



For release on delivery

Statement by

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before the

Committee on Ways and Means

House of Representatives

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I am pleased to meet with this distinguished Committee to discuss with you the difficult fiscal problems now confronting our nation. The specific issue with which the Committee is now grappling involves the \$16 billion of tax reductions recommended by the President to stimulate the economy. The larger question that you and your colleagues in the Congress must face is how to deal with the current recession and yet maintain the fiscal discipline needed to end the inflation that has been weakening our economic and financial institutions.

The tax reductions proposed by the President raise fundamental issues of economic stabilization policy. Let me say at once that I support the principle of temporary tax cuts under current conditions. I remain convinced, nevertheless, that defeat of inflationary forces must remain a major goal of public policy. We cannot realistically expect a lasting resurgence in economic activity until our people regain confidence in the stability of their currency. The critical task is to find ways to cushion recessionary forces without undermining our ability to bring inflation under control. Unless we succeed in that, the economy may be plunged before long into even deeper trouble.

The economy is now in the midst of a serious decline in business activity. Over the past several months, employment and production have decreased about as rapidly as at any time during the postwar period. Unemployment has risen sharply, to over 7 per cent of the labor force, and the length of the work-week in manufacturing industries has also been substantially reduced.

As so often happens in a recession, consumer demand for new homes, autos, household furnishings, and other durable goods -- items whose purchase can be most easily postponed -- has declined markedly. Moreover, weakness has also been evident in markets for clothing and other nondurable consumer goods. In an effort to avoid a buildup of unsold inventories, business firms have cut back sharply on their production schedules and on their orders for materials and supplies. Sales have fallen so rapidly, however, that a substantial involuntary buildup of inventories occurred during the fourth quarter of last year. Consequently, efforts to trim excess stocks will probably continue for several months.

A more serious concern is the mounting evidence that many businesses are postponing or cancelling plans for constructing new facilities or for installing new machinery and

equipment. Larger business expenditures for fixed capital are now needed to add to the number of jobs and expand personal incomes, thereby strengthening consumer purchasing power. Larger investment expenditures are also needed to provide, later on, the modernized industrial plants and the additional productive capacity that are essential to combating inflationary pressures and raising our living standards.

With the demand for goods and services weak in most major sectors of the economy simultaneously, we are likely to see some further decline of economic activity in the months immediately ahead. Evidence is accumulating, however, that the corrective forces needed to lay the basis for an upturn in economic activity are even now underway. For example, in recent weeks the volume of new car production by domestic manufacturers has fallen below the volume of sales. New car inventories, therefore, began to decline in December. Significant price rebates by auto manufacturers, moreover, should help to bolster lagging sales, and thus speed the working down of excess stocks. No less important, many business managers are responding to declining profits by concentrating production in more efficient plants, by economizing on labor and materials, by encouraging their employees to work more

diligently, by working harder themselves, and thus improving the current productivity of their enterprises or laying the basis for later improvement in unit costs of production.

Furthermore, conditions in financial markets have been easing rather steadily since last summer. Interest rates have declined, especially on short-term securities; stock prices have recently recovered; savings inflows to banks and thrift institutions have resumed; more funds are now available for mortgages and other loans; and financial institutions have begun to rebuild their liquidity -- an essential preparation for a subsequent expansion in lending.

These are encouraging developments, but a solid economic recovery may well await evidence of greater progress in checking the relentless upward march of prices. During 1974 as a whole, the average level of wholesale prices rose by 21 per cent and the average level of consumer prices by 12 per cent. The rate of advance in consumer prices has, however, lessened in recent months, and the wholesale price index actually declined last month. Despite these indications of progress, it would be premature to assume that the menace of inflation is, or soon will be, behind us. The sorry fact is that although

substantial slack now exists in both labor and product markets, inflation is continuing to erode the real value of wages, business profits, and accumulated savings.

The inflation in which we are so deeply enmeshed began to spread across the economy some ten years ago when our government embarked on a highly expansionary fiscal policy. The grave consequences of letting inflation get out of hand did not become fully evident, however, until recently. Two years ago, inflation in the United States began to accelerate rapidly, as it did also in most other industrial countries. Soon thereafter, the rate of economic expansion showed signs of faltering both here and abroad, and many nations around the world now find themselves caught in the grip of contractionary forces.

