RAY WHITNEY, O.B.E., M.P.

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HOUSE OF COMMONS
LONDON SW1A 0AA

22nd December 1980

The Rt. Hon. Sir Geoffrey Howe, Q.C., M.P.,
11, Downing Street,
London S.W.1.

Dear Geoffrey,

We spoke this afternoon about the enclosed paper which I brought back from my visit to Washington last week. It was drafted by Congressmen David Stockman and Jack Kemp and Stockman was subsequently appointed as Head of the Office of Management and Budget by the President-Elect. (Not all the marginalia are mine.)

I also enclose a copy of a New York Times summary of the document.

Given that, sadly, there is a widespread fear among the incoming Administration of being "Thatcherised", (see page two below), your New York Times article scheduled for January 19th will be of crucial importance - both for the projection of H.M.G. in the United States and for Mr. Reagan and his colleagues.

I am sending a copy of this letter and enclosures to Ian Gilmour and Ian Gow.

Yours ever.

Ray.

Encls.

ECONOMICS

Memo to Reagan: 'Avoiding an Economic Dunkirk'

Two of President-elect Ronald Reagan's closest advisers have offered a strong and detailed plan, "Avoiding a GOP Economic Dunkirk," for the first 100 days of the new administration. The authors of the report, prepared last month shortly before the latest run-up in interest rates, are Representatives David A. Stockman of Michigan and Jack F. Kemp of upstate New York.

Mr. Stockman was appointed last week to head the Office of Management and Budget. Mr. Kemp, new chairman of the House Republican Conference, has lent his name to a tax-cutting bill that Mr. Reagan has espoused. Following are excerpts from the 23-page Stockman-Kemp plan.

Gathering Storm

THE momentum of short-run economic, financial and budget forces is creating the conditions for an economic Dunkirk during the first 24 months of the Reagan Administration. These major factors threaten:

A SECOND 1980 CREDIT CRUNCH. By year end, rising bank rates will cause further deterioration in long-term capital markets for bonds and equities, a renewed consumer spending slowdown, and intensified uncertainty throughout financial markets.

There are a number of potential contributory forces. The most important is the fact that the Federal Reserve Board has been substantially overshooting its 1980 money supply growth goals ever since mid-summer. In addition, the Treasury will impose massive financing requirements on the market through Jan. 1, including about $100 billion in refinancing and potentially $25 billion to $28 billion in new cash.

In all, President Reagan will inherit thoroughly disordered credit and capital markets, punishingly high interest rates, and a hair-trigger market psychology poised to respond strongly to early economic policy signals in either favorable or unfavorable ways.

A DOUBLE-DIP RECESSION IN EARLY 1981. This is now at least a 50 percent possibility. Stagnant or declining real growth in the gross national product in the first two quarters would generate a further worsening of an already dismal budget posture and a profusion of "quick-fix" remedies for various "wounded" sectors of the economy — autos, housing, etc.

There is a further danger; the Federal budget has now become an automatic "coast-to-coast soup line" that dispenses remedial aid with almost reckless abandon. For instance, estimates for fiscal 1981 trade adjustment assistance have exploded from $400 million in June to $2.5 billion as of November.

For these reasons, the first hard look at the unvarnished fiscal 1981 and 1982 budget posture is likely to produce an intense polarization between supply-side tax cutters and the more fiscally orthodox. An internecine struggle over deferral or temporary abandonment of the tax program could ensue. The result would be a severe demoralization and fractionalization of G.O.P. ranks and an erosion of our capacity to govern successfully and revive the economy before November 1982.

FEDERAL BUDGET AND CREDIT HEMORRHAGE. The latest estimates place fiscal 1981 outlays at nearly $650 billion. That represents a $36 billion growth between the first budget resolution passed in June and the outlook in November. Of the $36 billion, fully $26 billion, or 72 percent, is due to automatic budget responses in entitlements, indexing, debt servicing, budget authority spend-down rates, and loan facilities spread throughout the Federal Government.

When the off-budget deficit is included, which it must be, since most of this category is ultimately financed in the government market for bonds and Treasury bills, the pre-tax-cut deficit for fiscal 1981 ranges between $50 billion and $60 billion.

The vigorous tax-cut package required to spur the supply side of the economy could raise the total fiscal 1981 deficit to the $60 billion to $80 billion range. Thus, unless the tax-cut program is accompanied by a credible and severe program to curtail fiscal 1981-1982 outlays, future spending authority, and overall Federal credit absorption, financial market worries about a "Reagan inflation" will be confirmed.

COMMODITY SHOCKS AND MONETARY POLICY. The United States economy is likely to face two serious commodity price run-ups during the next five to 15 months.

First, if the Iran-Iraq war is not soon terminated, today's excess worldwide crude and product inventories will be largely depleted by February or March. OPEC contract rates will rise toward spot market levels in the $40 to $50 per barrel range during the first and second quarters of 1981.

Similarly, the present rapid drawdown of worldwide feed grain and protein oil reserves could turn into a rout by the fall of 1981, if the Soviets have another "Communist" (i.e. poor) harvest and production is average-to-below-average elsewhere in the world. Per bushel prices of $4 to $5 for corn, $6 to $7 for wheat, and $10 to $11 for soybeans are a distinct possibility.

If the Federal Reserve chooses to accommodate these price/credit shocks, as it has in the past, then in the context of the massive Federal credit demand and financial market disorders described above, only one result is certain: the already tattered credibility of the post-October 1979 monetary policy of Federal Reserve chairman Paul Volcker will be destroyed. The conditions for full-scale financial panic and unprecedented global monetary turbulence will be present.

THE REGULATORY TIME BOMB. During the early and mid-1970's, Congress approved more than a dozen sweeping environmental, energy and safety enabling authorities, which for all practical purposes are devoid of policy standards and criteria for cost-benefit, cost-effectiveness, and comparative risk analysis.

