

5/25/79 [1]

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THE WHITE HOUSE
WASHINGTON

25 May 79

Bob Lipshutz

The attached was returned in
the President's outbox today
and is forwarded to you for
appropriate handling.

Rick Hutcheson

Frank Moore

THE WHITE HOUSE

WASHINGTON

May 24, 1979

Good
J

MEMORANDUM FOR THE PRESIDENT

FROM: ROBERT J. LIPSHUTZ *RL*

SUBJECT: Passage of Ethics Legislation

This afternoon, the House passed those amendments to the Ethics in Government Act which we supported. The amendments proposed by Congressman Bob Eckhardt were defeated.

The House and Senate have now passed the technical amendments to the financial disclosure title and the post employment restrictions title of the Act which we supported and felt were necessary to moderate unintended interpretations of the Act. The House version of the post employment restrictions title does contain the two additional amendments negotiated by Congressman George Danielson; those amendments are not in the Senate version. The two House amendments:

- Amend 207(d) to allow the Director, OGE to limit the one-year ban on contacts with a former agency to portions of that agency instead of the entire agency, where different portions of the agency perform distinctly different functions. For example, a former employee of FDA would be permitted to contact HEW, but not FDA, during the one-year no contact ban.
- Amend 207 by adding Subsection(e) which would exempt from the one-year ban established by Subsection(c) any person who is an elected official or full-time employee of a State or local government, or of any institution of higher education, or of any non-profit medical or research facility.

As I advised, Representative Danielson felt that support for these amendments was necessary. A House-Senate conference will be necessary to resolve the differences between the two bills. Because the Senate passed version had our full support and because the House version is not significantly detrimental to our objectives, we will be able to support any compromise worked out by the conference.

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I am advised by Michael Cardozo of my staff that Attorney General Bell and Secretary Califano worked effectively to help bring about passage of the amendments in the House. Their respective legislative directors were on the scene throughout the day garnering support for the legislation which ultimately passed.

THE WHITE HOUSE
WASHINGTON

Phil has

beer

MEMORANDUM

THE WHITE HOUSE

WASHINGTON

May 24, 1979

cc Fran

C

TO: The President
FROM: Phil Wise *Phil*
RE: A. Philip Randolph Memorial Service

Friends of Randolph asked that you attend a National Memorial Service for him in New York City.

With the schedule as tight as it is, we did not feel you could add a trip to New York anytime before the foreign travel schedule begins.

Alternatively, they ask that you attend a Memorial Service here in Washington. Louie Martin, Hamilton and Rafshoon recommend that you agree to do so. It would probably be at the National Cathedral.

If you approve, we recommend Sunday afternoon, June 3. You are here that Sunday; Rosalynn is out of town.

approve disapprove

reluctantly

*Let me see
my schedule
J*

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for Preservation Purposes

C
/

THE WHITE HOUSE
WASHINGTON

May 25, 1979

MR. PRESIDENT

Lipshutz was not available so Mike Cardozo returned the call to Mrs. Spenkelink. He talked with her and Rev. Joe Ingle. They fully understood that you had no legal authority and were appealing to you as a Christian to ask Governor Graham to stay the execution. They were calm during the call and no accusations were made against you.

The full Supreme Court denied the stay of execution this morning and the execution occurred at 10 a.m.

PHIL

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for Preservation Purposes**

THE WHITE HOUSE
WASHINGTON

25 May 79

FOR THE RECORD;

THE ATTACHED WAS GIVEN TO BOB
LINDER FOR HANDLING. STU
EIZENSTAT RECEIVED A COPY.

2257

THE WHITE HOUSE

WASHINGTON

MEMORANDUM FOR

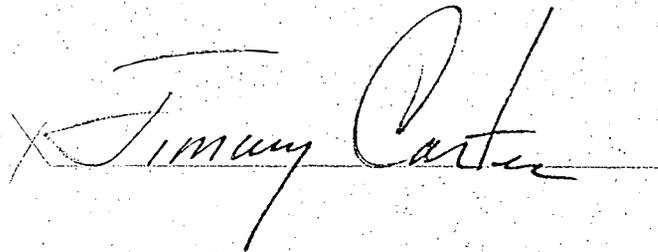
THE ATTORNEY GENERAL
THE SECRETARY OF ENERGY

SUBJECT:

Gasoline Shortages

You shall jointly conduct a comprehensive investigation of the apparent gas shortage situation, using all available and appropriate authority and resources at your disposal, to determine whether there is reason to believe that the apparent shortfall is a result of concerted activity by firms at the refining and/or marketing level, or of excessive stockpiling or hoarding of supplies by any person or firm, in violation of federal antitrust or energy laws. This investigation shall be limited, in the first instance, to an analysis of PAD V and the particular facts of the California gasoline shortfall, with such further investigation of nationwide markets-as later appears necessary.

A report of your initial findings shall be submitted to me within 30 days, with such further analysis and reporting as may be required thereafter.

A handwritten signature in cursive script, reading "Jimmy Carter", written over a horizontal line.

THE WHITE HOUSE

WASHINGTON

MEMORANDUM FOR

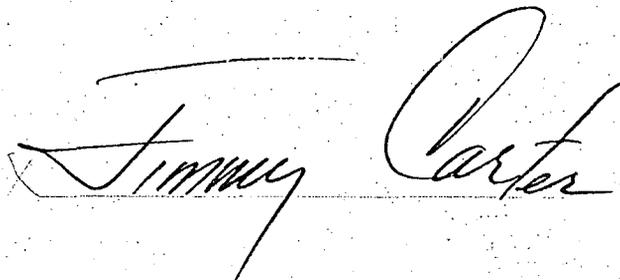
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Jimmy Carter

THE WHITE HOUSE

WASHINGTON

May 23, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: STU EIZENSTAT *Stu*
KITTY SCHIRMER

SUBJECT: DIRECTIVE TO JUSTICE AND DOE ON OIL
INDUSTRY INVESTIGATIONS

Attached is a proposed directive to the Departments of Justice and Energy to undertake the joint oil industry investigation you announced last week in the meeting with the California delegation.

While DOE and Justice have already begun organizing their work, this directive will underscore the importance of this effort, both for the agencies and for the public.

1:15 PM

THE WHITE HOUSE

WASHINGTON

May 24, 1979

MEETING WITH HEATH LARRY, PRESIDENT, AND FORREST RETTGERS,
EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Friday, May 25, 1979
1:15 p.m. (10 minutes)
The Oval Office

From: Anne Wexler *AW*

I. PURPOSE

To thank Heath and Forrest for their outstanding support of the Administration and to discuss some of Heath's ideas for improving relationships with the business community.

II. BACKGROUND, PARTICIPANTS & PRESS PLAN

A. Background: The National Association of Manufacturers is the second largest association representing business in Washington. Member companies are responsible for 78% of all goods manufactured in the United States. They represent 13,850 manufacturing firms including all the Fortune 1,000 except one (Ford Motor Company), as well as 120,000 additional manufacturing firms through their various state affiliations.

Heath was Vice Chairman of the Board of U.S. Steel from 1966 to 1977. Prior to that he was Vice President of U.S. Steel for Industry and Labor Relations and helped establish the National Labor Relations Board. He is well respected by labor leaders, including George Meany and I. W. Abel and helped establish liberal labor contracts which gave labor many of its benefits and advantages in the steel industry. He is active in the arts and believes in social responsibility for corporations.

He became President of the National Association of Manufacturers in 1977.

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You last met with Heath on November 16, 1977 at which time he offered his personal support and cooperation in any way you might be able to use them.

The NAM, as an organization, has supported the following of your programs:

- a. Department of Education
- b. Civil Service Reform
- c. Airline Deregulation (the only National business organization to do so)
- d. Lobby Law Reform (the only National business organization to do so)
- e. Wage and Price standards (Heath sent 14,000 letters to NAM members urging their compliance)
- f. Heath, sometimes at odds with the NAM membership, has individually supported the Panama Canal Treaties, and on Friday, the 18th of May, while giving the commencement address for the Grove City College, Grove City, Pennsylvania, he personally endorsed SALT II.

NAM is really national business organization to endorse trading deregulation
The NAM is and will be supporting oil decontrol, MTN and Federal Compensation Reform.

Forrest is the former Administrative Assistant to Senator Harry Byrd and is considered one of the top business lobbyists in the city.

- B. Participants: Mr. Heath Larry, President
Mr. Forrest Rettgers, Executive Vice President
National Association of Manufacturers
- C. Press Plan: White House photo

III. TALKING POINTS

1. You will want to thank Heath for his endorsement of SALT II as well as his consistent support and bold leadership at the NAM.
2. Heath will say that he wants to continue to support you but he is having some trouble because of your recent statement regarding the oil companies and corporate profits. He feels that these statements

are causing some loss of credibility and support within the business community.

3. Heath will say that you have a better opportunity to help the business climate than a Republican President. You might say that you have been working to reduce the Federal percentage of GNP and unnecessary Federal interventions in the private sector. You might then mention that this is the time we need to work closely together for National priorities such as the MTN, SALT and oil decontrol and ask for their help in selling SALT.
4. Heath will suggest a plan to develop an "industrial strategy" and may elaborate upon it. You might mention that you would like to continue your partnership with Heath and Forrest and that we all need to do a better job of drawing on business resources in this country to increase exports and enhance trade. You might suggest that he take his "industrial strategy" idea to Juanita Kreps (she is working in this area) for further development.
5. It will be important also to recognize Forrest's contributions as he has also been bold and dynamic in his support for you as has Heath.

THE WHITE HOUSE
WASHINGTON

SUSAN:

PLS ADD TO MEMO:

* NAM IS THE ONLY NATIONAL
BUSINESS ORGANIZATION TO
ENDORSE TRUCKING DEREGULATION.

THANKS

RICK

A handwritten signature in black ink, appearing to read "Rick Warren", written in a cursive style.

THE WHITE HOUSE

WASHINGTON

May 24, 1979

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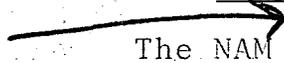
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regular foreign affairs breakfast

5/25/79

THE WHITE HOUSE
WASHINGTON

5-25-79

For Aff br.

Summit

Rhodesia - GBr 11/79 - Harkech

Mid East

SU - Turkey - 42

MFN - PRC vs SU

Iran -

N/S Korea

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THE WHITE HOUSE
WASHINGTON

25 May 79

Zbig Brzezinski

The attached was returned in
the President's outbox today
and is forwarded to you for
appropriate handling.

Rick Hutcheson

Stu Eizenstat
Frank Moore

NSC: Please notify Vance,
Blumenthal, Schlesinger and
Owen of President's actions.

FOR ACTION
FYI

*ask to 273:
pls notify Vance
Blumenthal
+ Owen
act on 3*

FOR STAFFING
FOR INFORMATION
FROM PRESIDENT'S OUTBOX
LOG IN/TO PRESIDENT TODAY
IMMEDIATE TURNAROUND
NO DEADLINE
LAST DAY FOR ACTION

	VICE PRESIDENT
	JORDAN
X	EIZENSTAT <i>pg 6 + McI memo</i>
	KRAFT
	LIPSHUTZ
X	MOORE <i>pg 6 + McI memo</i>
	POWELL
	RAFSHOON
	WATSON
	WEXLER
X	BRZEZINSKI <i>+ cc memo D OMTS</i>
	MCINTYRE
	SCHULTZE
	ADAMS
	ANDRUS
	BELL
	BERGLAND
	BLUMENTHAL
	BROWN
	CALIFANO
	HARRIS
	KREPS
	MARSHALL
	SCHLESINGER
	STRAUSS
	VANCE

	ARONSON
	BUTLER
	H. CARTER
	CLOUGH
	CRUIKSHANK
	FIRST LADY
	HARDEN
	HERNANDEZ
	HUTCHESON
	KAHN
	LINDER
	MARTIN
	MILLER
	MOE
	PETERSON
	PETTIGREW
	PRESS
	SANDERS
	WARREN
	WEDDINGTON
	WISE
	VOORDE

ADMIN. CONFIDEN.
CONFIDENTIAL
SECRET
EYES ONLY

THE WHITE HOUSE
WASHINGTON

5/22/79

Mr. President:

Attached are memos proposing competing energy initiatives for the upcoming economic summit:

- a Vance/Blumenthal/Schlesinger/Owen proposal that you authorize consultations on an "International Energy Finance Corporation";
- a dissenting memo from Jim McIntyre, proposing an "Energy Technology Commercialization Agency";
- an Eizenstat memo objecting to 'preliminary consultations' on the Vance et al plan, and concurring with McIntyre; and
- a "split the difference" memo from Henry Owen suggesting that you authorize consultations on the Vance et al plan, offering the OMB proposal as an alternative to other summit governments.

