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The Optimal Taxation of Commodities and Income

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OTA Paper 8 December 1975

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The last few years have seen a resurgence of interest in the old question of how best to raise tax revenue. Roughly speaking, two different problems have been studied. The first is to find a set of commodity taxes that is optimal given certain efficiency and (sometimes) equity considerations. In a second strain of the literature, it is assumed that the revenue system is based upon income rather than commodity taxation, and the problem is to determine the optimal degree of progressivity (or regressivity).[1/], [2/]

The principal motivation of some writers in the optimal taxation literature seems to be the discovery of fairly simple rules which policy makers actually can implement. Others are more interested in theoretical exploration of the implications of alternative economic assumptions than in developing usable policy recommendations. Practically all the contributions, however, have been quite mathematical and thus inaccessible to many practitioners in the public finance area. The purpose of this essay is to discuss in a nontechnical way the methodology and principal conclusions of the optimal taxation literature.[3/]

In section I we present briefly the history of thought on optimal taxation. Sections II and III discuss the optimal commodity and income tax literatures, respectively. We conclude with some observations on the accomplishments of the optimal taxation research and on some open questions.

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I. SOME HISTORY OF THOUGHT

The debate over the properties of a good tax system goes back hundreds of years. Some of the discussion may seem at once cynical and amusing to contemporary economists. One eighteenth century writer considered a good tax to be one that was easy to disguise. (Jones, p. 93) Similarly, the French statesman Colbert argued ". . . the art of taxation is the art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing." (Armitage-Smith, p. 36)

However, the striking aspect of the old literature is its concern with the same efficiency and equity issues discussed today. It was viewed as desirable that tax induced distortions be kept at a minimum: "Taxation should interfere as little as possible with the processes of industry." (Armitage-Smith, p. 55) The effect of taxes on work incentives was a concern for politicians as well as economists. Gladstone opined that the income tax did ". . . more than any other tax to demoralize and corrupt the people." (Wells, p. 516)

Equity was also a major issue, and the fairness of progressivity was hotly debated. Adam Smith believed that individuals should pay taxes ". . . in proportion to their respective abilities, that is in proportion to the revenue enjoyed." (Stamp, p. 29) Mill characterized a graduated tax as ". . . a graduated robbery," (Stamp, p. 38) while others thought that progressivity had a firm scientific basis in the theory of diminishing marginal utility. (Stamp, p. 40).

As far as formal theorizing is concerned, the history of optimal commodity taxation is rich and long, while that of optimal income taxation is surprisingly thin, if not short. This is no doubt because the commodity tax problem is formally equivalent to the problem of pricing policy in nationalized, increasing returns enterprise. Recent work is in a tradition dating at least from J. Dupuit, writing in the middle of the nineteenth century. However, the most famous forerunner is Frank Ramsey, who derived the proposition that (second-best) optimal commodity taxes cause an equi-proportionate contraction in quantities of all commodities, in a paper published in 1927. Subsequent development has consisted of refinement and re-discovery of Ramsey's result. Important landmarks since then include Samuelson's 1952 U.S. Treasury memorandum (unfortunately never published, but widely circulated informally) and Marcel Boiteux's elegant treatment of the regulation of public monopolies which are subject to budget constraints. In almost all of the work the predominant question was the same: how can we raise a specified amount of revenue (or finance a specified program of expenditures), using commodity taxes, in such a way as to minimize deadweight loss. While distributional issues were generally acknowledged, the focus of attention was on the efficiency question.

In thinking about income taxation the early contributions tended to lean in the other direction, to the point that Edgeworth, in the first important attempt to derive a tax schedule in an optimizing framework, ignored efficiency altogether. He pointed out that if all individuals have identical declining marginal utility of income schedules and the government's goal is to collect its revenue with the minimum aggregate loss of utility, then the appropriate policy is to level off income from the top. Edgeworth's analysis does not take into account the probable efficiency effects of the confiscatory tax rates. Perhaps because the conclusion made so little sense, there seems to have been no further attempt to derive income tax characteristics from an explicit optimizing problem until very recently. Richard Musgrave in his well known text reviewed and clarified this and other criteria (equal absolute or relative utility sacrifice -- interestingly, not derivable from a utilization maximizing framework) which might be used in determining equitable tax shares, but he did not in that context formally introduce the equity-efficiency trade off. Integrating these aspects has been the principal objective of the optimal income tax theorists of the 1970's.

II. OPTIMAL COMMODITY TAXATION

Since the cited literature contains many and varied derivations of the principal theorems of optimal commodity taxes, we shall not carry out detailed proofs here. We can point out, however, some of the variations in the way the problem is posed. Most commonly a revenue constraint is taken as a starting point, together with an assumption that the government must use per unit commodity taxes. (Thus lump-sum taxes are excluded.) If x_i is the quantity of the ith good purchased by the household sector from the production sector (x_i is negative if the households are net sellers, as in the case of the commodity "leisure"), and T_i is the per unit tax, the revenue constraint is

(1) $\quad \Sigma\, T_i x_i = R,$

where R is the required revenue level.

The taxes are the difference between the prices, p_i, received by producers and P_i, paid by the consumers.

(2) $\quad T_i = P_i - p_i \quad .$

It is frequently assumed that producer prices are fixed, so that by setting taxes we set consumer prices and hence consumer welfare. The problem is then to make the choice of taxes in such a way as to maximize the resulting consumer welfare. Another way of describing the objective is to obtain the required revenue with minimum excess burden or deadweight loss to consumers -- the cost in inefficiency which is in addition to the value of output necessarily foregone to meet the government's requirements.

Samuelson uses a somewhat different formulation of the problem and one which has the virtue of emphasizing the resource releasing function of taxes. He begins with the assumption that the government wishes to obtain a vector $g = (g_1 \ldots g_n)$ of quantities of each of the n commodities. Assuming constant returns to scale (and hence no profits under competition) the behavior of firms will be governed by the producer price vector $p = (p_1, \ldots p_n)$ while the demands and welfare of the households will be determined by consumer prices $P = (P_1, \ldots P_n)$. At p the firms will supply the vector $y(p) = (y_1, \ldots y_n)$ of net outputs; at P the households will demand $x(P) = (x_1, \ldots x_n)$. The trick of feasibility is to choose P and p so that

(3) $y(p) - x(P) = g$,

that is the amounts produced less the amounts demanded by the household just equal the government's requirements. The problem of optimality is to pick from among the pairs of consumer and producer price vectors satisfying (3) one which maximizes consumer welfare. To work out the problem it is generally easier to go behind the producer supply relationships. Thus if $F(y) = 0$ implicitly defines the transformation frontier of the economy, the constraint (3) might be expressed by

(4) $F(x(P)+g) = 0$

$F_i(x(P)+g) = \alpha p_i, \; i = 1 \; . \; . \; . \; n,$

where the subscripted conditions are those associated with producer profit maximization.

Because the emphasis is generally on efficiency, a typical approach is to assume there to be only one consumer (hence no distribution problem). Thus the objective might be to choose P and p to

(5) Maximize $U(x(P))$

subject to (4) and to

(6) $U_i(x(P)) = \gamma P_i, \; i = 1, \; . \; . \; . \; n$

Conditions (6) are the familiar first order implications of the household's optimization. More often an indirect utility function $V(P, 0) = U(x(P))$ is used, (the zero argument draws attention to the assumption of no transfer income) as the derivations become very simple when use is made of "Roy's Identity"

(7) $$\frac{\partial V}{\partial P_i} = -x_i(P) \; . \; \frac{\partial V}{\partial M} \quad .$$

where $\partial V/\partial M$ is the derivative of the indirect utility function with respect to budget level.

Putting these pieces together in any of several sequences leads to the famous Ramsey result on optimal commodity taxation:

(8) $\sum_i T_i S_{ik} = \beta x_k, \; k = 1, \; . \; . \; ., \; n$

where S_{ik} is the Slutsky coefficient, the derivative of the demand for the ith good with respect to the kth price, other prices and utility being held constant, and β is independent of k. The left hand side gives an estimate of the change in demand for the kth good which would occur if the taxes were removed. Hence (8) says that the proportional change in demand (thus estimated) should be the same for all commodities -- the Ramsey result.

Condition (8) can also be expressed in terms of elasticities. Probably the most familiar "optimal tax" result is the form which applies when the off-diagonal elasticities are zero. In this case the first order conditions associated with (5) lead to the "inverse elasticity rule":

$$(9) \qquad t_r = \frac{\delta}{E_{rr}}, \ r = 1, \ldots, m,$$

where $t_r = T_r/P_r$, the percentage or ad valorem rate of tax, δ is a constant, and E_{rr} is the elasticity of the ordinary (uncompensated) demand function for the kth good. This formula has certainly been of importance in forming economists' intuitions on tax and price regulatory questions. In underlies the notion of charging according to "what the traffic can bear" in transportation, for example, and is the basis for the acceptance on efficiency grounds of high taxes on tobacco and alcohol, the demand for which is presumed price inelastic.

One of the important contributions of the optimal commodity tax literature, indeed, has been to reconcile economists' sometimes opposing intuitions. For example, the intuition that prices should be set at marginal cost, so that producers' and consumers' price vectors are at least proportional, is seen to be correct under the assumption that (a) distributional objectives are otherwise achieved and (b) sufficient revenue can be raised. If there is insufficient profitability in the economy (as, for example, in the case of constant returns to scale production technologies with competition) the second of these conditions cannot be met. [4/] Where prices must deviate from marginal costs, the inverse elasticity rule is appealing, but we see that it will be strictly appropriate only under the rather strong assumptions of independent commodity demands.

Another application of the analysis is to the presumptive case for direct over indirect taxation. The classic Hotelling argument for marginal cost pricing seemed to support the conclusion that an "income tax" will involve no efficiency cost. When it was recognized, however, that the "income" of the tax system is not the "budget level" of the elementary theory of consumer demand, but rather the product of a certain price, the wage, and a demanded quantity (net purchase) of leisure, the apparent *a priori* advantage of an income tax was lost. The analyses of Corlett and Hague, Little and Friedman to this effect all are applications of the theory of optimal commodity taxation, as is neatly shown by Sandmo.

While the extensive subsequent work has shown how difficult it is to sustain <u>any</u> simple rules for commodity taxation, the result of the spreading awareness of this work has been to make economists think about tax questions in a new way and to hasten the search for rules which are reasonably robust.

For example, as Sliglitz and Atkinson point out, optimal tax analysis makes it clear that there is no <u>a priori</u> assurance that the income tax is the single best instrument for income redistribution. "Commodity taxes", such as housing subsidies or food stamps, might contribute to an optimal program. Boskin notes that, in view of the differences in the observed elasticities of household supply of the two types of labor (husband labor and wife labor), it is probably efficient to tax these "commodities" at different rates. Feldstein (1975) uses the same basic approach to examine the choice between "tax expenditures" and direct expenditure methods of achieving an increase in a specified activity.

A natural question in view of the interpretation of the income tax as a commodity tax is whether taxation of labor only (i.e., uniform taxation of commodities) is appropriate. Not surprisingly, the answer is that it will be appropriate when labor is inelastically supplied. Sandmo shows that this in turn will follow if utility is separable between leisure and all other goods and homogeneous in those goods. Intuitively this separability means that further efficiency cannot be gained by differential taxation of goods that are "related" to leisure. Several writers have noted an important consequence when this result is reinterpreted in an intertemporal context. If utility is a function of consumption and leisure at different dates and separability obtains, then no taxes on interest income should be levied -- consumption is the appropriate tax base. This simply illustrates the challenge, implicit in the optimal tax approach, to the widespread acceptance of taxation on the basis of Haig-Simons income which has been emphasized by Feldstein.

While an "income tax" can be regarded as a tax on the sale of labor (negative net purchase of leisure), there is a feature of actual income taxes which is slighted by such a point of view: it is institutionally feasible to assess taxes at different rates on different individuals; in particular progressive taxation of earnings is possible. Depending upon the allowable features, the possibility arises of, in effect, duplicating a lump-sum tax by a (regressive) income tax structure. When distributional considerations are introduced this is not terribly useful; however, the fact that tax rates can vary from household to household makes the income tax, and such related taxes as the expenditure tax, the principal instruments for distribution objectives. We now turn to the studies which consider the trade-off between such distributional objectives and economic efficiency.

III. OPTIMAL INCOME TAXATION

As we noted in Section I, the problem of optimal income taxation has a long history in economics. However, most of the recent literature stems from a paper published by James Mirrlees in 1971. A natural way to organize our discussion, then, is to summarize Mirrlees' techniques and conclusions, and then view the ensuing literature as an attempt to explain and modify some of his results.

In Mirrlees' model, society is composed of individuals who have identical atemporal utility functions in after-tax income and leisure. Individuals differ only in their earnings abilities (wage per hour). The government must collect an exogenously determined amount of tax revenue. The problem is to find an income tax schedule (tax function) which maximizes the sum[5] of individuals' utilities subject to this revenue constraint.

Using the tools of the calculus of variations to solve the constrained maximization problem, Mirrlees finds that the optimal tax function exhibits marginal tax rates between zero and one, and that when it is operative, part of the population does not work. Although these results may seem weak, they are really quite remarkable given the absence of specific functional forms for the key relationships in the problem.

In order to get more specific results, more specific assumptions must be built into the analysis. Mirrlees assumes that the utility functions are Cobb-Douglas, and considers both lognormal and Pareto distributions of earnings abilities. With these assumptions, the following results emerge: a) the optimal tax function is approximately linear with a negative intercept, and b) the optimal tax function is characterized by 'low' marginal tax rates which fall somewhat with income. (Atkinson's interpolations of Mirrlees' results indicate rates in the neighborhood of 20 percent).

Mirrless was surprised at how low the marginal tax rates were: ". . . I must confess that I had expected the rigorous analysis of income-taxation in the utilitarian manner to provide an argument for high tax rates. It has not done so." A study by Fair in the same year also generated fairly low implied marginal tax rates. Apparently, those who read the Mirrlees paper also found the low marginal tax rates counter-intuitive, for much of the literature appears to be an attempt to explain them.

One concern was the maximand of Mirrlees' problem, an unweighted sum of individual utilities, which implies that a 'util' to a rich individual adds as much to social welfare as a 'util' to a poor individual. To what extent would more egalitarian results (i.e., higher marginal tax rates) emerge if a social welfare function were used which weighted the utilities of the rich less than those of the poor? Atkinson and Feldstein (1973) consider social welfare functions of the form:

(10) $W = (\Sigma U_i^{\upsilon})^{1/\upsilon} \qquad \upsilon \leq 1$

Clearly, when $\upsilon = 1$, welfare (W) is the simple sum of utilities (U_i). When υ is less than 1, however, it can be shown that a given increment to the utility of a low utility individual adds more to W than if awarded to a high utility individual. It should be noted, however, that the specifications of the social welfare function and the individual utility functions are not really independent of each other. We could, for example, specify the utility of the i^{th} individual to be U_i^{υ}, 6/ and then write social welfare as the arithmetic sum of these utilities.

Atkinson focuses attention on the case in which υ approaches minus infinity. Under such circumstances, maximizing W is equivalent to maximizing the utility of the worst off individual in society: the maximin case. 7/ This case has received considerable attention due to philosopher John Rawls' argument that it is particularly compelling as an ethical criterion. (A number of criticisms are suggested by Klevorik.)

Atkinson uses a Rawlsian social welfare function in a model with a linear income tax, no net government revenue requirement (i.e., taxation for redistribution only), and a Pareto distribution of skills in the economy. He finds that optimal marginal tax rates range between 30 and 45 percent. Thus, one solution to the mystery of Mirrlees' low marginal tax rates is his formulation of the objectives of the government. Social welfare functions which are more egalitarian than the classical utilitarian variety may yield higher marginal rates.

Another potential explanation for Mirrlees' results is the Cobb-Douglas assumption concerning the form of individuals' utility functions. Stern has investigated this possibility by assuming that individuals have constant elasticity of substitution (CES) utility functions in leisure and income. Using results on the elasticity of labor supply from the econometric literature,[8/] he finds that an elasticity of substitution of 0.4 is more realistic than 1.0.[9/] When a variant of Mirrlees' problem is solved using CES utility functions with this lower elasticity of substitution, the optimal marginal tax rates are substantially higher -- without appeal to a more egalitarian social welfare function.

So far, it has been assumed that there is one type of labor, and individuals differ only in their ability to perform it. Feldstein (1973) investigates the importance of this assumption by analyzing a two person society consisting of a skilled and unskilled worker whose wages are endogenously determined. He finds that relaxing the exogenous determination of wages has no major impact on optimal marginal tax rates, and as in the Mirrlees article, they are still 'low'. Even for the maximin case Feldstein finds a marginal tax rate of only 45 percent (assuming Cobb-Douglas utility functions).

Reexamination of the social welfare function suggests another possible explanation for the low tax rates typically generated by optimal income tax studies. Out intuition about optimal income taxation may perhaps be conditioned on social objective functions which are not utilitarian-individualistic. For example, the presence in the social welfare function of a variable parameterizing the 'aesthetics' of the income distribution would lead to more egalitarian results.[10/] Similarly, Feldstein (forthcoming) has shown that if interdependent utility functions are allowed for, very high marginal tax rates may be appropriate.

