of the claims is found in the usual consumption behavior of households, given the incomes they would be earning and the taxes they would be paying, and in the investment behavior of businesses, given the total output and demand projected. Other claims exist in the form of ongoing Government programs, goals stated in legislation, and proposals made by the Administration.

TABLE 13.—*Gross national product, 1969 and projections for 1970–75*

[Billions of dollars, 1969 prices; calendar years]

Claim	1969, actual	Projections					
		1970	1971	1972	1973	1974	1975
Gross national product available.....	932.3	944	980	1,042	1,103	1,150	1,200
Claims on available GNP.....	932.3	944	980	1,042	1,100	1,144	1,188
Federal Government purchases.	102.0	93	89	88	87	87	86
State and local government purchases.....	112.7	116	120	125	131	137	142
Personal consumption expenditures.....	576.0	594	620	664	704	735	769
Gross private investment.....	141.7	141	152	166	178	186	192
Business fixed investment.....	99.3	103	105	111	116	120	125
Residential structures.....	32.2	29	34	40	46	49	49
Other investment.....	10.1	10	14	15	16	17	18
Excess of claims.....	.0	0	0	0	—3	—6	—12

Note.—Projections are based on projected Federal expenditures (see Table 14) and their influence on various components of GNP.

Detail will not necessarily add to totals because of rounding.

Source: Council of Economic Advisers.



Large claims not recognized in these estimates exist and new ones will emerge. However, it is sufficient here to show that the existing, visible, and strongly supported claims already exhaust the national output for some years ahead. This is not to say that no other claims will be satisfied, or that claims included in these calculations should have preference over claims not recognized here. The basic point is that if other claims are to be satisfied some of those recognized here will have to be sacrificed.

The projection of claims on the national output shown here corresponds to a projection of Federal spending. Federal spending affects not only the Federal Government's own purchases of goods and services but also the purchases of State and local governments, through Federal grants to them, and the purchases of consumers, through Government transfer payments. The method of estimating the claims is described briefly here and in more detail in the Appendix to this chapter.

1. The estimate of Federal spending includes a *baseline* projection of the costs of the Federal Government's 1970 program, in 1969 prices, and the costs of new programs already proposed by the Administration. The baseline adjusts the 1970 program for changes related to population, workload, and pay increases in 1969 dollars. The new initiatives, shown separately in Table 14, project the 1969 dollar costs of proposed new programs, such as the Family Assistance Program and Revenue Sharing, and proposed expansion of existing programs.

2. State and local spending is the estimated consequence of projected growth of GNP (in 1969 prices) and population to 1975 plus the grants included in the Federal expenditure projections of Table 14.

3. Personal consumption is the expenditure that would result from the amount of income that households would have available if the projected GNP at 1969 prices were produced, present tax laws remained in force (with the income tax surcharge expiring June 30, 1970), and governments made the transfer payments included in the government expenditure projections.

TABLE 14.—*Projections of Federal expenditures, national income accounts basis, 1970-75*  
[Billions of dollars, 1969 prices; calendar years]

Priority category	1970	1971	1972	1973	1974	1975
Federal expenditures.....	189	192	196	200	204	206
Baseline.....	188	186	186	188	190	191
Purchases of goods and services.....	92	88	87	86	85	84
Transfer payments to persons <sup>1</sup> .....	56	59	62	65	68	70
Grants-in-aid.....	22	22	22	23	23	24
Other.....	19	16	15	14	14	14
New initiatives.....	1	6	10	12	14	15
Purchases of goods and services.....	1	1	1	1	2	2
Transfer payments to persons <sup>1</sup> .....	0	3	6	6	5	5
Grants-in-aid.....	0	2	3	5	6	7
Other.....	0	0	0	0	0	0

<sup>1</sup> Excludes transfer payments to foreigners, which are included under "Other."

Note.—Detail will not necessarily add to totals because of rounding.

Source: Bureau of the Budget.

It is assumed that personal saving is 6.5 percent of personal disposable income.

4. Residential construction expenditures are the amounts consistent with reaching the goal specified in the Housing and Urban Development Act of 1968 along the path of housing construction shown in the Second Annual Report on National Housing Goals.

