

down. Nevertheless, it should be recognized that interest rates are also pushed up by good business and by expectations that price inflation will continue for some time.

A tax increase and expenditure cuts should reduce the deficit and consequently reduce Treasury borrowing. But this would not permit the Federal Reserve to ease its policy suddenly and to bring about substantially lower interest rates. To the extent, furthermore, that consumers and businesses offset higher taxes through drawing

upon their liquid assets or borrowing, interest rates are likely to be supported. Under the circumstances, therefore, it would be highly desirable to remove restrictions on interest rates throughout the economy to permit markets to make adjustments. Andrew F. Brimmer, member of the Board of Governors of the Federal Reserve System, recently made a strong argument for such liberalization of the markets for mortgage funds. The same prescription would be beneficial in other markets for money.

Pitfalls of Fiscal Finesse

Actions taken by Congress on a tax-increase budget-cut package this month will have fateful consequences in the years ahead. The tax bill unveiled by the House-Senate conference committee on May 8 provides for a sharp turnaround toward fiscal restraint. Even more important, its enactment would immensely brighten prospects for bringing the rapidly rising trend of Federal spending under control. Over the past several years, major miscalculations of budget expenditures and reliance on short-term expedients to minimize the bulging deficit have caused serious disruptions in the financial markets.

Adoption of the 10 per cent tax surcharge and \$6 billion budget-cut package would slash the deficit in the Federal budget from about \$24 billion in the current year to \$5 billion or less in fiscal 1969. Despite the recent upward revision in Vietnam War spending, the budget economies called for in the bill would limit the growth of Federal outlays to \$4.6 billion. Though a significant rise, this would represent a sharp turn in the spending curve which has been climbing at an average rate of \$20 billion per year over the past three years.

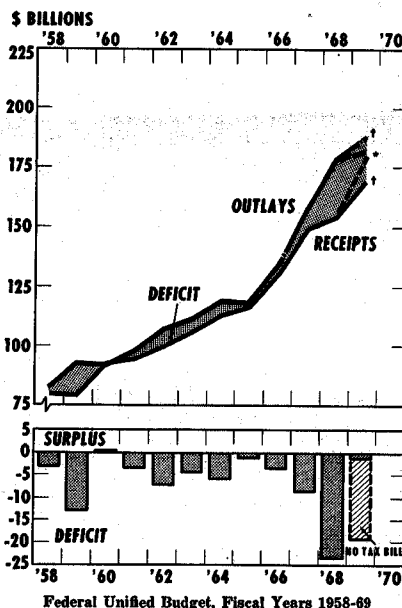
Moreover, authorizations for future spending in fiscal 1970 and beyond are to be slashed sharply from the Administration's budget requests. The fiscal package would require a cut-back of \$10 billion from the amount of new obligational authority which the President asked for in January. It would also require the President to submit to Congress next January recommendations for rescinding \$8 billion of unexpended funds authorized by Congress in earlier years.

Without such spending restraint, the 10 per cent tax surcharge could turn out to be the death knell of hopes for ever enjoying the full fruits of the 1964-65 tax reduction program. To a considerable extent, that reduction proved to be an illusion, in view of the sharp rise of Social Security taxes and the speedup in corporate income tax payments. Severe disruptions in the economy were caused by misleading estimates of Vietnam War costs at the crucial time when major non-

defense programs were being put in place. A scrutiny of the fiscal experience during the last several years is therefore very much to the point if we are to avoid these pitfalls in the future.

Anatomy of a Fiscal Squeeze

Back in 1964-65, it will be recalled, despite a reduction in income tax rates, the upsurge in economic activity produced a continued increase in



* Including a 10 per cent surcharge on corporate income taxes retroactive to January 1, 1968 and on personal income taxes retroactive to April 1, 1968, but with payments beginning in fiscal '69, and a \$6 billion expenditure reduction in fiscal '69.
† Without a tax surcharge and without a \$6 billion expenditure reduction.