We now turn to a limitation of the Mirrlees model which is just beginning to receive attention, its atemporal setting. The appropriate taxation of capital income is one of the most controversial aspects of the tax system, yet the studies cited above for the most part ignore it. Ordover and Phelps examine the optimal mix of taxes on two factors of production (capital and labor) in a one sector neo-classical growth model.[11/] Their model is very general, and therefore no results on tax rates emerge which can be compared to those discussed above. Moreover, the only social welfare function they consider is the maximin case. Despite these limitations, explicit attention to the taxation of capital income in the optimal income tax framework is an important step which will no doubt stimulate further research.

We could continue to list additional aspects of the Mirrlees model which have been changed and expanded in order to determine their effects on optimal tax rates.[12/] However, the basic thrust of the literature should now be clear. An exogenously determined amount of tax revenue must be raised by income taxes on individuals whose economic choices are distorted by the presence of those taxes. Given technological and behavioral assumptions, the optimal tax schedule is that which leaves some social welfare function at a maximum after the tax is collected. The literature shows how various assumptions on these components lead to different conclusions regarding the shape of the optimal tax schedule.

IV. CONCLUDING REMARKS

The accomplishments of the optimal taxation research have been considerable. It has upset many comfortable rules of thumb and lent precision to many informal arguments. But there remains work to be done. Part of this work will, of course, consist of increasing the stock of variations on the basic problems for which solutions have been described. Another, and very important, part will consist in the attempt to determine quantitatively which of these problems best describes the actual economy to be taxed -- filling in all those empty boxes with real, estimated elasticities.

However, work of another kind is needed to advance the normative power of the analysis. Normatively the optimal tax literature rests on a utilitarian base. It is true that the optimal commodity tax results, or some of them at least, can be cast in a form which says: if your tax system doesn't look like this there is a potential bargain which can be struck among your citizens which would make all better off. However, these bargains are complex and their possibility tends to be eliminated by the very assumptions that require the use of second-best instruments in the first place. For practical application implicit interpersonal utility comparisons are required. The optimal income tax results are also dependent on such comparisons. The missing link is a welfare function, and the question is how does one persuade a legislative or an electorate to decide tax questions in accordance with some particular welfare function? Asking the optimal tax researchers to resolve this problem is effectively asking them to make welfare economics persuasive, obviously a tall order.

Missing from the optimal tax arguments is the idea of horizontal equity, the notion that ". . . people in equal positions should be treated equally." (Musgrave, 1959, p. 160) (Customarily, "equal positions" are defined in terms of an observable index of ability to pay such as income, expenditure, or wealth.) In none of the studies discussed above has the injunction to treat equals the same appeared either as a constraint in the mazimization problem, or as an argument in the objective function. Therefore, they will in general [13] fail to provide horizontal equity. In light of this, Musgrave (forthcoming) and others have suggested that it is inappropriate to characterize such schemes as 'optimal.'

Defining horizontal equity in terms of income is inadequate because individuals with identical opportunity sets but different tastes will have different incomes. An alternative way to define equal position would be identical opportunity sets. However, it seems more in the spirit of the optimal taxation literature to define equal position in terms of utilities: individuals are 'the same' only if they derive identical amounts of utility from their consumption and leisure bundles. The choice of a criterion for horizontal equity is important because when tastes differ between individuals, different criteria may lead to different conclusions as to the fairness of a given tax. For example, an income tax which is perfectly fair according to conventional notions of horizontal equity hurts an 'income lover' more than a 'leisure lover.'

Ironically, although the optimal taxation literature ignored horizontal equity, it has sparked new interest in the topic, and modified the vocabulary of the discussion. For example, the optimal taxation literature emphasis on efficiency has reminded public finance practitioners that excess burden must be taken into account when allocating tax burdens across individuals. Similarly, the concern with the impact of tax changes on utility has focused attention on the equity implications of the differential taxation of pecuniary and nonpecuniary forms of income. It has been shown, for example, that if there is one type of ability and tastes are the same, then horizontal equity is satisfied even if identical individuals pay different amounts of tax. (See Feldstein (forthcoming))

In an attempt to put the discussion of horizontal equity and the optimal taxation literature on the same plane, Feldstein (forthcoming) has redefined the principle of horizontal equity in terms of utility rather than ability to pay.[14/] However, complete integration of horizontal equity into the optimal tax framework remains to be done. Perhaps this could be accomplished by including some measure of departure from horizontal equity as an argument in the social welfare function, but this approach is bedeviled by conceptual difficulties in measuring departures from horizontal equity.[15/]

It may well be that horizontal equity, ancient and honorable criterion of tax policy though it be, is not a helpful concept. However, the apparent appeal of this nonoperational idea to practical people suggests the attractiveness of properties of a tax structure which are independent of the economy to which that structure is applied. To discover whether there are any such properties which significantly narrow the range of "good" tax structures might be a useful topic of research.

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FOOTNOTES

The authors would like to thank Roger Gordon for useful conversations and Jay Stuart for assistance in gathering material.

[1]There is some overlapping of these strains. For example, Atkinson and Stiglitz consider the problem of differential commodity taxation in the presence of an income tax.

[2]Although we shall focus upon these problems in this paper, the optimal tax literature has had a somewhat wider scope. For example, Diamond and Mirrlees concider the problem of optimal expenditure along with taxation, and Atkinson considers the issue of wealth taxation.

[3]Our goal is not to provide a comprehensive literature review. Consult Atkinson and Stiglitz and Sandmo for more biblographical material.

[4]Thus, if y is the sector of net outputs of the production sector, net profits are given by p.y. Equilibruim requires that p.y=0 (otherwise firms would expand all components of y proportionately, which is possible under the assumption of constant returns to sale). For a vector T of taxes proportional to p, say T=rp, where r is a scalar, the revenue raised will be T.y=rp.y=0. In other words, a tax on economic profit would raise no revenue.

[5]He also considers a social welfare function of the form $-\frac{1}{\beta} \int e^{-\beta(u_n)} f(n)dn$, where u_n is the utility of the nth individual and f(n) is the distribution of abilities. In the application Mirrlees takes the cases $\beta = 0$ (yielding a simple sum of utilities) and $\beta = 1$.

[6]Such a transformation changes none of the behavioral implications of the utility function.

[7]The proof is similar to the demonstration of Arrow, et. al., that as the elasticity of a CES production function goes to zero, technology is characterized by fixed coefficients.

[8]These are measures of the elasticity of hours per year with respect to the wage, and thus do not take into account other, perhaps more important dimensions of labor supply.

[9]If the elasticity of substitution were zero, lump sum taxation would be possible. If the elasticity of substitution were infinite, no revenue could be raised.

[10]Such a social welfare function would be non-paretian, but there is nothing to prevent a reasonable set of value judgments from allowing for such a possibility.

[11]Sheshinski (forthcoming, a) considers taxation in a one sector neo-classical growth model with earned and unearned income taxed at the same rate.

[12]For example, Stern has suggested changing the assumptions on the underlying distribution of skills, while Sheshinski (forthcoming, b) focuses on a model in which

taxes influence human capital accumulation.

[13]It can be shown that if all individuals have identical tastes and there is only one type of ability, then horizontal equity will be satisfied by virtually any broad-based tax. (See Feldstein (forthcoming)). Such assumptions, as we have seen, are built into a number of the optimal tax studies. (For an exception, see Diamond and Mirrlees.)

[14]"If two individuals would be equally well off (have the same utility level) in the absence of taxation, they should be equally well off if there is a tax."

[15]See Rosen for a discussion of these problems and some attempts to surmount them.

DEPARTMENT OF THE TREASURY

FISCAL SERVICE - BUREAU OF GOVERNMENT FINANCIAL OPERATIONS

STATEMENT OF THE
DEPUTY COMMISSIONER OF GOVERNMENT FINANCIAL OPERATIONS
FOR PRESENTATION TO THE SUBCOMMITTEE
ON LEGISLATION AND NATIONAL SECURITY
OF THE COMMITTEE ON GOVERNMENT OPERATIONS

GENERAL STATEMENT

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, IT IS A PLEASURE TO APPEAR BEFORE YOU TODAY TO DISCUSS (1) THE INCLUSION IN SECTION 45 OF H.R. 12605 OF AN AMENDMENT TO THE CONGRESSIONAL BUDGET ACT OF 1974, SECTION 503(B), AND (2) THE PROVISION CONTAINED IN SECTION 209 OF H.R. 12606 WHICH PROVIDES FOR FUNDS APPROPRIATED TO AN ACCOUNT FOR THE PERIOD JULY 1 THROUGH SEPTEMBER 30, 1976 TO BE MERGED ON JULY 1, 1976 WITH THE BALANCES AVAILABLE FROM APPROPRIATIONS MADE FOR THE FISCAL YEAR 1976 FOR SUCH ACCOUNT.

TREASURY REQUESTED AMENDMENT OF SECTION 503(B) TO CORRECT TIMING PROBLEMS IN THE FORMAL CLOSING OF THE BOOKS AND TO ACCOMMODATE THE EFFICIENCY OF THE GOVERNMENT'S ACCOUNTING SYSTEMS.

SECTION 503(B) OF THE CONGRESSIONAL BUDGET ACT OF 1974 AMENDED LAW CODIFIED AT 31 U.S.C. 701(B). WITH THIS AMENDMENT 31 U.S.C. 701(B)(1)(A) DIRECTS THAT OBLIGATED BALANCES IN APPROPRIATION

ACCOUNTS FOR FY 1976 OR EARLIER FISCAL YEARS BE TRANSFERRED TO MERGED APPROPRIATION ACCOUNTS OF THE AGENCIES CONCERNED ON THE JUNE 30 WHICH OCCURS TWENTY-FOUR MONTHS AFTER THE END OF THE APPROPRIATE FISCAL YEAR. THE AMENDED 31 U.S.C. 701(B)(1)(B) ALSO PROVIDES FOR THE TRANSFERRAL OF OBLIGATED BALANCES ASSOCIATED WITH THE JULY 1 TO SEPTEMBER 30, 1976 PERIOD, AND WITH ANY FISCAL YEAR AFTER OCTOBER 1, 1976, ON SEPTEMBER 30 OF THE SECOND FISCAL YEAR THEREAFTER.

THE AMENDED 31 U.S.C. 701(B)(2) DIRECTS THAT: (A) UNOBLIGATED BALANCES IN APPROPRIATION ACCOUNTS FOR FY 1976 OR EARLIER BE WITHDRAWN FOR REVERSION TO THE GENERAL FUND OR OTHER SUITABLE FUND, NOT LATER THAN SEPTEMBER 30 OF THE FISCAL YEAR FOLLOWING THE FISCAL YEAR IN WHICH AVAILABILITY EXPIRES, AND (B) UNOBLIGATED BALANCES IN APPROPRIATION ACCOUNTS FOR THE JULY 1 TO SEPTEMBER 30, 1976 PERIOD, AND FOR ANY FISCAL YEAR STARTING AS OF OR AFTER OCTOBER 1, 1976, BE WITHDRAWN NOT LATER THAN THE NOVEMBER 15 FOLLOWING THE PERIOD OR FISCAL YEAR IN WHICH AVAILABILITY EXPIRES.

THE PRESENT PROVISIONS OF SUBSECTIONS (B)(1)(A) AND (B)(2)(A)

WOULD REQUIRE TWO CLOSINGS OF THE BOOKS EACH YEAR FOR TRANSFERS TO MERGED ACCOUNTS AND WITHDRAWALS FROM ACCOUNTS. THESE PROVISIONS WOULD IMPOSE ADDITIONAL AND UNPRODUCTIVE PAPERWORK AND ACCOUNTING WORKLOAD REQUIREMENTS ON THE TREASURY AND REPORTING AGENCIES.

THE AMENDMENTS WHICH ARE NOW INCLUDED IN SECTION 45 OF H.R. 12605 WILL CORRECT THESE TECHNICAL DEFICIENCIES.

WE ALSO SUPPORT THE PROVISION IN SECTION 209 OF H.R. 12606 WHICH PERMITS THE MERGER ON JULY 1, 1976 OF TRANSITION QUARTER APPROPRIATIONS WITH THE BALANCES AVAILABLE FOR FISCAL YEAR 1976 FOR AGENCY ACCOUNTING AND OBLIGATION CONTROL PURPOSES. THE PROPOSED AMENDMENT WILL SIGNIFICANTLY REDUCE THE AGENCY ACCOUNTING WORKLOAD REQUIREMENTS RELATING TO THE CHANGE IN FISCAL YEAR. AGENCIES HAVE INDICATED TO US THAT THEY WILL HAVE TO MAKE EXTENSIVE REVISIONS IN THEIR ACCOUNTING SYSTEMS IN ORDER TO MAINTAIN SEPARATE OBLIGATIONAL RECORDS FOR AN ADDITIONAL ACCOUNTING PERIOD.

IT IS OUR PLAN TO ISSUE WARRANTS FOR THE TRANSITION QUARTER AS OF JULY 1, 1976. THESE APPROPRIATIONS WILL NOT BE AVAILABLE TO THE AGENCIES DURING FISCAL YEAR 1976. WE ALSO PLAN TO ACCUMULATE

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DATA SEPARATELY FOR CASH TRANSACTIONS OCCURRING DURING FISCAL YEAR 1976 AND THE TRANSITION QUARTER IN THE ANNUAL COMBINED STATEMENT.

THE EFFICIENCY AND ECONOMIES RESULTING FROM PASSAGE OF SECTION 209 WILL ENHANCE THE ABILITY OF AGENCIES TO MEET OUR EXTREMELY TIGHT REPORTING REQUIREMENTS FOR FISCAL YEAR 1976 AND THE TRANSITION QUARTER. WE PLAN TO ACCOMPLISH THE SUBMISSION OF THIS DATA FOR BOTH ACCOUNTING PERIODS IN A TIME SCHEDULE WHICH CUTS IN HALF THE TIME PREVIOUSLY AVAILABLE FOR COMPILATION OF YEAREND ACCOUNTING INFORMATION. THIS TIME SCHEDULE WILL PLACE EXTREMELY HEAVY WORKLOAD DEMANDS ON TREASURY AND THE AGENCIES DURING THE REMAINDER OF 1976.

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO TESTIFY ON BEHALF OF THE TREASURY DEPARTMENT AND WOULD BE HAPPY TO RESPOND TO ANY QUESTIONS YOU MIGHT HAVE AT THIS POINT.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
AD COUNCIL, WASHINGTON, D.C.
April 1, 1976

Chairman Adams, President Keim and members of the Ad Council.

It is a pleasure for me to address this luncheon session of your 32nd Annual Conference. In looking over your agenda I see that you have taken great pains to hear from a broad spectrum of people in government, including an impressive list of senior spokesmen from the executive, legislative and judicial branches. And I notice that you have already received one extensive economic briefing at the able hands of my esteemed colleagues, Bill Seidman, Jim Lynn and Fred Dent.

Under the circumstances, there probably isn't much left for me to say about the current state of the economy that you haven't already heard. So, in my remarks today, I would like to give you a brief account of my recent visit to the Middle East, and some of the impressions I brought back with me, and then go on to consider both our nation's economic future and the role that people like you -- some of the most talented communicators in the country -- can play in making that future a bright one.

There isn't a more diverse, fascinating part of the world than the Middle East. That turbulent area that is terribly bound up with the future of global peace has many problems and none of them is going to vanish overnight. While I did return fully aware of the grave problems that confront them, I did return with one positive impression. Today, despite old animosities and differences, both the Arabs and the Israelis, regardless of their other conflicts, realize that the United States has developed the most dynamic and efficent economic system the world has ever known. They see the United States as the major source of strength and stability -- economic as well as political -- in an unstable world.

As Secretary of the Treasury, I find this both encouraging and awesome. Encouraging, because I am convinced that the way to a peaceful world political order can only come through a strong, stable world economic order -- because, for the Middle East, peace and prosperity can and must go hand in hand. And I find it awesome because if reminds me once more of how vitally important the American economy is, not only to our everyday comfort and convenience, but to the preservation of peace and freedom in the world.

Economic statistics may make for pretty dull reading, but the facts behind the figures are a massive, perhaps decisive shaping force in the lives we live today, and in the future course of America and the world.

We must never lose sight of the fact that a strong, non-inflationary domestic economy is an absolute necessity. The only way to be strong abroad is to be strong at home.

Now you would be perfectly right to ask how in the world I can reasonably expect the general public to understand economics when even the experts disagree among themselves. And, up to a point, you would be right. The same objection could be made in almost any specialized field, from horse-racing to psychiatry. There is no single, exhaustively all-embracing economic formula that can answer all the questions and solve all the problems.

But there are a number of economic basics -- fundamental, common-sense guidelines and warning signals -- that can help all of us -- from Milton Friedman to Archie Bunker -- to understand where our country is heading economically and what we can and should do about it.

There is where advertising and communication skills come in. You, as skilled communicators, individually and collectively, can make an enormous contribution by helping to educate the public. For if my three years in Washington have taught me anything at all, it is the vital importance of your specialty -- getting an often complicated message across in simple, lucid terms. Getting to the essence of things clearly and forcefully.