5. Business fixed investment in real terms is estimated to decline as a fraction of privately produced real GNP from 12 percent, which it has averaged since 1966, to 11.5 percent by 1975. This would continue the downward trend of the ratio of capital stock to real output experienced since World War II.

6. The two other components of real GNP—inventory investment and net exports—are both projected to rise slowly with their total growing from \$10.1 billion in 1969 to \$18 billion in 1975 (in 1969 prices).

#### BALANCING CLAIMS AND RESOURCES

The results of these calculations are summarized at the bottom of Table 13 in the figures on the excess of claims over resources. The projected claims, which assume no addition to present Federal nondefense programs beyond those already proposed by the Administration, would approximately absorb all available resources through 1973 and leave room for significant additions only by 1975.

The basic lesson of the estimates is that the country is already at a point where, despite prospective rapid growth of output, a decision to satisfy an existing claim on a larger scale or to satisfy a new claim will require giving up something on which people are already counting.

These estimates are based on a number of assumptions which may turn out to be wide of the mark. Even a generous allowance for errors in the assumptions, however, is unlikely to change the fundamental picture. And some of the assumptions may themselves be optimistic. If potential output grew by only 4.0 percent rather than 4.3 percent, the excess of claims would increase, but only slightly, because consumption expenditures and business investment, which amount to about 80 percent of total claims, would also be smaller. On the other hand, the excess of available output over claims would be a little larger, about \$4 billion more in 1975 (in 1969 prices), if personal savings were 7 percent of disposable income instead of the 6.5 percent assumed here. This is possible, but it is no more likely than that the personal savings rate should turn out to be 6 percent, which would increase claims on available output. Other departures from the assumptions are possible—certainly there will be some—but none seems sufficiently large or probable to change the conclusion. Moreover, there is little reason to expect that these departures will all be in the same direction.

Inability to meet all the visible claims would not deny that the country is rich and growing richer. The most comprehensive index of the economic

condition of the population—real per capita personal consumption—would rise about  $3\frac{1}{2}$  percent per year under the Table 13 projections, compared to  $2\frac{1}{2}$  percent per year in the period 1957 to 1967. The conclusion is simply that choices must be made.

In fact, of course, choices will be made. The total of satisfied claims cannot exceed the available output. Policies, whether of omission or commission, will determine which claims get satisfied and which do not. The following discussion of ways in which claims and resources can be brought into balance is not intended to support any particular claims or any particular ways of meeting them. It is only intended to illustrate the options that are permitted and not permitted by the arithmetic of the economic system.

If the projections of output prove reasonably accurate, and Federal expenditures run at the projected level, or higher, with taxes unchanged, trimming of claims on output would fall mainly on investment. Private saving, together with the Federal surplus, would be inadequate to finance all the private investment claims shown here through 1973. Interest rates would rise, and, while this might stimulate saving, the main effect would be to make funds scarce and expensive and keep some investment demands from being met. Since housing is more sensitive to the supply of funds than other investment, the shortfall would probably be relatively larger in housing. If, however, the shortfall occurred in capital outlays of businesses, productivity would tend to be adversely affected, and the economy's rate of growth would lag.

Government policy could bring about a different pattern of resource allocation. If it were desired to do so, the combined investment claims shown here could be satisfied by either of two approaches, or some combination of them. One would be to hold Federal expenditures down, below the level projected here through 1973 and not too much higher thereafter. Federal purchases of goods and services would be lower, and State and local purchases and consumers' purchases would also be lower as a result of smaller grants and transfer payments. With purchases in these categories lower, more of the national output would be available for investment. As a corollary to this, there would be a larger budget surplus, which would make more funds available to finance private investment. To obtain the same level of investment with higher Federal expenditures, the second alternative would be to raise taxes to restrict private consumption, thus releasing resources for investment and sustaining the budget surplus needed to finance investment. These methods of generating a surplus to finance a desired total of private investment would not in themselves assure any particular division of the total between business investment and housing.