Subsequently, McGovernite no-growth activists assumed control of most of the relevant sub-Cabinet policy posts during the Carter Administration. They have spent the past four years "tooling up" for implementation through a mind-boggling outpouring of rule-makings, interpretative guidelines, and major litigation — all heavily biased toward maximization of regulatory scope and burden.

All told, there are easily in excess of $100 billion in new environmental safety and energy compliance costs scheduled for the early 1980's.

Regulatory Ventilation

ACTION	IMPACT
Grant model year 1982 carbon monoxide waiver	$300 million auto industry savings
Rescind passive restraint standard (airbags)	$300 million to $600 million auto investment savings over three years
Relax 1984 heavy duty truck emission standard	Minimum savings of $100 million
Simplify auto emissions certification and testing	$80 million a year
Modify ambient air standard for ozone to permit multiple exceedences or higher standard value in conformance with scientific evidence	$15 billion to $40 billion in reduced costs over next eight years
Eliminate unnecessary New Source Performance Standards for small industrial boilers	$1 billion to $2 billion over the next five years
Cancel E.P.A. fuel additive testing program	Savings of $90 million to $120 million
Relax proposed light duty truck emission standards for post-1983	Savings would be a substantial fraction of currently estimated $1.3 billion compliance cost
Modify or defer E.P.A. pretreatment standards for industrial waste-water	Savings of a substantial fraction of the $6 billion compliance cost for just three sectors — utilities, steel and paper
Cancel D.O.E. appliance efficiency standards	Avoids multi-billion dollar havoc in an industry that is already improving product efficiency in response to market pressure
Modify the Resource Conservation and Recovery Act to incorporate "degree of hazard" and control system simplification	Savings would be some fraction of $2 billion a year
Defer new OSHA workplace noise standards	Save $250 million a year
Modify or defer pending OSHA standards on scaffolding, asbestos exposure, cadmium and chromium exposure, and grain elevator dust control	More than $1 billion in annual combined savings

Political Threat

This review of the multiple challenges and threats lying in ambush contains an inescapable warning: If bold policies are not swiftly, deftly and courageously implemented in the first six months, Washington will quickly become engulfed in political disorder commensurate with the surrounding economic disarray.

The specific danger is this: If President Reagan does not lead a creatively orchestrated high-profile policy offensive based on revision of the fundamentals — supply-side tax cuts and regulatory relief, stern outlay control and Federal fiscal retrenchment, and monetary reform and dollar stabilization — the thin Senate Republican majority and the de facto conservative majority in the House will fragment.

Emergency Program

In order to dominate, shape and control the Washington agenda, President Reagan should declare a national economic emergency soon after inauguration. He should request that Congress quickly clear the decks for exclusive action for 100 days on an Emergency Economic Stabilization and Recovery Program he would soon announce.

Five major principles should govern the formulation of the package:

- A static "waste-cutting" approach to the fiscal 1981 outlay component of the fiscal hemorrhage will hardly make a dent in the true fiscal problem. Policy initiatives designed to spur output growth and to lower inflation expectations and interest rates must carry a large share of the burden.
- For this reason, dilution of the tax-cut program in order to limit short-run static revenue losses during the remainder of fiscal 1981 and 1982 would be counterproductive.
- A dramatic, substantial recission of the regulatory burden is needed both for the short-term cash flow relief and the long-term bullish signal it will provide to business investment planners.
- New budget authority increased from $556 billion in fiscal 1979 to nearly $660 billion in fiscal 1980 and much of this authority will create outlay streams and Treasury cash borrowing requirements in fiscal 1981 and beyond. The fiscal stabilization package, therefore, must be at minimum equally weighted between out-year spending and entitlement authority reductions and cash outlay savings for the remainder of fiscal 1981.
- Certain pre-emptive steps must be taken early on to keep control of the agenda and to maintain Capitol Hill focus on the stabilization and recovery program. Foremost, all remaining petroleum product controls and allocations should be canceled on Day 1. In addition, some informal agreement with key lawmakers should be sought to defer such items as the labor policy agenda until next fall. There is no point in antagonizing organized labor during this critical period.

Major Components

SUPPLY-SIDE TAX CHANGES. The calendar year 1981 and 1982 installments of Kemp-Roth, reduction of the top income tax rate on unearned income to 50 percent, further cuts in capital gains, and a substantial reform along 10-5-3 lines of corporate depreciation are needed.

FISCAL STABILIZATION. Cash outlays for the remainder of fiscal 1981 should be held to the $635 billion range. A hiring freeze and a severe cutback in agency travel, equipment procurement, and outside contracting would be the major savings areas. The out-year authority reduction package should cut Federal program levels by $30 billion to $50 billion a year in fiscal 1982-1983.

We are now spending about $25 billion a year for highways, mass transit, sewer treatment facilities, public works, national parks and airport facilities. The benefit stream from this will accrue over the next 20 to 40 years. Thus, a modest deferral and stretch-out of activity rates (a 10 percent to 20 percent reduction) in these areas should be considered.

Current expenditures for non-Social Security entitlements, including food stamps, Medicaid, disability, heating assistance, housing assistance, school lunches, unemployment compensation, and so on amount to $100 billion. A carefully tailored package to reduce eligibility, overlap and abuse should be developed for these areas — with potential savings of $10 billion to $20 billion.

Total fiscal expenditures for the National Aeronautics and Space Administration, the Comprehensive Employment and Training Act, the Community Development Program, the Economic Development Administration, urban parks, arts and humanities, and the like amount to $25 billion. Most of these programs are ineffective or of low priority and could be cut by at least one-third, or $8 billion.

REGULATORY VENTILATION. First and most urgent, a series of unilateral administrative actions must be taken to defer, revise or rescind existing and pending regulations where clear legal authority exists. The potential here is really staggering, as the hastily compiled list of specific action indicates [see table].