CL observes that consultations on the Hill will take about a week.

Rick

MEMORANDUM

2978

THE WHITE HOUSE

WASHINGTON

May 17, 1979

3/19
J

INFORMATION

MEMORANDUM FOR: THE PRESIDENT
FROM: ZBIGNIEW BRZEZINSKI *ZB*
SUBJECT: Economic Summit Energy Initiative:
International Energy Finance Corp.

There will be wide public expectation of significant action on energy at the Economic Summit. The attached proposal of an International Energy Finance Corp. is the only presently foreseen initiative that might fill the bill. We need to test it, without committing you, in consultations with other Summit governments and key Congressmen. OMB may oppose it, and other governments may as well, but we need to get a full set of reactions before putting together a final Summit proposal.

I recommend, therefore, your approval of immediate consultations as proposed by Vance, Blumenthal, Schlesinger and Owen.

Attachment:
Action Memorandum

THE WHITE HOUSE

WASHINGTON

ACTION

May 17, 1979

MEMORANDUM FOR: THE PRESIDENT

FROM:

CY VANCE *CV*
MIKE BLUMENTHAL *WMB*
JIM SCHLESINGER
HENRY OWEN *HO*SUBJECT: Economic Summit Energy Initiative:
International Energy Finance Corp.

At your direction, we have begun exploratory discussions with our Summit partners on Economic Summit initiatives to attain greater energy supply security for all nations. The Tokyo meeting, coinciding with likely OPEC decisions on further price increases, will be expected by world public opinion to come up with specific and important initiatives to this end.

We need to submit to the Preparatory Group meeting here Friday morning any US proposals requiring extensive consideration by Summit governments if we are to get agreement at Tokyo. One of our draft proposals needs to be reviewed by you before we ask the other governments to consider it thoroughly.

Proposal

We propose to initiate consultations with other Summit governments and members of Congress looking to a possible Tokyo Summit decision to establish an International Energy Finance Corporation. It would pool resources of Summit and other interested governments to provide long-term capital financing for the first generation of projects using commercially unproved technologies in large-scale production of energy. It would be limited to projects that cannot obtain sufficient private financing. By including some OPEC countries (e.g., Venezuela) it would create a practical partnership of producing and consuming countries to expand the world's energy supplies.

This decision could save what may be a critical number of years in launching additional energy production processes that the world will need by the 1990s.

It also would save money as compared with present plans for financing energy demonstration projects. First, capital would be raised internationally; we would be mobilizing subscriptions from other countries on a scale about double our own. Second, the Corporation would borrow its project-financing funds in relatively low-cost markets. Third, by financing projects largely on a loan basis, a larger portion of risk would be assigned to project sponsors than would be the case with either US Government equity financing or ad hoc international equity funding by several governments. This more efficient system would yield more projects for the same amount of governmental capital outlays.

Paid-in US subscriptions to support a lending-only program would be \$100 to \$150 million annually for each of the first three years. Appropriations would be the same unless appropriation of callable capital also were required, in which case callable capital might be subscribed and appropriated incrementally over three or four years.

The Corporation would speed the application of processes coming out of our intensified energy RD&D programs -- initially using heavy crude, shale oil, tar sands, coal (in solid, liquid, and gaseous forms), wood and other biomass, and ultimately direct solar and other technologies. Projects supported by this corporation would produce fuels usable in existing combustion and transport or transmission systems. The Department of Energy lists many promising technologies (Tab A), some of which are ready now, some likely to be ready in the early 1980s for commercial demonstrations.

Background

The IEA Secretariat predicts that, even with optimistic assumptions about Mexican and other oil production and with heroic assumptions about nuclear and coal production, the world will need to create the equivalent of another Saudi Arabia by the early 1990s. The alternative is increasingly severe and damaging energy price increases.

We believe it would be imprudent, perhaps recklessly so, to wait until private companies and banks are likely to finance fully the initial production scale projects demonstrating promising energy technologies in commercial settings. These pioneer projects' billion dollar costs, coupled with great uncertainties as to actual production costs, virtually preclude full private financing, at least so long as projections of oil prices are subject to widely varying estimates.

The Corporation would enable us to get international financing for some of the planned DOE commercialization projects and would thus free up US budget funds for support of a more extensive global effort to create new energy capacity. For example, it would provide a politically acceptable vehicle for certain international projects such as the initial commercial scale use of new technologies for extracting and processing Venezuela's vast deposits of heavy crude. DOE believes, however, that over time a larger proportion of the Corporation's funds would be devoted to US-sponsored projects than was subscribed by the US, because we have more diverse technological and resource potential than other prospective members.

The Corporation would not duplicate planned DOE support of projects. Rather, it would give us a means of lowering the DOE capital outlay and/or lowering DOE budget subsidies to some projects.

Ideally the US subscription should be drawn from the Energy Trust Fund, but this decision need not be made immediately.

The Corporation would normally require a sponsoring company or group to raise at least 25% of the capital as equity and to obtain required legal and other clearances, host government floor price guarantees or other subsidies before obtaining a loan from the Corporation. The Corporation would lend to a project and in some cases take a minor equity position when desirable.

Fears have been expressed that an international corporation would foster "white elephant" projects, whose production costs would far exceed oil or natural gas prices. This risk is inherent in any action, whether national or international, to commercialize new technologies. A corporation controlled by an intergovernmental board, weighing risks and balancing national interests in different technologies and feedstocks, seems at least as likely to be prudent about risking limited funds as individual governments acting singly in pursuit of locally promoted technologies.

There also are fears that the US would be forced, in such a corporation, to support technologies and projects that do not commend themselves to us. Our experience in international financial institutions to date suggests that we will have little difficulty in blocking unsound projects. It also suggests that we will be able to mobilize substantial resources from other countries for projects that we do favor.

Critics also may assert that the proposed corporation would tend to support projects sponsored by the biggest international energy companies, because only they have the capacity to meet requirements for large amounts of risk

capital, alongside the corporation's loan funds. On the contrary, the fact that the corporation would increase the amount of loan capital that could be offered to sponsors over what would otherwise be available, and would provide it directly to project enterprises without requiring parent companies to guarantee repayment, would make possible sponsorship of projects by a broader universe of companies than seems likely otherwise to be involved.

Cost

The corporation would be established by international agreement among the Summit governments, which would subscribe about 70 percent of the stock. By objective criteria, the US share should be about 30-40 percent. The remaining 25-30 percent of shares would be offered to other industrial and OPEC countries. Subscriptions would be 90 percent callable capital and 10 percent paid in over a period of two or three years.

Initial capitalization might be \$10 billion -- sufficient to permit financing 12-18 large projects over the first four to five years of operation. If this capitalization were agreed, the nominal US share would be \$3-4 billion, requiring annual pay-in of \$100 million to \$150 million over the three initial years. If defaults requiring additional pay-in of capital occurred in some projects, the net additional pay-in after liquidation should not be so large as to alter the above orders of magnitude. Recovery on failures would be higher in a loan program than in the alternative of grant/equity financing.

As you know, we hope to persuade the Congress to approve a procedure to require appropriations only for paid-in capital of established international financial institutions. In this case, however, the likelihood of calls being made on some part of the callable subscriptions is greater than in the multilateral development banks.

If appropriations were also required in this case to establish the callable portion of a new international corporation's capital, incremental capitalization could be adopted so as to spread appropriations over three or four years.

RECOMMENDATION

We request your authorization to propose active preparatory consideration of this initiative in the Summit Preparatory Group, reserving your personal decision on it pending our

securing preliminary reactions of the Summit governments through this Group and pending further exploration of the idea in the Executive Branch and in consultations with key Members of Congress.

Agree _____ Disagree _____

*This proposal leaves
me cold. OMB idea has
some merit. I'll read ASC idea.
Consultations should be
conducted on a very
tentative basis -
JC*

MCINTYRE



EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

MAY 21 1979

MEMORANDUM FOR: THE PRESIDENT
FROM: JAMES T. McINTYRE, JR. *Jm*
SUBJECT: Proposal to establish a \$10 billion
International Energy Finance Corporation

Zbig has suggested that we float this proposal in advance of the Summit reserving the right to back away from it at a later date. I believe you need to make a decision now as to whether we should advance it at all, since a decision to back away from it later--after other Summit participants become interested or committed to it--would be most embarrassing.

I have reviewed this proposal, and I think there are three basic issues involved:

1. Would the Corporation make more investment money available to accelerate commercialization of new energy technologies on a worldwide basis?
2. Would the Corporation benefit the U.S. by making additional investment capital available domestically to accelerate commercialization of new technologies?
3. Is there a more effective alternative to accelerate commercialization of new technologies?

According to the sponsors, without the Corporation commercialization of new technologies would be slower because:

- o companies would either have to use equity or borrow against parent corporation assets to finance plants, and not enough capital will be available.
- o only the largest corporations have sufficient funds to do so and they are not so inclined, because at present world oil prices new technologies are not price competitive.

1. Would the Corporation make more money available on a worldwide basis?

We have reviewed in depth the technologies that are or may be ready in the next few years for commercial scale demonstrations. We have

found that for each technology either commercialization is already underway or large scale demonstration or pilot plants are in the process of being planned and built. We did not find--nor were the proponents of the corporation able to provide--a single case of a technology with promise that is not being pursued because of a lack of capital. We did find that both governments and corporations have either invested or are committed to investing in commercial scale demonstrations of new technologies as shown in Exhibit A. For example, nearly \$3 billion has been invested in Canadian tarsands development--mainly by corporations but also with government payments. (See Exhibit B.) The Canadian government has also provided other incentives including the world price for tarsands synthetic crude, very low royalty payments, tax incentives and possibly special license arrangements to participating companies. Development has resulted because:

- a carefully tailored package of incentives were made available--not just capital.
- corporations were willing to invest substantial capital because of the potential for future profits--e.g., the technology would work and produce syncrude at a price that participants believe would be eventually lower than the OPEC price.

We have reached these conclusions about worldwide capital availability:

- promising technologies are already undergoing extensive development.
- all such technologies today and for the next few years require government subsidies--not just capital.
- when governments are willing to provide the "right" subsidies for the development of promising technologies, capital is available in the private market.

The proposed corporation, on the other hand, would likely:

- displace capital that otherwise would have been invested by individual governments and private corporations.
- increase the time required to develop a project because two sets of approvals will be required; one for a loan from the corporation, and the other for subsidies from the host government. This adds one approval over what would be necessary with only a host government sponsor.

- ° provide capital to the riskiest, least promising projects that would otherwise not have been financed.

2. Would lower cost capital be available on a domestic basis, making more project commitments possible than already have been made?

Shown below are estimates for non-nuclear energy development contained in the FY 80 budget, the Energy Security Trust Fund and those resulting from phased decontrol.

