Chapter V   Public Expenditure, Investment and Private Consumption

This chapter estimates how available resources might be divided up between the public and private sectors, and between consumption and investment, given the level of GDP and the net resources devoted to the balance of trade. After reviewing the claims of the public sector and of private investment it will be possible to see how much is left over for private consumption, and to examine the implications for the growth of personal incomes.

Public expenditure

2. It is well known that it can be rather misleading to measure the share of resources appropriated by public expanditure at constant 1963 prices. In current price terms the share taken by the public sector tends to grow more rapidly because a substantial proportion of public expenditure is incurred for services such as administration, health, education and defence in which little or no productivity growth is imputed. The relative price effect - i.e. the extra growth of the public sector's share of resources when measured at current prices - is normally of the order of about 1% per year for all public expenditure on goods and services; the effect is attributable to current rather than investment expenditures.

3. Estimates published in the White Paper (Cmnd. 5178) imply that when measured at 1963 prices public expenditure on goods and services will grow between 1972 and 1976 at almost the same rate as par GDP. There will be rather faster growth of current expenditure and slower growth of investment than in the past.

4. Table V-1 shows past and projected ratios of public expenditure to GDP, both at constant 1963 prices and in current price terms. The latter figures for 1976 are based on estimates of the relative price effect in the White Paper.

Table V-1 Public expenditure on goods and services

(£ million, 1963 market prices)

Year	Current expenditure	Investment in dwellings	Other fixed investment	Total public expenditure on goods and services	Total as % of GDP at factor cost	
					At 1963 prices	At current prices
1961	4933	315	1644	6892	26.9	26.4
1965	5396 (2.3)	526 (13.7)	2061 (5.8)	7983 (3.7)	27.3	28.2
1969	5806 (1.8)	686 (6.9)	2297 (2.7)	8789 (2.4)	27.4	30.3
1972	6249 (2.5)	546 (-7.3)	2598 (4.2)	9393 (2.2)	27.7	30.8
Fast growth assumption						
1976	7000 (2.9)	537 (-0.4)	3020 (3.8)	10557 (3.0)	26.0	30.1
Slow growth assumption						
1976	7000 (2.9)	537 (-0.4)	3020 (3.8)	10557 (3.0)	27.8	32.2

Figures in brackets are average growth rates, % per year.

5. The share of resources absorbed by the public sector (measured at current prices) increased significantly between 1961 and 1965 and again between 1965 and 1969. The reason for the small size of the increase in the ratio of public expenditure to GDP since 1969 is that the relative price effect has been very much smaller than usual; and this can only have happened because the pay of public sector employees has risen unusually slowly relative to other incomes. The figure for 1972 is therefore a misleading guide to the share of resources absorbed by the public sector; and if the pay of public employees were to catch up again in relative terms, the current-price ratio of public expenditure to GDP in 1976 could be nearly 1% higher than the figures projected in the table.

Private investment

6. The level of private housebuilding in 1972 has been about 20% higher than in the previous year, while other private fixed investment has risen by only

4% above the very depressed 1971 level and is still lower than in 1970. Using the same methods as in the earlier paper to adjust private investment for variations in the pressure of demand, the underlying par growth rate since the middle 1960's is estimated to have been just under 6% per year.

7. In the past, booms in private housebuilding such as those in 1964 and 1968 have been followed by downturns of some severity. While the present boom must be expected to flatten off over the next two or three years, the level of private housebuilding is unlikely to decline because of the strong incentives to the private sector provided by government housing policy. Given the low levels of public sector housebuilding forecast in Cmnd. 5178, total investment in housing in 1976 is expected to be no higher than the previous peak in 1968, even under the assumption of fast growth of GDP

Table V-2 Private investment and stockbuilding
(£ million, 1963 prices)

Year	Fixed investment	Stockbuilding	Total investment	Total as % of GDP at factor cost
1961	2956	352	3308	12.9
1965	3449 (3.9)	436	3885 (4.1)	13.3
1969	3923 (3.3)	441	4364 (2.9)	13.6
1972	4232 (2.6)	100	4332 (-0.2)	12.8
Fast growth assumption				
1976	5638 (7.4)	493	6131 (9.1)	15.1
Slow growth assumption				
1976	5141 (5.0)	187	5328 (5.3)	14.0

Figures in brackets are average growth rates: % per year.

8. Other private fixed investment will grow more rapidly, recovering from very depressed levels in 1971 and 1972. An increase of 7% is expected next year and a further increase of about 12% in 1974. Under the slow growth assumption little further increase in expected, but under the stimulus of fast growth in demand private fixed investment is expected to continue to grow at 6% per year up to 1976.