On a second front, both temporary and permanent statutory revisions will be needed. There are literally dozens of rule-making and compliance deadlines on the statute books for the next 20 months that cannot be prudently met. An omnibus "suspense bill" might be necessary during the 100 days, then the implementation of a proposed one-year moratorium on new rule-makings.

Finally, a fundamental legislative policy reform package will have to be developed. This would primarily involve the insertion of mandatory cost-benefit, cost-effectiveness and comparative risk analyses into the basic enabling acts — Clean Air and Water, OSHA, etc.

ENERGY PACKAGE. Beyond the pre-emptive step of dismantling controls before an oil crisis really hits — incidentally, immediate decontrol and a $10-a-barrel world price rise would increase windfall profits tax revenue by up to $25 billion during calendar 1981 — a planning team should be readying a package of emergency steps to increase short-run domestic energy production and utilization in case of a severe supply pinch.

The primary areas for short-run gains would be: accelerating the licensing of a half-dozen completed nuclear plants; removing all end-use restrictions on natural gas; permitting accelerated infill drilling; eliminating stripper and marginal oil properties from the windfall tax; allowing emergency variances for industrial and utility coal boilers, etc.

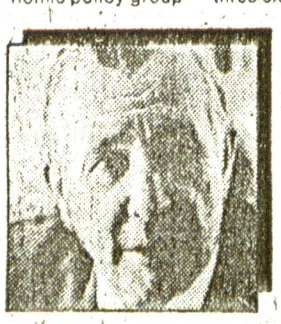
If the crisis is severe enough, rapid statutory revision of the natural gas decontrol program and modification of the windfall tax might be considered as part of the 100-day agenda.

A MONETARY ACCORD. President Reagan should meet with Mr. Volcker or the entire Federal Reserve Board at an early date and issue them a new informal "charter" — namely, to eschew all consideration of extraneous economic variables like short-term interest rates, housing market conditions, business cycle fluctuations, etc., and to concentrate instead on one exclusive task: bringing the growth of Federal Reserve credit and bank reserves to a prudent rate and stabilization of the international and domestic purchasing power of the dollar.

The President and Congress would stoutly defend the Federal Reserve from all political attacks. Insulation of the Fed from extraneous economic and financial preoccupations, political pressures, recalibration of its monetary objective, and restoration of its tattered credibility is the critical linchpin in the whole program. ■

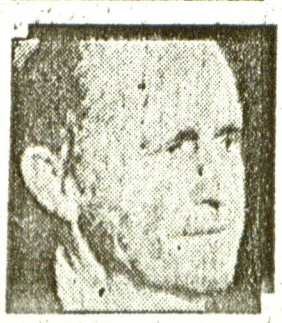
Reagan's Economic Team

Ronald Reagan named the first members of his cabinet last week. Among them were four of the top positions of his economic policy group — three experienced businessmen and a two-term Congressman. As the weekend began, the Secretary of Energy and the members of the Council of Economic Advisers were still to be named.

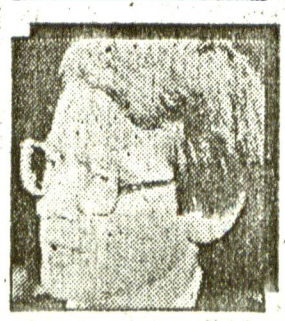


Donald T. Regan, 61
Treasury Secretary
Chairman of Merrill Lynch . . . member of Business Roundtable's policy committee . . . on boards of Committee for Economic Development and Council on Foreign Relations . . . former vice chairman of New York Stock Exchange.

Andrew L. Lewis Jr., 49
Transportation Secretary
Trustee for the bankrupt Reading Railroad . . . deputy chairman of Reagan-Bush Committee and Republican National Committee . . . ran Pennsylvania campaigns for Gerald Ford in 1976 and Mr. Reagan this year.



Malcolm Baldrige, 58
Commerce Secretary
Chairman of Scovill . . . member of the Business Council . . . ran George Bush's successful Connecticut primary campaign . . . president of the Eastern Company in 1960 . . . a professional rodeo steer roper.



David A. Stockman, 34
Budget Director
Staff aide to John B. Anderson in 1970 . . . executive director of the House Republican Conference in 1972 . . . elected to House in 1976 . . . member of Interstate and Foreign Commerce Committee.

04-P12 Rep. Jack Kemp (R, NY)
Rep. Dave Stockman (R, Mich)

603.130

AVOIDING A GOP ECONOMIC DUNKIRK

I. The Gathering Storm

The momentum of short-run economic, financial and budget forces is creating the conditions for an economic Dunkirk during the first 24 months of the Reagan Administration. These major factors threaten:

1) A Second 1980 Credit Crunch

By year end bank rates are likely to hit the 15-17 percent range, causing further deterioration in long-term capital markets for bonds and equities, a renewed consumer spending slowdown, and intensified uncertainty throughout financial markets.

There are a number of potential contributory forces. The most important is the fact that the Fed has been substantially overshooting its 1980 money supply growth goals ever since mid summer. Were Volcker to attempt to use the interregnum to impose the severe constraint necessary to get back on track, M1-B, for example, would have to be held to essentially a zero growth rate for the remainder of the year to fall within the 6.5 percent upper target for 1980.

In addition, the Treasury will impose massive financing requirements on the market through January 1, including about $100 billion in refinancing and potentially $25-28 billion in new cash requirements at current budget operating levels (fourth quarter). While private credit requirements are likely to soften

in response to the emerging slowdown in housing, durables and other real sectors, year-end seasonal borrowing requirements are still likely to be heavy.

In all, President Reagan will inherit thoroughly disordered credit and capital markets, punishingly high interest rates, and a hair-trigger market psychology poised to respond strongly to early economic policy signals in either favorable or unfavorable ways.