	(In billions)
	<u>80 - 84</u>
FY 80 budget	\$ 4.0
Energy Security Trust Fund ^{1/}	7.5-18.5
Additional Producer Net Revenues - Phased Decontrol	<u>17.5</u>
TOTAL	\$29.0-40.0

In addition, a commitment has been made to provide Federal loan guarantees for commercialization projects as part of the Energy Security Trust Fund. This would assure project sponsors of capital availability at less than market rates.

The following are some of the commercialization or demonstration projects already supported by the Administration:

- ° Solvent Refined Coal I
- ° Solvent Refined Coal II
- ° Shale Oil Commercialization (\$3/bbl tax credit)
- ° High btu coal gasification plant
- ° Low-medium btu coal gasification plants
- ° Fluidized bed gasification plant
- ° Petroleum substitutes from coal
- ° H-Coal liquids plant
- ° Gasohol (exemption from 4¢ per gallon Federal gasoline tax)

The projected U.S. contribution to the Corporation will require appropriations and outlays. Proponents of the Corporation suggest that only the paid-in portion of U.S. subscriptions be requested for appropriation from Congress; the callable portion (about \$3 billion) of the subscribed capital would not be requested and only proposed if the Congress so demanded. The fact of the matter is that the proposed Corporation will be lending on high risk projects--not relatively secure projects. That would require having callable capital appropriated and ready for use if certain projects default. Therefore,

^{1/} For 85-90 up to \$63 billion is estimated to be available.

the callable capital should be appropriated. Shown below are budget authority and outlay estimates that would be necessary.

(In Millions \$)

	<u>FY 81</u>	<u>FY 82</u>	<u>FY 83</u>
Budget Authority	\$1,167	\$1,167	\$1,167
Outlays	117	117	117

Although the sponsors' projections show no outlays beyond FY 83, in my judgment there is a high probability that outlays will occur in the post FY 83 period because of project defaults. By definition, the corporation will be financing untried, high risk technologies that will involve failures. If 10-25 percent fail (1-3 projects) losses could be \$1-3 billion (after salvage recovery) requiring further outlays to the corporation.

The substantial commitments already made by the Administration to demonstrate and commercialize new energy technologies make it very difficult to explain how the Corporation would benefit the U.S. In my judgment--and Stu shares this view--any attempt to provide the U.S. capital share for the Corporation from the Energy Security Trust Fund will therefore put the whole Fund concept seriously at risk, since the Congress will object to tax revenues for energy development beyond our borders and without advantage to the U.S. Finding this kind of money in the FY 81 DOE budget, on the other hand, will be impossible under the budget plans which you have just approved without making serious cutbacks in domestic energy development programs (e.g., solar or coal).

3. An Alternative

Because I see no international or domestic advantages to the proposed Corporation--and many risks--I urge you to disapprove it.

Nevertheless, we do need to encourage on a worldwide basis:

- additional development and production of competitively-priced conventional oil and gas, and
- development of new energy production and conservation technologies through demonstration and commercialization.

This need has been recognized by your energy decisions on the FY 80 budget, phased decontrol, the proposal to establish an Energy Security Trust Fund, and U.S. support for World Bank lending for oil and gas development. There may be opportunities to increase conventional production. With recent increases in OPEC prices, ample incentive will exist if nations with resources pass through the increases to companies. Under your phased decontrol program, the U.S. now provides companies with world price for newly

discovered crude. However, other nations such as Canada and the United Kingdom do not. One way of increasing production would be to encourage these countries to match the U.S. incentives for new production at the Summit. I suggest this be done.

With regard to the development and commercialization of new technologies, I believe the project-by-project development approach makes the most sense for international cooperation. This approach works as demonstrated by Canada in their tarsands development project and by DOE on the SRC-II plant. A carefully tailored mix of government incentives (lower royalties, higher market price, loans or guarantees) and private company equity and debt can be designed for each project, so that market-rate loans will not be the only alternative.

I therefore suggest that we recommend to the Summit participants that a non-nuclear Energy Technology Commercialization Agency be established to:

- 1) ask participating nations to make commitments in proportion to the U.S. to develop non-nuclear energy technologies.
- 2) share information among participating countries on developing technologies.
- 3) perform an international investment-banking function for demonstration and commercialization projects, arranging on a project-by-project, country-by-country basis whatever government assistance or subsidies (loans, tax breaks, price guarantees, etc.) are necessary and whatever private capital is available. This agency could facilitate licensing arrangements on promising technologies that would encourage broad use.

DECISION ON OMB ALTERNATIVE: APPROVE _____ DISAPPROVE _____

Attachments

TECHNOLOGIES THAT MAY BE READY FOR COMMERCIALIZATION AS
SUGGESTED BY CORPORATION SPONSORS

<u>Technology</u>	<u>Summit Countries With Significant Reserve Base 1/</u>	<u>OMB Assessment</u>
<u>Geothermal</u>	U.S., Italy, Japan	More R&D needed for hot rock resources. Technology not ready for commercialization and will not be for a decade or more. FY 80 budget contains \$16 million R&D.
° Dry hot rock		
° Steam		Drysteam and hydrothermal applications already commercial in Iceland, Italy, Mexico, Japan, U.S. and several other countries.
<u>Oil</u>		
° Heavy tar sands upgrading	Canada (75), USA (U.S. resources relatively small 2.5 relative to Canada and a few other non-summit countries)	This technology now in commercial scale use in Canada. Two major commercial tar sands projects presently operating and two more are planned. Total investment in two commercial operations \$3 billion (U.S. dollars) cost of production about \$17 per barrel. ^{2/} Another \$7.5 billion is planned to be invested by 1986 for two additional plants by groups of large and small, U.S. and Canadian companies. Significant subsidies are provided by the government. (Refer to Exhibit B for details.)
° Heavy Crudes	U.S. (Venezuela, USSR and Columbia have substantial resources)	Technology to produce and refine California heavy oils largely developed. Commercial U.S. production underway and more planned. Upgrading technology, e.g. flexicoking already in commercial use. Domestic producers have adequate revenues to commercialize this technology.

TechnologySummit Countries With
Significant Reserve Base 1/OMB AssessmentCoal

- ° Atmospheric Fluidized Bed Combustors (AFB's)

USA (26%), Europe (23), (China (21), USSR (20) and Oceania (5.3) are other areas with major coal resources)

Little incentive to use this technology outside of U.S. because other countries have less strict air quality standards. RD&D is still needed for this technology and \$26 million has been included in the FY 80 budget for development of improved components and systems optimization. May be ready for use in utility applications in 4 or 5 years. Industrial applications not capital intensive and will be commercialized without need for subsidies.

- ° Low-medium Btu coal gasification

Hundreds of coal gasifiers using existing technology already in use throughout the world. More advanced technology still in RD&D stage and not ready for commercialization. FY 80 budget includes \$30 million for R&D work. An additional \$300 million may be committed to build a commercial scale demonstration plant using newer technology. Commercialization of new technologies could not occur for 6 or 7 years at minimum.

- ° High Btu gasification

Existing gasifiers suitable for high Btu gasification, e.g. Lurgi and Koppers-Tozek, are in commercial use in Germany, South Africa (largest), Australia and Great Britain to produce coal derived gas. U.S. firms have application before FERC and if they receive a favorable regulatory ruling a commercial high Btu coal gasification project will proceed using existing technology. If they do not, a loan guarantee may be needed and could be available from the Energy Security Trust Fund.

Summit Countries With
Significant Reserve Base 1/

OMB Assessment

Technology

Coal cont'd

° High Btu gasification cont'd

For newer technology U.S. is supporting R&D (\$133 million in FY 80) and is funding construction of a commercial demonstration. About \$276 million will be committed to this demonstration facility. Several other processes are in various stages of development, e.g. Texaco, Hygas, Shell-Koppers, none are ready for commercialization. The DOE and 13 U.S. companies are also participating in demonstration of advanced Lurgi technology in Scotland.

° Methanol from coal

Existing technology not cost effective because of price that is equivalent to about \$23 per barrel. Unless this price can be reduced substantially it will not be competitive with other fuels. RD&D underway in U.S. and elsewhere to reduce costs.

° Coal Liquefaction

Hydroliquefaction

Not ready for commercialization for 7 to 10 years. U.S. sponsoring R&D and construction of cost shared pilot plants using EDS and H-Coal technologies (FY 1980 budget \$110 million). Pilot plant phase expected to be completed in early 1980's

Two commercial scale demonstration plants using SRC technology are proposed, one with German and Japanese government participation. Plants would each produce about 20,000 bbls/day of oil equivalent. The second facility would be financed from the Energy Security Trust Fund. Total U.S. cost expected to be \$.9 to \$1 billion dollars. Estimated time to complete construction and operation

Technology

Summit Countries With Significant Reserve Base 1/

OMB Assessment

Coal cont'd

of plants is 6 to 7 years at which time competitiveness may be known. Commercialization not advisable until then.

Indirect Liquefaction

Lurgi-Fisher-Tropsch conversion of coal to liquid fuels has been in commercial operation in South Africa (SASOL I) since 1956. Process suffers from low overall efficiency and would not be competitive in U.S. with higher coal and labor costs and more stringent environmental standards. Improved process (SASOL-II) is expected to greatly improve efficiency of process and could be marginally competitive in U.S. However, SASOL-II is under construction and its readiness for commercialization elsewhere could not be determined until project is constructed and made operational in early 1980's.

Oil Shale

U.S.(1059), Canada(91),
China(153), USSR(24), Zaïre
(11), Brazil(4), Sweden
Morocco

Oil shale may be ready for commercialization in a year or two. Two commercial demonstrations planned for federally leased lands in western U.S. but commercial production will not be achieved until 1986 or later according to approved plans. DOE FY 1980 budget for surface and in-situ shale R&D \$28 million. Proposed \$3 per barrel tax credit from Energy Security Trust Fund proposed through 1999 and the world price for production should be more than adequate incentive. Studies have shown that loans are not a sufficient incentive to force commercialization.

Technology

Summit Countries With Significant Reserve Base 1/

OMB Assessment

Solar Thermal Electric, Solar "Panels" (Photovoltaics), OTEC,

N/A

According to DOE these technologies are far from being commercially ready. The DOE's Solar Funding Strategy, Sept. 1978 on page 6 states that solar photovoltaics, solar thermal, OTEC and biomass plantations "have significant potential for long term but are now far from economic application."

- 1/ Non-summit countries in parenthesis also have identified resources. Numbers in parenthesis are estimated reserves in billions of barrels of oil equivalent except for coal where numbers represent percentage of total world reserves.
- 2/ The \$17 per barrel figure is the average cost over the 25 year lifetime of the mine in current dollars and does not include profits, taxes and royalties.

Canada: Oil Sands Commercialization Plants and Projects

<u>Project/Location</u>	<u>Participants and Share of Equity</u>	<u>Design Capacity (Thousand b/d)</u>	<u>Capital Cost (Million U.S. \$)</u>	<u>Construction Start</u>	<u>Extraction Completion</u>	<u>Government Incentives</u>
Great Canadian Oil Sands, Ft. McMurray, Alberta	Sun Oil (96%), Other 4%	45 .60	385	1965 1980	1969 1982	Royalty equals 8% of selling price of first 900,000 barrels per day versus royalties paid on convention oil of 28-40%. Producers get world price of \$17-20 per barrel versus new convention crude of \$12.75. Producers deduct royalty payments for tax purposes which is not allowed for convention oil.
Syncrude, Ft. McMurray, Alberta	Ontario (5%), Alberta (10%), Petro-Canada (15%), Gulf (16%), Imperial (32%), Cities Services (22%)	129 200	2,850	1973 1981	1978 1983	
Imperial, Cold Lake, Alberta	Esso (90%), Petro-Canada (5%), Alberta Energy Co. (5%)	145 ^{1/}	4,700 ^{1/}	1981 ^{1/}	1985 ^{1/}	
Alsands Project Group Ltd., Ft. McKay, Alberta	Shell Canada (25%), Gulf (8%), Shell Explorers (20%), Dome (4%), Socal (8%), Petro-Canada (9%), Amoco (10%), Petrofina (8%), Hudson Bay Oil and Gas (8%)	140 ^{1/} 2/	4,200 ^{1/}	1979 ^{1/}	1986 ^{1/}	

^{1/} Projected.^{2/} Including 15,000 b/d of LPG's.^{3/} Note that royalties above 900,000 b/d for Great Canadian is 20%. For the Syncrude project, Alberta may either take one-half revenues minus operating costs depreciation and interest on investment or alternatively royalty payments of 7.5% of gross revenues.