The success of public policy, even more than the success of a commercial product, is directly dependent on the communications ability of those who advocate it. In fact, one of the biggest problems we face today in government is the paradox of too many good communicators selling bad policies and too many bad communicators selling good policies. A rhetorical spellbinder could sell ice cubes to Eskimos, but some of the advocates of fiscal responsibility and the free enterprise system are so unimaginative that they'd have trouble peddling Alka-Selzer on New Year's morning.

Perhaps the most significant -- and distressing -- fact confronting this country today is closely related to your field. I refer to the decline in public confidence in our institutions. Instead of observing our Bicentennial on the upbeat, we find our nation in a mood of deep and widespread distrust of many of the very elements that made our society great. No group -- business, government, the press, education, labor -- enjoys the credibility and trust it once did.

Many people sensed this decline in public confidence long before the pollsters confirmed it. George Shultz, a former Secretary of the Treasury, has summed up the problem pretty well: "We need moorings in our society," he points out, but "We have let go of many old moorings and we do not have new ones to replace them."

This decline in public confidence has been building for a long time. Many different things have contributed to it: Vietnam, Watergate, and the overpromising and underperformance of government. It now seems to pervade every facet of our social structure and poses a threat to the system that has enabled this country to achieve the greatest prosperity and the highest standard of living every known.

One of the institutions whose credibility has lost the most ground is business -- or what I prefer to call free enterprise. Today the American private sector is reexamining itself to determine not only what has caused this loss of confidence but also what it can do to regain it.

One opinion researcher says the major concern facing business is to overcome the public's alienation and cynicism. I'm not sure I agree. I certainly don't agree with those who allege there is something basically wrong with the American enterprise system itself.

Part of the problem, I believe, is that many people are misinformed and misled on the economic issues. Most people simply do not have time to read the fine print behind the headlines, and most detailed economic coverage is written for the specialist rather than the general public. The result is often serious misunderstanding of the private sector. According to a recent study by the Opinion Research Corporation, the key issues on which the public is most misinformed are the level and trend of corporate profits and their interrelationships with prices, wages, unemployment and inflation -- a major part of the system of economic causes and effects that influence their daily lives. They also found that people were misinformed about antitrust problems, monopolistic practices and competition and the relations between corporations and governmental regulatory agencies.

If that worries you, there's more. Some of you may recall that report last year by the Commerce Department and your own Advertising Council, which portrayed the average American as a virtual economic illiterate who perceives our economic system almost solely in terms of his or her own personal situation rather than in its broad functional aspects.

This is only human -- but it is also dangerous.

People usually fear what they don't understand. And people tend to reject what they fear. So we shouldn't be surprised if they're tempted to unknowingly embrace programs -- and quack economic remedies -- that are destructive to our system. Let's take a look at that system and ask ourselves whether or not it is worth preserving. Even the most cursory glance at recent history shows us that is has outperformed all others, both in terms of the material benefits it has produced and the free way of life it has protected. Here are some measurable standards of performance:

-- Since the late 1950's alone, real purchasing power of Americans has jumped by 40 percent, average family income has risen to over $13,000 a year, 20 million new jobs have been created, and we have cut the number of people below the poverty line in half.

-- Our farmers harvest more than twice as much grain with fewer workers compared to a generation ago.

-- Medical science has added 10 years to our lives over this period.

-- Our economic abundance has made it possible for us to give $110 billion in food and economic aid to less fortunate nations since the end of World War II.

-- And Americans today have more leisure time for study, recreation and self-improvement than any society in recorded history. We continue to spend about 90 percent of our personal disposable income on ourselves.

No other country -- no other system -- has achieved so much for its people. Yet these tremendous achievements are the product of the same free-market system that now finds itself under attack.

The Free Enterprise System, where does it stand today? For all the talk about excessive profits, it's a system that, on the average, offers a profit incentive of less than five cents on the dollar, a small reward for all the effort and risk-taking that goes into developing and operating a successful business.

Nevertheless, it remains the real productive source of our nation's wealth, as well as that of each individual American.

Despite the growing influence of government over our lives, this system produces the food we eat, the goods we use, the clothes we wear, the homes we live in.

It is the source of five out of every six jobs in America, and it pays the taxes to provide most of the rest of the jobs in our all-too-rapidly expanding public sector.

It is the foundation for defense security for ourselves and most of the Free World.

It is the productive base that pays for government spending to aid the elderly, the jobless, the poor, the dependent and the disabled. Indeed, far from being the anti-human caricature painted by political demagogues, the American private sector is in reality the mightiest engine for social progress and individual improvement ever created.

In a nutshell, the values we live by -- all of the material and spiritual values that make our country unique and make us so proud to be Americans -- could not exist without the free enterprise system. Yet many people still fail to understand the crucial link between our economic and our political freedom. Destroy one, and the other will soon disappear.

If the prospect of seeing a system like ours go down the drain doesn't worry you, let me call you attention to a recent syndicated column by Charles Bartlett: "More than 10 years ago," Mr. Bartlett said, "Arthur Koestler wrote that a loss of incentive was ailing Britain far more than its loss of empire, and the glummest aspect of today's scene is the bowed spirit of a creative, courageous, ebullient people."

If that can happen to a nation that once was one of the proudest bastions of free enterprise, we are in no position to assume that it can't happen here.

Every generation hopes it will leave its children a better world. But there is no guarantee of endless prosperity in the United States any more than in any other country. Properity doesn't happen by accident. Tamper with its source and the shock is felt throughout our entire society.

And I am convinced that, today, the private sector -- indeed, our very society -- is enduring the greatest series of shocks and challenges since the 1930s. In my opinion the threat can be traced directly to the explosive growth in government and the ominous concentration of power on the Potomac. Today government spending at all levels accounts for some 38 percent of our gross national product.

If recent growth patterns continue, it will reach 60 percent before the end of this century.

It is my firm belief that any government that taxes away more than half of what people earn has robbed them of their economic freedom. And can there be any doubt that when our economic freedoms are destroyed, our personal and political freedoms will not long survive them?

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The head of one of our major corporations says it's no longer just a challenge. In the New York Times' annual economic roundup last January, Richard Riley, the President of Firestone Tire and Rubber Company, was reported to have pronounced free enterprise already dead. I shudder to think how many other business leaders share in that counsel of despair. If they give up, who is left to uphold economic freedom?

Yet the same article quoted another executive as saying that unless something is done to halt "the systematic destruction by federal and state government of the ability to make profits, the word 'corporation' will be something to be studied... along with the buggy whip."

Now no one would seriously question the role of government in such areas as health and education. But the layer upon layer of regulations that government has piled on all aspects of the private sector, and its proliferation of programs and administrative devices has seriously hobbled the American businessman -- especially the small businessman, the very backbone of our free enterprise system. Every business in America, from the little shop around the corner to General Motors is being buried under a growing load of federal paperwork and requirements to the tune of $20 billion a year.

The men and women who run this country's businesses turn to many of you in your individual professional capacities. You work with them daily. Both you and they know there is justification for some of the charges lodged against their industries. Most of them recognize that they must put their own houses in order by correcting these faults. And most realize that failure to do so would surely contribute to the further underming of the system they profess to cherish.

But survival requires more than internal reform, and that is where you become so important.

Even the misinformed consumers who were studied in that survey by Opinion Research Corporation said they had no wish to destroy our free enterprise system. They said they still consider business a progressive force, but they would like to see it "cleaned up."

According to the same pollsters -- and here I quote: "The pressure is on coporations to overcome misconceptions about their activities while correcting abuses for which they are responsible."

Advertising, it seems to me, has its work cut out. It's a big job and a critical one. There is an urgent need for leadership in helping to restore the faith of the American people in their economic system, as well as in government, and I don't know of any group of professionals better qualified to do it than you.

It's been said that communications is the web holding civilization together -- the central nervous system of any organized society. It's also the only means of perpetuating the traditional values handed down by our forefathers which give our civilization stability and continuity.

Never has that function been more important than today. It is largely up to you to communicate the great story of freedom -- to dispel the confusion that has made free enterprise a dirty word; to let our lawmakers and leaders in government know they cannot let the system that generates our wealth, our strength, and our freedom be destroyed. If ever communication of the highest professional caliber was desperately needed, it is NOW; if ever there was an assignment that challenged your profession to the core, it is this one.

Too many in government have too long acted on its assumption that good economics is not good politics. We must show them the error of their way. We must make it politically attractive to support responsible economic policies. Our lawmakers must be convinced that this is what the public wants. For they know better than anyone that the public attitude of today is the public statute of tomorrow.

Given the facts about the very real threats to our economic system, I for one have no doubt about what the public's reaction will be. But the public must know them in order to act on them.

The people have a right to know how government restrictions are undermining individual and industry initiative. They must learn how our Government's tax and spending policies are sopping up capital needed for investment and the creation of jobs.

They must understand that runaway spending and unending deficits fuel inflation -- a silent thief that picks every American's pocket, undermines public confidence in the future and turns the desperate to government for still more illusory help.

In short, the job before you -- if you hope to preserve this system of ours -- is to convince both the public and its leaders in Washington that government just can't go on wringing the neck of that marvelous goose that lays those golden eggs.

This is not a question of liberals versus conservatives or Democrats versus Republicans; it is a matter of sense against nonsense, freedom against oppression. There is no doubt whatever in my mind that you can do this job. But all of us must be united in our resolve:

. To set a high moral and ethical standard by eliminating any practices in our own organizations and operations that may be questionable,

. To square practices with principles by refusing government subsidies, quotas, handouts, bailouts or other inducements that offer an illusory, empty promise of security in exchange for sacrifices of freedom, and

. To initiate, and, in some cases, redouble our efforts to inform and educate the public about the benefits and realities of the private enterprise system.

Given this commitment, you can help to create a real understanding of how the private enterprise system benefits individuals and groups, and of its absolute essentiality to progress, prosperity... and, above all, our freedom.

Sages throughout history have placed freedom at the top of all the things we hold sacred. Our founding fathers built a new nation around that concept and, ever since, freedom has been synonymous with American itself.

This, ladies and gentlemen, is the crucial theme that must be communicated broadly and deeply into the national consciousness: The American production and distribution system is the very wellspring of our Nation's strength -- the source of present abundance and the basis for our hopes of a better future. America can solve all of its pressing problems if it preserves and continues to improve this immensely productive system. And in this process, we'll also be preserving the freedoms that made it all possible.

This is one ad campaign none of us can afford to lose. And you, more than anyone else can help us to win it.

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Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

MEMORANDUM TO EDITORS April 2, 1976

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FROM: William F. Rhatican
Special Assistant to the Secretary
Public Affairs

The Department of the Treasury will reissue the two-dollar Federal Reserve Note this April 13. The new bill will be available at all savings and loans banks and Federal Reserve Banks on that date.

The front of the bill will feature an engraving of Thomas Jefferson, while the reverse of the bill will carry an engraving of "The Signing of the Declaration of Independence." By April 13, 225,000,000 of the new notes will be printed.

Public acceptance and frequent use is the key to success of any currency or coin issuance. While the issuance of the new two-dollar bill is connected with the nation's bicentennial, it is intended to be a permanent and practical part of our currency system and is not intended simply as a commemorative or special issue.

Following are suggestions, for your use, of how the reissuance of the two-dollar bill may be utilized in the creation of feature stories or photo features on the subject. Also enclosed is a press kit containing information on the new note, as released by the Treasury Department on November 3, 1975, at a press conference announcing the reissuance.

(1) Photo feature of local Federal Reserve Bank disbursing bills on first day of issue.

(2) Photo feature of local banks disbursing bills on first day of issue.

(3) Photo feature of citizens using the new bill in grocery stores, retail stores, etc.

(4) Story on cash-handlers in banks, stores, fast-food chains, etc. and their reactions to the new bill.

(5) Story on consumer reactions to new bill.

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(6) Story on local banks one week after release date on numbers of two-dollar bills moved.

(7) Story on local businesses one week after release date on numbers of new bills received.

(8) Story on history of new bill.

(9) Photo feature on bills being unloaded from armored trucks into banks.

(10) Story on currency distribution process.

(11) Photo feature with local bank officials and new bill day before issuance.

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FOR IMMEDIATE RELEASE March 31, 1976

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,200 million of 52-week Treasury bills to be dated April 6, 1976, and to mature April 5, 1977, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	94.196	5.740%	6.09%
Low -	94.143	5.793%	6.14%
Average -	94.155	5.781%	6.13%

Tenders at the low price were allotted 90%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted
Boston	$ 27,590,000	$ 17,090,000
New York	4,740,620,000	2,484,505,000
Philadelphia	49,440,000	28,940,000
Cleveland	131,130,000	99,630,000
Richmond	64,775,000	35,075,000
Atlanta	39,465,000	27,670,000
Chicago	419,270,000	169,420,000
St. Louis	41,055,000	16,055,000
Minneapolis	92,770,000	66,770,000
Kansas City	20,145,000	11,135,000
Dallas	24,845,000	21,645,000
San Francisco	393,455,000	223,840,000
TOTAL	$6,044,560,000	$3,201,775,000

The $3,201,775,000 of accepted tenders includes $ 114,920,000 of noncompetitive tenders from the public and $ 920,330,000 of tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities accepted at the average price.

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FOR IMMEDIATE RELEASE March 31, 1976

CUSTOMS-ATF EFFORTS CUTTING CARGO THEFT LOSSES, ASSISTANT SECRETARY DAVID MACDONALD REPORTS

Inroads against cargo thefts are being made by the U.S. Customs Service and the Bureau of Alcohol, Tobacco and Firearms, David Macdonald, Assistant Secretary of the Treasury for Enforcement, Operations, and Tariffs, disclosed today.

Both agencies, branches of the Treasury Department, participate in the National Cargo Security Program to reduce theft and pilferage from U.S. piers, terminals, and carriers.

Speaking at the National Cargo Security Conference in Washington, Macdonald reported progress both in ATF's Interstate Firearms Theft Project, initiated in 1973, and Customs' ongoing Cargo Security Program.

Through the voluntary cooperation of the U.S. trucking industry, ATF has received, to date, 1,794 reports of thefts or losses of firearms from interstate shipments involving approximately 12,250 firearms, Macdonald said.

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Criminal action has been brought against 66 defendants, 29 of whom were trucking company employees.

The Customs Program Against Cargo Crime (C-PACC) made 247 seizures and 66 arrests during calendar year 1975, according to Macdonald.

Macdonald described Imported Merchandise Quality Control (IMQC), a second facet of Customs' three-part program, which determines the amount of cargo manifested, unladen, and delivered, and develops statistics to pin-point specific piers, terminals or warehouses, and types of merchandise involved in thefts of cargo being imported into the country under U.S. Customs control.

The IMQC program accounted for 64 seizures for manifesting violations between July and November 1975, he said. These violations led to the assessment of nearly $3 million in penalties against carriers. Discrepancies detected between invoiced quantities entered and quantities actually landed subjected $14,132,830 worth of merchandise to seizure during calendar 1975.

Customs' program to educate and inform the cargo industry on crime prevention, Macdonald continued, has conducted more than 500 cargo security surveys of airport and marine terminals, warehouses, foreign-trade zones, and container stations since its inception in 1972.

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Department of the TREASURY
OFFICE OF REVENUE SHARING
WASHINGTON, D.C. 20226

NEWS

TELEPHONE 634-5248

THE DEPARTMENT OF THE TREASURY 1789

FOR IMMEDIATE RELEASE
FRIDAY, APRIL 2, 1976
CONTACT: PRISCILLA CRANE (202) 634-5248

The U.S. Treasury Department's Office of Revenue Sharing mailed 37,490 checks for $1.6 billion to units of State and local government today, in the 15th regular payment of general revenue sharing funds made since the program was authorized, in 1972.

Today's payment represents the third quarterly payment of funds allocated for Federal fiscal year 1976 (entitlement period six). The fourth and final quarterly checks for the current period will be issued at the end of the first week of July.

Including the amount distributed today, the Office of Revenue Sharing has returned $25.1 billion to nearly 39,000 States, counties, cities, towns, townships, Indian tribes and Alaskan native villages since the first checks were mailed in December 1972. A total of $30.2 billion will have been paid these governments when the currently authorized five-year program expires at the end of calendar year 1976.

The City of Chicago's revenue sharing payment was withheld today by the Office of Revenue Sharing, as required by Court order, due to a finding of discriminatory employment practices in Chicago's Police Department. Since January 1975, a total of

$113.7 million has been withheld from the City of Chicago.

Approximately one million dollars also is being held for 514 local governments which have not reported their planned and actual uses of revenue sharing funds to the Office of Revenue Sharing. Use reports are required by section 121 of Title I of the State and Local Fiscal Assistance Act of 1972 (P.L. 92-512, revenue sharing law). The funds to which these governments are entitled will be paid when the reports have been received and accepted by the Office of Revenue Sharing.

The General Revenue Sharing Act will expire December 31, 1976, and final payments under the presently authorized program will be issued during the first week of January 1977. Legislation to continue the program is now being considered by the U. S. Congress.

