

The main purpose of this study is to provide information which will assist discussion of policy decisions which have their main consequences some years after they are taken. A particular focus of the exercise is public sector expenditure which can only be adjusted in the short run to a minor extent and at considerable cost to longer-run social objectives.

2. Public sector expenditure is conventionally classified into several categories; expenditure on goods and services, current transfers to the private sector, capital transfers to the private sector, and current and capital transfers abroad. Each of these types of expenditure has a number of important kinds of effect on the economy. The consequences of expenditure policies with which this study is mainly concerned are its effects on the level and composition of aggregate demand and its implications for the net burden of taxation on the personal sector. Public expenditure programmes do of course also have major effects on the distribution of real income between different social groups and on the efficiency of production in the economy, as well as their direct contribution to the achievement of various social and political goals.

3. The procedures conventionally used for short term forecasting and demand management are by now very familiar. It is customary first to forecast what would actually happen over the next eighteen months, particularly to output, unemployment and the balance of payments, on the assumption that there is no change in policy. Forecasts of the consequences of alternative policies can also then be made, and it is on the basis of these forecasts that the Government decides what to do. Many aspects of policy, such as public expenditure, local authority rates, the exchange rate and trade policy, are assumed to be given; and so, broadly speaking, is the underlying structure and rate of growth of the economy. The short term forecasting exercise is designed to guide the Government's decisions on changes in Central Government tax rates and on credit conditions, which are in practice the most flexible instruments for management

of the economy which the Government possesses.

4. In the end, the power of fiscal and credit policy to regulate the economy is rather limited, particularly as regards the composition of demand in relation to G.D.P. and the surplus or deficit on the balance of payments. Decisions about the desired level of G.D.P. and pressure of demand cannot be taken independently of their inevitable consequences for the burden of personal taxation and for the balance of trade. The outcome is generally a compromise forced by circumstances over which, in the short term, the Government has little control.

The par economy as a framework of analysis

5. In this study we have set up a framework for examining those problems in economic management which can only be resolved in a longer term context. For this purpose we deliberately avoid any specific assumptions about short-term policy decisions and do not attempt to make forecasts of what would actually happen under unchanged policies. As the horizon of policy-making is extended further into the future, such forecasts would have little relevance because short-run decisions will be able to be reconsidered and revised many times in the light of actual developments before our time horizon, set in this exercise at 1975, is reached.

6. We abstract from the complexities of short-term demand management by assuming that the level of aggregate demand can be adjusted more-or-less to any desired level, subject to the usual resource constraints; fiscal and credit policy is assumed to act on demand through private consumption, and the latter is therefore treated as a residual in our calculations as though it were a direct instrument of Government policy.

7. In the main set of estimates we also abstract from the complexities of exchange-rate management and the control of domestic inflation and assume that the competitiveness of the U.K. economy can be adjusted so as to achieve a satisfactory balance of payments.

8. These two abstractions enable us to construct a set of estimates of the economy as it could have been in the past, or would be in the future, if demand were adjusted so as to maintain a steady level of unemployment and if the balance of trade were regulated to ensure the long-term viability of the U.K.'s reserve position. The economy, regulated in this way, will be termed the par economy. For the past it is reconstructed from the recorded actual outcome, as measured in the national income and balance of payments accounts, and for the future it is projected on the basis of our very imperfect knowledge of the underlying trends and exogenous changes which are to be expected.

9. The estimates for the par economy are in fact conditional predictions of the state of the economy given a certain pressure of demand and an assumed balance of payments position. Given our methods and assumptions, the estimates are defined precisely by the postulated steady level of unemployment and trade surplus or deficit. An alternative but equivalent definition of the estimates is given by postulated levels of G.D.P. and the terms of trade (which reflect the competitiveness of the U.K. economy).

Alternative projections

10. It is also useful in exploring future prospects for the structure of demand and the balance of payments to make alternative estimates which are projections conditional on assumed movements of actual G.D.P. and the terms of trade. In this exercise we have made two such hypothetical projections which are designed to explore the problems which may arise as a result of reflation of demand up to 1975, with or without devaluation. These hypothetical projections are in no sense forecasts of what would happen under unchanged policies. They may imply substantial changes in tax rates or credit controls.