THE WHITE HOUSE

WASHINGTON

May 21, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: STU EIZENSTAT *Stu*
KITTY SCHIRMER

SUBJECT: INTERNATIONAL ENERGY FINANCE CORPORATION

This memorandum provides my views on the International Energy Finance Corporation proposed by Messrs. Vance, Blumenthal, Schlesinger & Owen to be floated at the preparatory sessions for the Tokyo Summit.

1. Floating Proposals Before We Are Firmly Committed to Them

I am concerned about the procedure proposed here of discussing a U.S. initiated concept in the international area before we ourselves are fairly certain of our commitment to it. You will remember that our commitment at the Bonn Summit last year to raise oil prices to world levels by the end of 1980 arose from similar "preliminary consultations". We therefore concur with Jim McIntyre's recommendation that you make a firm decision about the acceptability or desirability of this proposal in advance of any further international discussions wherein this proposal may become unstoppable regardless of attempts to reserve a final decision for later.

2. Can we afford this proposal?

I am persuaded, after the difficulties we had with the FY 1980 budget, and those that we are likely to encounter in FY 1981, that it will be extremely difficult to justify expenditures of \$100-150 million for an International Energy Finance Corporation. In the FY 1980 budget process, we had to forego a number of energy commercialization projects for lack of funds. Notable among these projects were a second SRC facility, loan guarantees for additional coal gasification with conversion facilities, and continuation of work on the high temperature gas cooled reactor. Many of these projects have strong Congressional sponsors as well as potential for adding to energy supplies, and yet, citing the need to control spending, we did not recommend funding. I think it would be very hard to now

turn around and ask Congress for these additional funds for projects which we cannot fully guarantee will be directly relevant to U.S. needs, or will be built here. These difficulties can be expected to intensify as we move into an election year and individual project sponsors begin to press their own proposals in a more shaply political way.

Notwithstanding these concerns, however, I believe there is some merit in establishing a forum for development of international cooperation on energy projects. Jim McIntyre's proposal for an "Energy Technology Commercialization Agency" seems to me to be a reasonable step toward furthering joint international efforts, while permitting us to remain within our budget levels, and carefully choosing those projects to which U.S. capital is committed.

3. Relationship to the Energy Security Trust Fund

I feel extremely strongly that any proposal in this area should be separate and apart from the Energy Security Trust Fund. We already have a difficult battle on our hands in gaining Congressional agreement to our proposed uses of the Fund. To further complicate that debate with an international program -- and the issue of whether callable capital would have to be appropriate -- would be, in our view, a serious mistake.

Summary

While I can see several advantages associated with an international effort to develop energy alternatives, I concur with Jim McIntyre's recommendation that we support only a facilitating agency for putting international arrangements together on a case - by - case basis. An independent financing agency would cost more than I can see that we can afford, and would use funds which could be put to good use, both substantively and politically, here at home.

Finally, I recommend that any decision you make be a firm one, and that if you have reservations about the International Energy Finance Corporation, you not approve international consultations unless and until the issue is firmly decided within the Administration.

THE WHITE HOUSE

WASHINGTON

May 21, 1979

ACTION

MEMORANDUM FOR: THE PRESIDENT

FROM: HENRY OWEN *HO*

SUBJECT: Economic Summit Initiative on Energy
Technologies

You will be receiving competing plans for a major Economic Summit initiative on commercial development of new energy technologies. One, from Vance, Blumenthal, Schlesinger and me, advocates capitalizing an international energy finance corporation to lend to projects, while the other, from Jim McIntyre, would create a group without capitalization, disposed but not committed to consider broader support of projects.

These proposals are not ready for your final decision until we get the views of other Summit countries and congressional leaders. My guess, based on discussions Friday and Saturday with my Summit Preparatory Group counterparts, is that we can get a consensus at Tokyo on something between the two alternatives.

We badly need Summit agreement on some significant action in this field, to demonstrate determination to tackle the global energy problem on a global scale. If this is to happen, we urgently need to get on with international consideration of a concrete US proposal or proposals.

RECOMMENDATION

That you approve our submitting to other Summit governments a paper on the State-Treasury-Energy proposal and our offering the OMB proposal as an alternative, inviting other suggestions before the final Preparatory Group meeting, with a view to presenting a range of options to the heads of government.

Approve _____

Disapprove _____

ID 792110

THE WHITE HOUSE

WASHINGTON

DATE: 18 MAY 79

FOR ACTION: STU EIZENSTAT

JIM MCINTYRE *attached*
Owen - attached

FRANK MOORE (LES FRANCIS) - *concess of commencing consultations*
CHARLIE SCHULTZE *(will consult. will take a week)*

INFO ONLY: THE VICE PRESIDENT

HAMILTON JORDAN

ALFRED KAHN

SUBJECT: VANCE BLUMENTHAL SCHLESINGER AND OWEN MEMO RE ECONOMIC
SUMMIT ENERGY INITIATIVE: INTERNATIONAL ENERGY
FINANCE CORP.

+++++
+ RESPONSE DUE TO RICK HUTCHESON STAFF SECRETARY (456-7052) +
+ BY: 1200 PM MONDAY 21 MAY 79 +
+++++

ACTION REQUESTED:

STAFF RESPONSE: () I CONCUR. () NO COMMENT. () HOLD.

PLEASE NOTE OTHER COMMENTS BELOW:

<input checked="" type="checkbox"/>	FOR STAFFING
<input type="checkbox"/>	FOR INFORMATION
<input type="checkbox"/>	FROM PRESIDENT'S OUTBOX
<input type="checkbox"/>	LOG IN/TO PRESIDENT TODAY
<input type="checkbox"/>	IMMEDIATE TURNAROUND
<input type="checkbox"/>	NO DEADLINE
<input type="checkbox"/>	LAST DAY FOR ACTION -

ACTION
FYI

<input type="checkbox"/>	ADMIN CONFID
<input type="checkbox"/>	CONFIDENTIAL
<input type="checkbox"/>	SECRET
<input type="checkbox"/>	EYES ONLY

<input checked="" type="checkbox"/>	VICE PRESIDENT
<input checked="" type="checkbox"/>	EIZENSTAT
<input checked="" type="checkbox"/>	JORDAN
<input type="checkbox"/>	KRAFT
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<input checked="" type="checkbox"/>	SCHULTZE

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<input type="checkbox"/>	SCHLESINGER
<input type="checkbox"/>	STRAUSS
<input type="checkbox"/>	VANCE



TABA.

Department of Energy
Washington, D.C. 20585

MEMORANDUM FOR STUART EIZENSTAT

FROM:

JOHN F. O'LEARY

o'leary 5-15-79

SUBJECT:

PROPOSED INTERNATIONAL ENERGY FINANCE CORPORATION

This is in response to your request for an explanation of the relationship among the proposed International Energy Finance Corporation ("IEF"), the supply initiatives in the proposed Energy Security Fund ("ESF"), and current DOE demonstration and commercialization programs. The purpose for all three efforts is to address, by means of commercially unproven technologies, the short and mid-term problems that result from the permanent crossover of world demand versus world supply for petroleum; a crossover which is rapidly approaching. The consequences of the crossover are evident: high inflation, high unemployment and a deep recession -- possibly all at the same time. The problem is not limited to the United States; the solution cannot be. Worldwide action is needed to provide:

- Both the capability and capacity to replace or substitute petroleum products internationally.
- A price cap for petroleum and petroleum products.
- A visible institutionalized partnership of consuming and producing nations to develop supply.

The IEF, if successful, will address these needs. It is axiomatic that any significant addition to world energy supplies will help to dampen demand and, therefore, the price for oil.

The Administration has already taken dramatic steps to address the Nation's energy problems. The IEF would be an additional Presidential initiative, in a time of chronic

gasoline and middle distillate supply shortages, that is a logical extension to current and proposed Administration programs. There is no duplication of effort. Rather, it is a recognition of the necessity to provide additional energy for the American and world consumer, by focusing international industrial, technological, and financial resources, to meet the challenges sooner.

The Administration's current program in energy supply is two-fold:

- DOE's budget provides for programs to commercialize improved energy technologies, via equity for commercial-scale demonstration (e.g., SRC I or II), favorable rate regulations (e.g., the Great Plains coal gasification project), and tax incentives (e.g., tax exemptions and increased investment tax credits enacted in the 1978 National Energy Act).
- The Energy Security Fund, when enacted, will provide equity funding for a plant to demonstrate a second form of solvent-refined coal; tax credits for shale oil; a program to encourage the U.S. private sector to produce synthetic liquids, including synthetic gasoline; and additional loan guarantee authority.

In both programs, financial assistance is provided outside the normal commercial investment channels. The IEF, however, proposes to use commercial investment procedures and funding to the maximum extent feasible, as lender of last resort at commercial rates. In essence, it provides for an international "assigned risk pool" for energy development and facility financing. Our experience to date has been that traditional debt financing is not yet attractive to lenders due to the technical uncertainty of the processes and the high cost of the end products when compared to traditional competing energy sources. Some lending institutions are willing to approach these technologies on a venture capital basis. However, the amount of such venture capital is strictly limited and the very nature of venture capital alters the economics of the projects. To be sure, if left to its own devices the financial community will eventually provide normal debt financing for these projects. The issue is one of timing. The financial community will hold off until significant operating experience has accrued. It is one thing to pioneer and quite another to replicate. Hence, we are talking about the IEF as a mechanism to save time -- perhaps 5-10 years.

The concept of the IEF will be most valuable in dealing with three categories of technologies:

1. Those that may be economically competitive today, but require large amounts of capital that either are not available or cannot effectively compete with capital expenditures for "conventional" development efforts.
2. Those known to work technically on a commercial scale, where energy product costs may be competitive with oil in the late-1980's, but where the required investment is large and the economic risks prevent the private sector from building.
3. Those that appear likely to be technically successful based on pilot-scale experience, with energy product costs potentially competitive with late 1980's oil, but where questions of technical scale-up, together with economic risks, deter private investment.

Appended is a list of the technologies which appear to be prime candidates for IEF financing. However, the complementary international aspects of the IEF can be best demonstrated by considering several specific examples.

We have previously discussed the vast domestic and worldwide resources of heavy oil and tar sands. Barriers to the exploitation of these resources include the capital requirements necessary for extraction and refining and the hesitancy on the part of some non-industrialized countries to open up their resources to the traditional consuming nations. Hence, the international financing mechanism of the IEF can provide a means, currently absent, for accelerating in a politically acceptable way, the development of those supplies of heavy oil and tar sands.

Coal can be the most important resource for the production of electricity. Many nations, notably Japan, are using petroleum for the major portion of their electrical needs. Barriers to the increased use of coal for electric utility applications are primarily environmental and the economic competition with oil and gas consuming systems at current world prices. Technologies under development that would alleviate these barriers include Fluidized Bed Combustors and Combined-Cycle (Direct) Gasification Systems. Both systems are candidates for first commercial demonstration (200 MWe) as early as 1981. The IEF's activities in this area

could increase the replication of these technologies and assure that evolutionary improvements are incorporated in a timely manner. Additionally, the IEF could focus coal-utility technologies such as MHD and molten carbonite fuel cells. These systems, and advanced versions of them, offer substantially improved efficiency and environmental performance. All of the above technologies are the subject of intense domestic and international interest, yet very little concerted effort.