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Contact: Richard B. Self
Extension 8256
March 31, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES PRELIMINARY COUNTERVAILING DUTY DECISION ON BONELESS BEEF IMPORTS FROM EC COUNTRIES

Assistant Secretary of the Treasury David R. Macdonald announced today the initiation of investigation and preliminary determination under the Countervailing Duty Law (19 U.S.C. 1303) that bounties or grants are being paid or bestowed on imports of frozen boneless beef from Denmark, The Netherlands, West Germany, Italy, Belgium, Luxembourg, France, United Kingdom and Ireland. Notice to this effect will be published in the Federal Register of April 1, 1976. Interested parties will be given a period of seven days to present views regarding this action.

Information before the Treasury indicates that boneless beef is receiving bounties or grants in the form of export restitution payments under Common Agricultural Policy of the European Economic Community.

During 1975 imports of frozen boneless beef from EC countries were $3,635,000.

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FOR IMMEDIATE RELEASE

Contact: H. J. Hintgen
Extension 2427
March 31, 1976

FORMATION OF A TREASURY-FEDERAL RESERVE TASK FORCE
ESTABLISHED TO EXPAND THE BOOK-ENTRY PROGRAM
OF ISSUING GOVERNMENT SECURITIES

Secretary of the Treasury William E. Simon today announced the formation of a Treasury-Federal Reserve Task Force, established to expand the book-entry program of issuing Government securities. The Secretary commented that the expansion of the book-entry program over the past eight years has been most gratifying. At the end of February 1976, the amount of United States Treasury bills, notes and bonds in book-entry form reached a level of $299.1 billion or 79% of the total marketable debt.

Initiated in 1968, the book-entry procedure eliminates the issuance of engraved Treasury securities in favor of book-entries maintained at Federal Reserve Banks for the accounts of commercial banks which are members of the Federal Reserve System. The book-entry procedure is currently available to both individuals and institutions acting through such member banks. The book-entry procedure offers substantial benefits to investors, the financial community, and the Treasury. It reduces the burden of paperwork created by the mounting volume of public debt transactions; it protects against loss, theft, and counterfeiting; and it substantially reduces the cost of issuing, storing and delivering Treasury securities.

The Treasury-Federal Reserve Task Force will design and adopt an expanded book-entry system with the ultimate objective of completely eliminating the use of definitive securities in new public debt borrowings. During the course of this effort, the views and comments of the financial community and other interested parties will be solicited.

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FOR RELEASE ON DELIVERY

Statement of the Honorable William E. Simon
Secretary of the Treasury
Before The Senate Committee On
Banking, Housing and Urban Affairs
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NEW YORK CITY'S FINANCIAL SITUATION AND OUTLOOK

Mr. Chairman and Members of this distinguished Committee, I am pleased to provide you with the first formal report to Congress on the administration of the New York City Seasonal Financing Act of 1975. Much has occurred since the New York City financial situation was last before this Committee and later in my remarks today I shall summarize the key events. But at the outset, let me provide you with an overview of the situation as we see it today.

We presently have $1.26 billion of loans outstanding, and we expect repayment of the first $270 million on April 20. Repayment is in part dependent upon successful completion of the New York State financing in April and I am pleased to report that it now appears that the financing will be completed. Accordingly, I am satisfied that there exists a reasonable prospect that the entire $1.26 billion will be repaid by June 30.

Looking at the balance of the three year period, there is now basis for a degree of cautious optimism. Last week, Mayor Beame responded forcefully to increased estimates of the budget deficit by announcing a comprehensive and detailed program of expenditure cuts designed to achieve a budget surplus by fiscal 1978.

Carrying out this plan will not be easy for New York City. Undoubtedly there will be those who will urge that it is impossible, those who will claim that it can only be accomplished over a longer period of time and those who will urge that the price of achievement is severe human hardship.

In my experience in government, too often have I witnessed an unfortunate tendency to allow the naysayers, the purveyors of gloom and doom, to stifle sound and meaningful reform. Clearly it would be wrong to adopt a pollyanna attitude and blithely assume that all the problems are solved. But it would be even more wrong to deny New York City, by our words and by our actions, the chance it so clearly has earned by its progress in the past few months.

I believe the job can be done and done within the allotted time frame. I believe the job can be done without disrupting essential services. And most importantly, I believe the rewards of doing the job well and properly are potentially enormous.

Throughout this entire period, there has been much talk about the question whether New York City will be in a position to reenter the capital markets in 1978. I think it's fair to say that it has become fashionable in some circles to assume that there exists no chance of reentry for many years. But I would submit that such predictions are based upon an incorrect factual perspective: an assumption that New York City will not achieve the reforms it is on its way to achieving.

I look at the situation quite differently. I ask myself whether I, as a private lender, would be willing to lend money to an entity which has

-- successfully weathered a severe financial crisis;

-- taken, within a 30 month period, firm actions to correct more than a decade's worth of extreme fiscal and financial neglect, including the permanent elimination of an operating budget deficit of $1 billion;

-- established a sound and credible accounting and financial reporting mechanism; and

-- developed a first rate financially oriented management team.

Today these are still objectives. But if they become reality, I believe New York City will be perceived entirely differently by the credit markets in 1978. This is our goal, and it now appears to be the City's goal as well. As I said a moment ago, let's give them the chance to achieve it.

I. Background

Before outlining New York City's current progress toward fiscal reform, let me take a few moments recalling certain key events that brought us to this point.

At the time I first testified before Congress on New York City's financial situation in June 1975, it was on a hopeful note, immediately following the creation by New York State of the Municipal Assistance Corporation. MAC was authorized to borrow $3 billion on New York City's behalf, intercepting City sales and stock transfer tax revenues to fund what it borrowed. Passage of the MAC legislation prevented default in June, and provided, we then believed, ample time through the summer to make the necessary corrections.

Our optimism was unwarranted. As June turned into July without meaningful action on the fiscal front, the market began to close to MAC as well. Its July issue sold sluggishly, despite an "A" rating and a 9¼% interest rate. Exploratory efforts regarding an August sale indicated that investors would not purchase MAC securities without solid evidence that the City was making meaningful progress toward fiscal and financial reform. On July 17, underwriters informed MAC that its planned August issue could not be marketed unless the City announced meaningful fiscal reform and spending cuts.

In late July, the City and MAC announced plans to reduce spending. Wage freezes, pay cuts for higher salaried employees and layoffs were openly discussed. The announcements were accompanied, however, by a public dispute about MAC's authority to intervene in the City's financial affairs. In addition, the City's labor unions denounced all talk of wage freezes and layoffs of municipal employees.

It soon became clear that MAC could not raise the $840 million needed to cover New York City's August cash needs by public sales of its securities. Less than $300 million was raised from the public despite a tax-exempt interest rate of 11 percent. The remainder was sold to banks and state employee pension funds. Perhaps more importantly, the August sale marked, as a practical matter, the end of MAC's utility as a viable and independent financing vehicle.

In September, New York State took the major step of committing its own credit and resources to the problem. This action was accompanied by a substantial restructuring of the governmental relationship between City and State: The Emergency Financial Control Board was established and given virtually unlimited powers over the fiscal and financial affairs of New York City. Moreover, the law mandated achievement of a balanced budget in the fiscal year ending June 30, 1978, and a showing of substantial progress toward a balanced budget in fiscal years 1976 and 1977.

Under the legislation, New York City was required to submit for Control Board approval a financial plan designed to eliminate the budget deficit by fiscal 1978. The plan as submitted on October 15 predicted a budget deficit of approximately $700 million in fiscal 1978 and proposed to eliminate it in three stages: $200 million in annual expenditure reductions in fiscal 1976 and $262 million per year in both fiscal 1977 and fiscal 1978, thus achieving a small surplus in 1978. As I shall discuss later in my testimony, this deficit estimate proved too low. Much more in the way of expenditure cuts was required.

As required by law, the plan also addressed the capital budget. Total capital spending was cut from the approximately $2 billion originally proposed for fiscal 1976 to $1.6 billion in that year, $1.1 billion in fiscal 1977, and $900 million in fiscal 1978. Operating items in the capital budget -- nearly $700 million in fiscal 1976 -- were to be reduced at a rate of $50 million per year. As I shall discuss later, according to current projections, this target has already been exceeded.

Two issues remained open. First, there was the question of financing the deficits accumulated over the previous decade that resulted in a multibillion dollar overhang of short term debt. And second, in view of the fact that the public credit markets were closed, New York City needed a source of funds to finance operations and the capital program during the 1976-1978 period.

In numerous appearances before this Committee and elsewhere, New York City and New York State officials insisted that they had done all they could and demanded that Federal taxpayers provide the funds to eliminate the overhang of short term debt and meet all of the City's financial needs during the 1976-1978 period. But these demands were seriously questioned in Congress and flatly rejected by the Administration. We believed that such deficit financing had to be provided at the State and local level.

Finally, in late November, we were presented with a financing plan that met the City's requirements. The package consisted of the following elements:

-- New and increased taxes designed to yield $500 million during the period December 1, 1975 through June 30, 1978. Included were higher taxes on personal income, increased bank, estate and cigarette taxes, an increase in the minimum corporate income tax and extension of the sales tax to cover personal services.

-- Increased real estate taxes designed to yield $400 million.

-- Investment of $2.5 billion by the City's pension and sinking funds.

-- Refunding of $1 billion of maturing City notes into 6 percent City bonds by the City's sinking funds, pension funds and major banks.

-- Legislation imposing a moratorium on retirement of the $1.6 billion of New York City notes which were held privately and reducing the interest rate on such notes to 6 percent. In lieu of the moratorium, holders of these notes were given the option of exchanging the notes at face value for ten year MAC bonds, bearing an 8 percent interest rate. Despite the favorable exchange terms, only $500 million of the notes -- less than a third -- were so exchanged.

-- A commitment by New York State to continue to advance $800 million in welfare and education aid in the spring quarter.

These steps were designed to result in a balanced cash flow over the course of each fiscal year, eliminating the need for deficit financing. However, because revenue collections are not uniform throughout the year, seasonal loans remained necessary to assure that payrolls were met, vendors paid and essential services performed in the months in which the City's revenues fell short of its regular monthly expenditures. Accordingly, to assure the continuity of essential services, we asked the Congress for authority to make short-term seasonal cash-flow loans. In early December, Congress passed the New York City Seasonal Financing Act of 1975, providing for up to $2.3 billion in seasonal loans.

II. The Seasonal Loan Program

The Federal Seasonal Loan Program began almost immediately after passage and approval of PL 94-143. On December 18, 1975, the Federal Government loaned New York City $130 million at an interest rate of 6.92%. As required by the statute, the rate reflected the average rate on Treasury debt of comparable maturity, plus a one percent premium. The loan was secured by a pledge of $180 million in State aid to education, and is scheduled to be repaid on April 20.

Credit Agreement

On December 30, 1975, after two weeks of extensive negotiations, we entered into a Credit Agreement with New York City, New York State, the Municipal Assistance Corporation and the Emergency Financial Control Board. The Agreement, a copy of which I shall submit for the record, provides a number of specific protections to the Federal Government. The principal requirements are as follows:

-- Certification by the Emergency Financial Control Board that loans requested are consistent with the City Financial Plan.

-- Agreement by the Mayor, City Comptroller, and Control Board to take all actions necessary to insure that revenues securing repayments are paid into a special repayment account, controlled by the Secretary of the Treasury.

-- Power to require the Governor and State Comptroller to prevent disbursement of State-funded repayment revenues, except to the Secretary of the Treasury.

-- Submission of detailed analyses on a regular basis to provide the flow of information needed to track and monitor the City's performance and adherence to the Financial Plan and Credit Agreement.

-- Right to audit and inspect the books and records of New York City and New York State.

Subsequent to the signing of the Credit Agreement, we loaned New York City $240 million on December 31, 1975, $140 million in January, $430 million in February, $250 million on March 1, and $70 million on March 15. All loans are scheduled to be repaid in full during the spring quarter. Two hundred and seventy million dollars mature on April 20, $240 million on May 20, $250 million on June 20, and $500 million on June 30.

Let me focus on the security. As I have indicated, each loan is directly secured by a specific revenue due New

York City on or before the maturity date of the loan. These encumbrances total $1,944 million and consist of $50 million in City tax levy funds, $382 million in State revenue sharing funds, $602 million in State aid to education and higher education, $110 million in State welfare payments and $800 million of advances of fiscal year 1977 State welfare and education aid. The Agreement provides that these funds cannot be used for any other purposes until our loans are repaid.

Arthur Andersen Report

Prior to signing the Credit Agreement, I retained Arthur Andersen and Company to report to me on the Three-Year Financial Plan and to evaluate New York City's financial reporting and accounting systems. In addition, we asked them to help in the preparation of a financial reporting package.

The Report provoked numerous concerns. I wrote to Mayor Beame on January 20 and asked for his comments on six specific questions raised by the Andersen Report. Chairman Proxmire and Senator Stevenson wrote to me on January 23, asking, in light of the Report, to be "apprised of the factors which led (me) to conclude that there is nevertheless a reasonable prospect of repayment by June 30, 1976," and, in addition, for my answers to eight related questions. I am submitting this correspondence for the record.

While we must be aware of the warnings in the Andersen Report, it is equally important to understand its limits. It did not comment specifically on the Federal loan program or address the question of whether there was "a reasonable prospect" of timely repayment by New York City of the Federal loans which have been made to date.

It is not inconsistent to regard as tenuous the assumptions and forecasts of the City's Three-Year Financial Plan, while at the same time concluding that the City will repay the Federal loans on time. The critical issue involves the aid and advances that New York State is committed to provide New York City in the spring quarter. If it receives the State aid and advances that it is scheduled to receive, New York City's cash flow will be sufficient to repay the Federal loans maturing between now and June 30.

As suggested in the Andersen Report, some of the original assumptions and forecasts in the Plan have already been discarded. As predicted by the Andersen report, the estimated deficit today is substantially higher than the October forecast. But, as Mayor Beame's recent proposal makes clear, this does not mean the plan cannot work. If revenues fall short of projected levels, or if expenditures are higher, other revenues will have to be found, or expenditures cut further. In the final analysis, targeted budget balances can be hit and debts repaid on schedule, if there is a will to cut spending.

In this regard, it is important to note that New York City has little in the way of alternatives. Congress did not contemplate and PL 94-143 does not allow the seasonal loan program to become a vehicle for financing New York City's deficits. And New York City can no longer finance elsewhere the level and diversity of programs and activities they would like to provide but cannot afford. Accordingly, without the prospect of either more Federal loans or funds from other sources, revenues and expenditures must balance by fiscal year 1978. As Mayor Beame recognized last week, quoting Governor Carey's State of the State message, "the days of wine and roses are over."

The Mayor's budget reduction proposal is clearly the most significant indication that this important message appears to be getting through. City officials now recognize that major changes in the way the City conducts its affairs have to be made. But before turning to the specifics of Mayor Beame's new budget proposal, let me first outline the progress in other areas.

Management

There is a new top financial management team on the job. Mayor Beame has two new Deputy Mayors: Kenneth Axelson, on leave from his positions as Senior Vice President of Finance and Administration and Director of the J.C. Penney Company; and John Zuccotti, formerly Chairman of the City Planning Commission. The Mayor also has appointed Donald Kummerfeld, formerly Vice President for Public Finance of the First Boston Corporation, to be the City's Budget Director. Comptroller Goldin has hired Martin Ives, formerly Deputy State Comptroller, to be his Deputy. These are first-rate people.

Reporting and Record-Keeping

As I observed earlier, the Andersen Report concluded that the City's present financial reporting, record-keeping and controls systems are inadequate. We have been advised by Mayor Beame that "a major effort is underway to correct deficiencies in these systems." In that connection, Touche-Ross and Company and American Management Systems are designing a new accounting and controls system to be in place by July 1, 1977. By July 1 of this year, an interim obligation encumbrance reporting system for all agencies will be in operation. This step will help tremendously in controlling unbudgeted spending, which until now has been a serious concern.

Monthly Reports

The Credit Agreement requires detailed monthly financial reports to allow us to oversee the City's progress toward budgetary balance. These reports also will enable City and Control Board officials and staff to monitor progress, and to spot any variances from the forecasts before they get out of hand. The reporting package will be refined and improved as time passes and we gain experience. Andersen personnel are assisting us in this area, and we also are working closely with City, Control Board and GAO staff to perfect the monitoring formats.

Expenses

Expenditures are very close to target for fiscal year 1976. Expenses through January were $12 million higher than planned. Spending for social services and education was $28 and $21 million above targeted levels. Debt service, including MAC, was $34 million above forecast. On the other hand, spending on health and hospitals was $38 million below forecast and spending on police protection and higher education was $9 and $10 million below targeted levels.

Employment

Significant progress has been made in reducing New York City's large payroll. In the first seven months of fiscal year 1976 -- July 1, 1975 to January 31, 1976 -- the payroll was reduced by the equivalent of nearly 35,000 full time employees. And when these gains are added to progress made earlier in calendar 1975, the total payroll reduction exceeds 40,000. In my view, trimming a massive public payroll by 15 percent in one year is a truly laudable accomplishment.

Capital Budget

New York City's most recent monthly forecast shows total capital budget expenditures for fiscal 1976 at

$1.597 billion, $3 million below the financial plan. More importantly, the forecast shows a significant acceleration of the removal of operating expenses from the capital budget.