9. The recovery in demand in 1972 and 1973 will probably lead to substantial stockbuilding in 1973. Published estimates show very large reductions in stocks in the first three quarters of 1972. But recent research(1) suggests that the official estimates of the stock appreciation component of the increase in value of stocks have been too high in recent years, and consequently that stockbuilding has been underestimated A revised series for stockbuilding has been constructed on the assumption that the stock appreciation component of the reported change in the value of stocks has been overestimated by a fraction rising from 11% in 1960 to 25% in 1965, and remaining constant thereafter. (See Appendix Table 11). The revised figures imply a rather stable ratio of end-year stock to GDP over the whole period 1960-72 and stocks do not appear to be very far below their normal levels relative to output even at the end of 1972.

10. Total private investment, including stockbuilding, absorbed a very low share of output in 1972. Even under the slow growth assumption the ratio of private investment to GDP is expected to rise sharply from under 13% in 1972 to nearly 15% in 1974; with fast growth in demand the ratio would rise to about 15½% in 1974. The upswing in private investment together with increases in public expenditure will absorb a considerable part of the increase in output over the next few years.

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(1) A project at the Department of Applied Economics sponsored by the Department of Trade and Industry has been investigating the measurement of stock appreciation by companies.

Private Consumption

11. To calculate par levels of private consumption and the future growth of consumption consistent with different assumptions about the growth of G.D.P. and about the balance of trade, consumption must be treated as the residual component of demand. It is implicitly assumed that consumption is stimulated or restrained by fiscal or monetary action so as to achieve the given overall growth of demand for G.D.P.

12. Under par conditions the rate of growth of private consumption must normally be slightly less than the rate of growth of G.D.P because of the tendency for investment to take a rising share of the available resources and because of the increased target surpluses on goods and services needed to maintain a reasonable balance of payments position. Over the past twelve years private consumption has actually grown at an average rate of 3% per year; the growth rate was much lower than this when the balance of payments position improved, during 1967-71, and rather faster in years such as 1972 when the balance of payments position was allowed to deteriorate.

13. Table V-3 gives summary projections for private consumption in 1972-6 under various different conditions; a full set of estimates will be found in Appendix Tables 11-14. It is worth noting that in 1972 G.D.P. was about £1,000 million (at 1963 prices) below par, defined as a level consistent with 2½% unemployment. But private consumption in the same year was if anything already above par; under conditions of steady growth and with adequate resources devoted to the foreign balance the whole of the extra £1,000 million of resources available in the par economy would have been required for fixed investment, stockbuilding and larger net exports.

Table V-3 Resources available for private consumption

(Expenditures at factor cost: £ million, 1963 prices)

Year	GDP (1)	Public expenditure	Private investment (2)	Balance of trade (3)	Private consumption
Actual					
1961	25609	6639	3149	-286	16107
1965	29118	7683	3700	-402	18138 (3.0)
1969	31939	8408	4153	18	19359 (1.6)
1972	33726	9037	4105	-710	21294 (3.2)
Par					
1972	34741	9037	4652	-48	21100
<u>Fast growth assumption</u>					
1976	40465	10157	5828		
(a) devaluation to $1.60 in 1973				306	24174 (3.2)
(b) continued depreciation to $2.00 in 1976				-1847	26328 (5.4)
(c) fixed exchange rate at $2.35, 1973-6				-2446	26926 (6.0)
<u>Slow growth assumption</u>					
1976	37802	10157	5052		
(a) devaluation to $1.80 in 1973				178	22416 (1.3)
(b) continued depreciation to $2.00 1976				-1050	23644 (2.7)
(c) fixed exchange rate at $2.35, 1973-6				-1648	24242 (3.3)

(1) Expenditure estimate of GDP at factor cost.

(2) Including stockbuilding.

(3) Exports less imports of goods and services, at factor cost.

Figures in brackets are average growth rates, % per year.

14. For the period up to 1976, the fast G.D.P. growth assumption will naturally permit quite rapid growth of private consumption. But only if the balance of payments could be allowed to go into massive deficit (as under (b) and (c) in Table V-3) could consumption grow as fast as output. If a reasonable balance of payments position is to be achieved (as for example under (a) in the Table), the average growth of consumption will have to be restrained to about 3% per year, considerably less than the assumed 4½% per year growth of G.D.P., in order to leave adequate resources for private investment, stockbuilding and net exports.

