The original documents are located in Box 8, folder "Reagan/Bush - Transition - Policy Analysis" of the John E. Robson Papers at the Gerald R. Ford Presidential Library.

DEC 4TH/5TH TRIP

JOHN E. ROBSON
BOX 1045
SKOKIE, ILLINOIS 60076

December 1, 1980

Dr. James Cavenaugh
c/o Reagan Transition Staff
1726 M Street, N.W.
Washington, D.C. 20270

Dear Jim:

A couple of months ago I co-chaired with Charlie Zwick a symposium on the need for change in the quantity, quality and organizational arrangement of policy analysis for the President. The symposium was sponsored by the Institute of Governmental Research of the University of Washington and funded by the German Marshall Fund of the United States. Participants in the effort were a bipartisan group of current and ex bureaucrats (list attached). The conclusions of the symposium are summarized in the brief paper attached. With the thought that this may be useful to the Reagan Transition, I submit it and ask that you bring it to the attention of the appropriate people in the transition team.

I'd be pleased to learn of any reaction to it.

Thanks.

Sincerely,

John E. Robson

JER:jfw
encs.

POLICY ANALYSIS FOR THE PRESIDENCY

POLICY STATEMENT

On September 27, 1980, a meeting was held in the offices of the Carnegie Endowment, in Washington, D.C., to consider the needs of the American Presidency for an increase or restructuring of resources to carry out policy analysis as an aid to presidential policymaking. The meeting was sponsored by the Institute of Governmental Research of the University of Washington (Seattle) and funded by the German Marshall Fund of the United States.

Of the twenty-two participants, names and affiliations of whom are listed below, twenty were or are senior officials of the four most recent administrations, the majority having served with the Bureau of the Budget/Office of Management and Budget or the White House staff. The meeting was called and carried out on a nonpartisan basis; the major purpose was to consider presidential needs, and options that might be of assistance to the administration taking office on January 20, 1981. The initial impetus for the meeting came from several former officials who perceived aneed for an institutional strengthening of policy analysis for the President and Presidency, and had become interested in a possible British model for a central analytical institution, the Central Policy Review Staff, serving the Cabinet. (The only overseas participant was the Director-General of the Royal Institute of Public Administration.)

Defining Policy Analysis as the set of techniques stemming from economics, operations research and systems analysis, which in the last fifteen years have proliferated in cabinet agencies, typically under Assistant Secretaries for Planning, and in such Congressional staff offices as the General Accounting Office and the Congressional Budget Office (an approach to policy which the majority but not all the participants agreed differs from more traditional Budget Analysis), the participants reached a substantial degree of consensus on needs; less of a consensus on options:

A. NEEDS

1. The problem is not a shortage of analytical resources in the federal government. Further, the intellectual quality of the analysis is generally high. Little dissent was heard, however, from the observation of one participant that too many current analysts and too many new analysts entering the government from graduate schools fail to understand the ways in which public decisions are made, and therefore provide analyses which are too frequently irrelevant. None of the participants in the meeting felt that analysis could provide more than partial assistance to policy decisions; most felt that too many government analysts do think they have "answers". It was also felt that policy analysis too frequently slights issues of implementation, and that without such issues analysis can have a negative impact on the quality of policy.[1]

2. Given this, however, a consensus felt that the current organization of analytical resources may fail to bring the analytical results produced by executive agencies to bear effectively on presidential decisionmaking, nor does it enable the President to evaluate the effects of these analyses on his policy proposals. It was felt that a need exists for a better synthesis, bringing policy analysis into the process by which the President synthesizes decisions from his own perceptions and needs the views of his agencies. It was recognized that because presidential decisionmaking is necessarily more than the summing up of the views of agencies, each of which has its own needs and constituencies, the analytical input into the President's decisions cannot be simply added up from the results of agency analyses. The President needs his own analytical filter -- a better one that he now has.