The original October plan included $697 million of operating items in the fiscal 1976 capital budget and forecast a $50 million annual reduction in both fiscal 1977 and 1978, reducing the total amount included in the capital budget to $597 million in 1978.

The current forecast shows a further reduction of $22 million to $675 million for this fiscal year. For fiscal 1977, the amount eliminated will be almost double that originally planned: a $95 million cut reducing the balance to $580 million. Another $60 million will be cut in 1978, leaving a balance of $520 million, $77 million better than the original projection.

<u>The Budget, the Financial Plan and Mayor Beame's New Proposals</u>

Let me turn now to the highly complex, but critically important, subject of New York City's budget deficit and how it will be eliminated. In evaluating the current status, let's begin with the forecasts of the October financial plan.

The October plan forecast operating deficits of $1.19 billion in fiscal year 1976, $932 million in fiscal year 1977 and $693 million in fiscal 1978, <u>before</u> taking into account the effect of the expenditure reduction program. In other words, New York City predicted that its annual operating deficit would decrease by some $500 million in the normal course of events and thus premised its expenditure reduction plan on the projected 1978 deficit of $693 million. According to the plan, this amount was to be cut from the budget in three steps: $200 million in fiscal 1976, $262 million in fiscal 1977 and $262 million in fiscal 1978. Since the program reductions imposed in 1976 and 1977 would of course also result in savings in 1978, the gross savings in 1978 would be $724 million, generating a $31 million operating surplus.

The $500 million "natural" decrease in the deficit was suspect from the start, and data released by New York City in February confirmed the error. The February forecast showed that the deficit to be eliminated in fiscal 1978 -- again before the effect of any spending cuts -- is $986 million, $293 million more than had been projected in October.

For clarity, let me emphasize one point. Program cuts imposed in 1976 and 1977 obviously have the effect of reducing the operating deficits in those years. But in evaluating the financial plan, we must keep in mind that the target is a balanced budget in fiscal 1978. Accordingly, all cuts -- irrespective of the year in which they are implemented -- should be viewed as reducing the $986 million 1978 deficit.

Until Mayor Beame's recent announcement, New York City had not announced the details of any expenditure reductions other than the $200 million announced and imposed in the current fiscal year. Accordingly, the Beame Plan must and does address the remaining 1978 deficit of $786 million.

The Beame plan calls for deficit reductions of $379 million in fiscal 1977 and $483 million in fiscal 1978. When added to the $200 million savings anticipated this year, the total savings are $1.062 billion, eliminating the projected fiscal 1978 deficit of $986 million and generating a $76 million surplus.

The Beame proposals are incorporated in a detailed document that was submitted to the Control Board on March 26. I am submitting a copy for the Record.

FISCAL YEAR 1977

The Beame plan proposes reducing expenditures by $379 million during the fiscal year ending June 30, 1977. Fifty-four million dollars of this reduction would result from proposed increases in Federal and State funding. The remainder would be achieved through the City's own efforts -- nearly all through reduction in the scope and cost of services and programs currently provided.

The City would cut $250 million by reducing existing programs. Cuts in current programs and residual savings would reduce the City's expenditures for education and higher education by $84 million. Police expenditures would be cut by $40 million, primarily through personnel reductions and management improvements. Previously identified proposals would reduce payments to the Health and Hospital Corporation by $27 million. These proposals, and other means for reducing the City program expenditures by nearly $250 million, are spelled out in the Mayor's Plan.

The Plan provides considerable detail about how the City plans to save an additional $75 million: reducing non-mandated welfare costs ($30 million), reducing fringe benefits ($24 million), and an anticipated reduction in power costs ($16 million) are the key measures.

Finally, the City plans to receive approximately an additional $54 million in Federal and State revenues during FY 1977. State assumption of court and probation costs on April 1, 1977 would save the City $24 million. Increased Federal subsidies for public housing and senior citizens under existing programs is estimated to provide the remaining $30 million.

FISCAL YEAR 1978

The largest saving in 1978 ($113 million) would result from phasing out City support for the City University. In addition, the City would expect to achieve $100 million in savings through further program reductions, increased productivity, greater management efficiency, and other measures.

The remaining savings would be achieved through several measures: withdrawal from the Social Security system ($43 million); increased use of community development funds for tax levy purposes ($50 million); and further reductions in non-mandated welfare costs ($30 million). Additional savings would result from further reductions in power costs, and other measures.

Finally, the Plan calls for an additional $128 million in deficit reductions during fiscal year 1978 through increased State and Federal funding. Most of this is attributable to proposed assumptions by the State of additional court and correction costs ($103 million). The remaining $25 million would arise through proposed Federal assumptions of certain costs for public housing and senior citizen rent increase exemptions. It should be noted, however, that the plan also includes contingency reductions in City programs to be used in the event the State does not agree to participate.

The Mayor submitted his Plan to the Control Board on March 26 with a letter stressing the need for immediate action. The proposal was generally well received and is being intensively reviewed. A full Control Board appraisal is expected by May 1.

Mayor Beame's plan plainly dispels two myths which have permeated the year-long debate on New York City. How often have we heard it said in some quarters that it was simply impossible for New York City to balance its budget within three years? And how often have we heard from others that New York City officials simply were incapable of facing up to the hard decisions and developing sound and credible solutions?

Mayor Beame's plan shows that New York City's budget can be balanced -- soundly and credibly -- within the alloted time frame. And in so doing, it reflects a recognition that hard measures must be taken and that detail is required now. It does not attempt to avoid cuts in 1977 by unduly backloading them into 1978. It recognizes that some assumptions are questionable and identifies contingency measures in the event they prove too optimistic. All in all, it reflects an unambiguous desire to deal with, not evade, the problems New York City faces.

New York State's Prospects

To conclude my status report, let me briefly review the financial situation in New York State. Our analysis indicates that the state's financial condition is fundamentally sound, and that its cash flow later this year will be adequate to repay its borrowings this spring. These factors should enable the State to raise the funds it needs. If it does, New York City will receive the State aid and advances required to repay the Federal loans.

In recent months, the State's leaders have directed their efforts toward financing the state agencies, producing a credibly balanced budget and obtaining financing for seasonal needs. The first two jobs now have been done. Substantial progress has been made toward completing the third.

With the help of the State's retirement systems, a \$2.5 billion financing package was put together, allowing the state agencies to refund short-term notes into bonds and to finance completion of projects now in progress. No further projects will be undertaken. And, most significantly, moral obligation bonds are now prohibited by law.

Second, the State legislature adopted what appears to be a credibly balanced budget. Significantly, expenditures in the new budget are only \$123 million higher than in the fiscal year that ended yesterday. Investors are certain to be reassured by this move to hold down spending.

As a result, the State now should be able to place the $4 billion of securities it must sell before mid-June. As of now, all but $1.7 billion has been tentatively placed with various State funds and New York City's commercial banks.

III. Long-Term Prospects

While the recent actions by New York City are clearly a major step toward a solution to New York City's immediate financial crisis, prior to June 1978 unforeseen events will undoubtedly require more in the way of actions and responses. However, while we should not be complacent in dealing with the immediate situation, I believe the time has come to address the longer term outlook as well. Accordingly, I would like to devote the remainder of my time this morning to setting the framework for what I hope will be a comprehensive review of New York City's economic condition and outlook.

Let's begin by identifying the objectives. First, and foremost, New York City must recreate an environment in which economic activity can flourish. That in turn requires a rational approach to business taxation and a stable and satisfied labor force. As Mayor Beame and Governor Carey have squarely recognized in recent weeks, New York City's economic future depends upon its ability to attract and retain business investment.

My remarks today are only a beginning. In the months and years ahead New York City's leadership must mobilize all elements of society -- the business and financial community, organized labor and the citizenry at large -- toward achieving this common goal. Without it, the herculean efforts of the past months will be viewed by future generations as an empty gesture.

To put this portion of the discussion into context, let's first explore on a fundamental plane the problems which led New York City into a unique dependency relationship with the Federal Government.

New York City is bound by local and State Laws to balance its operating expenses and revenues. Accordingly, the first response to spending pressures was more and higher taxes. Ultimately, the tax base was pushed beyond its ability to generate more in the way of revenues and deficit spending, hidden by accounting gimmicks, was the inevitable option. As a consequence, New York City has run operating deficits each year since fiscal year 1961. By fiscal year 1975, these deficits totalled over $4 billion. In addition, more in the way of past deficit spending is forever buried in the capital program.

As a first step in a program of long-term economic reform, the spending pressures which precipitated the problem in the first place must be evaluated. If these pressures can be moderated, then we will have made major progress in creating an environment where business can invest and citizens can settle.

I. Spending Pressures

Unique Services

New York City simply provides services that other cities do not provide. The 1975-1976 fiscal year budget, as originally submitted, provides, apart from pension costs, $477 million for higher education, $890 million for City hospitals, $586 for charitable institutions, most of which consist of payments to private hospitals, $90 million for activities of the Health Department, including mobile health units and labs, $71 million for addiction services, $5 million to administer mental health programs, $137 million for various housing activities and $180 million in subsidies for the transit system. State and Federal matching programs account for a major share, but the City's taxpayers must provide $1 billion to fund these activities.

Health and Hospitals

It must be determined whether New York City residents could receive a satisfactory level of health care if public outlays for this purpose were reduced. The operating expense budget for New York City's Health and Hospitals Corporation in fiscal year 1975-1976 called for total expenditures of $1 billion, including pension costs; $390 million of this amount comes from city taxes. Of the City tax funds, approximately $165 million is spent for medicaid and other necessary programs. The remaining $225 million reflects administrative costs and delivery of health care services over and above those paid for by third party programs such as medicaid, medicare, workmen's compensation, and private insurance. Such extra services may be desirable, but it must be asked whether they are affordable under present conditions.

Progress clearly has been made in the health area. The Beame plan provides for large cuts by the Health and Hospitals Corporation. However, the possibility of similar cuts by the Health Department and Addiction Services Agency, in the budget for Charitable Institutions, and in mental health programs must also be studied. Particular attention ought to be paid to the possibility of eliminating unnecessary administrative expenses.

Transit

Re-evaluation of the system of financing mass transit is needed. Transit subsidies now cost New York City's taxpayers $183 million per year. As we look into the future, alternative approaches must be evaluated. An across the board fare increase might hurt the poor; but if that is the concern, why not explore the feasibility of a direct method of helping the poor, while more affluent riders pay their fair share.

Another area to explore is the fare structure. Many cities have sucessfully experimented with a fare based on distance travelled, and with off-peak discounts and rush-hour premiums. The possibility of these innovations should not be ruled out in advance.

Fringe Benefits

Everyone would agree that no long range study of New York City's economy can ignore the question of public employee fringe and retirement benefits. In the current fiscal year, employee fringe benefits -- pensions, health insurance, vacations and the like -- will cost New York City's taxpayers more than $2 billion. Based on the 232,000 person full time equivalent payroll at the end of January, this cost averages more than $8,600 per employee. In other words, New York City's taxpayers spend more per employee on fringe benefits than the annual income of the average American.

Clearly, ample fringe benefits are essential to an efficient, productive and contented labor force. But given the large costs, and the significant disparity between New York City and other employers, a careful study is certainly warranted.

Before turning to particular benefits, let's review the overall level of benefits for certain key employee groups. The cost of vacations and sick leave are excluded from these examples because of the difficulties in making precise calculations. But these costs are well above average and would add considerably to the level of disparity.

The base pay of a New York City patrolman first grade, including the latest cost-of-living adjustment, now is $16,800. Fringe and retirement benefits, excluding vacations, equal $8,500 or 51% of the base. For a sanitationman, benefits are 39% of the base. For a fireman first grade they are 49%. For a teacher with a masters degree and eight years of service they are 37%. For senior clerks, using their median salary, benefits equal 34% of the base. All of these percentages dwarf the national average of less than 20 percent.

Specific Benefits

The current costs of certain key fringe benefits are:

- Pensions	$1,165 million
- Social Security	214 million
- Health and Hospitalization Insurance	170 million
- Union Welfare Funds	107 million
- Union Annuity Funds	36 million
- Uniform Allowances	19 million
- Training Funds	1 million
	$1.712 billion

Social Security

New York City has announced that it is withdrawing from the Social Security System as of March 1978. Given my concern for the financial condition of the Social Security System, I cannot be entirely sanguine about this development. However, it may have been inevitable under the circumstances.

Ideally, Social Security benefits should be integrated with pension benefits to provide a reasonable level of retirement income. However, accomplishing such integration in New York City is complicated by two factors. First, the New York State Constitution has been interpreted to prohibit reduction in levels of pension benefits already vested. Second, a New York State law enacted at the time state and local governments were made eligible for Social Security, prohibits taking Social Security benefits into account in collective bargaining regarding pensions. In light of these factors, and given the anticipated savings of nearly $200 million a year, New York City may have had little choice but to withdraw.

Annuity Funds

New York City now pays $36 million per year into Union Annuity Funds. These funds involve per diem contributions toward the provisions of still more retirement benefits in the form of annuities for certain employee groups. The continuation of these payments should be assessed in light of the overall level of retirement benefits employees now receive.

Union Welfare Funds

The 1976 fiscal year budget provides for direct payments of $107 million to municipal unions. These funds enable the unions to provide both active and retired workers with still more in the way of fringe benefits: free dental care, eyeglasses, counseling and legal services. Certainly these benefits are desirable for the employees. But their value must be weighed against the burden imposed on New York City's taxpayers.

Uniforms

Uniform allowances and training funds now are budgeted at $19 million per year. Uniform subsidies can, of course, be justified in the cases of policemen and firemen. But the allowances also are given to marine engineers, aqueduct captains, speech and hearing therapists, public health nurses, nurses aides, ambulance technicians, food service supervisors, bridge operators, deckhands, water plant operators, and swimming pool operators. Uniform allowances should be carefully studied to determine whether certain allowances could be eliminated and whether cost savings could be achieved by direct City purchases of essential uniforms.

Health Insurance

Like many private employers, and certain other cities, New York City pays 100% of the cost of employee health insurance programs. But most cities, and the Federal Government as well, require the employee to pay a fair share of the cost of providing health care protection for the employee and his family. In light of the current fiscal and financial realities, division of this expense between the City and its employees warrants study.

Working Time

Additional areas of study include night shift pay provisions, vacation benefits and working hours. The night shift pay differential is normal -- 10%. But night is defined to cover 16 of every 24 hours. Cutting it down to 8 hours, or even 12 hours, would produce annual savings of approximately $10 and $20 million.

Vacation and sick leave costs are quite high. For example, such costs are estimated to exceed $4,000 per year for patrolmen and $3,000 for sanitationmen. These high costs are attributable to the fact that every employee is entitled to 20 vacation days in the first year on the job and most have unlimited sick leave privileges. By comparison, new Federal employees receive only 13 days vacation and do not reach 20 days until their fourth year of service.

In the case of patrolmen, consideration should be given to reducing the current work day from 8 and 1/2 hours to 8, while increasing the work year by the equivalent number of days -- 18, from 243 to 261. Little is gained by the 8 and 1/2 hour day, while the cost of the 243 day year (versus 261) is nearly 7 and 1/2% of total compensation, or $57 million per year under the current contract.

Many other New York City employees now work only 35 hours per week. Others work 37½. In addition, under the "summer hours" program, an even shorter work week is the norm in some cases. The possibility of moving to a 40 hour week -- thus achieving substantial reductions in costs without a loss in services -- should be examined.

Pensions

Quite appropriately, many aspects of the pension situation are under careful review at present. I have already noted one step New York City has taken: its planned withdrawal from Social Security. In view of the substantial disparity in net pension benefits between New York City and other large cities, further actions might be considered.

For example, a married New York City employee who retires at age 65, with 25 years of service, receives in net after tax retirement income an amount equal to 125 percent of his disposable income in his last year on the job. In Atlanta the same worker receives 43 percent, Chicago 47 percent, Dallas 52 percent, Los Angeles and Memphis 54 percent. Only Denver and Detroit -- at 91 and 104 percent -- are even close.

* * *

Let me reiterate the spirit in which these areas for discussion have been identified. I mean absolutely no criticism of the creative plan Mayor Beame announced last week. I do not mean to suggest that the plan as currently proposed will not accomplish its intended objective. I simply want to make clear that if New York City is to recapture its proper leadership role the plan can not be viewed as defining the outer limits of possible fiscal and financial reform.

The Real Estate Tax Base

The heart of any great city is its real estate. Not only does it provide the physical facilities for housing and economic activity, but it is also an important financial asset, since real estate taxation is the core of any city's revenue stream. Accordingly, in providing for New York City's future, we cannot avoid a careful look at the impact on the tax base of the long and costly experiment with rent controls and stabilization.

Like many of the programs we have discussed today, rent control is a subsidy program and must be evaluated as such. Simply stated, rent control provides a subsidy to a small, largely middle class group, the members of which have occupied apartments for a substantial period of time and are paying rentals which bear no resemblance to current costs. Few poor people benefit: typically, they have arrived too recently or moved too frequently to qualify under the program. But all poor people, indeed all citizens, pay for the subsidy in the form of higher taxes, deterioration of the housing stock and a general decline in the economic well-being of the city.