In sum, I believe the IEF fills a vacuum in our energy supply initiatives by focusing on technologies with international consequences and interest. It provides the United States and the rest of the world with an institution capable of accelerating the development and deployment of commercially unproven technologies and mitigating the consequences of the crossover of demand for petroleum versus supply.

The IEF would complement not duplicate the currently planned and proposed DOE commercialization program. It would give us an alternative to 100% U.S. financing of demonstration projects sponsored by U.S. companies. Providing these projects with capital supply from lower cost money markets the IEF would offer advantages for the U.S. budget over USG equity financing and potential advantages on debt financing when there is a cost of money differential between U.S. and foreign money markets.

If you have any additional questions, please do not hesitate to call me.

cc: Henry Owens
Rutherford Poats

THE WHITE HOUSE

WASHINGTON

May 21, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: STU EIZENSTAT *Stu*
KITTY SCHIRMER

SUBJECT: INTERNATIONAL ENERGY FINANCE CORPORATION

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

cc Charlie
Mike - Stu

J

May 25, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: Charlie Schultze *CLS*

In response to your request at the breakfast the other morning, we are attaching a background paper on the economic situation, the alternative broad lines of economic policy, and a very preliminary assessment of the impact of further OPEC price increases. This was very quickly put together, but may help provide some background.

enclosures

**Electrostatic Copy Made
for Preservation Purposes**

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

May 25, 1979

MEMORANDUM FOR THE PRESIDENT

FROM: Charlie Schultze *CLS*
W. Michael Blumenthal *WMB*

SUBJECT: Outlook for Economic Growth and Inflation
and Policy Alternatives

During the next 12 to 18 months, our economy will experience both slow economic growth and high inflation. Even under the best of circumstances, economic performance is likely to be unsatisfactory.

Economic growth has already begun to moderate; a slow pace of expansion is likely to be maintained in the second half of this year.

- o Inflation is cutting back on consumer purchasing power and reducing the rise of consumer spending.
- o High mortgage interest rates and reduced availability of mortgage credit have already reduced home construction somewhat. Moreover, financial constraints on housing are increasing, and further reductions in housing starts and construction must be expected.
- o Energy concerns are causing consumers to reduce their purchases of motor vehicles.

Outlook for Economic Growth

Under favorable conditions, economic growth will slow to about a 1 to 1-1/2 percent rate from mid-1979 to mid-1980. A faster pace may resume thereafter.

- o This outcome hinges upon the assumption that inflation moderates significantly in the second half of this year, and that interest rates then begin to decline.
- o A growth rate in the 1 to 1-1/2 percent range would imply a rising unemployment rate, to about 6-1/2 percent by late 1980, unless productivity performance is very bad.

The prospects for achieving this favorable outcome are diminishing. The sharp April decline in new orders for durable goods may mean that business sentiment is deteriorating, but we cannot yet be sure. The greatest threat to achievement of favorable outcome is the possibility that OPEC oil prices may rise considerably faster than we have allowed for in our forecast of GNP growth and inflation. Another threat is that the world crop situation might turn out less favorable than anticipated earlier, and that food prices would accelerate again in 1980.

Under less favorable conditions, the economy will slip into a mild recession late this year or in early 1980. This outcome would be very likely if inflation does not moderate significantly in the second half, and if interest rates rise significantly further. The squeeze on consumer purchasing power would then continue, and the outlook for housing would worsen. Weakness in these two sectors would gradually spill over into business inventory building and long-term investment plans.

- o The recession would probably be relatively mild and shortlived -- with recovery beginning in the latter half of 1980.
 - o The recovery, however, would probably be less vigorous than the typical recovery from postwar recessions.
- In most earlier recessions, the downturn was accompanied, and made worse, by outright inventory liquidation. Correspondingly, growth of output during the first few quarters of recovery was strengthened by a return to inventory building. The kind of recession and recovery that might occur in 1980 would probably lack this development. Since businesses have, in general, kept their stocks lean relative to sales, both the extent of the downturn and the strength of the recovery would be mild.

-- Moreover, in most earlier postwar recessions, monetary and fiscal actions were taken to limit the decline in activity and accelerate the recovery. A major shift of economic policy toward stimulus, however, would severely damage longer-run prospects for progress against inflation.

- o The unemployment rate in this case might rise to around 7 percent by the end of 1980.

A sharper and more long-lasting recession is possible, particularly if the pay standards break down, or if inflation of industrial prices accelerates in the second half of this year. Either development would call into play significantly tighter monetary policies. Further sharp increases in OPEC oil prices would exert a drag on the economy directly through their effects on consumer purchasing power, and indirectly by slowing economic growth abroad and hence the demand for our exports.

Outlook for Inflation

During the past two years, the rate of inflation has accelerated substantially. During 1977, the consumer price index increased 6-1/2 percent. Between the first quarter of 1978 and the first quarter of 1979, the CPI rose by 10 percent.

The increase of 3-1/2 percentage points in the rate of consumer price inflation between 1977 and early 1979 can be explained, in a statistical sense, as follows:

- o About 1 to 1-1/4 percentage points is due to acceleration in the rise of wages and fringe benefits.
 - About three-fourths of a percentage point reflects acceleration in wages and private fringes.
 - About one-half of a percentage point stems from increases in the minimum wage and higher social security tax rates on employers.
- o Between 1 and 1-1/4 percentage points stems from lower productivity growth.

- o The remainder, about 1 percentage point, stems from a variety of factors other than unit labor costs:
 - In the first quarter of this year, food prices were 12-1/2 percent above a year earlier.
 - Over the past year, prices of energy items in the CPI have risen by 10-3/4 percent.
 - Home purchase prices and home finance, insurance and taxes have increased about 14 percent in the past year.

In 1977, the underlying rate of inflation was around 6 to 6-1/2 percent -- compensation per hour worked was rising at an 8 percent rate, while long-term productivity growth was in the range of 1-1/2 to 2 percent. Since then, the underlying rate has increased about 2 to 2-1/2 percentage points (due to higher compensation per hour and lower productivity growth), and is now in the 8 to 9 percent range. The actual rate of inflation is still higher, due to rapid increases in prices of food, energy and homes, and in mortgage interest rates. The underlying rate of inflation will move up further if these special factors (other than unit labor costs) that affect consumer purchasing power feed back to higher rates of wage increases.

Inflation will continue to be an extremely troublesome problem for the foreseeable future.

- o The rise of food prices is expected to be much more moderate in the second half of 1979.
- o Energy prices, however, will rise more rapidly than other prices over the next several years, even if real OPEC oil prices are unchanged.
- o Continued poor productivity is putting strong upward pressure on labor costs.
- o Moderation in the rise of industrial prices may occur in the second half of this year as economic growth slows, but the extent of moderation is uncertain.

Under the most favorable circumstances, the inflation rate might fall to between 7-1/2 and 8 percent in 1980. This outcome would require:

- o That the pay standards remain effective, and are not relaxed next year.
- o That OPEC oil prices are not increased significantly further in June, and that real OPEC oil prices are not increased in 1980.
- o And that market forces, together with the price standards, operate to slow substantially the rise in prices of industrial raw materials and finished products as economic growth moderates.

Under unfavorable conditions, there may be little or no moderation of price increases outside the food area in the second half of this year.

- o Some relief from price pressures might still occur if the economy goes through a mild recession next year.
 - o But if the pay standards break down, wage rate increases may accelerate later this year and especially in 1980, even in a relatively weak economy, as workers seek to recoup losses of real income because of inflation.
- The underlying inflation rate could move up to the 9 to 10 percent range with an acceleration of wage rate increases. It is extremely difficult in any short period of time to reduce an inflation rate that gets built into the wage-cost structure.

The principal risks on the price front are likely to be developments that would worsen inflation, not ameliorate it.

- o The OPEC countries may well increase prices again in June, and the increase in 1980 could be more than the rate of inflation, i.e., real oil prices could increase further.
- o Economic growth abroad has strengthened, so that pressures may continue on prices of internationally-traded raw materials.
- o The pay standards probably cannot survive in their present form. There may be a need to relax the pay standard in 1980 to maintain its viability, so that an acceleration of wage rate increases next year may be inevitable.

Effects of Rising OPEC Oil Prices

Recent actions of the OPEC countries indicate a very aggressive attitude with respect to price increases. Early this week, Algeria announced an increase of \$2.45 in the price of Algerian crude, effective immediately. This may set the stage for another round of increases at the June meeting of the OPEC countries. Spot prices in the Rotterdam market are over \$30 a barrel, and in a tight world supply/demand situation, the price of marginal supplies of oil traded in the spot market exerts a strong upward tug on the average price of all oil transactions. Part of the upward pressure on spot prices is probably coming from customer hoarding, and as storage capacity fills up, that pressure will disappear. But even then, a demand-supply imbalance probably will still remain.

In the absence of major new conservation measures by oil-importing countries, the OPEC nations will not find it difficult to make higher prices stick. We must therefore be prepared to face both slower economic growth and higher inflation than we have been forecasting as a consequence of OPEC price increases.

The OPEC oil price assumptions used in the economic forecast underlying the Spring Budget Review presented to you last week are shown in the left-hand column of Table 1. An alternative, more pessimistic, path of OPEC oil prices is shown in the right-hand column. Developments of recent weeks -- the sharp increase in spot prices of oil and the Algerian announcement -- make a more pessimistic trajectory of prices increasingly likely.

In this alternative, the price of a barrel of imported oil increases over 60 percent during the two years 1979-1980. Even after adjustment for world inflation, the real price would be up more than 40 percent. Expressed in terms of a "tax" on American consumers, the tab comes to \$17 billion, or about 0.6 percent of nominal GNP. That is roughly half the size of the OPEC tax (relative to GNP) that occurred in the 1973-74 period.

The difference between the two price paths would have a sizable effect on the U.S. economy. An extensive analysis of probable economic effects is now underway. Our tentative judgment is that the higher OPEC prices would add almost a full percentage point to the level of consumer prices by the end of 1980 -- and most of that effect would occur next year. Assuming that fiscal and monetary actions were not taken to offset the dampening effect on economic activity, it would reduce real GNP growth by roughly one-half percentage point next year, and the unemployment rate would be pushed up by about one-fourth percentage point.

The higher OPEC prices in the pessimistic alternative would add about \$3 billion to our import bill for oil in 1979 and about \$10 billion in 1980. Effects on our overall trade and current account deficit are more conjectural. Since economic growth would slow here, our non-oil imports would not go up as fast; however, economic growth would also slow abroad and dampen the demand for our exports. Exports to OPEC countries would rise somewhat. These secondary effects on our imports and exports seem likely, on balance, to offset part of the increase in the trade deficit from higher oil prices. The effects on the value of the dollar in exchange markets are uncertain. Since the United States is relatively less dependent on imported oil than other large industrial countries, however, it seems unlikely that the effects of higher OPEC prices would put significant downward pressure on the dollar. Recent strength of the dollar in face of OPEC price announcements suggest that foreign exchange market traders are drawing this conclusion.

Policy Alternatives for Dealing with Inflation

Our hopes for maintaining a reasonably satisfactory economic performance over the next several years depend importantly on bringing down the rate of inflation. The anti-inflation program put into place last fall has gotten off to a very poor start.

- o Economic growth in the fourth quarter was much stronger than we or almost anyone else had expected. Although growth has slowed early this year, industrial markets are still tight and there has been little resistance to price increases.
- o Sharp increases have occurred in prices of food, energy, and a wide range of industrial raw materials; such price increases cannot effectively be constrained by the price standard.