The pre-eminent danger is that an initial economic policy package that includes the tax cuts but does not contain decisive, credible elements on matters of outlay control, future budget authority reduction, and a believable plan for curtailing the Federal government's massive direct and indirect credit absorption will generate pervasive expectations of a continuing "Reagan inflation." Such a development would almost ensure that high interest rates would hang over the economy well into the first year, deadening housing and durables markets and thwarting the industrial capital spending boom required to propel sustained economic growth. Thus, Thatcherization can only be avoided if the initial economic policy package simultaneously spurs the output side of the economy and also elicits a swift downward revision of inflationary expectations in the financial markets.

2) A Double-Dip Recession in Early 1981

This is now at least a 50 percent possibility given emerging conditions in the financial markets and gathering evidence from the output side of the economy. Stagnant or declining real GNP growth in the first two quarters would generate staggering political and policy challenges. These include a further worsening of an already dismal budget posture (see below) and a profusion of "quick fix"

remedies for various "wounded" sectors of the economy. The latter would include intense pressure for formal or informal auto import restraints, activation of Brooke-Cranston or similar costly housing bailouts, maintenance of current excessive CETA employment levels, accelerated draw-down of various lending and grant aids under SBA, EDA, and FmHA, a further 13 week extension of Federal unemployment benefits, etc. Obviously, the intense political pressures for many of these quick fix aids will distract from the Reagan program on the economic fundamentals (supply side tax cuts, regulatory reform, and firm long-term fiscal discipline) and threaten to lock in budget costs and policy initiatives that are out of step with the basic policy thrust.

There is a further danger; the Federal budget has now become an automatic "coast-to-coast soup line" that dispenses remedial aid with almost reckless abandon, converting the traditional notion of automatic stabilizers into multitudinous outlay spasms throughout the budget. For instance, the estimates for FY 81 trade adjustment assistance have exploded from $400 million in the spring to $2.5 billion as of November, and the summer drought will cause SBA emergency farm loan aid to surge by $1.1 billion above planned levels.

For these reasons, the first hard look at the unvarnished FY 81 and 82 budget posture by our own OMB people is likely to elicit coronary contractions among some, and produce an intense polarization between supply-side tax cutters and the more fiscally orthodox. An internecine struggle over deferral or temporary abandonment of the tax program could ensue. The result would be a severe demoralization and fractionalization of GOP ranks and an erosion of our capacity to govern successfully and revive the economy before November 1982.

3) Federal Budget and Credit Hemorrhage

The latest estimates place FY 81 outlays at nearly $650 billion. That represents a $20 billion outlay growth since the August estimates; a $36 billion growth since the First Budget Resolution passed in June; an outlay level $73 billion above FY 80; and a $157 billion growth since the books closed on FY 79 just 13 months ago.

The table below illustrates the full dimension of the coast-to-coast soup line problem mentioned above and the manner in which it drives outlay aggregates upward at mind-numbing speed. A worsening of the informal "misery index" (i.e. higher inflation and interest rates, or lower output growth and employment rates) drives hard on entitlements, indexing, debt servicing, budget authority spend-down rates, and loan facilities spread throughout the Federal government, resulting in a surge of incremental outlays.

Between June and November, for example, Federal outlay estimates have risen from $613 billion to $649 billion. Of the $36 billion growth in outlay estimates, fully $26 billion or 72 percent is due to automatic budget responses to the mechanisms listed above.

The $3.2 billion increment for interest outlays represents a revision of the 1981 average T-bill rate from 9.6 in June to 11.0 in the latest estimate. Similarly, the $9.2 billion increment for trade adjustment assistance, food stamps, cash assistance, and unemployment benefits represents a revised assumption about the expected duration of high unemployment during calendar 1981. The continuing disintermediation crisis in the thrift sector will cause nearly a billion dollar draw-down from the savings and loan insurance fund. Category (4)

presents still another example of the soup line dynamic: when private sector orders soften, Federal defense and "brick and mortar" contractors tend to speed up delivery on contract work, increasing the spend-out rate against obligated authority in the pipeline -- in this case by about $5 billion.

These illustrations drive home a fundamental point: achieving fiscal control over outlays and Treasury borrowing cannot be conducted as an accounting exercise or exclusively through legislated spending cuts in the orthodox sense. Only a comprehensive economic package that spurs output and employment growth and lowers inflation expectations and interest rates has any hope of stopping the present hemorrhage.

SOURCES OF $36 BILLION GROWTH IN FY 81 OUTLAY ESTIMATES
BETWEEN JUNE AND NOVEMBER

Program:	Excess Cost Over June (First) Budget Resolution	
1) Due to Higher Inflation:		
Indexed Benefits		
Social Security	$0.75 billion	
Pension Benefits	0.40	
Specific Price Reestimates		
Defense Fuel Costs	1.20	
Medicare	1.90	
Food Assistance	1.65	
Subtotal		$ 5.90 billion
2) Due to Higher Interest Rates:		
Student Loans	0.40	
Interest on the Debt	1.30	
Rural Housing Programs	0.15	
FSLIC Outlays	0.95	
Subtotal		2.80
3) Due to Higher Unemployment:		
Medicaid	0.60	
Assistance Payments	0.75	
Unemployment Insurance	4.70	
TRA	2.10	
Food Stamps	0.30	
Federal Supplemental Unemployment Insurance Benefits	0.70	
Subtotal		9.15
4) Due to General Economic Conditions:		
Defense Department Procurement	3.35	
Non-Defense Procurement	3.25	
Corps of Engineers	0.10	
EPA Sewer Construction	0.10	
VA Construction	0.10	
SBA Disaster Loans	1.35	
Subtotal		8.25
GRAND TOTAL		$26.10 billion

The deficit and total Federal credit activity figures are even more alarming. When the off-budget deficit is included, which it must be since most of this category represents Treasury advances to the Federal Financing Bank (which in turn are financed in the government market for bonds and T-bills), the pre-tax cut deficit for FY 81 ranges between $50-60 billion.* This follows a closing level of nearly $80 billion for FY 80 (including off-budget).