What has been said about the combination of taxes and expenditure programs that would be required to permit satisfaction of the private investment claims implies a certain relationship between the Federal surplus and private investment. The surplus must be large enough, when added to pri-

vate saving, to finance the private investment. The higher the private investment desired, the larger, in general, will be the budget surplus required. This is the main longrun implication of a budget surplus.

The additional surplus that would be required to support an additional amount of private investment, say \$1 billion, would probably be larger than \$1 billion if the additional surplus is created by raising taxes to reduce consumer spending. This is because the higher taxes will probably reduce private saving somewhat, and the surplus must be large enough to cover the additional investment desired plus the loss of private saving. Thus, on the assumption used in this section that personal saving is 6.5 percent of personal income after tax, additional personal taxes and a further surplus of \$1.07 billion would be required to increase the total of private saving and the surplus by \$1 billion.

These are propositions about the national income accounts budget, which, unlike the unified budget, does not include as an outlay the net lending of the Federal Government. To the extent that net lending of the Federal Government to finance private investment is already included in the unified budget as outlays, the surplus that would be required in the unified budget would be smaller. The required surplus would be the excess (if any) of desired private investment over private saving plus Government net lending. That would not, however, affect the amount of taxes that would be required to bring about a given amount of private investment. It would only mean that part of the taxes would be used to finance the Government lending, rather than the repayment of Federal debt which would permit private lenders to supply more funds to private investment.

## CONCLUSIONS

The estimates of this section are, of course, hypothetical calculations based on inevitably somewhat arbitrary assumptions. The costs of programs now on the books may turn out to be different from projections used here. Moreover, programs now in being can be modified or eliminated if people decide that costs are excessive or that other things are more important. The capability of the economy to grow may be different from what has been assumed. Nevertheless, for all of their necessarily hypothetical character, these estimates do highlight three important points that have major implications for fiscal policy. First, existing claims upon the growing available national output already exhaust the probable output and real national income that the economy can generate for several years to come. The satisfaction of a new claim, therefore, necessarily will require the rejection of another claim which now exists. Second, the Federal Government's fiscal policies will directly affect which claims on our national income are satisfied—not only the direct Federal claims but also State, local, and private claims. Federal actions that increase State, local, or private expenditures—even if those actions are not reflected in the Federal budget—

generate claims against the national output. Therefore, the Federal Government should be concerned that its extrabudgetary as well as its budgetary actions do not generate excessive claims or do not cause more important uses of the national output to be displaced by less important ones. Third, the level of private investment in business plant and equipment, and particularly in housing, is necessarily directly affected by decisions that determine the character of the budget and the target for a longrun average surplus or deficit. The budget and the budget surplus should not be regarded merely as conventional symbols of sound finance; they have a profoundly important functional role in achieving national goals.

## APPENDIX

### Basis for Estimates of Output and Claims

#### POTENTIAL AND PROJECTED GNP

The available total output by years from 1970 to 1975 is estimated in two stages, one yielding potential output and the second yielding projected available output.