3. Such a filter would not be an organization carrying out its own studies or its own sponsorship of outside studies. Rather, it would analyze the analyses from elsewhere for validity and relevance, and summarize their relation to the needs of the President's synthesis. A number of participants did see a need for longer-range strategic planning, but this was not a majority view.[2]

B. OPTIONS

The consensus opposed any proliferation of presidential staffs - addition of a new analytical staff to existing ones. There was less agreement, however, on the degree of restructuring needed, if any. As one participant observed, most of those attending (including himself) had a tendency to see all movement as being downhill since the golden age when they had been in government. As one result, those with most recent tenure tended to see the least need for change from recent or current practices.

The range of alternatives suggested can be summariezed into two basic options, within each of which there was a large number of variations:

1. The majority felt that the perceived needs could best be met within the Office of Management and Budget.[3] Within this majority, views ranged from a belief that OMB can do pretty much what is needed by providing current sorts of personnel with a bit more focus and guidance on the issues raised by policy analyses; to a feeling that the Office needs an influx of more policy analysts of the Economics/Operations Reserach/Systems Analysis type defined here, possibly organized into a new staff. Some participants felt that room could be made for more policy analysts in OMB by resolving the "M" so that the Office could return to the old Bureau of the Budget function, focusing more concentratedly on budgeting as such. Others agreed in part, feeling that the "old" Bureau of the Budget did get into management de facto, but that the formal organization of a management function had turned out to be dilatory. Some discussion also took place as to whether OMB had become "too political" in recent administrations. While the phrase was never completely defined, a number of participants felt that the Deputy Director of OMB should come from a civil service background, as had been the case in the old Bureau; one structuring that received general approval was

that of a political Director, a civil-service Deputy, and a number of political (or policy) Associate Directors. This resembles the top structure of the old Bureau, and although there seems little tendency to try to reverse the need imposed in recent years for Senate confirmation of these officials, this did not arise as a major issue that might interfere with the needed mixed political/civil service structure.

2. A minority felt that presidential policy analytical support should be concentrated outside of OMB. The major reasons adduced for this were that: the role of providing analytical synthesis for the President would distract from the budgeting role; conversely, the budgeting role would necessarily bias the analysis provided to the President; the President, in fact, needs new institutional inventions to act as a counterforce to OMB. It was also suggested that the staff of the National Security Council provides a favorable example of policy analysis parallel to OMB.[4]

In recent years, the Domestic Policy Staff (formerly the staff of the Domestic Policy Council) has served the President in various coordinating functions. The policy analytical capabilities of this staff could be increased, and, were the decisions made that the major analytical synthesis be kept outside of OMB, it could be focused here or in some other Executive Office organization. Even with increased OMB stress on the analytical functions, some small number of analysts on the White House staff might help fill the President's needs.

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[1] Mr. Cohen felt that the thought expressed in this sentence should be restated as follows: "It was felt that the analysis fails to cover adequately issues of implementation. Without such issues, analysis can have a negative impact on the quality of the policy decision process and, even more importantly, the quality of the actual program."

[2] Mr. Cohen would add the following sentence at the end of sub-section 3: "Most felt strategic planning was a subject different from the one under discussion."

[3] Mr. Stern felt it important to point out that far more of those participants in the meeting have had BOB/OMB experience than in any other executive office organization including the Domestic Policy Staff.

[4] Mr. Stern believes that a desirable additional option to consider would be a new policy analysis staff concerned with both domestic and foreign issues with the capability to integrate the two.

CONFERENCE PARTICIPANTS

All participants endorse the attached Policy Statement without qualification (except as noted below).

