

surgery the patient may die of peritonitis. In using a medical simile to illustrate a point, let me add that the patient with whom we are concerned enjoys a basically quite good constitution. This we should not forget when considering what treatment to recommend for his ailments.

In order to evaluate the adequacy of the fiscal and economic policies proposed in the Budget and Economic Report we should appraise the relative strength of the inflationary and recessionary forces. In order not to disappoint you, let me admit right now that we can at best consider certain probabilities and then discuss the fiscal and economic policies which are most appropriate, recognizing the elements of uncertainty in the evaluation of both the inflationary and recessionary tendencies.

I. INFLATIONARY TENDENCIES EMANATING FROM THE BUDGET

The Budget, as it has been transmitted to Congress, provides for a continued rise in expenditures, but at a pace which is slowing down. The slowdown is particularly pronounced in defense expenditures. The annual rate of increase was \$7.8 billion from the first to the second half of calendar year 1966. According to the estimates implied in the fiscal 1968 Budget, this rate of increase will go down to \$2.4 billion from the first half to the second half of calendar 1967 (see Appendix Table 1). This committee has been assured that the defense expenditures for fiscal 1968 present a more realistic estimate than the one transmitted a year ago. This year's estimate is based on the assumption of continuing the war in Vietnam and is intended to reflect future military requirements resulting from present war strategy. Such a planning assumption expresses neither our wishes nor a probability statement. It is the most useful planning assumption, if at the same time contingency plans are developed for the case of war escalation and especially for the, I hope more likely, case of de-escalation of the war. Even though I am not an expert on the financial requirements of military plans it appears to me that under the assumption of continued war the projected flattening of the increase in defense expenditures may turn out to be on the low side, although I do not mean an upward revision of the magnitude which was experienced for the fiscal year 1967. I repeat, my impression that the expenditure estimate for defense may be low relates to the assumption of continued war with no end in sight, which means continued replacement of used-up matériel.

The revised 1967 Budget shows a substantial upward revision also in the non-defense activities of the Federal Government, especially if measured by the administrative budget. This is due in part to a failure to sell as many assets as was estimated, and to the effects of rising interest rates on the Budget, but also in part to actions of the Congress and administrative changes in various programs. Several members of the Congress have expressed their conviction that the non-defense budget could and should be substantially reduced. I do not claim to have any more insight into the political considerations of the Congress than into military requirements, but in view of the relative tightness of programs with which I am familiar, and in view of the economic and social significance of the nondefense programs, I regard it as a prudent assumption that in the final analysis reductions of and additions to proposed nondefense expenditures may offset each other.

In evaluating the economic impact of these expenditures it should be noted that the proposed increase in social security benefit payments is likely to be immediately translated into substantial increases in demand for a great variety of consumer goods (the recipients being a group which tends to spend almost all its disposable income). The large increases in military procurement and in the Medicare programs that made for most of the increase in the fiscal 1967 budget had a narrower effect which created bottlenecks and had probably a lesser impact on the growth in total Gross National Product in real terms (see Appendix Table 1).

Expenditures show the largest over-all increase from the first to the second half of calendar 1966. It was also during this period that a swing occurred from a substantial budget surplus to a budget deficit (in NIA terms). Deficits—without adoption of the proposed income tax surcharge—would continue to rise from \$2½ billion annual rate in the second half of 1966 to \$5 and \$7.3 billion in the first and second half of 1967. Thus, looking at projected Federal expenditures, revenues (under existing legislation), and deficits it appears that the