Relevance to short-term and medium-term strategy

11. From the discussion above it should be clear that this study is not intended as a substitute for any conventional pre-Budget exercise. But it

does enable us to reach some broad conclusions about budgetary strategy.

The problems which emerge from our projections to 1975 are directly relevant to short-term policy because they help to show whether current policies are temporary or sustainable in the longer run. They indicate whether the short-term objectives are likely to prove consistent or in conflict with the longer-term requirements of economic management.

12. The main conclusions which can be reached using this framework of medium-term analysis concern the management of the balance of payments, the implications of public expenditure for the allocation of resources to the private sector, and its consequences for the real burden of taxation on the personal sector.

Plan of the study

13. The detailed analysis in the following chapters starts with an examination of the relationship between aggregate demand (G D P. at factor cost) and the levels of employment and unemployment. This provides the basis for an estimate of the resources available in the par economy, as measured by G D P. at factor cost, at the steady 2.5 per cent unemployment which is adopted as a definition of par in this study.

14. Chapter III investigates the various non-trade balance of payments flows and the balance sheet of foreign assets and liabilities in order to establish reasonable targets for the balance of trade which then fully define the par economy for the purposes of this exercise. The following chapters estimate the resources required to achieve the target balance of trade, for public sector expenditure (forecast for the future in the White Paper on Public Expenditure, Cmnd. 4829) and for private investment and stockbuilding.

15. The projections of the balance of trade to 1975 reveal that at the par pressure of demand, or in the course of any actual reflation, severe balance of payments problems are likely to be encountered by 1974-5.

16. Given the available level of G.D.P. at the par pressure of demand and all the claims on resources estimated in earlier chapters, consumers' expenditure is obtained in Chapter VII as a residual demand which matches the aggregate level of demand with G.D.P. Different estimates of consumers' expenditure are then derived on alternative assumptions about the real burden of taxation; these latter estimates represent the level of private consumption which would normally be generated by the flow of incomes at the given level of G.D.P. The difference between required consumption and that which would be generated under given fiscal assumptions indicates the size of the 'tax gap', or the increase (or reduction) in real taxation of the personal sector, which would be required in order to adjust aggregate demand to the postulated level.

17. The estimates indicate that given the levels of public expenditure forecast in the White Paper, private consumption would have to fall as a share of G.D.P. (as compared with the actual position in 1971) by 1975, even if the pressure of demand is by then at, or above, par. The increased pressure of demand would in itself cause some reduction in the share of private consumption, given an unchanged real tax burden, because of the improvement in the share of company profits; a further small reduction in the share of consumption is expected to follow from a rise in the personal savings ratio from its abnormally low level in 1971.

18. The calculations on which our conclusions rest are based on uncertain assumptions and are therefore subject to wide margins of error. It appears that under all the conditions which we have postulated, the share of consumption in G.D.P. in 1975 would be more-or-less appropriate without any increase in the net burden imposed by taxation and the terms of trade, as compared with the present position. A policy of reflation raises serious balance of payments difficulties which could be solved by devaluation. But the personal sector need not suffer the deflationary consequences of the implied deterioration in the terms

of trade provided the par pressure of demand is maintained by appropriate fiscal action. If, on the other hand, the balance of payments problem were to be staved off for a time by deflation, the personal sector would inevitably suffer a very large loss of resources potentially available for consumption.

19. The method we have developed will in due course enable us, at least in principle, to verify the predictions we have made. We have evolved a precise way of converting the actual to the 'par' past; we shall be able to use these precise operations to convert future 'actuals', as these become available, to par values which can be directly compared with those we are now presenting.

It is admitted that the strict implication of our method (to the extent it has so far evolved) is that there is no interaction between the way the economy has been or will be managed in the short term and its structural evolution through the medium and long term. We are not begging any questions, however. We make this assumption because we cannot establish any presumption about these interrelationships. In other words, our estimates of the par economy are intended as genuine estimates of how the economy would have evolved under the conditions defined.