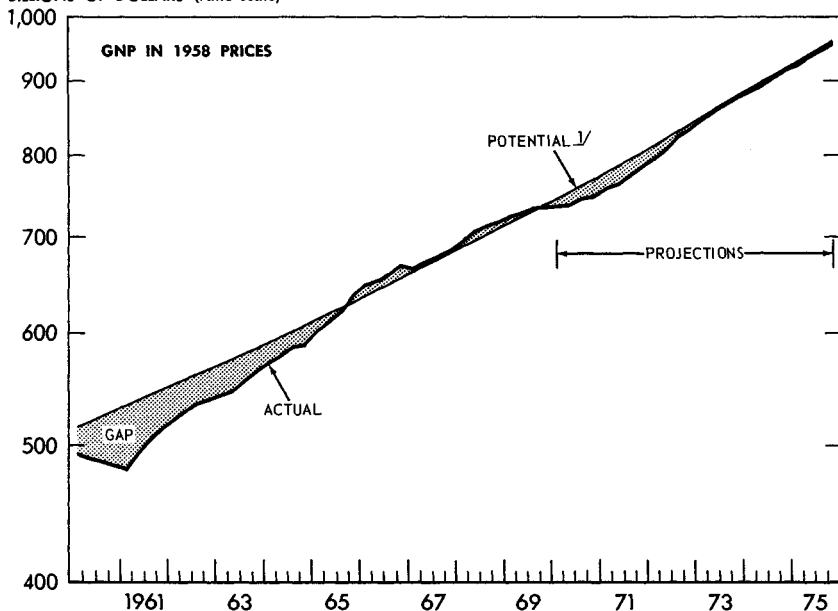
Potential output is considered to be the output the economy would produce when operating at a 3.8 percent unemployment rate. This is slightly above the rate in the last half of 1969 when actual output was considered to be close to the potential. The annual growth of real potential output is determined by the growth of the labor force, estimated at  $1\frac{3}{4}$  percent per year, the decline in annual average hours of work per person, estimated at one-quarter of 1 percent per year, and the growth of output per man-hour. In the private sector of the economy, output per man-hour is estimated to grow by about 3.1 percent per year—less than in the early 1960's when resource utilization rose, but more than in 1965–69 when the economy operated under excessive demand pressure. Allowance for the fact that productivity growth in the Government sector, which produces about 9 percent of national output, is zero by definition (because Government output is measured by labor input) reduces the overall productivity growth rate to about 2.8 percent per year. Combined with the estimates of labor input, this yields about a 4.3 percent rate of growth of potential real GNP.

Projected available real output lies below potential output from 1970 to 1972 because some gap between actual and potential output is necessary to slow down inflation. A gradual closing of the gap is projected to permit the potential to be regained without reviving inflation. Potential and projected real GNP, in 1958 dollars, are shown in Chart 8. Projected available GNP in 1969 dollars is shown at the top of Table 13.

Chart 8

## Gross National Product, Actual and Potential

BILLIONS OF DOLLARS (ratio scale)\*



\*SEASONALLY ADJUSTED ANNUAL RATES.

1/ TREND LINE OF 3.5 PERCENT FROM MIDDLE OF 1955 TO 1962 IV, 3.75 PERCENT FROM 1962 IV TO 1965 IV, 4 PERCENT FROM 1965 IV TO 1969 IV, 4.3 PERCENT FROM 1969 IV TO 1970 IV, 4.4 PERCENT FROM 1970 IV TO 1971 IV, AND 4.3 PERCENT FROM 1971 IV TO 1975 IV.

SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

### CLAIMS ON THE NATIONAL OUTPUT

#### *Federal Expenditure Projections*

Federal expenditure projections are presented before those for the private and State and local government sectors, because the level and nature of Federal expenditures affect the other expenditure components. The amount of Federal transfer payments to individuals affects consumer expenditure, and the level of grants affects State and local purchases. Because of these effects it is convenient to have an initial projection of Federal spending preparatory to making projections of expenditures in the rest of the economy.

**Baseline Expenditures.** The cost of the 1970 Federal program, adjusted for increases in workload and pay increases at 1969 prices, gives the projection of baseline expenditures in Table 14, broken down into purchases of goods and services, transfer payments, grants, and other expenditures.

The major increases in the baseline are projected for *transfer payments*, which rise by \$14 billion (in 1969 prices) from 1970 to 1975, and *grants* to

State and local governments, which rise by \$2 billion in that period. Much of the increase in transfers will be due to increased coverage and population growth, as more people receive checks for social security, disability insurance, and so forth. But part will also be due to higher real benefits. Much of the increase in grants will come in essentially open-ended programs, such as Medicaid, in which the Federal Government must provide matching funds if the States choose to provide funds for the program.

*New Initiatives.* The costs at 1969 prices of new programs proposed by the Administration in the Fiscal 1971 Budget are added to the baseline expenditures to give the projections of Federal expenditures used here. These in turn are broken down into purchases, transfer payments, grants, and other expenditures.