The vigorous tax cut package required to spur the supply side of the economy could raise the total static FY 81 deficit to the $60-80 billion range, depending upon the timing of tax cut implementation and real GNP, employment and inflation levels during the remaining nine months of the fiscal year. These parameters make clear that unless the tax cut program is accompanied by a credible and severe program to curtail FY 81-82 outlays, future spending authority, and overall Federal credit absorption, financial market worries about a "Reagan inflation" will be solidly confirmed by the budget posture.

An alternative indication of the fiscal management crisis is given by the figures for new loan and loan guarantee activities during FY 81 by Federal agencies. These are now estimated at $150 billion, with only $44 billion of this amount included in the official on-budget accounts. Thus, Federal credit agencies will absorb an additional $100 billion in available funds beyond the Treasury's requirements for financing the official deficit.

It is these spending growth trends, deficit levels, and Federal credit absorption parameters which are generating market expectations of a chronic and severe Reagan inflation: market participants simply will not accept the Federal

*This assumes current estimate revenues of $615 billion, outlays of $649 billion, an on-budget deficit of $35 billion, and an off-budget deficit of $20 billion.

Reserve's money growth and anti-inflation goals in light of this massive governmental domination of credit markets.

4) Commodity Shocks and the Final Destruction of Volcker Monetary Policy

The U.S. economy is likely to face two serious commodity price run-ups during the next 5-15 months. First, if the Iran-Iraq war is not soon terminated, today's excess worldwide crude and product inventories will be largely depleted by February or March. Under those conditions, heavy spot market buying, inventory accumulation, and eventually panic bidding on world markets will once again emerge. Indeed, unless the war combatants exhaust themselves at an early date and move quickly back into at least limited production, this outcome is almost certain by spring. Under these circumstances, OPEC contract rates will rise toward spot market levels in the $40-50 per barrel range during the first and second quarters of 1981, with a consequent price shock to the U.S. economy. Even a $10 per barrel increase in average U.S. refiner acquisition cost would add $50-60 billion annually to aggregate national petroleum expenditures (assuming full decontrol).

Similarly, the present rapid draw-down of worldwide feed grain and protein oil reserves could turn into a rout by the fall of 1981, if the Soviets have another "Communist" (i.e. poor) harvest and production is average-to-below-average elsewhere in the world. Under an adverse 1981 harvest scenario, but not an improbable one, $4-5 corn, $6-7 wheat, and $10-11 soybeans are a distinct possibility.

The problem here is that demand for these basic commodities is highly inelastic in the very short run; and this generates strong credit demands from

both the business and household sectors to finanace existing consumption levels without cutting back on other expenditures. If the Federal Reserve chooses to accomodate these commodity price/credit demand shocks, as it has in the past, then in the context of the massive Federal credit demand and financial market disorders described above, only one result is certain: the already tattered credibility of the post-October 1979 Volcker monetary policy will be destroyed. The Federal Reserve will subsequently succumb to enormous internal strife and external pressure, and the conditions for full-scale financial panic and unprecedented global monetary turbulence will be present. The January economic package, therefore, must be formulated with these probable 1981 commodity shocks and resulting financial market pressures clearly in mind.

5) Ticking Regulatory Time Bomb

Unless swift, comprehensive and far-reaching regulatory policy corrections are undertaken immediately, an unprecedented, quantum scale-up of the much discussed "regulatory burden" will occur during the next 18-40 months. Without going into exhaustive detail, the basic dynamic is this: During the early and mid 1970's, Congress approved more than a dozen sweeping environmental, energy and safety enabling authorities, which for all practical purposes are devoid of policy standards and criteria for cost-benefit, cost-effectiveness, and comparative risk analysis. Subsequently, McGovernite no-growth activists assumed control of most of the relevant sub-Cabinet policy posts during the Carter Administration. They have spent the past four years "tooling up" for implementation through a mind-boggling outpouring of rule-makings, interpretative guidelines, and major litigation -- all heavily biased toward maximization of regulatory scope and burden. Thus, this decade-long process of regulatory evolution is just now reaching the stage at which it will sweep through the

industrial economy with near gale force, preempting multi-billions in investment capital, driving up operating costs, and siphoning off management and technical personnel in an incredible morass of new controls and compliance procedures.

In the auto manufacturing sector, for example, new of substantially tougher regulations in the following areas will impact the industry during 1981-84: passive restraint standard (airbags)...1981 passenger tailpipe standard (including an unnecessary 3.4 gram/mile CO limit)...unproven 5 mph bumper standards...final heavy duty engine emission standards...vast new audit, enforcement and compliance procedures, and a new performance warranty system...light duty diesel particulate and NO_x standards...heavy duty truck noise standards... model year 83-85 light duty truck emission standards...MY 83-85 light duty truck fuel econo standards... bus noise standards... ad infinitum. These measures alone will generate $10 to $20 billion in capital and operating costs while yielding modest to non-existent social benefits.

Similarly, a cradle-to-grave hazardous waste control system under RCRA will take effect in 1981 at an annual cost of up to $2 billion. While prudent national waste disposal standards are clearly needed, the RCRA system is a monument to mindless excess: it treats degreasing fluids and PCB's in the same manner; and the proposed standards and controls for generators, transporters and disposers, along with relevant explanations and definitions, encompass more than 500 pages of the Federal Register.