15. Under the slow growth assumption, Table V-3 shows a very low average growth rate of consumption (1.3% per year under (a) in the Table) unless the balance of payments could be allowed to run into huge deficit.

16. The main squeeze on private consumption comes in 1973-4. Whether under the fast or slow growth assumptions, there would be large increases in investment and stockbuilding in these two years as compared with 1972. Public expenditure is also forecast to rise particularly fast. If progress is to be made towards putting the balance of payments to rights, there will have to be a virtual standstill in private consumption for at least the next year because it is already over 3% higher than the average level in 1972.

17. Once the disposition of resources has been put into a more sustainable pattern, with larger provision for investment and net exports, private consumption could of course be allowed to start to grow once more at almost the same rate as G.D.P.

Consumption and fiscal policy

18. The real income of the personal sector varies in relation to G.D.P. not only because of taxation and transfers from the public authorities but also on account of changes in the ratio of import prices to domestic prices and because

of variations in the share of income accruing to companies as undistributed profits. To see how the growth of personal income and hence consumption may have to be stimulated or restrained relative to G.D.P. we have made estimates of the likely effect of some of these influences on personal consumption.

19. The projections already described in the preceding section show required levels of private consumption, under alternative assumptions about the future growth of G.D.P. and exchange rate movements, needed to provide the assumed growth of demand. Estimates can also be made of the levels of consumption which would be generated by the assumed growth of G.D.P. on specified assumptions about fiscal policy, import prices and the distribution of income between companies and the personal sector. The projections of generated consumption in this paper allow for changes in the share of income retained by companies which occur because of changes in the pressure of demand; but they assume a constant personal savings ratio, a constant ratio of net taxation to income and constant relationships between import prices, export prices (which also affect company profits) and domestic prices. The projections start from the actual ratio of consumption to G.D.P. in 1972.

20. The difference between required and generated consumption (the 'initial consumption gap') must be assumed to be closed either by changes in the ratio of net taxation to income or by movements of import and export prices relative to domestic prices. The effects of the latter ('terms of trade' effects) have been calculated on the same assumptions as in our earlier paper. Figures for the terms of trade effect can be used to show how much of the initial gap remains to be closed by fiscal monetary action.

21. Appendix Table 15 gives detailed projections of the initial consumption gap and terms of trade effects for 1972-76 under various assumptions about the growth of G.D.P. and movements of the exchange rate. Par figures are shown in Table V-4 below. Already in 1972 there is an initial consumption gap

because of the need to make more resources available for investment and the balance of trade; the less favourable terms of trade in the par economy (because of the lower level of relative costs needed to achieve sufficient export growth) would largely have closed this initial gap. This implies that the actual effects of net taxation on consumption for 1972 as a whole were not very different from par requirements; but of course the average for the year only reflects a part of the large tax reductions in the budget and by comparison with the present position the par economy would require tighter fiscal policy.

Table V-4 Par consumption and fiscal policy

(£ million, 1963 prices)

	Required consumption	Generated consumption (1)	Initial gap	Terms of trade Effect (2)	Fiscal policy Effect (3)
1972	25202	25942	-740	-576	-164
1973	25618	26687	-1069	-748	-321
1974	26326	27494	-1168	-915	-253
1975	27356	28472	-1116	-1072	-44
1976	28495	29528	-1033	-1230	197

(1) Assuming the same ratios of net taxation to income and the same relationship between import and export prices and domestic incomes as for the actual economy in 1972.

(2) The effects on generated consumption of differences between par and actual 1972 import and export prices (relative to domestic incomes).

(3) Additional effects on generated consumption required to make it equal to required levels.

See Appendix for more detailed explanations.

22. The par estimates for 1973-76 show an increasingly deflationary terms of trade effect because of the need for continued reductions in relative costs to maintain the external position. The projections suggest that very slight fiscal stimulus might be needed after 1973 to keep demand growing at the par rate.

23. The par figures show the implications of assuming that the economy follows a path of steady growth and balance of payments equilibrium. Alternative projections starting from the actual position in 1972 (see Appendix Table 15) have quite different implications for the consumption gap and fiscal policy, depending on what is assumed to happen to the balance of payments. Without large devaluation continued fiscal stimulus is required to sustain the growth of demand in the face of rapidly widening deficits on trade in goods and services. If very large devaluations are assumed, the growth of consumption must be restrained in order to leave room for fast growth of exports within the assumed overall totals for G.D.P; most of the necessary deflation of domestic demand is projected to come from the terms of trade effect.