Richard Cheney*
Representative
U. S. House of Representatives

Howard Cohen**
Secretary of Revenue
State of Pennsylvania

Lynn Daft
Domestic Policy Staff
The White House

John M. Deutsch
Massachusetts Institute of Technology

John Ellwood
Princeton University

James C. Gaither
Cooley, Godward, Castro, Huddleson & Tatum

Harry Havens
Asst. Comptroller General
General Accounting Office

Phillip S. Hughes*
Undersecretary
Smithsonian Institution

Robert A. Levine
Vice President & Manager
Human Resources Studies, Evaluation & Training Division
System Development Corporation

Cecil Mackey
President
Michigan State University

Richard Meserve
Office of Science Technology Policy

Paul H. O'Neill
Vice President
Corporate Planning
International Paper Co.

Philip Odeen
Coopers & Lybrand

William Plowden*
Director General
Royal Institute of Public Administration

Alice Rivlin*
Director
Congressional Budget Office
U. S. Congress

John Robson (Co-chairperson)
Executive Vice President
G. D. Searle

H. Guyford Stever
Consultant

Alfred Stern**
Domestic Policy Staff
The White House

William N. Walker
Partner
Mudge, Rose, Guthrie & Alexander

John White
Deputy Director
Office of Management & Budget

Walter Williams
Director
Institute of Governmental Research
University of Washington

Charles J. Zwick (Co-chairperson)
President
Southeast Banking Corporation

*The names so marked either abstained because they felt it inappropriate to respond positively or negatively (Hughes, Plowden) or were not available for considering the statement (Cheney, Rivlin).

**Both Cohen and Stern added brief comments as noted on the attached statement.

AN IDEA FOR REAL CHANGE IN THE SIZE AND SCOPE OF GOVERNMENT

This is a proposal for reduction in the number of Federal Government employees by 30% to 40%. The idea stems from the belief that it is only through such an approach that priorities can be established and the role of Federal Government diminished.

1. The orthodox approach to "smaller government" and cutting the budget has been a combination of hiring freezes and specific reductions in program expenditures. It hasn't worked. The impact of the "orthodox" approach has proven peripheral and not durable. Invariably, even the modest initial gains are rapidly dissipated. An inexorable "creep" quickly repopulates the Federal bureaucracy and restores the rich diet for programs perceived as undernourished. Moreover, program-specific spending cuts run head-on into well defined external constituencies and pockets of Congressional supporters.

2. A true reordering of government priorities will result from the absence of the human resources necessary to carry out all the activities the Federal Government is now pursuing. As long as the people are there they will want to "do something" and the current level and scope of Federal activity is likely to continue.

3. The problem of big government cannot be successfully confronted with a scalpel-like program adjustment, or "trimming" approach. The approach must rest on a broad philosophical and political foundation. The analogy is to Proposition 13.

4. The basic elements of the proposal:

-- An across-the-board cut in Federal employment by 30% to 40%.

-- All agencies participate equally except specifically identified exempted critical populations (e.g., uniformed military, FAA Controllers, etc.).

-- Phase the cut over three years (10% a year -- maybe link to the Reagan tax reduction program).

-- A restriction on outside consulting would be concurrently imposed to preclude "contracting around" the employee reduction.

- Some sort of outplacement/severance program would accompany the cuts to ease the hardship on individuals and allow for relocation and turnaround time to seek new employment.

- Legislation would no-doubt be required. But Congressional opposition might be more diffuse since there would be no program-specific cuts.

5. The results could be dramatic:

   - Priorities would be established because they would <u>have</u> to be.

   - Money would be saved.

   - Programs would be abandoned <u>de</u> <u>facto</u> and fall into desuetude.

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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 <u>$60-80 billion</u> 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 <u>$150 billion</u>, with only $44 billion of this amount included in the <u>official on-budget accounts</u>. Thus, Federal credit agencies will absorb an additional <u>$100 billion</u> 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 <u>monument to mindless excess</u>: 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 <u>$100 billion in new environmental safety and energy compliance costs</u> scheduled for the early 1980's.

<u>II. The Threat of Political Dissolution</u>

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) <u>Supply-Side Tax Components</u>

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) <u>Fiscal Stabilization Component</u>.

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 restraint 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 waste-water	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.