Multi-billion overkill has also bloomed in the regulatory embellishment of the Toxic Substances Control Act, which threatens to emulate FDA "regulatory lag" on new chemical introductions. The proposed OSHA generic carcinogen standard and the technology based BACT, RACT, LAER and NSPS standards under the

Clean Air Act also represent staggering excess built upon dubious scientific and economic premises. Three thousand pages of appliance efficiency standards scheduled for implementation in 13 categories of home appliances in 1981 also threaten to create multi-billion dollar havoc in the appliance industry.

There are also literally dozens of recently completed or still pending rule-makings targeted to specific sectors of the industrial economy as follows: proposed NSPS standards for small industrial boilers (10 to 250 million BTU per hour) are estimated at $1-2 billion over 1980-85; proposed utility sector standards for bottom ash, fly ash and cooling water control could cost $3.3 billion; pending OSHA hearing conservation standards, $500 million; abrasive blasting standards, $130 million; and asbestos control standards, up to $600 million. New industrial waste water pretreatment standards...EPA's proposed fluorocarbon-refrigerant control program... the CAA stage II vapor recovery and fugitive hydrocarbon control program...the vehicle inspection and maintenance program...all have price tags in excess of $1 billion. Moreover, most of the country will fail to meet the 1982 compliance deadline for one or more regulated air pollutants, thereby facing a potential absolute shut-down on the permitting of new or modified industrial sources. All told, there are easily in excess of $100 billion in new environmental safety and energy compliance costs scheduled for the early 1980's.

II. The Threat of Political Dissolution

This review of the multiple challenges and threats lying in ambush contains an inescapable warning: things could go very badly during the first year, resulting in incalculable erosion of GOP momentum, unity and public confidence.

If bold policies are not swiftly, deftly and courageously implemented in the first six months, Washington will quickly become engulfed in political disorder commensurate with the surrounding economic disarray. A golden opportunity for permanent conservative policy revision and political realignment could be thoroughly dissipated before the Reagan Administration is even up to speed.

The specific danger is this: If President Reagan does not lead a creatively orchestrated high-profile policy offensive based on revision of the fundamentals -- supply side tax cuts and regulatory relief, stern outlay control and Federal fiscal retrenchment, and monetary reform and dollar stabilization -- the thin Senate Republican majority and the de facto conservative majority in the House will fragment and succumb to parochial "fire-fighting as usual" in response to specific conditions of constituency distress.

For example, unless the whole remaining system of crude oil price controls, refiner entitlements, gasoline allocations, and product price controls is administratively terminated "cold turkey" by February 1, there is a high probability of gasoline lines and general petroleum market disorder by early spring. These conditions would predictably elicit a desultory new round of Capitol Hill initiated energy policy tinkering reminiscent of the mindless exercises of Summer 1979. Intense political struggles would develop over implementation of the stand-by conservation programs, extension of EPAA controls and allocations, and funding levels for various pie-in-the-sky solar, conservation, synfuels and renewables programs. The Administration would lose the energy policy initiative and become engulfed in defensive battles, and frenetic energy legislating would preempt Hill attention from more important budget control, entitlement reform, and regulatory revision efforts. In short, if gas lines are permitted to erupt due to equivocation on revocation of controls, debilitating legislative, and

political distractions will be created.

Similarly, failure to spur early economic expansion and alter financial market inflation expectations will result in a plethora of Capitol Hill initiatives to "fix up" the housing, auto and steel sectors, hype up exports, subsidize capital formation, provide municipal fiscal relief, etc. Again, the Administration would be thrown on the defensive. Finally, persistence of "misery index" driven budget deficits, high interest and inflation rates, and continued monetary policy vacillation at the Fed would quickly destroy the present GOP consensus on economic policy, pitting tax cutters against budget cutters and capital formation boosters against Kemp-Roth supporters.

To prevent early dissolution of the incipient Republican majority, only one remedy is available: an initial Administration economic program that is so bold, sweeping and sustained that it --

--totally dominates the Washington agenda during 1981;

--holds promise of propelling the economy into vigorous expansion and the financial markets into a bullish psychology;

--preempts the kind of debilitating distractions outlined above.

The major components and tenor of such an orchestrated policy offensive are described below.

III. Emergency Economic Stabilization and Recovery Program

In order to dominate, shape and control the Washington agenda, President Reagan should declare a national economic emergency soon after inauguration. He

should tell the Congress and the nation that the economic, financial, budget, energy, and regulatory conditions he inherited are far worse than anyone had imagined. He should request that Congress organize quickly and clear the decks for exclusive action during the next 100 days on an Emergency Economic Stabilization and Recovery Program he would soon announce. The Administration should spend the next two to three weeks in fevered consultation with Hill Congressional leaders and interested private parties on the details of the package.

Five major principles should govern the formulation of the package:

1) A static "waste-cutting" approach to the FY 81 outlay component of the fiscal hemorrhage will hardly make a dent in the true fiscal problem. Persisting high "misery index" conditions in the economy will drive the soup line mechanisms of the budget faster than short-run, line-item cuts can be made on Capitol Hill. Fiscal stabilization (i.e. elimination of deficits and excessive rates of spending growth) can only be achieved by sharp improvement in the economic indicators over the next 24 months. This means that the policy initiatives designed to spur output growth and to lower inflation expectations and interest rates must carry a large share of the fiscal stabilization burden. Improvement in the "outside" economic forces driving the budget is just as important as success in the "inside" efforts to effect legislative and administrative accounting reductions.

2) For this reason, dilution of the tax cut program in order to limit short-run static revenue losses during the remainder of FY 81 and FY 82 would be counter-productive. Weak real GNP and employment growth over calendar 1981 and 1982 will generate soup line expenditures equal to or greater than any static revenue gains from trimming the tax program.

