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TO PRIORITY FCO  
TELEGRAM NUMBER 622 OF 20 FEBRUARY 1981

MY TELEGRAM NO. 577: INITIAL REACTIONS TO REAGAN'S PROGRAMME FOR  
US ECONOMIC RECOVERY

1. THE COOPERATION OF CONGRESS WILL BE CRUCIAL FOR THE IMPLEMENTATION OF REAGAN'S PROPOSALS FOR A PROGRAMME OF ECONOMIC RECOVERY. HIS 18 FEBRUARY SPEECH WAS WELL RECEIVED, WITH CONGRESSIONAL APPLAUSE BEING NOTICEABLY LOUDER DURING PASSAGES ABOUT SPENDING CUTS THAN THOSE ABOUT TAX CUTS. GENERAL PUBLIC SUPPORT FOR SPENDING CUTS HAS UNDOUBTEDLY INCREASED THE DESIRE OF CONGRESSMEN TO BE AT LEAST PUBLICLY ENTHUSIASTIC ABOUT THEM. THE PRESENTATION OF PLAUSIBLE AND COMPREHENSIVE PROPOSALS AT THIS EARLY JUNCTURE IS WIDELY REGARDED BY THE MEDIA AS A SUCCESS BOTH FOR PRESIDENT REAGAN HIMSELF AND FOR STOCKMAN, DIRECTOR OF MANAGEMENT AND BUDGET.

2. FOLLOWING FORMAL PRESENTATION OF THE DETAILS TO CONGRESS IN MARCH, IT WILL BE FOR TREASURY SECRETARY REGAN TO PILOT THE TAX CUTS THROUGH CONGRESS AND FOR HEADS OF INDIVIDUAL SPENDING AGENCIES, UNDER STOCKMAN'S WATCHFUL EYE, TO DO THE SAME FOR THE SPENDING CUTS. US BUDGETARY PROCEDURE, WHICH REQUIRES CONGRESS ULTIMATELY TO CONSIDER THE IMPLICATIONS OF SPENDING AND TAXATION TOGETHER, SHOULD HELP ACHIEVE THE OBJECTIVES OF THE ADMINISTRATION. BUT THIS WILL NOT PRECLUDE CONGRESSMEN FROM EMPLOYING DELAYING TACTICS TO OPPOSE CUTS IN SPECIFIC PROGRAMMES, OR DISSUADE SPECIAL INTEREST GROUPS FROM BRINGING THEIR CONSIDERABLE POWER TO BEAR. AREAS WHERE THE PROPOSED CUTS LOOK TO BE PARTICULARLY VULNERABLE INCLUDE THE PROPOSALS THAT EXIM BANK LOANS SHOULD BE REDUCED BY ONE-THIRD, SYNFUELS (SEE OUR TELEGRAM NO. 595), REDUCTIONS IN SUBSIDIES FOR MASS TRANSPORT, AND SOME OF THE CUTS IN HEALTH, EDUCATION AND WELFARE (OPPOSED BY MANY GROUPS INCLUDING THE AFL/CIO AND THE BLACK CAUCUS IN CONGRESS).

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3. REAGAN HIMSELF HAS NOW ACKNOWLEDGED THAT THE MAIN THREAT TO THE INTEGRITY OF HIS PACKAGE IS WIDESPREAD CONGRESSIONAL DOUBTS ABOUT HIS TAX PROPOSALS. SENATE MINORITY LEADER BYRD HAS SAID THAT THE DEMOCRATS WOULD PRODUCE THEIR OWN TAX PACKAGE AS AN ALTERNATIVE TO REAGAN'S AND HAS REPORTEDLY SET UP AN ADVISORY GROUP TO ESTABLISH ONE. WHILE SENATE MAJORITY LEADER BAKER HAS SAID THAT HE EXPECTS THE EXPENDITURE REDUCTIONS TO BE PASSED IN THE SENATE IN A MONTH OR SO, HE BELIEVES THAT DISCUSSION OF THE TAX PROPOSALS COULD EXTEND INTO NEXT YEAR. JAMES JONES (CHAIRMAN OF THE HOUSE BUDGET COMMITTEE) HAS SAID THAT MANY DEMOCRATS WOULD WISH THE BALANCE OF TAX CUTS TO BE SLANTED MORE TOWARDS BUSINESS AND LESS TOWARDS PERSONS.

