Mr. SCHULTZE. As I indicated—the Economic Report of the President and this committee have focused on one major question. Among many others, I think one has stood out:

> How should fiscal policy be designed over the next 18 months in order to moderate the recent acceleration of price increases and upward pressure on interest rates, while still preserving high employment and economic growth?

Now, in the context of present circumstances this question can be separated into two parts:

> 1. In the absence of a tax increase, the Federal budget deficit will exceed $20 billion—and on a national income accounts basis, approach $15 billion—for 2 years in a row. Is a substantially more restrictive fiscal policy called for?
>
> 2. If the answer to this first question is "Yes," should a significantly larger part of that restriction take the form of expenditure reductions and a smaller part the form of tax increases, than has been proposed in the President's economic and budget messages?

This way of posing the question quite clearly rules out the approach which one sometimes hears—"The economy is not strong enough to stand a tax increase. We do need, however, sharp expenditure reductions." If an actually or potentially overheated economy requires more restrictive fiscal policy, then the particular combination of tax increase and expenditure reductions to achieve this end is indeed a legitimate question of policy. But, one cannot argue that the economy is too weak to stand the reduction in disposable income which a tax increase accomplishes, and at the same time propose a reduction in disposable income through the medium of expenditure cuts.

I. IS A RESTRICTIVE FISCAL POLICY NEEDED?

Let me turn then to the first question—whether or not a more restrictive fiscal policy is required in the coming year and a half.

Appropriate Federal fiscal policy decisions obviously depend upon the behavior of the non-Federal sectors of the economy. A large and growing Federal deficit may be temporarily called for when private demands are so weak as to threaten high unemployment and underutilized economic potential. In early 1967, as private inventory investment fell by the huge amount of $18 billion during a period of only 6 months, the Federal budget deficit rose sharply—from $3 billion in the last quarter of 1966 to $15 billion in the second quarter of 1967.

This rise was much larger than the automatic growth in the deficit associated with the slowing down of the economy. In part at least, because of this swing in the deficit what might have been a recession turned out to be only a short-lived pause in economic growth.

Conversely, in periods when the level and rate of growth of demand for goods and services exceed the level and rate of growth in the Nation's economic potential a reduced Federal deficit—or a surplus, depending upon the specific nature of this situation—will be called for.

Fiscal policy must be planned in advance. Moreover, the impact of that policy takes time to be felt throughout the economy. As a consequence, intelligent fiscal policy decisions hinge importantly upon a forecast of the future behavior of the major private sectors of the