3) The needed rebound of real GNP growth and especially vigorous expansion in the capital spending sector of the economy can not be accomplished by tax cuts alone. A dramatic, substantial recission of the regulatory burden is needed both for the short-term cash flow relief it will provide to business firms and the long-term signal it will provide to corporate investment planners. A major "regulatory ventilation" will do as much to boost business confidence as tax and fiscal measures.

4) High, permanent inflation expectations have killed the long-term bond and equity markets that are required to fuel a capital spending boom and regeneration of robust economic growth. Moreover, this has caused a compression of the financial liability structure of business into the short-term market for bank loans and commercial paper, and has caused a flight of savings into tangible assets like precious metals, land, etc. The result of this credit market dislocation and inversion is that super-heated markets for short-term credits keep interest rates high and volatile and make monetary policy almost impossible to conduct.

The Reagan financial stabilization plan must seek to restore credit and capital market order and equilibrium by supporting monetary policy reform and removing the primary cause of long-term inflation pessimism: the explosive growth of out-year Federal liabilities, spending authority, and credit absorption.

This points to the real leverage and locus for budget control: severe recession of entitlement and new obligational authority in the Federal spending pipeline, which creates outlay streams and borrowing requirements in FY 82, FY 83 and beyond. The critical nature of future spending authority

is dramatically illustrated by the experience during FY 1980: new budget authority increased from $556 billion (FY 79) to nearly $660 billion in FY 80, an increase of more than $100 billion, or 18 percent. Much of this authority will create outlay streams and Treasury cash borrowing requirements in FY 81 and beyond.

The fiscal stabilization package adopted during the 100 day session, therefore, must be at minimum equally weighted between out-year spending and entitlement authority reductions and cash outlay savings for the remainder of FY 81. Indeed, the latter possibilities are apparently being exaggerated and over-emphasized. Of the current $649 billion FY 81 outlay estimate, $187 billion stems from prior year obligations or authority and cannot be stopped legally; $97 billion represents defense spending from current obligations and should not be stopped; another $260 billion represents permanent authority primarily for Social Security and interest. The latter can only be reduced by "outside" economic improvements, and the former would be a political disaster to tinker with in the first round. This leaves $159 billion in controllable outlays, half of which will be spent or obligated before Congress acts in February-April. In short, $13 billion (2 percent) in waste-cutting type FY 81 cash outlay savings must be gotten from an $80 billion slice of the buget. Achieving this 16 percent hold-down will be tough and necessary, but if it is the primary or exclusive focus of the initial fiscal package, the ball game will be lost.

Again, the primary aim of the fiscal control component must be to shift long-term inflation expectations downward and restore bond and equity markets. Severe reductions in out-year authority and Federal credit absorption can accomplish this. In turn, robust long-term capital markets would

lessen the traffic jam in short-term credit markets by permitting corporate portfolio restructuring and by drawing savings out of unproductive tangible assets. The conditions for re-establishing monetary policy credibility would be achieved and short-term interest rates, demand for money and inflation expectations would adjust accordingly.

5) Certain preemptive steps must be taken early on to keep control of the agenda and to maintain Capitol Hill focus on the Stabilization and Recovery Program. Foremost, all remaining petroleum product controls and alocations should be cancelled on day one. This will prevent a "gasoline line crisis," but will permit retail prices to run up rapidly if the world market tightens sharply as expected. This prospective price run-up can be readily converted into an asset: it can provide the political motor force for a legislative and administrative program to step up U.S. energy program production (see below).

In addition, some informal agreement should be sought with Chairmen Hatch, Garn and others to defer the labor policy agenda (minimum wage, Davis Bacon, etc.) until the fall of 1981. Both committees will have a substantial role in the stabilization program, and there is no point in antagonizing organized labor during this critical period. Similarly, the Moral Majority agenda should also be deferred. Pursuit of these issues during the 100 day period would only unleash cross-cutting controversy and political pressures which would undermine the fundamental Administration and Congressional GOP economic task.

The following includes a brief itemization of the major components of the Stabilization and Recovery Program:

a) Supply-Side Tax Components

The calendar year 1981 and 1982 installments of Kemp-Roth, reduction of the top income tax rate on unearned income to 50 percent, further reduction in capital gains, and a substantial reform along 10-5-3 lines of corporate depreciation.

b) Fiscal Stabilization Component.

This would consist of two parts. First, the cash outlay savings measures for the remainder of FY 81 would be aimed at holding outlays to the $635 billion range. A hiring freeze and a severe cutback in agency travel, equipment procurement, and outside contracting would be the major areas for savings.

The second part would be oriented toward entitlement revisions and budget authority reductions in FY 82 and beyond. Some of this could be accomplished through budget authority recissions included in the remainder of the FY 81 appropriations bill. This would have to be enacted before the expected December-March continuing resolution expires. Expiration of the continuing resolution would provide strong leverage. Another part could be accomplished through the revised FY 82 budget and scaled-back requests for new budget authority. The remainder would require the legislative committees to address a carefully tailored package of initial entitlement revisions.

Expressed in functional program and spending areas the out-year authority reduction package should address the following items, with a view to reducing Federal domestic program levels by $30-50 billion per annum in the FY 82-83 period:

1) Public sector capital investment deferrals. We are now spending about $25 billion per year for highways, mass transit, sewer treatment facilities, public works, national parks, and airport facilities. These are all necessary and productive Federal investments, but their benefit stream will accrue over the next 20-40 years. In light of the current financial crisis, a modest deferral and stretch-out of activity rates (a 10-20 percent reduction) in these areas should be considered.

2) Non-Social Security entitlements. Current expenditures for food stamps, cash assistance, Medicaid, disability, heating assistance, housing assistance, WIC, school lunches, and unemployment compensation amount to $100 billion. A carefully tailored package to reduce eligibility, overlap and abuse should be developed for these areas -- with potential savings of $10-20 billion.