4. IT IS NOT ONLY LIBERAL CONGRESSMEN CONCERNED ABOUT DIRECTLY BENEFITING THE RICH WHO HAVE OBJECTIONS TO THE TAX PROPOSALS. IT ALSO SEEMS LIKELY THAT THEY MAY BE DELAYED BY THOSE WHO WISH TO INCLUDE IN THE FIRST TAX BILL SOME OF THE REFORMS WHICH REAGAN WISHES TO DEFER (INDEXING TAX BRACKETS, ABOLITION OF TAX DISCRIMINATION AGAINST MARRIED COUPLES, TUITION TAX CREDITS, AND REDUCING THE IMPACT OF INHERITANCE TAX ON SMALL BUSINESSES). THE TREASURY TEAM'S RELATIVE LACK OF EXPERIENCE IN DEALING WITH CONGRESS MAY ALSO BE A FACTOR SLOWING THE PASSAGE OF THE TAX MEASURES. ACCORDING TO A RECENT PUBLIC OPINION POLL, A MAJORITY WOULD WISH THE SPENDING CUTS TO BE ACHIEVED BEFORE TAX CUTS ARE MADE (A VIEW WHICH REFLECTS WIDESPREAD FEARS OF CONTINUING INFLATION). IT MAY WELL BE THAT THE ADMINISTRATION WILL BE FORCED TO ACCEPT SOME MODIFICATION IN ITS TAX PROPOSALS, AND PERHAPS TO HAVE THE PERSONAL TAX CUTS ENACTED ONLY A YEAR AT A TIME.

5. THE ECONOMIC ASSUMPTIONS AND PROJECTIONS LYING BEHIND THE ADMINISTRATION'S PROPOSALS ARE A COMPROMISE BETWEEN THE SUPPLY SIDE SCHOOL, THE MONETARISTS, AND THE FISCAL CONSERVATIVES. THE PROJECTIONS DO NOT STEM DIRECTLY FROM ANY ECONOMIC MODEL, AND SHOULD BE REGARDED AS TARGETS RATHER THAN PREDICTIONS.

6. EVEN IF THE CONGRESS WERE TO ENACT THE WHOLE PACKAGE, THERE ARE TWO LARGE QUESTION MARKS. ONE IS THAT, AS THE TAX SYSTEM IS NOT INDEXED FOR INFLATION, THE PERSONAL TAX CUTS, BIG THOUGH THEY SEEM, WOULD ONLY REDUCE THE AVERAGE BURDEN OF PERSONAL TAX BACK TO WHERE IT WAS IN ABOUT 1978. THEY ARE THEREFORE NOT SO RADICAL AS APPEARS AT FIRST SIGHT, AND THEIR SUPPLY SIDE EFFECT MAY BE CORRESPONDINGLY MUTED. THE SECOND IS WHETHER THE GRADUAL ACHIEVEMENT OF BUDGET BALANCE BY 1984, WHICH EVOKES MEMORIES OF CARTER'S SIMILAR GOAL 4 YEARS AGO, WILL HAVE A SUFFICIENTLY DRAMATIC EFFECT EITHER ON INFLATION OR ON INFLATIONARY EXPECTATIONS.

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7. THE INITIAL REACTION FROM WALL STREET AND INDUSTRIALISTS WAS THAT THE REAGAN PROPOSALS ARE ON THE RIGHT LINES, ALTHOUGH THEY WOULD HAVE LIKED DEEPER SPENDING CUTS AND GREATER ASSURANCE THAT REAGAN'S PROPOSALS WILL ACTUALLY BE ENACTED. THERE WERE NO STRONG MOVEMENTS IN THE STOCK MARKETS IN THE MORNING FOLLOWING REAGAN'S SPEECH, BUT STOCKS FELL SHARPLY LATER IN THE DAY. FEARS ABOUT THE CONGRESSIONAL REACTION TO REAGAN'S PROPOSALS WERE REPORTEDLY A FACTOR IN THE FALL.

8. THERE ARE UNDOUBTEDLY MAJOR CONGRESSIONAL DIFFICULTIES AHEAD, AND SOME OF THE ECONOMIC ASSUMPTIONS BEHIND THE PROPOSALS MAY BE DEBATABLE, BUT OUR ASSESSMENT IS THAT THE REAGAN ADMINISTRATION HAS MADE A GOOD START IN ITS AMBITIOUS ATTEMPT TO STEM THE TIDE OF PUBLIC EXPENDITURE AND TAXATION, TO PROVIDE INCENTIVES TO INITIATIVE AND ENTERPRISE, AND TO OFFER RELIEF FROM THE EXCESSIVE BURDEN OF FEDERAL REGULATION.

9. TEXT OF SPEECH FOLLOWS BY BAG.

10. FCO PLEASE ADVANCE TO BOTTRILL (TREASURY), KEITH (INLAND REVENUE) AND HAYWARD (BANK OF ENGLAND).

HENDERSON

[ADVANCED AS REQUESTED]

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