The costs of Federal programs at 1969 prices are projected to rise from \$189 billion in 1970 to \$206 billion in 1975. Two aspects of these expenditure projections are especially noteworthy. First, the projections include expansions of transfer and grant programs and a reduction of purchases. Expanded Federal programs would focus upon providing money to people in transfers, and to States in grants, rather than upon purchasing output directly. Second, projected Federal expenditures build up rapidly through 1974 and rise less rapidly thereafter. If this path were in fact to materialize, the claims-resources position would be tighter in the early 1970's, and a bit easier in the middle 1970's. But this flattening out of the expenditure path may instead reflect simply the difficulty of seeing more than 3 or 4 years ahead. As these years arrive, further proposals for new programs or extensions of existing programs can be expected to come forward. Thus it should probably be assumed that the position will be just as tight in the middle 1970's as in the next year or so.

#### *State and Local Government Purchases*

State and local government purchases of goods and services at 1969 prices are projected to grow with real GNP, population, and projected levels of Federal grants-in-aid from 1970 to 1975. Projected growth of these items yields the estimates of State and local purchases shown in Table 13. In 1969 dollars, State and local purchases are projected to increase from \$116 billion in 1970 to \$142 billion in 1975, or at an average annual rate of 4 percent. Of the \$26 billion increase in State and local purchases from 1970 to 1975, \$8 billion is projected to be due to population increases. This leaves a projected increase of \$18 billion over and above the cost of providing State and local services at the present per capita level. This \$18 billion represents an increase of 2.8 percent per year in the real per capita quantity of the services provided by State and local purchases, compared to the 1962 to 1968 average increase of 3.8 percent.

#### *Personal Consumption Expenditures*

Consumer spending is a fairly stable fraction of personal income after taxes, aside from shortrun variations. Personal income other than transfer

payments is assumed to be 73 percent of GNP. Adding to this transfers by Federal, State, and local governments gives total personal income. Projected Federal, State, and local personal taxes are subtracted to arrive at disposable personal income, which is allocated between consumption expenditures, personal interest and transfer payments, and personal saving.

The projections assume a saving rate of 6.5 percent, and 2.5 percent for personal interest and transfers, leaving 91 percent for consumer spending. The projections of consumer expenditures in 1969 prices, based on the projected Federal expenditures, are shown in Table 13.

Two important assumptions in the consumer spending projections should be noted. First, the 6.5 percent saving rate is near the middle of the 4.9–7.4 percent range experienced since 1960. Second, the projections in the table assume present tax law.

### *Private Investment Demand*

The remaining four elements of private demand are estimated independently of the Federal expenditure projections. These are business fixed investment, residential construction, inventory investment, and net exports.

*Business Fixed Investment.* Since cumulative net business investment equals capital stock, the projection of investment should yield an accumulated capital stock consistent with the projected GNP path and a reasonable capital-output ratio.

Since 1966, real business fixed investment has averaged 12 percent of real private output. It is estimated that if this fraction gradually falls to 11½ percent by 1975, the ratio of capital stock to real output would continue the slow downward trend experienced since World War II. The projections of business fixed investment in 1969 dollars are shown in Table 13.

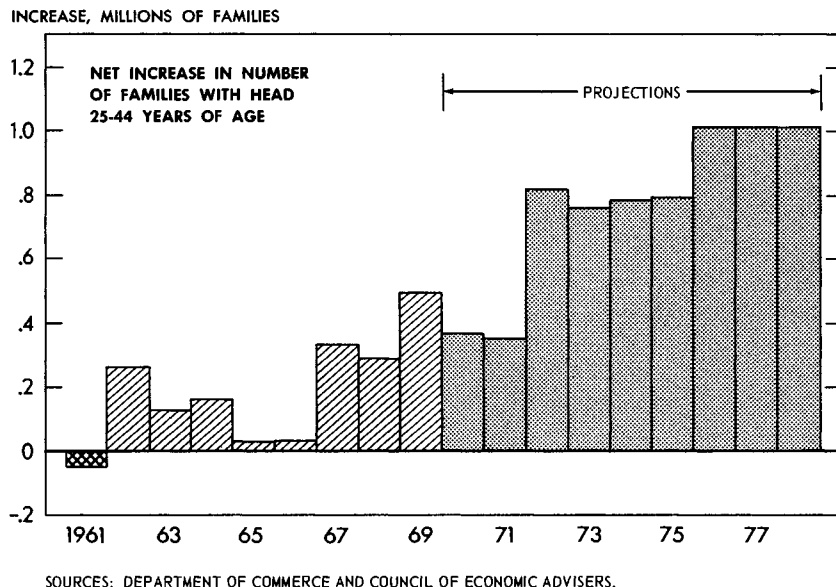
*Residential Construction.* A key area of the projections is residential construction. Twice in the last half decade homebuilding has been severely squeezed by the competition of the Federal deficit and high business investment for the supply of private saving. Moreover as Chart 9 shows there will be a substantial increase in the rate of family formation in the next 5 years. Both because of the backlog of need created by the housing declines in 1966 and 1969–70 and because of the increased demand for housing generated by family formation, the number of housing starts is likely to rise considerably in the early 1970's.