The question at issue is whether the time has come for a basic change in our strategy for dealing with inflation.

There are two different courses of action that might offer hope of a dramatic breakthrough on the inflation front. (A less dramatic course of action is discussed below.)

- o Severe measures of monetary and fiscal restraint, designed to induce or at least risk a sharp recession, and thereby hopefully break the inflationary psychology that presently underlies wage-price decisions and spending decisions of individuals and businesses.

OPEC Oil Prices
(FOB Import Values for Petroleum and Products)
Dollars per barrel

	<u>Assumptions used in Spring Budget Review Forecast</u>	<u>Higher OPEC Prices</u>
1978 Q4	13.25	13.25
1979 Q1	13.93	13.93
Q2	15.34	15.85
Q3	16.25	17.17
Q4	16.63	18.84
1980 Q1	16.95	19.34
Q2	17.26	20.35
Q3	17.58	20.90
Q4	17.88	21.55

- o Mandatory wage-price controls.

Severe Monetary and Fiscal Restraint

Slamming the monetary and fiscal brakes hard would make a recession next year a virtual certainty.

- o The recession would probably be severe -- probably less severe than the 1974-75 decline, but perhaps deeper than other postwar recessions.
- o The unemployment rate could rise rapidly to 8 percent and above.

A sharp recession would lead to declines in raw materials prices and reductions in profit margins. But, wage rates would probably show relatively little response in the short run.

In judging the effectiveness of this strategy for achieving a breakthrough on the inflation front, it may be well to recall the results of the 1974-75 recession, the deepest of the post war period. The inflation rate dropped from double-digit figures in 1974 to a range of about 6 to 6-1/2 percent by mid 1975. Most of the improvement occurred because of smaller increases in food and energy prices and the end of the price bulge associated with the removal of mandatory controls in 1974. The underlying, or hard core, rate of inflation declined only a little, and there was no further improvement in the early stages of the subsequent recovery, despite high unemployment and much excess capacity.

There is no reason to think that the anti-inflation benefits would be any greater now. Inflationary expectations are more deep-seated now than in 1975. A deep recession would give us a start on reducing inflation, but to achieve a lasting turnaround, it would probably be necessary to maintain high unemployment rates (rates in the 7 to 8 percent range) for at least several years.

Relying on severe fiscal restraint alone to induce a severe recession would require either tax increases or drastic cuts in outlays in 1980 and 1981 relative to current OMB projections -- cuts of perhaps \$20 to \$30 billion. Such a shift in fiscal policy would have no direct effect on inflation. It would help to reduce inflation partly because its symbolic effect might influence inflationary expectations, but mainly by depressing economic growth and increasing the degree of slack in labor and product markets.

A sharp recession could also be induced by a severe tightening of monetary policy, leaving the fiscal dials unchanged from present plans. To accomplish this, interest rates might have to be pushed up to, say, 12 to 13 percent for 3-month Treasury bills (which presently yield about 9-5/8 percent).

- o. Monetary restraint has no direct effect on inflation either. It, too, affects prices principally by slowing economic growth.
- o The effect of relying on monetary restraint alone would be a disaster for the housing industry.
- o There is reason to expect that the Federal Reserve would resist efforts to go this route.

In summary, using severe fiscal and monetary restraint to achieve substantial progress on inflation has numerous shortcomings. The principal problem is that any permanent reduction in inflation would require depressing the economy and raising unemployment for a prolonged period. The economic and social costs in terms of lost output and human hardship would be enormous. If political realities required restimulation of the economy after a sharp recession, there would probably be no significant lasting reduction in the inflation rate.

Mandatory Wage and Price Controls

The Administration has repeatedly stressed its strong opposition to mandatory controls, arguing that they are ineffective, and has insisted that they would be imposed only in the event of a national emergency. A reversal of that position could have negative effects on your public image as a decision-maker. The more likely result, however, would be the opposite. At least initially, a substantial part of the public might regard such a move as a display of decisive leadership in dealing with the nation's principal economic problem. That is what occurred in 1971.

The early euphoria that developed when mandatory controls were imposed in 1971, however, was gradually replaced by a growing disenchantment with the workings of the controls. Four major kinds of problems emerged.

- o There were very serious adverse effects on resource allocation. Shortages of critical commodities became worse; goods were sold abroad instead of in domestic markets.

- o The controls were almost completely ineffective in dealing with prices set in auction markets, such as prices of farm products and of internationally-traded raw materials.
- o Investment in many industries was curtailed because of lack of profitability. Capacity constraints in materials industries now partly stem from low investment in those industries during the period of mandatory controls.
- o Real or perceived inequities required adjustment in wage and price ceilings that tended to undermine the effects of the program.

The Nixon Administration sought to deal with these problems by adjusting and modifying the ceilings, but then inflation began to accelerate again. A second freeze was imposed in the middle of 1973, but the problems that emerged were so severe that it was soon removed, and the controls were relaxed further. By early 1974, the controls were removed altogether because the adverse effects had become intolerably large, and the political support for controls had evaporated.

When controls were removed, suppressed inflationary pressures were released and wages and prices shot up. Estimates of the permanent effect of the controls on inflation vary. Most economists believe there was no permanent effect on prices, and some economists believe that the rebound of prices after controls were removed in 1974 was larger than the effects of controls in suppressing inflation while they were in force. Thus, they believe that controls actually made inflation worse -- because of the adverse effects of the controls on productivity growth.

The problems that emerged during the 1971-74 period of mandatory controls stemmed in part from the fact that the economy was overheated from roughly mid 1972 to the end of 1973. If controls were imposed again in an economy strong enough to keep the unemployment rate around 6 percent, the distortions and inequities created could be so severe as to force their removal in 6 to 9 months. They would have a greater chance of success if they were imposed simultaneously with a program of severe monetary and fiscal restraint. Thus, if unemployment were pushed up to 7 to 8 percent and held there for several years, controls might successfully wind down the inflation rate without a wage-price explosion when they were removed.

The adverse effect on economic efficiency and investment that controls produce, however, cannot be completely avoided unless there is so much slack in the economy that controls on the price side are not binding constraints on business price decisions. In that case, the benefit of controls stems from the fact that they hold down the rise of union wage rates, which are relatively insensitive to the overall rate of unemployment.

But, even in this case, the impact on investment and productivity growth from both a sluggish economy and the effects of controls could reduce our potential economic growth rate for many years to come.

Besides these problems that are inherent in the use of controls at any time, there would be other problems created by imposition of controls under present circumstances.

- o Enabling legislation would be needed; there is no authority extant under which mandatory controls could be imposed.
 - The debate in Congress in trying to win approval of control authority would be long and arduous.
 - In today's overheated economy, introduction of enabling legislation would almost certainly lead to a wage-price explosion.
- o Controls in 1971 induced a temporary euphoria and led to increased spending by consumers and businesses. If that happened again, it could aggravate economic overheating.

In summary, mandatory controls have serious deficiencies as a tool for stopping inflation. The initial response to the imposition of controls, however favorable it might be, is unlikely to be sustained unless the controls are effective in reducing inflation. Past experience strongly indicates that any benefits to be gained would be short-lived, and the potential damages are long lasting.

Continuation of Present Policies

The other alternative is to continue on our present course of action -- using monetary and fiscal restraint to achieve a moderate rate of economic growth, but if possible avoiding a sharp recession, and relying on the pay and price standards to unwind inflation gradually.

- o It must be remembered that "gradualism" didn't work in 1969-70; frustration led to mandatory controls in 1971.
- o It would require imaginative selling to be perceived as an effective program; it could have minimal impact on inflationary expectations.
- o But persistence with the present degree of restraint would have minimal disruptive effect on the economy, less risk of creating deep or prolonged recession, less long-term structural distortions than are likely to emerge from either severe demand restraint or mandatory controls.

Continuation of the present course of fiscal policy would preserve the option of a balanced budget in fiscal 1981. That option might not be open, however, if a recession occurs next year. And a balanced budget in 1981 would mean little or no reduction in taxes in the fiscal 1981 budget, increases in personal tax rates to very high levels, and a relatively sluggish economy again in 1981.

As indicated earlier in this memo, the present course of anti-inflation policy will, even under the best of circumstances, succeed in unwinding inflation only very slowly. And it may not achieve significant results over the next year or two. Initiatives to supplement the present course and speed the process of damping inflation would therefore be desirable.

Tax Reductions. Tax reductions aimed at reducing costs, increasing productivity growth, or encouraging moderate wage-price behavior are one possible set of initiatives.

- o Social security tax cuts are a prime candidate. Scheduled increases in rates and the base amount to \$18 billion in calendar 1981 (\$10 billion in fiscal 81). It will be hard to match a tax cut of this size with outlay reductions. Also, a major reduction in social security taxes would jeopardize the solvency of trust funds unless general revenues are substituted.
- o Revenue sharing could be used to encourage State and local governments to lower their sales taxes. We have studied and rejected this possibility earlier; it has administrative problems, many political difficulties and would have only a one-shot effect in lowering prices.
- o Tax reductions to stimulate investment and encourage productivity growth are another possibility. While further incentives for capital formation are needed, any business tax cut is hard to sell without accompanying personal tax reduction. Across-the-board reductions in taxes,

however, are not consistent with a policy of fiscal restraint to cool the economy.

- o A new program of real wage insurance could be developed. To be an effective incentive for moderation in wage demands, in the context of high inflation, the scale of any program that would attract labor support would have to be very large. We would have to be prepared for a payout, in FY 1981, of perhaps \$10 to \$20 billion, and this would rule out budget balance in 1981. Moreover, there was little Congressional support this year for the more moderate program we advanced, and the prospect of a significantly larger program would probably reduce support further.
- o Another tax initiative would be a proposal to reduce income taxes in FY 1981 if overall wage and price increases moderated in FY 1980. For example, if prices decelerated by a specified amount, both corporate and individual taxes would be reduced. If wage rate increases, decelerated, but prices did not, individual taxes would be reduced but corporate tax rates would not. The pay-off in tax reductions would have to be large to serve as an adequate incentive for moderation in wage and price behavior, and it would probably be impossible to maintain the objective of budget balance for FY 1981.

Possible Actions Outside the Tax Area

A more concerted attack on the costs of regulation would be well received by the business community.

- o One possibility would be to request legislation to suspend new regulations (all or those with estimated costs above some threshold) for a limited period. The political fall-out would be heavy; the inflation pay-off would not be evident for several years, and a backlog of regulatory problems would accumulate to be dealt with later. A request could also be made for accelerated Congressional consideration of a "regulatory budget."

The wage/price standards could be tightened in several respects.

- o The profits margin test could be tightened by not allowing companies with margins below those of their base period to increase their margins to their base. This, however, could elicit such strong objections from the business community that the entire program could be put in jeopardy.

- o We could require a 30-or 60-day prenotification of price increases; but this would require a much larger CWPS staff to enforce. (In the previous period of mandatory controls, prenotification and delays in processing requests for relief helped to hold down inflation simply by delaying price increases.)
- o The price guidelines could be reinforced with tax penalties for violators. This would be administratively very difficult, given the fact that the price standards are not written in terms of the accounting procedures followed in tax administration, moreover, a tax penalty would make the present voluntary system very much akin to mandatory controls.

Greater weight could be given to inflation in decisions affecting agricultural prices, imports, new social programs, e.g., NHI.

Selective credit controls could be invoked. However, Presidential authority, under the Credit Control Act of 1969, is limited to authorizing the Federal Reserve to set credit terms and conditions. It is doubtful, under present conditions, that the Federal Reserve would be willing to pursue this course. Moreover, selective controls are essentially unworkable except in the areas of consumer and mortgage credit; neither of these is currently expanding at an exceptionally rapid rate.