Let's look at some specific costs. Since 1960, 300,000 rental units have been abandoned, and abandonments are now running at an annual rate of 30,000 per year.

From 1965 to 1975, New York City's housing stock increased only 2%, and the number of rental units declined 3.8%. The City's supply of rental units is old. Nearly half were built before 1929. More than half are "walk-ups."

The aging, decay and decline of New York's housing stock should come as no surprise. Rents have not been allowed to increase as fast as operating costs. Landlords have been compelled to absorb the larger part of the sharp increases in fuel costs. Small wonder that maintenance has been postponed and tax delinquencies and abandonments have increased. Landlords cannot suffer losses endlessly.

But landlords are not the only ones to suffer. All New Yorkers suffer in their capacities as taxpayers and users of City services. Everyone suffers because property values and, as a corollary, property taxes, decline. In this regard, total arrears of real estate taxes are estimated to be over $700 million, not including arrears in water rents and sewer rents.

Because of the erosion of its real estate tax base, New York City has had to resort to more taxation of business and personal incomes. Such taxes tend to drive employers and higher income workers out of town.

The ability to own one's own home -- one of the fundamental goals of our society -- is another frequent victim of the rent control system. Applications to restore subdivided brownstones to the original one or two family status can take over a year to process through the rent control bureaucracy and often are turned down, despite the neighborhood improvement which would result. Clearly, the administrators of the complex rent control laws do not recognize the direct relationship between the spread of urban blight and the flight of middle-class families from New York City.

In short, rent control is inequitable as well as uneconomic. If it were phased out, the following benefits would accrue:

-- the existing housing stock would be better utilized, reducing both over-crowding and under-occupancy;

-- new construction starts and rehabilitation work would create thousands of jobs and provide New York City's underemployed youth with a chance to learn a skill;

-- the real estate tax base would stop eroding and start growing;

-- the need for public housing projects, which have been a tremendous drain on the City's financial resources, would decline;

-- business and personal taxes could be reduced and, as a result, investment, jobs and income earners would return to New York.

Welfare and Federal Aid

Before concluding, let me turn briefly to the role of the Federal Government, particularly in the welfare area. Mayor Beame's statement of last week reiterated a commonly heard contention: New York City would not have a financial problem if the Federal Government took over welfare. In light of such contentions, it may be useful to outline the large and growing Federal role in financing state and local governments generally. But before I do, let me address specifically the welfare question.

First, let me reiterate my conviction that we need a comprehensive re-examination of Federal, State and local relationships in the area of assistance to the disadvantaged. I personally favor the simple, non-bureaucratic approach of income maintenance. But whatever the outcome, we plainly must assure ourselves that current policies are consistent with the needs of the last quarter of the twentieth century.

As is clear from my remarks to this point, however, I do not believe a change in welfare policy is itself a solution to New York City's financial problems. To be sure, it is factually correct to say that if the Federal Government assumed all of New York City's welfare obligations, the budget deficit would be substantially reduced since City expenditures would fall by approximately $800 million. But it is equally correct to say that the same effect would be realized if the Federal Government took over responsibilty for schools, for operating the police and fire departments, or by paying for any of the other services which New York City now provides. Accordingly, if the arguments regarding welfare have any validity, they must be accompanied by a credible showing that New York City's welfare problem is somehow unique. And the facts simply don't bear that out.

The percentage of New York City's population which is on welfare is 10.9%, a lower percentage than in Philadelphia, Washington, D.C., St. Louis, Newark, or Baltimore. Median minority family income is $8,108, almost $2000 more than the national average. The proportion of families below the poverty level fell by more than a third in the 1960's and is well below the national average. These facts plainly belie the allegation that New York City is a haven for the poor and, as such, performs a service which Federal taxpayers must pay for.

The real financial problem presented by welfare in New York City is a problem which has its roots at the State level: specifically the division of responsibility between the State Government and local governments for the non-Federal portion of the welfare payment. This Committee is well aware of the burden New York State has traditionally imposed on its local governments: 25 percent of total welfare costs, as opposed to 1 percent in Illinois and 12 percent in California. But this Committee is also aware of the fact that New York State is hardly in a financial position to change this formula now.

Let me turn now more generally to the subject of Federal aid. Federal aid to State and local governments has risen steadily during the post-war period, and very rapidly since the late 1960's.

In 1950, direct Federal aid to state and local government was $2.3 billion. Two decades later, in 1970, aid had increased tenfold, reaching $24.4 billion. And this fiscal year the figure will more than double again to $60 billion. These are only direct grants. If other Federal expenditures -- in the form of housing subsidies, transfer payments, Federal employment and the like -- are included, the total benefit is more than $100 billion higher.

Moreover, the growth in Federal aid to New York City has outpaced even these rapid increases. In fiscal year 1965, direct Federal aid to New York City was $228 million and equalled 6% of the City's general revenues. By the current fiscal year, direct Federal aid had grown to $2.437 billion: 22% of scheduled general revenues. This eleven fold increase in aid is precisely double the nationwide growth rate over the same period.

Federal aid has hurt New York City -- and every other city -- in one respect. The bulk of Federal aid is in the form of categorical grants. Of the total $2.437 billion being provided to New York City in the year ending June 30, 1976, $2.174 billion, or nearly 90%, consists of categorical grants. These grants are nearly always tied to matching funds being provided from State and local sources. Matching programs provide a clear and dangerous path to over-commitment of local financial resources.

There is nothing more important that the Congress can do to help New York City (and other municipalities as well) than to enact the President's proposal to extend revenue sharing, and to embrace the Administration's proposal to substitute functional or block grants for large elements of the present categorical matching grant system. We need to let states and municipalities decide by and for themselves the kinds of activities they want to support, and how much of their own financial resources they want to put into these activities.

Conclusion

I began my testimony today by suggesting that the situation is much as we expected it to be. The financing package and the Federal seasonal loan program have served the purpose they were designed to serve: they have provided New York City with ample time and ample opportunity to solve its fiscal and financial problems.

At this time, no one can predict with complete confidence whether the job will be done. Clearly the challenges are great. But the potential rewards are even greater. New York City has been given the opportunity to restore itself to pre-eminence among our urban centers. And in so doing, its accomplishments can serve as a model for all the cities of the nation -- and for the Federal Government as well.

The question is very straightforward: what do the people want from their Government and what are they willing to pay for? Most political units must answer this question every day. Congress has given New York City two more years to find the answer. It must use this time wisely.

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FOR IMMEDIATE RELEASE

STATEMENT OF WILLIAM M. GOLDSTEIN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
ON H.R. 12224
BEFORE THE WAYS AND MEANS COMMITTEE
APRIL 5, 1976, 10:00 a.m.

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss certain problems that have arisen involving the taxation of transactions on a securities option exchange. One of these exchanges, the Chicago Board Options Exchange, has obtained a private ruling letter from the Internal Revenue Service which has received extensive publicity in the securities field and has been relied upon by some to promote a plan designed to convert ordinary income into capital gains. H.R. 12224, which is before you today, seeks to terminate this potential tax advantage. The Treasury supports the bill, but we would like to suggest certain changes which, we believe, will more effectively accomplish the purposes of the legislation.

BACKGROUND

The present rules governing the tax consequences of option transactions have been developed over the years through a series of Internal Revenue Service rulings, which have been issued in the absence of specific provisions in the Internal Revenue Code. Let me note in passing that there are proposals to codify the Service rulings, with some modifications. Such proposals, put forward by the American Bar Association, seem worthy of further study and the Committee may want to consider them at a later date.

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As applied to a taxpayer who sells an option in direct dealings with a purchaser (as distinguished from an exchange transaction), the rules are reasonably clear and produce results generally accepted as fair. The seller's receipt of the premium for writing the option does not result in the recognition of income until either the option expires unexercised, the option is terminated through reacquisition by the option writer, or the option is exercised. If the option expires unexercised, the amount of the premium received upon writing the option constitutes ordinary income. If the option is exercised, the premium is considered part of the proceeds from the sale of the underlying securities in the case of a call option and is applied as a reduction in the basis of the purchased securities in the case of a put option. While there is some controversy regarding the proper tax result when the option is reacquired by the writer, such transactions occur infrequently.

The distinguishing feature of the options exchanges, which at present deal only in call options, is that the purchaser of an option does not look to the actual writer of the call for delivery of the securities named in the option. Instead, an option clearing corporation is the primary obligor. Since there is no obligation on the part of the writer to the purchaser of the option and since the options exchanges have created secondary markets in options, a writer of an option in an exchange transaction can terminate his obligation merely by purchasing on the exchange an option having the same terms as the option he had previously written. This so-called "closing transaction" essentially permits the writer to cancel his option contract.

If a call is written at the prevailing market price and the market rises, the purchaser of the call will exercise the option in order to realize the spread between the option price and the higher market price. In the case of a face to face option (that is, one not traded on an options exchange), the writer of the option adds the proceeds from the sale and the option premium in determining his capital gain or loss on the transaction. In the case of an option traded on an options exchange, the option writer instead engages in a closing transaction in which there is no sale or exchange of securities. Thus, the creation of options exchanges presented a novel situation for which there were no established tax rules.

The Service's letter ruling holds, in part, that where the writer of an option enters into a closing transaction he realizes ordinary income or loss based upon the difference between the amount of premium received and the amount paid to repurchase the option. The rationale for treating income from the lapse or termination of an option as ordinary income is that in writing an option the writer merely has an obligation to perform in the event that the holder exercises the option. He does not have a capital asset even though he may own stock with which he may satisfy his contractual obligation if the option is exercised. Consequently, it was held that a closing transaction does not constitute a sale or exchange and does not give rise to capital gain or loss.

POTENTIAL FOR TAX ABUSE

As an interpretation of the existing rules, we believe the letter ruling reached a correct result. Nevertheless, because the exchange separates the option from the interest in the underlying stock, an opportunity has been created for writers of calls to adopt investment strategies designed to create capital gains on one side of their investment position and ordinary loss on the other. Thus, in the case cited by Congressman Mikva when introducing H. R. 12720, an investor may save tax by following this procedure:

(1) The investor purchases 100 shares of IBM stock at $200 and at the same time writes an IBM call for 100 shares at $200 for a premiumof $2, 500.

(2) After six months, when IBM goes up to $250, he sells the IBM stock and realizes a $5, 000 long-term capital gain and closes out the IBM call at a cost of $5, 000.

In economic terms, the consequence of these transactions is a net gain of $2, 500, arising from the $5,000 gain realized from the sale of stock less the $2, 500 ordinary loss from the dealings in the option. However, for tax purposes, these transactions can result in a "wash" and the investor will not pay any tax at all on the gain. Assuming a taxpayer with a marginal tax rate of 50 percent, the tax on the $5, 000 capital gain will be $1, 250 and the tax saving from the $2, 500 ordinary loss will also be $1, 250. The net tax, resulting from offsetting the long-term capital gain against the ordinary loss is thus zero.

Actually, there are a number of variations on this theme. For example, similar advantages are available in cases where investors have useless capital loss carryovers which they want to convert into useable ordinary losses. We also understand that additional opportunities for manipulation will arise when the national options exchanges begin dealing in puts at some date in the future.

It should be noted, however, that there is a substantial tax detriment to the investor who follows the above-described plan in the event the market goes down and he suffers an economic loss. For example, if the value of the IBM stock in the previous example had declined to $150, the investor would have sustained a $5,000 capital loss if he had sold his stock and a $2,500 ordinary gain from the lapse of his option. While in economic terms he would have sustained a $2,500 out-of-pocket loss, for tax purposes he will offset only $2,000 of his capital loss against $1,000 of ordinary income, carry over a capital loss of $3,000 to the next taxable year and pay tax on $1,500 of ordinary income.

ANALYSIS OF BILL

H. R. 12224 would amend section 1234 of the Code to provide that gain or loss from any closing transaction shall be treated as a short-term capital gain or loss. A closing transaction is defined as a purchase of a put or call in stock or securities or commodities to terminate, in whole or in part, the taxpayer's obligation under the existing put or call in substantially identical stock or securities or commodities.

Under the proposed statutory change, the tax system would assume a neutral stance with respect to these transactions. That is, our investor in the example cited will now have a short-term capital loss ($2,500) from the closing transaction which will reduce his long-term capital gain ($5,000) from the sale of stock and he will pay a tax on a $2,500 long-term capital gain. On the other hand, in the event the value of the investor's stock decreases, and he enters a closing transaction to terminate his interest in the option, he will be able to offset his $2,500 short-term capital gain from the writing of the option against his long-term capital loss of $5,000 from the sale of stock. Since the tax law limits the offset of capital losses against ordinary income to $1,000 of ordinary income, he will have a $2,000 long-term capital loss to apply against $1,000 in ordinary income and a $500 long-term capital loss as a carry-over to the next taxable year. We believe such tax neutrality is desirable, and for that reason we support enactment of H. R. 12224.

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You will note, however, that in order to obtain the benefit of this new provision in the situation where the market falls, the investor must go through the formality and expense of a closing transaction. This is in contrast to the normal procedure where the value of stock decreases; in such event, the holder of a call will allow the option to lapse and the seller will retain the premium. But H. R. 12224, as drafted, does not extend to lapsed options. Therefore, we suggest that it would be desirable to amend the bill so that it applies not only to closing transactions but also to lapses of options. Failure to make this change would give rise to discrimination between those investors who are sophisticated enough to enter into a closing transaction and those who, through ignorance of the tax laws or otherwise, permit their options to lapse. We recommend that the income realized upon the lapse of an option be treated as short-term capital gain in all events.

The proposed new rules will require some elaboration, either in the bill or in the Committee report. The Internal Revenue Service has ruled in Rev. Rul. 66-47, 1966-1 C.B. 149, that premium income received by a tax exempt organization from the writing of "covered" call options that is, call options respecting stock owned by the organization is subject to unrelated business income tax where the options lapse without being exercised and the writing of options is regularly carried on by the organization. The Service has also ruled in Rev. Rul. 63-183, 1963-2 C.B. 285, that amounts derived by a regulated investment company from writing put and call options which are not exercised do not constitute "gains from the sale or other disposition of stock or securities" within the meaning of section 851(b) (2) of the Code. Accordingly, a corporation will not qualify as a regulated investment company for income tax purposes if more than 10 percent of its gross income consists of such premium income.

In each ruling the Service has taken the position that the premium received by the writer upon the lapse of the option is not associated with, and has no relevance in, fixing the amount of gain or loss from the disposition of any particular stock or securities. Nor, in the view of the Service, can the premium be viewed as gain from the sale or other disposition of the option itself. This is because the writer is viewed as being compensated for assuming an obligation and the income he receives upon the lapse of the obligation is in no way attributable to a sale or other disposition.

If the bill is amended as we propose, it might be interpreted as reversing the principle enunciated in these rulings since gain or loss from lapsed options and closing transactions will now be treated as gain or loss from the sale or exchange of a capital asset. Such an interpretation, if applied to all options, might encourage undesirable speculative activities on the part of exempt organizations and regulated investment companies.

With respect to exempt organizations, this Committee, after separately considering the question, has decided to favorably report H. R. 3052. That bill, which has the Treasury Department's support, would exempt from the unrelated business income tax, income of exempt organizations from the writing of covered call options.

An exempt organization which writes covered call options is writing options as an incidence of its investment activities in order to maximize the yield from its securities portfolio, and exemption from the unrelated business income tax is appropriate. Different questions would be raised respecting the proper sphere of exempt organization activities if the present bill were to be interpreted as also exempting income from the writing of naked options, that is, where the exempt organization does not own the underlying stock.

Similar considerations may apply in the case of regulated investment companies. We believe this question should be further studied and that the views of industry representatives and the Securities and Exchange Commission should be obtained to determine what is the appropriate policy to follow in this area.

Accordingly, we recommend that it be made clear that the present legislation does not affect the application of the unrelated business income tax to exempt organizations and section 851 of the Code to regulated investment companies, leaving the special problems of such organizations to be resolved by specific legislation tailored to meet their special circumstances.

Another modification which we recommend is to add to the bill a provision excluding gains or losses realized by traders dealing in options in the ordinary course of their trade or business from short-term capital gain or loss treatment. A similar provision is contained in present-law section 1234(c)(2).

We would also like to draw the Committee's attention to the impact this provision would have on foreign investment in option markets. At present there is some uncertainty regarding the tax treatment of nonresident aliens and foreign corporations who desire to engage in option writing transactions. The uncertainty, involves first, the question whether the foreign investor will be considered engaged in a trade or business in the United States and, second, whether the United States withholding taxes apply to the receipt by a foreign investor of premium income.

The Foreign Investors Tax Act of 1966 was enacted to stimulate investment by foreign investors in the United States securities markets. However, neither section 864(b)(2)(A)(ii) of the Code, which provides that a foreign investor engaged in "trading in stocks or securities for the taxpayer's own account" will not be deemed to be engaged in a United States trade or business, nor the Treasury regulations under that provision are clear that the writing of options constitutes "trading in stocks or securities".

