

That the placement of government orders ("obligations incurred" by the Federal agencies) is the phase of the government spending process which energizes private production on government account has been noted by a number of observers:

The initial stimulus to production is provided by government contracts for procurements.³¹

* * * it is the placing of a contract, or its anticipation, which leads industry to plan its acquisition of materials and labor and to schedule its production.³²

The initial impact of Government purchases results when new orders are placed * * * New orders initiate a demand for raw materials, working capital, and labor required in manufacturing the products. The flow of new orders has had an important influence on inventory policy and rate of production in certain durable goods and industries such as transportation equipment and primary metals, where defense orders represent an important part of their total business.³³

It is in the stimulus to productive activity rather than in the minor amounts of initial "make ready" production that the contract placement stage exercises an important effect on economic activity.

PHASE III. PRODUCTION OF GOODS

As quantity production gets under way on the government order, payments are made by the government contractor for wages to the employees engaged in the work, materials delivered, and the interest due on the working capital loan. He will also be accruing profits on the order.³⁴ The costs incurred by the contractor during the entire production period, i.e., the "value added," should total the amount of the order.

The outlays of government contractors are not reflected in government purchases of goods and services nor in any other government expenditures series at the time they are made. These outlays will currently show up in GNP—in the change in inventory segment of gross private domestic investment.

Inventories, as measured in the national income accounts, include the following kinds of goods: (1) all types of raw materials and supplies that must be kept in stock if production is to flow smoothly; (2) a certain quantity of goods in semifinished state, so-called work in process; and (3) stocks of finished goods. Accordingly, government-ordered production in the private sector will show up in GNP (on a value-added basis) as it goes through the above three stages prior to its receipt by the Government and its recording as a government expenditure.

The *Survey of Current Business* has explained the phenomenon quite clearly:

After work starts on government contracts, there is a considerable period, depending upon the type of goods in question, during which such production is recorded as private investment—specifically, as a component of the change in business inventories. It is only upon delivery of finished goods that government expenditures are affected.³⁵

The amount of production on government orders remaining in business inventories during a given period cannot be identified in the

³¹ Melvin Anshen and Francis D. Wormuth, *Private Enterprise and Public Policy*, New York, Macmillan, 1954, p. 530.

³² John Perry Miller, *Pricing of Military Procurements*, New Haven, Yale University Press, 1949, pp. 24-25.

³³ Federal Reserve Bank of Philadelphia, "The Budget for 1956," *Business Review*, February 1955, p. 11.

³⁴ "It is * * * a generally accepted accounting procedure to accrue revenues under certain types of contracts and thereby recognize profits, on the basis of partial performance * * * Particularly where the performance of a contract requires a substantial period of time from inception to completion * * *"

American Institute of Accountants, *Restatement and Revision of Accounting Research Bulletins*, New York, 1953, p. 95.

³⁵ *Survey of Current Business*, November 1950, p. 8.