Productivity Growth. There is an urgent need for a major, well-publicized, assault on our productivity problem. The collapse of productivity growth over the past decade is still not adequately understood. It is clear, however, that hopes for achieving better productivity performance hinge critically on business investment to expand and modernize our industrial plant. This will require orientation of future tax reductions toward investment incentives, and commitment of Federal expenditures to basic research and development. We could also consider a national conference on productivity, under Presidential aegis, in order to dramatize our concern with the problem, and hopefully generate new ideas for dealing with it.

A widely-publicized attack on the productivity problem would help to improve our public image in the fight against inflation. But neither we nor the public should be under any illusion that productivity growth can be increased quickly. The necessary actions will take many years to be effective.

Concluding Remarks

Sticking with the present course of policy appears to be the best alternative for dealing with inflation. New initiatives are needed in a variety of areas, however. Our present course of policy lacks drama and glamour, and it also needs more coherence. Many of our microeconomic policy decisions in the past 2-1/2 years have added significantly to inflation, while our macro economic policies have, in retrospect, been too expansive. The course of macroeconomic policies has already shifted substantially toward restraint, and the results are now visible in terms of a slowing economy. The benefits on the inflation front will show through faster if actions with regard to agricultural policy, import decisions, regulatory activities and related areas give a larger weight to their effects on prices.

It is hard to convince the public that a strategy designed to improve the inflation outlook over the longer-term, rather than to achieve a dramatic breakthrough, is the best course of action. We therefore need to consider ways to make our case more effectively.

- o One possibility would be to set up formal, well-publicized, consultations with business, labor, and other groups. Such consultations might be helpful in eliciting support for our basic approach, ideas for new initiatives, and proposals for modifying the wage-price standards in ways that would keep them viable and make them more effective.
- o The Tokyo summit meeting may arrive at agreement on a concerted attack on the energy problem. We will need to find ways to put new initiatives in this area in the context of a general approach to dealing with inflation.
- o Strong emphasis could be given to steps to attack inflation from the supply side -- by increasing capacity to produce, improving productivity performance, increasing our energy independence, expanding exports, reducing barriers to imports further, and increasing competition in domestic markets through deregulation and anti-trust policy. Suggestions for an approach along these lines were presented recently in a memo from Secretary Blumenthal to the EPG. The EPG has discussed the issue, but has not reached any decision. Secretary Blumenthal's memo is attached for your information.

This seems best
Let's move



THE SECRETARY OF THE TREASURY
WASHINGTON 20220

May 25, 1979

MEMORANDUM FOR THE PRESIDENT

From: W. Michael Blumenthal

WMB

Subject: Attached paper

These are my personal thoughts on how best to sell publicly a policy of long-term economic austerity. The EPG Steering Group has discussed this memorandum, but has by no means reached agreement on it.

would almost certainly cause a reacceleration of prices and bring the dollar under new pressures. Investment plans would be thrown into disarray. The President would face a series of enlarging budget deficits and an economy heading toward no stable equilibrium. He would have no credibility as an economic manager with a long view and the ability to follow through on his plans.

Accordingly, the task before us is to convince the American people (and electorate) that it makes sense to maintain tight limits on federal spending, to forego large consumption-stimulating tax cuts, and to sweat through a period of slow economic activity and slowly unwinding inflation.

I freely concede that this is no easy task.

What is needed is a vivid and understandable explanation of why this belt-tightening is necessary and why it will pay off. An economic program of austerity needs an overarching theme that engages the imagination and deep convictions of the people.

The theme I suggest is American economic preeminence in the world. The theme is a natural, patriotic outgrowth of the motto "Why not the best?" The President should present his program as the only way to make the American economy, once again, second to none in the world. It should be a frank appeal to national pride. The President should present himself as the leader making the hard choices to ensure that no country - Japan, Germany, or others - can successfully outperform us and best us in world markets.

This means a program that

- . halts our perceived slide relative to Japan and Germany -- both in world export markets and in international comparisons of investment, technology, productivity, and price stability;
- . keeps the dollar strong and steady;
- . works to liberate our economy from the dictates of OPEC price increases;
- . unites American business, labor, and government in an effort to rebuild our productive potential, our leadership in frontier technology, and our skills as an international trader. The unifying theme is the creation of more jobs for all in future years!

The economics of this theme can be stated in non-technical terms: All through Vietnam, Watergate, the formation of OPEC, and the inflation of the 1970's, we have let our economic security

slide through neglect of the economic basics. As individuals, as a national economy, and as a government, we have been borrowing and consuming -- living off deficits in our personal, governmental and trade accounts. We have been living off our capital, while other nations have chipped away at our economic position throughout the world. We can no longer afford this. We must now sacrifice and rebuild, so as to ensure a solid expansion of permanent job opportunities, and a position of U.S. economic leadership in the world, for the 1980's.

This overarching theme justifies narrowing our economic priorities to four goals:

- . beating inflation,
- . increasing our productivity and investment,
- . building a new base of domestic energy sources,
- . and expanding our exports.

These goals fit logically together and reinforce each other. Each of them can be directly linked to creating more long term, real jobs for Americans. By constant recourse to these goals, the President would have a consistent rationale for the many hard decisions he will have to make over the next 18 months:

- . rejecting mandatory controls on wages and prices generally, and on oil prices in particular, as controls bring short term relief at the expense of long term inefficiencies and stagnation;
- . vetoing spending programs that would prejudice a balanced budget and aggravate inflation;
- . deferring new liberal spending programs (e.g. NHI) until the productive base of the economy is rebuilt to support the programs;
- . deferring environmental and other regulations that would heighten inflation or blunt productivity;
- . concentrating social spending on targeted job training rather than broadly distributed transfer payments;
- . turning away from short term reflation, for the goal is to rebuild supply capacity;
- . rejecting large tax cuts for individuals, while

May 15, 1979

entertaining smaller cuts to encourage savings and investment and to boost productivity;

fighting protectionism, so as to ensure an open world economy for our exports.

The President has frequently positioned himself as the champion of the general interest, standing up against special interests. But, in doing so his terminology has been either too abstract to attract notice, or too negative and "populist" to sound convincing and Presidential. This new approach attempts to lend shape, color, and excitement to the general interest -- by associating it with widespread anxieties about our economic position in the world and about our productivity and economic discipline at home. A "strong economy" has, I believe, the same political potentials as a "strong defense".

President Carter is well placed, by style and background, to lead a "back to basics" campaign in the area of economic policy. It is a theme that leads back again and again to job creation and to the need for national unity and labor-business cooperation. It is not divisive.

With this approach, I think the President would have a good shot at creating genuine excitement and commitment for economic policies that would otherwise cause him great political problems. The approach would put him on the offensive -- as a responsible visionary -- against those in the Congress and the Party who think it the highest duty of a Democratic President to meet the short run demands of every special interest group.

W. Michael

W. Michael Blumenthal

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CPI Increases

<u>Weight</u>		<u>April</u>	<u>(s.a.a.r.) Last 6 months</u>
100.0	Total	1.1	11.4
18.2	Food	1.0	14.0
8.5	Energy	3.7	22.0
	(Gasoline)	(6.0)	(39.3)
	(Fuel oil & coal)	(3.8)	(31.8)
73.3	All less food & energy	.9	8.7
10.2	Home purchase	1.3	12.0
9.7	Home financing, etc.	1.7	17.2
53.5	All other	0.6	7.7
	. medical care	0.6	9.2
	. new cars	1.4	11.9
	. footwear	1.1	7.7
	. apparel	-0.5	5.4
	<u>Within food</u>		
	. beef & veal	4.1	55.7
	. pork	-1.7	18.2

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Table 1

Average OPEC Prices
(dollars per barrel)

	Prices assumed last December for budget forecast	:	Prices assumed several weeks ago for spring	:	Possible price pattern if supplies stay tight <u>1/</u>
1978 4Q	13.25		13.25		13.25
1979 2Q	14.04		15.34		15.85
1979 4Q	14.46		16.63		18.84
1980 4Q	15.47		17.88		21.50

1/ The average OPEC price at the present time is about \$16.50

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Table 2

OPEC prices and Rotterdam spot prices

(dollars per barrel)

	OPEC crude oil price	:	Rotterdam spot price for gasoline	:	Difference
Dec. 1978	13.25	:	23.90	:	10.65
3 weeks ending May 11	about 16.25	:	38.69	:	22.44

WHAT HAS HAPPENED TO INFLATION

	Rate of inflation		Change
	1977	Last 4 quarters	
1. Consumer price index	6.5	9.8	3.3
2. Price of goods and services produced by nonfarm U.S. business firms	6.4	8.7	2.3
3. Unit labor costs	6.6	8.9	2.3
Payroll costs (compensation)	8.1	9.2	1.1
(-wages and fringes)	(8.1)	(8.8)	(0.7)
(-increase in payroll taxes and minimum wage)	(-)	(0.4)	(0.4)
less: Productivity increase	1.5	0.3	1.2

Notes:

1. Consumer price inflation rose more rapidly than prices of output produced by U.S. business firms because:
 - . farm prices rose very sharply
 - . mortgage interest costs accelerated
 - . energy price increases have a greater impact on consumers than on other sectors of the economy.
2. The rate of price increase for output produced by U.S. producers accelerated in line with the acceleration of unit labor costs.
3. The rate of increase in unit labor cost accelerated by 2.3 percentage points:
 - . 3/4 percent because of wage acceleration
 - . 1/2 percent because of government mandated costs
 - . 1 percent because of slower productivity growth.

4. A thumbnail description of what has happened is:

- . Consumer price inflation accelerated by
3 to 3½ percentage points
- . "Special" factors accounted for 1 percentage
point
- . The underlying inflation rate has risen by
2 to 2½ percentage points
- . That rise in underlying inflation is due to
 - 3/4 percent acceleration in wage gains
 - 1/4 to 1/2 percent from government
mandated payroll costs
 - 1 percent from slower productivity
growth.

THE WHITE HOUSE

WASHINGTON

May 23, 1979

MEMORANDUM FOR THE PRESIDENT

FROM:

ALFRED E. KAHN *Fred*

SUBJECT:

The Attached Memorandum on Long-Range Anti-Inflation Strategy

This memo consists of little more than a series of suggestions. They have not been approved by your other economic advisers, and some of them would probably not be.

But we must in the next month or two begin reexamining with you the basic premises and components of the anti-inflation program, and I feel the need to expose to you some of the lines along which I have been thinking. If we plan to continue to ask the American people to be patient, I think we must give them reason to believe we are on the right path. The memorandum has some suggestions of what might go into such an explanation.

Attachment

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THE WHITE HOUSE

WASHINGTON

May 17, 1979

(Revised May 23)

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR EPG STEERING COMMITTEE

FROM: ALFRED E. KAHN *fed*

SUBJECT: Long-Range Anti-Inflationary Policy

These are notes that I have jotted down to give some structure to our discussions of long-range strategy and for whatever public document eventually emerges.

I am assuming, for present purposes, that the first topics will be:

1. The macroeconomic and inflation prospects for the next six months, which are sufficiently bleak to require the President to provide some explanation and set of plans for the year or years ahead; and
2. A careful explanation of why we continue to reject the dreary alternatives of a more drastic tightening of the monetary and budgetary screws and comprehensive mandatory wage and price controls, and why there are no other solutions that can assure dramatic results during the next six months, or a return of inflation to truly acceptable levels except over a period of years.
3. What short-term changes, if any, we should make for the second year of the program.

The purpose of this memorandum is to help start us thinking about what should be the components of our long-range strategy. Having persuaded

the American people to reject false, quick remedies, it seems to me we have an obligation (a) to make sure we have fully explored and developed a sound, integrated long-term program that offers the best hope for wringing chronic inflationary tendencies out of our economy; (b) to demonstrate to the American people that we know what we are doing in counseling patience; and (c) to explain why our plan of action does offer the best hope of bringing inflation under control.