3) Low priority program cut-backs. Total FY 81 expenditures for NASA, CETA, UDAG, the Community Development Program, EDA, urban parks, impact aid, Action, Department of Energy commercialization and information programs, arts and humanities, and the Consumer Cooperative Bank amount to $25 billion. Most of these programs are ineffective or of low priority and could be cut by at least one third or $8 billion.

4) Federal credit, lending and guarantee reform. As was indicated previously, concessional direct lending and loan guarantee activities by on-budget, off-budget, and government sponsored enterprises is now running rampant, absorbing ever bigger shares of available credit market funds. These programs are buried in HUD, SBA, FmHA, EDA, USDA, Commerce and HHS, as well as in the traditional housing credit and farm credit agencies.

Controlling SBA direct grant activities, for instance, will accomplish little if program activity is simply shifted to concessional loan authorities, with the resultant outlays laundered through the FFB.

c) Regulatory Ventilation

This component also has two segments. The first and most urgent is a well-planned and orchestrated series of unilateral administrative actions to defer, revise or rescind existing and pending regulations where clear legal authority exists. The potential here is really staggering, as this hastily compiled list of specific actions indicates. The important thing is that the work-up on these initiatives must occur during the transition and very early after the inauguration. Again, the aim would be to firmly jolt business confidence and market psychology in a favorable direction.

Action	Impact
1) Grant model year '82 CO waiver	$300 million auto industry savings
2) Rescind passive restrairt standard	$300-600 million auto investment savings over 3 years
3) Relax 1984 heavy duty truck emission standard	Minimun savings of $100 million
4) Simplify auto emissions certification and testing	$80 million per year
5) Modify ambient air standard for ozone to permit multiple exceedences or higher standard value in conformance with scientific evidence	$15 to $40 billion in reduced compliance costs over next 8 years
6) Eliminate unnecessary NSPS for small industrial boilers	$1-2 billion over next 5 years
7) Cancel EPA fuel additive testing program	Savings of $90 to $120 million

8) Relax proposed light duty truck emission standards for post-1983	Savings would be a substantial fraction of currently estimated $1.3 billion compliance cost
9) Modify or defer EPA pretreatment standards for industrial wastewater	Savings of a substantial fraction of the $6 billion compliance cost for just three sectors -- utilities, steel and paper
10) Cancel DOE appliance efficiency standards	Avoids multi-billion havoc in an industry that is already improving product efficiency in response to market pressure
11) Eliminate building energy performance standards	Market forces are working here, too, but rigid BTU budgets for each new structure could cost billions per year for non cost-effective energy savings
12) Modify RCRA to incorporate "degree of hazard" and control system simplification	Savings would be some fraction of $2 billion per year
13) Defer new OSHA workplace noise standards	Save $250 million per year
14) Modify or defer pending OSHA standards on scaffolding, asbestos exposure, cadmium and chromium exposure, and grain elevator dust control	More than $1 billion in annual combined savings

These are suggestive illustrations with rough savings parameters from among literally dozens of potential unilateral administrative actions of this sort. A centralized Transition Task Force charged with identification of targets for early action and determination of required legal and rule-making procedures to commence after inauguration could help speed this initiative.

On a second front, both temporary and permanent statutory revisions will be needed. There are literally dozens of rule-making and compliance deadlines on the statute books for the next 20 months that cannot be prudently met. An omnibus "suspense bill" might be necessary during the 100 day session to defer these deadlines and to implement the one year moratorium on new rule-makings

proposed by Murray Wiedenbaum.

Finally, a fundamental legislative policy reform package to be considered after the 100 day period will have to be developed. This would primarily involve the insertion of mandatory cost-benefit, cost-effectiveness, and comparative risk analyses into the basic enabling acts -- Clean Air and Water, Safe Drinking Water, TOSCA, RCRA, OSHA, etc. Without these statutory changes, administrative rule-making revisions in many cases will be subject to successful court challenge.

d) Contingency Energy Package

The probable 1981 "oil shock" could entail serious political and economic disruption. Therefore, the preemptive step of dismantling controls before the crisis really hits is imperative. Incidentally, the combination of immediate decontrol and a $10 rise in the world price would increase windfall profits tax revenue by $20-25 billion during calendar 1981, thereby adding substantially to short-run budget posture improvement, if not to long-run energy production prospects.

But beyond this, a planning team should be readying a package of emergency steps to increase short-run domestic energy production and utilization. This should be implemented if the world market pinch becomes severe. The primary areas for short-run gains would be: accelerated licensing of a half-dozen completed nuclear plants; removal of all end-use restrictions on natural gas; changes in NGPA to permit accelerated infill drilling and near-term production gains; elimination of stripper, marginal and EOR oil properties from the windfall tax; emergency variances from SO_2 standards for industrial and utility coal boilers; and power wheeling from coal-nuclear to oil-based utility systems.

If the crisis is severe enough, rapid statutory revision of the natural gas decontrol program and modification of the windfall tax might be considered as part of the 100 day agenda.

e) A Monetary Accord

The markets have now almost completely lost confidence in Volcker and the new monetary policy. Only an extraordinary gesture can restore the credibility that will be required during the next two years. President Reagan should meet with Volcker or the entire Federal Reserve Board at an early date and issue them a new informal "charter" -- namely, to eschew all consideration of extraneous economic variables like short-term interest rates, housing market conditions, business cycle fluctuations, etc., and to concentrate instead on one exclusive task: bringing the growth of Federal Reserve credit and bank reserves to a prudent rate and stabilization of the international and domestic purchasing power of the dollar.

The President and Congress would jointly take responsibility for ameliorating credit and capital market conditions through implementation of the Stabilization and Recovery Program and would stoutly defend the Fed from all political attacks. Insulation of the Fed from extraneous economic and financial preoccupations, political pressures, recalibration of its monetary objective, and restoration of its tattered credibility is the critical lynch-pin in the whole program.