In the Housing and Urban Development Act of 1968, Congress stated a goal of 26 million new housing units to be constructed from fiscal year 1969 to fiscal year 1978. The Second Annual Report on National Housing Goals to be submitted by the President this month projects a path of housing construction, including both conventional and mobile homes, to 1978 which will meet the goal and is considered feasible. The conventional



Chart 9

## Net Family Formation



housing starts portion of this path, on which the residential construction projection is based, is shown in Chart 10.

This path of starts gives the residential construction projection in 1969 dollars shown in Table 13. The projection assumes residential construction expenditures per start (in 1969 dollars) of \$21,800—the 1959–68 average—from 1970 to 1975. This cost figure will turn out to be high if the cost-reducing potential of Operation Breakthrough, the industrial housing program of the Department of Housing and Urban Development, is fulfilled.

The two small remaining components of GNP—inventory investment and net exports—are both projected to grow roughly in line with GNP from 1970 to 1975. Inventory investment along trend is expected to be roughly a constant fraction of GNP, perhaps 1 percent. This would maintain an approximately constant ratio of stocks to final sales. Net exports are projected to expand from the 1969 low as the U.S. trade position improves.

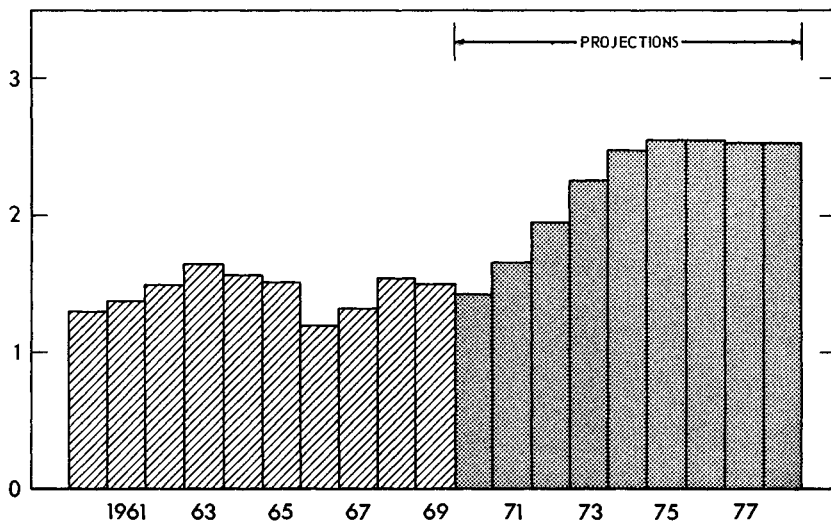
### *Total Expenditure Projections*

The second line of Table 13, “**C**laims on available GNP,” which adds up the expenditure projections assuming projected Federal expenditures, shows total visible claims on potential GNP.

Chart 10

## Housing Starts

MILLIONS OF UNITS\*



\*TOTAL PRIVATE AND PUBLIC. DATA EXCLUDE MOBILE HOME SHIPMENTS.

SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT.

To avoid confusion, it should be noted here that the "Claims on available GNP" of Table 13 is *not* the equilibrium GNP in 1969 dollars that would result if the "exogenous" investment and government expenditures were realized. This is because consumer spending is projected on the basis of present tax law, transfer payments in the Federal spending projections, and *available GNP*. Thus the difference between available GNP and "Claims on available GNP" is the reduction in exogenous expenditure needed to bring the demand for output down to the level of available GNP.