To fulfill these promises, it seems to me we must be prepared to argue that our plan gets somehow at the fundamental causes, that it is not part of a spasmodic process of macroeconomic stop-and-go, that it does not consist in temporary palliatives. Observe the close analogy to what the President has said about the energy problem.

I assume that the primary components of our plan will continue to be the ones we enunciated last October: continuing, long-term monetary and fiscal restraint -- this remains absolutely fundamental; some system of wage and price standards; and regulatory reform, broadly defined (as exemplified by the list I prepared for John deButts). The question is: what else should be in it?

I think we should give the President the opportunity to consider the following.

1. Energy policy

Actually, the need for action in this area is so pressing it probably belongs under the heading of short-run rather than long-run policy. In any event, it demands immediate attention.

I am not suggesting a reopening of the fight over crude oil decontrol; I made no secret of my relief at having my schizophrenia on this subject resolved.

At the same time, I am disappointed at how little attention is apparently being paid to other more radical methods of attacking the painfully increasing costs of energy (and I am not referring to tax credits for wood stoves).

In particular, we must consider whether there are any more drastic measures that might have some effect on OPEC pricing decisions. While it may well be that decontrol is the most effective instrument available to us for combating OPEC -- because of the (almost certainly relatively small) effects on our demand for imports -- scarcely a day passes in which I do not receive a letter demanding to know why we are so supinely accepting the continued sway of OPEC over price. Should we not be considering (have we ever?) the possible advantages of:

- (a) sharply increased import duties, or
- (b) import quotas, or
- (c) the Adelman plan, which would make the government the sole purchaser, whether by taking sealed bids or direct bilateral bargaining?
I don't see how anyone can be comfortable with a situation in which we depend for our purchases of crude oil from abroad on private companies whose interest -- because of their own substantial production -- is in having prices higher rather than lower.
- (d) I confess, also, that gasoline rationing (of course, with ration coupons freely transferable) has strong appeal for me as an anti-inflationary and anti-OPEC device, and as the only kind of strong action that really forces the American people to face up to our present straits. It seems to me they might welcome rationing if it were presented as a means of avoiding long lines at the pump and of increasing our leverage in bargaining directly with OPEC: a direct bargainer is weak unless he can make a credible threat to withhold purchases.

2. Increasing incentives to save

It is conceivable that the ten years of inflation we have experienced have given rise to a permanent change in our attitude toward savings; it is clear in any event that the increased willingness of consumers to go into debt has played an important role in its recent acceleration. Increasing the incentive to save, it seems to me, is a necessary part of a long-term anti-inflationary strategy.

Possible methods:

- a. Relaxation and eventual elimination of Regulation Q. (This accords also with our commitment to regulatory reform.)
- b. Tax inducements. Other countries, I understand, encourage savings in this way.
- c. A comparatively generous treatment of deferred wage increases in our wage standards. This would not, of course, mitigate the inflationary effect on employers' costs, but it would moderate the effect on current consumer spending.
- d. Encouragement of profit-sharing plans, perhaps by similarly favorable treatment under the wage standards. This could have several virtues. First, it might permit some relaxation of the wage standards at a time when profits and the rate of increase in the CPI are high -- exactly the time when it is proving most difficult to hold to the original 7 percent.

Second, it would do so without building into the permanent cost structure the large bonuses that workers would get at times when profits are high: as in the case of profit-sharing executive compensation plans, we could permit employers to evaluate them at some average or normal level.

Third, there is a general belief that profit-sharing increases workers' incentives and contributes positively to productivity.

- e. Direct credit controls, particularly of consumer credit. It is amazing to me how often these continue to be suggested from both the right and the left. I recognize that the case for them on short-term macroeconomic grounds is weak: it is unclear that we need additional consumer credit restraint right now. But to the extent that is true, it is in some degree true also of the case for a balanced Federal budget.

I think the case is clearer as part of a longer-term policy of discouraging excessive consumption, and encouraging net saving. Certainly the imposition of direct credit controls would be widely perceived as a serious step to combat inflation.

3. Productivity

One respectable criticism of our present program is that it is in some ways counterproductive: that the wage standards do to some (almost surely very limited) extent make it more difficult to induce and reward productivity improvement, and that slowing down the growth of GNP (and even worse, a recession) is likely to have negative effects. (I will not bother to elaborate the other side of that argument: regulatory reform will clearly work the other way, and so will the control of inflation itself.)

- a. At the very least, we ought to be developing tax policies to encourage capital formation, to introduce as soon as the budget permits -- and perhaps even sooner. The sooner we can turn the focus of future tax reduction strategies toward productivity improvements -- for example, accelerated amortization -- rather than general income tax relief, the better.
- b. Similarly, we must give prominence to attacks on the chronic problem of structural unemployment. I don't see how one can deny the importance of continued efforts along these lines as part of any long-term productivity program, and of an anti-inflation program that is going to have to involve macroeconomic restraints, with their inescapable threat of slowing the march toward reduced unemployment. Besides, (a) and (b) might make up a politically acceptable package.
- c. Encouragement of profit-sharing, and
- d. accentuated emphasis on regulatory reform are both reasonable parts of any such program.

4. Consumer protections and antitrust

What if anything can we suggest specifically other than the customary declaration in favor of strong consumer protection and antitrust policy? I have five suggestions, none of them adequately "staffed out," as they say.

- a. The costs of automobile repairs. Here is a single item, the excessive costs of which evidently exceed \$10 billion a year. The problem is inadequate consumer information. It must be

possible for us to mount a strong attack on this. Esther Peterson has a proposal I sent her for a publication that would simply summarize consumer reports on the service they received at particular repair shops. Her people have developed a plan to try the idea out.

- b. I also sent to Esther a proposal springing from the very wide disparities between the prices charged for the same standard products in different stores in the same localities. The proposal was to encourage merchants to supply, and local newspapers to publish, price quotations for a few hundred such products. While submission of this information by stores would be entirely voluntary, the ones with bargains to offer would presumably respond enthusiastically, and this in turn would put pressure on others to do the same.
- c. This is not a substantive suggestion, but it follows from the preceding two: I should like to see us bring into Washington the heads or representatives of these local consumer agencies, to consider proposals like the previous two, and to enlist them directly and explicitly in the anti-inflation program.
- d. Similarly, I would like to see the enforcement activities of the antitrust agencies more publicly identified as part of the anti-inflation program. These agencies have been active in attacking restraints of competition, particularly at the local levels, that bear directly on the prices of food, medical care, and housing. We are taking steps to involve them heavily in our State and local program.
- e. We should give continued prominence to our support of the Kennedy-Rodino bill to overturn the Illinois Brick decision, which denied ultimate consumers the right to bring treble damage suits against antitrust violators.

5. A direct attack on inflation in the necessities

The basic argument of the COIN people (Consumers Organized Against Inflation in the Necessities), echoed generally by the AFL-CIO -- that inflation in food, energy, medical care and housing has not only been more extreme than in the rest of the CPI, but also has had unique causes, so that monetary and fiscal restraint and wage guidelines are really inapplicable -- is fallacious.

At the same time, it is clear that increasing prices in these areas have been particularly painful; and there is everything to be said for doing what we can to attack the structural problems and regulatory policies that contribute to them -- strenuously and in a highly publicized way, at Federal, State and local levels.

6. International trade

We should make an explicit point of the contribution of freer international trade to the long-range anti-inflationary strategy. The MTN treaties are part of the program; so is our recent effort to enlist Congress in freeing the Treasury Department from the necessity of proceeding with the anti-dumping complaint of the Florida vegetable growers against Mexican vegetables, particularly tomatoes.

7. Regulatory reform

I think we should be taking stock on why it has been disappointingly difficult to make progress in this terribly important part of the President's program. In many cases, I think it is because it has been difficult to decide where the balance of public advantage lies: railroad deregulation threatens to permit sharply increased rates for captive traffic like coal; totally unregulated dairy markets would almost certainly be subject to intolerable fluctuations; there are the familiar problems of measuring and weighing costs and benefits of various environmental and safety regulations; and so on.

In other cases, there have been apparently overwhelming political obstacles: consider our frustrations with the minimum wage, Davis-Bacon, sugar protection, steel trigger prices, the 0.12 ozone standard, the proposed 1.0 ceiling for sulfur oxide emissions, the Jones Act, the Alaska swap.

- a. This underscores the urgent necessity for us to move forward vigorously and loudly in cases where the merits are clear and the political objections are not overwhelming. Trucking deregulation is the most obvious case, and we should give it great prominence. It seems to me we must be prepared to take an extremely tough attitude in our positions on restrictions of economic competition: on maritime shipping, for example, or Section 125a of the Clean Air Act. And what happened to the Administration's espousal of no-fault insurance?

- b. We should make a special effort to emphasize the need for structural improvements of markets. For example, while hospital cost containment is a necessary short-term, pragmatic expedient, we must not seem to make it the centerpiece of our efforts in the health field. The longer-term cure has got to be an attack on poor regional planning of facilities and equipment; the provision of direct incentives to doctors and hospitals to contain costs -- for example, by substituting prospective for cost-incurred reimbursement; and the promotion of price competition among health maintenance organizations and insurers.
- c. In view of the particular sensitivity of the cases where the environment, health and safety are at stake, we should be especially tough in resolving doubts on the anti-inflationary side in dealing with purely economic issues -- perhaps DOT's proposed schedule for fuel economy standards, for example, or mechanical deboning of meat -- where health or safety are not involved.
- d. We should be similarly tough where the economic advantages promise to be really large, as in departure from sustained yield practices in timber cutting on Federal lands.
- e. Where the economic pressure groups are particularly strong, all I can suggest is that we avoid simple, supine capitulation. The administration of Davis-Bacon seems to me a case in point -- as contrasted with a futile effort to change the Act itself. And if we must accept milk parity price supports at a legislatively dictated 80 percent, then we ought to press very hard for the introduction of some genuine discretionary flexibility when CCC stocks get too large. And if we must leave milk marketing orders untouched, we ought to consider a very strong attack on state-mandated minimum resale prices of milk, or the restrictions on reconstituting dried milk, which can have a substantial payoff in price relief.
- f. We plan to shift the emphasis of our State and local anti-inflation program to a comprehensive attack on local restrictions on competition and excessively burdensome regulations: see the long list of suggested regulatory reform actions included in our State and local program.

8. Use of the fiscal dividend

While recent experience has greatly increased our appreciation of the importance of moving toward a balanced budget, we should nevertheless be considering such eventual counter-inflationary uses of the fiscal dividend as accelerated amortization, partial rollback of the social security taxes, buying back State and local excise taxes, or even the negative excise tax on grocery store sales of food that Treasury once suggested as a possible use of the crude oil windfall tax revenues.

9. Ensuring fairness in the distribution of the burden

It seems to me an important emphasis in any program whether short-term or long, should be our determination to minimize the inescapable burden of restraint on the people least able to bear it -- for example, by indexation of social security costs, the liberal use of food stamps, the use of the proceeds from the oil industry excess profits tax to cushion the effect of decontrol on low-income families, the more precise targeting of CETA programs. We should be applying just as much imagination and dedication to this end as to the attack on inflation itself.

One last suggestion: as I said at our last breakfast meeting with the President, I have a feeling that our discussions of economic policy with him have been excessively sanitized, in our anxiety not to present him with any half-baked ideas or conflicting advice. I agree thoroughly about the desirability of the Economic Advisors trying to speak with a single voice. But I do not think the President should be insulated totally from the freer-ranging exchange of ideas that ought to precede the formulation of conclusions. His instincts about the directions in which we ought to think about moving may well be better than ours.