Under the Code, foreign investors generally are subject to withholding tax on their gross income which is "fixed or determinable annual or periodical gains, profits, and income", unless such income is "effectively connected" with a United States trade or business, in which case it is generally subject to regular United States tax. If a call option written by a foreign investor is exercised, there is no withholding tax owed since the premium is deemed to be part of the gain realized on the underlying stock and there is no witholding tax imposed upon the sale or exchange of property by a foreign investor. It is not clear under present law whether ordinary gain or loss realized upon the lapse of an option or in a closing transaction will receive similar treatment.

Under H. R. 12224, however, gain or loss arising from a closing transaction (or upon a lapse of an option if the Committee decides to so amend the bill) will be treated as gain or loss from the sale or exchange of a capital asset. Such treatment should make it clear that premium income is not subject to United States withholding tax. We believe that this is the appropriate result. It is consistent with the policy adopted by Congress in the Foreign Investors Tax Act of 1966 and with the Administration's policy to encourage foreign investors to trade in the United States securities markets.

Finally, we note that the bill contains a March 1, 1976, effective date. We suggest that the bill, as amended, apply only to options written after the date of the Committee's decision on the bill. Adoption of an earlier effective date may be unfair to taxpayers who entered into transactions in reliance upon existing law and in ignorance of the introduction of H. R. 12224.

CONCLUSION

In conclusion, the Treasury supports H. R. 12224 and recommends that the Committee adopt the modifications proposed relating to the lapse of options, the exclusion of tax-exempt organizations and regulated investment companies from the application of the bill's provisions, and the effective date rule. While we feel that the Committee should also consider the codification of all consequences of option transactions, as they apply to both investors and regulated investment companies, we do not think that action upon H. R. 12224 should be delayed pending the consideration of such matters.

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FOR IMMEDIATE RELEASE

REMARKS OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE
THE COLBY INSTITUTE FOR MANAGEMENT
COLBY COLLEGE
WATERVILLE, MAINE
APRIL 2, 1976

Thank you, Governor Jim Longley, President and Mrs. Robert Strider, Ben Haug, and ladies and gentlemen:

It is indeed a pleasure to be your guest on this distinguished campus and in a corner of the country where individualism, independence and self-reliance are not just handy catchwords, but a way of life -- today no less than in the early years of your rugged, vital state.

I am honored to be introduced by your outstanding Governor, my good friend Jim Longley. Jim offered to put me up for the night, just so long as I reimburse the State of Maine for any heat electricity, or running water that I may use while staying at the Executive Mansion. Well, I'm perfectly willing to go along with any reasonable economy drive because I believe in saving the taxpayers money, too -- and I plan to congratulate him on his many efforts to reduce spending as we hitchhike back to Augusta after the banquet tonight.

It is also a special pleasure to be included in this excellent program sponsored by Colby College. I am impressed not only by the scope of your deliberations but by their strong accent on long-range solutions rather than just short-range problems. Fred Webber -- one of your workshop leaders and an outstanding Assistant Secretary of the Treasury until recently -- can vouch for the fact that if you were holding these sessions in Washington, you would be committing one of the cardinal sins of that city: asking people to look beyond November in an election year. And yet the need for long-term vision in this country has never been greater, and we will all benefit from these efforts by you leaders in business and the professions to meet the challenge -- in the words of your conference theme -- of a post-recession economy.

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Finally, it is heartening to see a joining of the academic and business communities in this endeavor. Too often, our society tends to split up into neat and self-contained compartments rather than combining forces to work toward common goals. The Colby Institute for Management, with a generation of experience and service behind it, sets an example that should be emulated throughout the nation.

I intend to follow your lead tonight and also look beyond the recession, but first I'd like to take a moment to itemize our progress in recovering from this most severe economic slowdown since World War II. The decisions we have had to make in the past year or so, I believe, are instructive as we chart our course for the future.

Economists generally agree that the recession hit bottom last April, that the recovery began sooner than expected, and that it has been stronger than expected. Only a few months ago, we began to see light at the end of the tunnel. Today, we are nearly out of the tunnel and on our way to recovering a full head of steam. For example:

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been cut to approximately 6 percent, and February's consumer price index showed only a microscopic rise, the smallest in over four years. There will be ups and downs, but I believe the decline in inflation will be steady, overall.

-- Last spring, unemployment had reached nearly 9 percent. It has now dropped to 7.5 percent and our forecasts indicate a continuing downward trend -- perhaps falling below 7 percent by the end of the year.

-- Other signs point to an economy that is regaining its vitality: Real GNP, the stock market, personal income, industrial output, housing starts, retail sales -- all are registering gains and this reflects a rising public confidence about the economy that contrasts sharply with the deep pessimism reported by polltakers only a few months ago.

But although we made considerable headway in 1975 and we are making even more in 1976, this is no time for complacency. Inflation is not yet under control and the jobless rate is still too high. Right here in Waterville, unemployment is running at, or a little above, the national average -- and this translates into hardship and suffering for many families. Many other areas of Maine are far above that average and we will not be content until the rising vigor of the economy nationally is reflected in communities hit by long-term unemployment.

That is why the Administration is urging Congress to adhere to a broad-gauged plan to further nurture and stimulate the natural forces of growth in our private enterprise economy. An essential element of this plan is to put the brakes on the dizzying momentum of Federal spending -- to slow the rate of increase to about 5 percent this fiscal year, contrasted with 40 percent the past two fiscal years. This will allow us to continue to make progress on inflation and, at the same time, will make additional tax cuts possible for businesses and individuals and set the stage for a balanced budget within three years.

Further, the President has urged tax measures designed to stimulate job creation generally, encourage the building of sorely-needed electric power facilities, and increase construction of plant and equipment in areas where unemployment has topped 7 percent, which includes virtually every major job market in Maine and many other parts of New England.

Finally, the Administration has proposed elimination of the unfair double taxation of dividends that retards capital formation. This is the only major proposal I know about that seeks to correct the imbalance between corporate debt and equity. As you well know, we must redress this imbalance to allow the financial markets to channel society's savings more efficiently to the more promising investment opportunities. And, as you also know, improving our lagging capital investment picture is absolutely essential to meet our long-term goals of more jobs, higher incomes, greater productivity, lower inflation and sustained growth.

These steps and the balanced program we have pursued thus far are designed to fight inflation and unemployment simultaneously and strengthen the private sector of our economy.

We firmly believe that this course is working, that it is right for the nation, and that it is leading us back to the position of robust growth and expanding opportunities.

And yet you will hear a mournful chorus of rhetoric out of Washington, especially as the election campaign draws closer, claiming that we aren't spending enough, aren't pressing hard enough, aren't pushing enough panic buttons to solve our problems. Despite our steady gains, many of these critics assume there must be a basic flaw in the system and they cast about for other remedies: governmental control over economic planning -- guaranteed jobs for everybody at government expense -- a new round of wage and price controls -- and other encroachments on the market place which were discussed in one of your workshops this afternoon.

Frankly, I believe that many of these critics suffer from what Mark Twain called "loyalty to petrified opinions." They fail to see that efforts to strengthen the public sector at the expense of the private sector are a large part of the problem, not part of the solution. They refuse to recognize that the same excessive government fiscal, monetary and regulatory policies they call for today have led to abuse of our economy and helped trigger, first, a storm of inflation in the early 1970s and, second, the severe recession from which we are now recovering. And they fail to comprehend a gathering mood in this country against the further expansion of big government. They suffer from the economic variety of Potomac Fever -- the delusion that all economic cures must originate in Washington with the Federal government. As President Eisenhower once remarked; "there are a number of things wrong with Washington, and one of them is that everybody has been too long away from home."

However, public disenchantment with big government does not mean that all Americans are necessarily immune from the superficial appeal of quick-fix government programs whose short-term benefits are well publicized but whose long-term impact in terms of inflation and economic stagnation is carefully masked from view.

It may seem strange, and it is certainly ironic, but at a time when the vast majority of Americans are enjoying such abundance and opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible.

This is certainly not true in many countries abroad. I was reminded of this fact during my recent two-week trip to the Middle East. Israel and the Arab states have sharp differences, of course. But on one thing they are agreed. They all have a profound admiration for the achievements and performance of the American economy. The leaders of the Middle East believe, as I do, that the United States has developed the most dynamic and efficient economic system ever devised. Largely because of this, they see the United States as the major source of strength and stability in today's unstable world.

But here in the United States, somewhere along the line there seems to have been a dangerous breakdown in communication. Your fellow New Englander, Secretary of Commerce Elliot Richardson, put it succinctly the other day when he said that producers and consumers in this country tend to view each other as antagonists -- despite the fact that neither can thrive without the other.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the actual dynamics of prosperity in a free society.

Today, when nearly everybody takes the fruits of the free enterprise system for granted -- the abundance, the opportunities, the freedom of choice, and the chance for learning, travel and general upward mobility -- not everyone understands the basic economic facts of life that have produced these benefits.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people. And I believe that the men and women who make up our free enterprise economy -- in business, in the professions, in the factories -- must do even more than they are now if such a national dialogue is to succeed.

What is at stake is not simply the future of this or that company, or even this or that industry. At stake is the survival of the private sector, and, because of the interlocked nature of our freedoms, the survival of the individual liberties which can never long endure after the collapse of a society's free enterprise system.

This problem of communications exists, as I have had ample opportunity to observe in my job as Secretary of the Treasury, and it is getting worse, not better. It is a question of both policy and perception, for a faulty view or understanding of the economy makes faulty economic policy-making almost inevitable.

Part of the problem is a matter of image. Frequently, those who support bigger government spending and more government domination of the private sector are perceived as concerned and socially progressive individuals who "care", who are champions of the persecuted underdog.

And I don't have to remind those of you on the firing line that people who warn, on the other hand, that the government should not and cannot effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system, are seen as either outdated ideologues or a new generation of economic exploiters -- indifferent to human suffering and only out to make a fast buck for themselves or their companies.

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This stereotype wouldn't matter if it were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well-being of our citizens, especially those who are impoverished or face disadvantages because of artificial barriers of sex or color or national origin.

The central question if not who cares the most -- we all care. It is rather the method we choose to broaden prosperity, reduce human hardship and meet our other national goals without sacrificing our freedoms or destroying the most successful economic system that man has ever known.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean much to those who do not understand what it really menas and what makes it work. It's like trying to discuss the birds and the bees sensibly with somebody who unshakable in his belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to cue up for hours to buy a poor selection of over-prices food and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition an average shopping center found anywhere in the U.S. would represent to most of the world's people.

They have never asked themselves why a country like the Soviet Union, with some of the richest grain land in the world -- but with an agricultural system owned and operated by the government -- cannot even feed its own people without turning to American farmers who own their own land, make their own decisions and feed not only their fellow Americans but millions of others as well.

They have never lived in countries where the seemingly idealistic dream of a society without private property or profits has turned into a nightmare reality: where the state and the state alone dictates what kind of education you will receive, whether or not you will be allowed to travel, what kind of job you can have, what you will be paid, what you can buy with your own earnings, where you will live and, ultimately, where you will be buried.

The truth is that regimented societies inflict upon their citizens not only a political regime that reduces the individual, in Churchill's phrase, to a mere fraction of the state, they also inflict an economic regime that smothers enterprise and breeds inefficiency. Let's face it: Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many fresh ideas and new improvements. Whether we like it or not, this is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So I submit to you tonight that if America continues down the road toward greater governmental spending and greater governmental control over our economy and over our lives -- a road that we have been traveling for several decades -- then all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment and those who come after us will be robbed of their personal and economic freedoms. That is really what is at issue underneath the semantics and the misleading labels.

Let me be specific about how our private enterprise economy has been undermined by excessive government policies.

Just before the New Deal, government spending at all levels -- Federal, State and Local -- was about 10 percent of our total national output. Today, because budgets have mushroomed, government accounts for almost 40% of the GNP, and if recent trends prevail, the government's share of the total economy will reach 60 percent before the end of this century.

Let's put present spending in dollar signs. Today, and every day during this fiscal year, the Federal Government will spend $1 billion. And this week and every week this fiscal year it will go into debt an additional $1 billion. Since 1962, when the federal budget hit the $100 billion mark, it has almost quadrupled, and has been in the red for all but one of those years.

The interest on the federal debt alone by the end of fiscal 1976 will have climbed to $36 billion. The amount in fiscal 1977 will reach $45 billion. That's more than we spent in any one year on the war in Vietnam. It is almost half of what we will be spending on total national defense next year. And it is money, I'm sure you will agree, that could better be spent on improvements in health care, public transportation, rebuilding our cities or any of a dozen other national needs.

As business and professional people you know that it spells disaster to borrow and spend more than you take in for too long. You know that heavy government borrowing has fueled inflation and driven up interest rates so that strains have developed in money and capital markets. Many of you may have felt these strains as you have tried to get loans to expand your businesses and create new jobs, or even to buy a new home without paying an arm and a leg in mortgage interest.

Throughout the nation, we see signs that taxpayers, who have so long borne the burden of heavy government spending, are close to open rebellion. In the 1974 elections, for example, voters across the country turned down more than 75 percent of all bond issues on the ballot. And eight state legislatures, fed up with rising national debt, have now adopted resolutions calling for a constitutional amendment requiring a balanced national budget. As one state representative put it: "I don't want the government spending my grandchildren into a poorhouse."

So our major concern as we work our way to a sound and durable recovery is to avoid another dose of the same poison which brought on the recession in the first place: rampant inflation fed by runaway federal spending.

But spending isn't the whole problem. As government spending has grown by leaps and bounds, so too have government controls, regulation and red tape.

Did you realize that government regulatory agencies, with an army of 100,000 on the payroll, exercise direct control over 10 percent of everything bought and sold in the United States and indirect control over almost every other sector of the private economy?

The avalanche of paperwork required by this regulatory network is a tremendous burden on small and big businesses alike. Business spends an incredible $18 billion a year just to fill out government forms. General Motors recently calculated that it spent more than $1.3 billion in 1974 just to comply with existing government regulations or get ready for new ones. This is more than it cost to run the entire Federal Government for all of the first 75 years of our history -- and that includes the Louisiana Purchase.

Some of these regulations are, of course, necessary and in the public interest. But many more of them are counter-productive, wasteful, and obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Speaking in 1865, Lincoln said, "I have faith in the people... the danger is in their being misled. Let them know the truth and the country is safe."

What I have been trying to emphasize here tonight is the need to hammer home the truth -- the economic facts of life -- to the American people, including the young Americans who must lead us in the years ahead. Much of that task is, and should be, up to individuals like yourselves who are most knowledgeable in the everyday practices and strengths of a free economy.

It is a story that cannot be vividly portrayed on television like the war in Vietnam or the urban riots of the sixties. Yet it is the one thing that affects every aspect of our lives.

And I am convinced that the American public has not irrevocably closed its ears to this story. The polls tell us that businessmen themselves rank low in public confidence, and yet the principles of private enterprise rank high. A majority of Americans say they want more regulation of businesses, and yet business is the most popular major field of study among college students -- above education, science and the humanities. We can strike a responsive chord in telling this story to the American people if we tell it in human, comprehensible terms.

For when we talk about our free enterprise economy we are talking about food on the table, goods on the shelves and services at the counter. We are talking about medical breakthroughs that have added 10 years to our lives in the past generation. We are talking about labor-saving devices that have freed millions of women for productive careers and the pursuit of self-enlightment. We are talking about five out of every six jobs in America and wages and benefits that stagger the imagination of the rest of the world. We are talking about a productive base that pays for government support of the elderly, the jobless, the poor, the dependent and the disabled. And we are talking about basic freedoms; to choose a career, to choose what and where we buy, to choose where and how we live, and yes, to swim against the tide -- as did Fulton and Ford and Edison -- things you could never do living in the gray shadow of conformity under a regimented society.

And finally, those who are part of our private enterprise economy have the crucial responsibility of making sure the business community keeps its own house in order.

American business is being rocked by news of illegal corporate political contributions, payments of millions of dollars in bribes to help influence business decisions in foreign countries, and other questionable or downright illegal practices that have rightly shocked the majority of our citizens. Congressional committees have reacted strongly and many businessmen are calling for a voluntary business code of ethics and internal reforms.

I would applaud this mood of reexamination that is beginning to reveal itself in the business community. After all, no one has more to lose from corrupt practices than the vast majority of honest businessmen, and no one has more to gain from wiping out corporate corruption before it endangers the whole free enterprise structure, which would be a tragedy for each and every citizen.

And I would respectfully suggest that this reexamination be extended to include other practices that are perhaps less dramatic but which also create a gap between business principles and performance -- taking subsidies and bailouts and other forms of government intervention or protection -- resist regulatory reform solely to avoid competition in the marketplace -- putting high quantity above high quality in the manufacture of products and misrepresentation above truth in selling them to the public. Once people begin to roll all these abuses together in their minds it can mushroom into a general, unreasoning indictment of the system itself.

I would urge all of you who are part of our mighty private sector -- the real source of the vitality of our economy and the vitality of our society -- to place your convictions and your energies in the service of this cause of improving, and telling the facts about, our private enterprise system.

In this Bicentennial year, if we keep alive the spirit that infuses our national character -- the spirit of free enterprise that each of you personifies -- then we can be certain that it will endure for another 200 years and more.