In our own country, the corrosive effects of inflation spread across the economy. The sharply rising demands for credit drove interest rates to unprecedented heights. Stock prices fell. Many workers found that their real earnings, and also the real value of their savings, had begun to decline and they reacted by postponing or canceling plans for buying durable goods. Sales of new autos turned down as early as

the spring of 1973, and so too did purchases of mobile homes and of furniture and household appliances. The market for new conventional homes, meanwhile, was rocked by the combined effect of declining real incomes of workers, waning consumer confidence, rising land and construction costs, and the shortage of mortgage credit that developed as higher market interest rates pulled funds away from the specialized mortgage lenders.

Once widespread weakness begins to develop in consumer markets, general business activity is apt to follow. For a time, however, business managers failed to perceive the ominous trend of events -- perhaps because shortages of industrial materials continued to be acute; perhaps because prices were rising so sharply, particularly after the removal of controls in April 1974; perhaps, more fundamentally, because inflation tends to cloud business thinking. Inflation creates the illusion of rising sales and profits, when the real volume of sales and profits may in fact be declining. Inflation also creates the appearance of a reasonable balance between inventories and sales, when the physical volume of stocks relative to sales may in fact be rising. Whatever the reason, the failure of business firms

to adjust the scale of their operations more promptly to the declining real volume of sales led to serious imbalances in many lines of activity among stocks, sales, orders, and rates of production. These imbalances set the stage for the severe decline in production and employment that began last October.

Public policy is now confronted with a most difficult problem. A recession has developed, and a stimulus to private spending is needed to ensure that a cumulative contraction will not take place. But great care must be taken to avoid aggravating the underlying inflationary forces that have produced our present problems.

Action to reduce taxes temporarily is, I believe, an appropriate course for public policy at the present time. Because of the inflation, many individuals have moved into higher tax brackets, even though their real incomes have declined or remained unchanged. Unless tax rates are reduced, that trend will continue, and the automatic budgetary stabilizers we normally count on to moderate recessionary tendencies will therefore not function effectively. Moreover, inflation has created fictitious profits for businesses, because capital goods used up in production are valued at original rather than replacement cost, and also because many businesses still pursue accounting

practices that make no allowance for the effects of inflation on the cost of replacing inventories bought in earlier periods. Thus, while a substantial part of recently reported corporate profits is illusory, it is still being taxed by the Federal Government.

The President's fiscal program recognizes the need to deal with the current recession and yet avoid releasing a new wave of inflation. Both the tax rebate to individuals and the increase in the investment tax credit will provide a temporary boost to aggregate demand without adding to Federal deficits over the longer run. Increases in Federal expenditures, moreover, are to be limited in several ways -- by postponing new program initiatives apart from the energy area, by various rescissions and deferrals of spending for existing programs, and by ceilings on increases in social security benefits and on Federal pensions and salaries. The over-all program is thus designed with an eye to minimizing the inflationary effects of the proposed fiscal stimuli. Moreover, the temporarily larger incentives for business capital expenditures should also help moderate inflation -- by adding to our capacity to produce industrial materials, supplies of energy, and other goods.

In view of the massive Federal deficits in prospect for this and the next fiscal year, I would, however, urge the Congress to scrutinize Federal expenditures with special care and to look for ways to hold Federal spending well below the levels projected in the President's State of the Union message. Such a step would improve the prospects for moderating the rate of inflation, and would also bolster the confidence of our people by indicating the clear intent of the Congress to stick to a course of fiscal prudence.

I cannot emphasize strongly enough the need for moderation in our fiscal affairs at this critical time. Our people are weary of the inflation that has been robbing them over the past decade; they are confused and disturbed by the huge budget deficits that are in the making this fiscal year and next; and they are anxiously awaiting evidence that their Government can and will take the necessary steps to restore fiscal order and general price stability. Your Committee's efforts to maintain a sense of discipline in Federal finances can make the difference between success or failure in our national effort to regain lasting prosperity.