But, if we let free enterprise wither away, we may be sure that our other freedoms and individual liberties will expire as well. We must not, we will not, allow this to happen.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE April 1, 1976

The Treasury Department today unveiled the official portrait of former Secretary of the Treasury, John B. Connally. Governor Connally served as the 61st Secretary from February 11, 1971 to June 12, 1972.

Addressing Governor Connally and other officials, Secretary of the Treasury William E. Simon cited Governor Connally's "deep human resources, his sense of adventure and commitment, and his amazing capabilities that perhaps no painting -- however great -- can fully capture."

The portrait was painted by Everett Raymond Kinstler one of America's outstanding portrait artists. Mr. Kinstler also painted the official portraits of former Treasury Secretaries David Kennedy and George Shultz.

Governor Connally is also past recipient of the Alexander Hamilton Award, the highest honor the Treasury Department bestows.

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WS-760

April 2, 1976

NOTE:

Attached is a preliminary analysis on "Tax Treatment of Allowances Paid to U. S. Government Employees," prepared by the Office of International Tax Affairs of the Treasury Department, for consideration by the House Ways and Means Committee Task Force on the Taxation of Foreign Income.

The analysis does not represent an Administration position and does not contain recommendations.

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WS-761

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Tax Treatment of Allowances Paid to U.S. Government Employees

Department of the Treasury
April 1976

PREFACE

This preliminary analysis was prepared by Marcia Field and Brian Gregg of the Office of International Tax Affairs for consideration by the House Ways and Means Committee Task Force on the Taxation of Foreign Income. The analysis does not represent an Administration position and does not contain recommendations.

Table of Contents

I. ISSUE

The issue is whether the allowances paid to U.S. civilian government employees, primarily for overseas employment, which are now tax exempt under Section 912 of the Internal Revenue Code, should be made taxable. 1/ A related consideration is the extent to which the tax treatment of these allowances should parallel the treatment of income earned abroad by private sector employees.

Under Section 912 of the Internal Revenue Code, U.S. citizens employed outside the continental United States by the U.S. Government in a civilian capacity may exclude from their gross income certain allowances which supplement their base salary. The allowances in question are designed primarily to cover certain living expenses. In a number of cases, such as moving expenses, the expenses would generally be deductible as employee business expenses under current law. But other allowances, notably those for housing, cost-of-living differentials, education expenses and home leave travel, would be taxable income in the absence of the special exclusion under Section 912.

In 1974 the Ways and Means Committee voted to phase out both Section 912 and Section 911, which excludes certain foreign earned income of private sector employees. Both

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1/ This paper deals only with allowances paid to civilian government employees. Military allowances are treated under different provisions of the law.

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sections would be phased out over four years and with limited exceptions. That bill (H.R. 17488) was not acted on by the House before Congress adjourned. Many of its provisions concerning foreign source income were incorporated into H.R. 10612, including the phase out of Section 911. However, the Ways and Means Committee deferred consideration of Section 912 pending receipt of the report of an interagency committee which was reviewing the entire structure of overseas government allowances. Completion of that report in final form is expected to require another year, but in view of the Ways and Means Committee's interest, the interagency group has completed the portion of the report dealing with tax questions and has transmitted that portion to the Task Force as an interim report. 1/

1/ Interim Report of the Interagency Committee on Overseas Allowances and Benefits for U.S. Employees, (Chairman, John M.Thomas, Assistant Secretary of State for Administration) January 1976.

II. PRESENT LAW

1. Explanation. Section 912 of the Internal Revenue Code provides an exclusion from gross income for certain allowances paid to civilian government employees. The section refers to three categories of allowances, citing in each case the statutes which authorize their payment.

a. Foreign areas allowances. (Paragraph (1) of Section 912) The first category enumerated in Section 912 comprised the various allowances paid to government employees in foreign areas. There are about 50 such allowances, which fall into eight major groupings: living quarters, cost-of-living differentials (by comparison with Washington, D.C.), education of dependents, travel, expenses associated with transfers, expenses associated with separation from the foreign service, representation expenses, and residences (limited to certain officials). Table 1 gives an abbreviated description of the types of costs the allowances are intended to cover.

b. Cost-of-living allowances. (Paragraph (2) of Section 912) The second category excluded from income by Section 912 is cost-of-living allowances paid in accordance with regulations approved by the President to employees stationed in the U.S. territories and possessions or in Alaska or Hawaii. The statute refers to employees stationed outside the continental United States, which for this purpose

Table 1

PRINCIPAL CATEGORIES OF ALLOWANCES
OF U.S. GOVERNMENT EMPLOYEES IN FOREIGN COUNTRIES

Housing - Quarters provided or payments to cover rent and utilities.

Extraordinary Living Costs - "Post Allowance" for higher cost of living and "Separate Maintenance Allowance" where dependents must be living away from post of duty.

Education - Government provided schools or payments to cover tuition. Educational travel where appropriate schooling is not available at post of duty.

Community Services - Commissary privileges, medical care or reimbursement for medical expenses, after death services, personal transportation.

Hardship Incentives - "Post Differential" (presently taxable), Rest and Recuperative Travel, Unhealthful Post Credit

Relocation - Moving expenses (including auto), temporary lodging expenses, foreign transfer allowance for miscellaneous expenses, per diem while moving, home leave expenses, family visitation travel, emergency visitation travel, evacuation payments.

includes only the 48 states which were part of the United States in 1944, when the Revenue Act of 1943 was enacted, and the District of Columbia. To qualify for the exclusion, cost-of-living allowances paid to employees in the territories, possessions, Alaska and Hawaii must meet the second condition of being paid in accordance with regulations approved by the President. Those regulations authorized the payment of allowances to employees whose basic compensation is fixed by statute (Executive Order 10,000, 3 CFR 1943-48 comp., 792). If the basic compensation is paid from nonappropriated funds or is established by administrative order, the employee may not exclude under Section 912 any cost-of-living allowance he may receive.

c. Peace Corps allowances. (Paragraph (3) of Section 912). The third category mentioned in Section 912 covers certain allowances paid to Peace Corps volunteers and their families. This paragraph, added in 1961, is essentially limited to travel expense allowances and living allowances which do not constitute basic compensation. Termination payments and leave allowances for such individuals are specifically excluded from Section 912.

Section 912 specifically does not apply to another category of allowance, namely post differentials or "hardship" allowances. Post differentials are a percentage of base salary, up to 25 percent, paid to employees in locations where living conditions are uncomfortable. The Internal Revenue Service ruled in 1953 and 1959 that such payments were not excludable (Rev. Rul. 53-237, C.B. 1953-2, 52 amplified by Rev. Rul 59-407, C.B. 1959-2, 19). That position was incorporated into the statute in 1960.1/

2. Legislative History. The predecessor to Section 912 (Section 116(j) of the Internal Revnue Code of 1939) was enacted in the Revnue Act of 1943 as an amendment introduced by the Senate Finance Committee. The exclusion covered cost-of-living allowances of employees and officers of the Foreign Service, and cost-of-living allowances of other U.S. Government employees stationed outside the continental United States, if received in accordance with regulations approved by the President. The reasons for excluding the allowances was that wartime inflation was seriously reducing their value, particularly for foreign service personnel in Europe, that increases in allowances were partly nullified by the increase in tax, resulting from the Revenue Act of 1943, and that the State Department did not have the funds or authority to compensate the recipients for the added burden of the tax.

1/ In 1973 a new allowance was introduced to cover the additional housing and utilities costs incurred by U.S. Government employees stationed at U.N. headquarters in New York City who have entertainment responsibilities. Not more than 45 employees may claim the allowance at any one time. The amount is set to approximate the excess cost of housing and utilities in the neighborhood of the U.N. headquarters over the average of such costs in the metropolitan New York City area. The tax status of this allowance is not clear.

The Foreign Services Act of 1946 expanded the allowances and benefits authorized for foreign service officers and employees. The additional allowance included amounts payable for housing, cost-of-living, representation costs, travel expenses (for moving, home leave, and sick leave). That Act also added Section 116(k) of the 1939 Code to provide an exemption for such additional allowances.

Section 912 of the Internal Revenue Code of 1954 was identical to Section 116(j)(k) of the 1939 Code. In 1960, the 1954 Code was amended to add an exemption for allowances authorized under other Acts and to confirm the IRS position that post differentials are not excludable.

In 1961, certain Peace Corps allowances were added to the list of exclusions. The Treasury Department at that time expressed concern at expanding the list of benefits excluded from income. The excluded Peace Corps allowances do not include leave or living allowances which represent basic compensation, or allowances to family members of volunteer leaders training in the United States.

1. Scope of the exclusion. There are about 100,000 civilian government employees who receive one or more allowances that are excluded from income under Section 912. About 40,000 are employed in foreign countries, 20,000 in U.S. territories and possessions and 40,000 in Alaska and Hawaii. About 60 percent of the total are civilian employees of the Department of Defense (see Table 2). The allowances for foreign areas are administered by the State Department and those for non-foreign areas by the Civil Service Commission, but each of the 38 participating agencies may make its own variations in determining the amounts and conditions of allowances. Table 3 identifies the principal foreign countries where civilian U.S. Government employees are located.

The aggregate amount of allowances is not reported, nor does each agency report allowances separately in its budget. For example, the Defense Department, the largest single employer of personnel covered by Section 912, reports some civilian allowances with those of the military. The estimated total for all allowances in 1975 is $350 million, up from about $250 million in 1972 (see Table 4). The revenue cost in 1975 of excluding the allowances from taxable income was roughly $100 million, estimated on the basis of salary, location, and assumed family size. This is a gross figure relating only to the revenue side of the budget, and it does not take into account that the tax exemption of the allowances is in part

TABLE 2

Number of Federal Civilian Employees Eligible for Section 912 Benefits by Area and Agency, 1968, 1972 and 1975 e/

	1968				1972				1975			
	Total	Dept. of Defense	Dept. of State	Other Agencies	Total	Dept. of Defense	Dept. of State	Other Agencies	Total	Dept. of Defense	Dept. of State	Other Agencies
Total 1/	104,261	64,791	12,259	27,211	95,626	58,652	8,733	28,241	98,397	62,835	7,299	28,263
Overseas:	62,413	35,587	12,259	14,567	55,082	32,145	8,733	14,204	58,397	36,835	7,299	14,263
Foreign countries	41,887	25,671	12,240	3,976	33,134	21,817	8,732	2,585	38,041	28,886	7,299	1,856
U.S. territories	20,526	9,916	19	10,591	21,948	10,328	1	11,619	20,356	7,949	-	12,407
Alaska and Hawaii 2/	41,848	29,204	-	12,644	40,544	26,507	-	14,037	40,000	26,000	-	14,000

Office of the Secretary of the Treasury
Office of Tax Analysis

March 24, 1975

e/ Estimated

1/ Calendar year averages were used for foreign countries and U.S. territories for 1968 and 1972. The 1975 figures are averages for the first six months of the year.

2/ Figures for Alaska and Hawaii for 1968 and 1972 are as of December 31. The 1975 figures are estimates.

Table 3

Principal Locations of Civilian U.S. Government Employees in Foreign Countries, FY 1975

All foreign countries 1/	38,592
Germany	13,493
Japan	5,271
Korea	1,521
The Philippines	1,399
The United Kingdom	1,357
Italy	1,094
Thailand	1,066
Spain	714
Subtotal	25,915
All others	12,677
Selected other countries:	
Mexico	321
Canada	201
Belgium	405
France	410
The Netherlands	129
Barbados	274
Bermuda	255

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March 22, 1976

1/ Excludes about 20,000 employees in the territories and possessions and 40,000 in Alaska and Hawaii who also qualify for some benefits under section 912.

Source: U.S. Department of State, Office of Personnel Reports, U.S. Citizens Residing in Foreign Countries - FY 1975".

TABLE 4

Federal Civilian Employees Eligible for Section 912 Benefits; Estimated Salaries, Allowances Excludable under Section 912, and Associated Revenue Loss by Area, 1968, 1972, and 1975
(Dollars Millions)

	1968	1972	1975e/
Salaries			
Total	$880	$1,246	$1,555
Overseas	577	773	1,020
Foreign countries	431	510	740
U.S. territories	146	263	280
Alaska and Hawaii	303	473	535
Allowances			
Total	179	244	343
Overseas	156	209	303
Foreign countries	131	165	256
U.S. territories	25	44	47
Alaska and Hawaii	23	35	40
Revenue Loss			
Total	51	76	100
Overseas	45	66	89
Foreign countries	39	50	77
U.S. territories	6	11	12
Alaska and Hawaii	6	10	11

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Office of Tax Analysis

March 24, 1975

e/ Estimated

reflected in lower salary or lower allowances. If the allowances were subject to tax there would have to be some offsetting increase on the expenditure side of the budget in the amounts paid.

There are some 50 different allowances. Some of those would not be taxable in any case because they reimburse expenses which would be deductible (e.g., moving expenses), or because they are excluded from taxable income under other section of the Code (e.g., the government contribution to employee health insurance plans). Even within this group, there are several instances where the tax regulations for claiming allowable deductions were drawn up with domestic employment in mind and may not adequately take into account the requirements of overseas employment. The limit under the moving expense deduction of 30 days for household storage is one such example. Thus, if Section 912 were repealed, equitable treatment of overseas employees suggests a need to review present regulations.

There are four principal allowances, accounting for a substantial portion of the total, which would become taxable income if Section 912 were repealed, those for cost-of-living differentials, housing, education, and home leave travel. As already mentioned, post differentials or "hardship" allowances are specifically excluded from Section 912 and would not be affected by its repeal.

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2. Justification for the exclusion. When it introduced the exclusion of living allowances of U.S. Government employees outside the United States, in 1943, the Senate Finance Committee stated,

> "Payment of allowances to meet the extra cost of living at individual posts is indistinguishable from the payment of allowances to defray expenses of operation of the establishment..."

The Committee went on to conclude that since the State Department had neither the funds nor the authority to increase the allowances enough to offset the tax on them, tax exemption was the appropriate solution.

This line of reasoning continues to serve as the justification for the Section 912 exclusion. In brief, the justification is as follows: (a) the expenditures covered by the allowances do not represent a personal benefit to the recipient, but solely a reimbursement for costs incurred as a result of the employment assignment, (b) these expenses must, therefore, be borne by the employer, (c) the employer can either increase the payments to cover the tax on them, or exempt them from tax, (d) tax exemption is the only practical alternative for government employees, where the ability to alter compensation levels is limited, and (e) this case is distinguishable from that of private sector employees overseas and from U.S. Government employees in the United States. Each of the elements in the justification is discussed in detail in the following sections.

(a) Personal benefit vs. reimbursed costs. The Section 912 exclusion specifically does not apply either to post differentials paid to compensate for environmental conditions, or to living allowances paid to Peace Corps members as basic compensation. These exceptions are consistent with the general case for excluding government allowances, which usually rests on the argument that the allowances are not additional compensation to the employee, but simply reimbursement for costs necessitated by the conditions of employment, and therefore do not properly constitute taxable income of the employer. In other words, the allowances are designed to leave the overseas government employee in the same net position in terms of disposable income as his counterpart in the United States. Indeed, much of the recent criticism of exempting the allowances is directed at cases where allowances are excessive and do confer personal benefit, leaving the recipient better off than his domestic counterpart. Two recent studies, one by the Office of Management and Budget in 1973, and one by the General Accounting Office in 1974, called for an overhaul of the entire system of measuring and paying allowances to remedy the lack of uniformity and the excessive allowances.

While in general the allowances are designed to cover only extra living costs, there are some cases where the amounts paid go beyond that standard. The principal example is the housing allowance, which provides free housing, including utilities, and does not cover just the excess of the cost of housing and utilities at the particular post over what the employee would have paid in the United States. The State Department recognizes that this allowance confers a personal benefit:

> "As a financial inducement to overseas service, Government employees stationed abroad are furnished either with free Government acquired housing or an allowance to cover the cost of privately rented quarters. This provides the employee with additional income, equal to what he would have spent on housing in the United States, that is available for spending on other goods and services." 1/

Another example of an allowance which covers more than the additional cost necessitated by overseas in contrast to domestic employment is payment of home leave travel for the whole family to any point in the United States.

If the rationale for the tax-free allowances is merely to equalize the positions of foreign and domestic employees, it would seem to follow that there should also be some provision for a reduction in base pay where foreign living costs (for example, household help or food) are lower than in the United States.

1/ U.S. State Department, "Indexes of Living Costs Abroad," April 1975, published by Labor Department, Bureau of Labor Statistics (underscoring added).

Some observers would argue that exclusion from income is appropriate only for those allowances which reimburse the overseas employee for living costs above what he would incur in the United States and that exemption of that part of the allowance which exceeds the living cost differential provides a windfall to the recipients and leaves them better off than their counterparts in either the private or the public sector. Others would contend that, with very limited exceptions, 2/ the allowances are basically all income, whether or not they represent a reimbursement for excess costs, and that any exemption represents a windfall to the recipient.

The case for tax exemption is weakest in those instances where the allowance is for costs which the employee would incur in any event. In fact, the existence of windfalls within the allowances structure and the difficulty of eradicating them may be a reason for taxing all of the allowances; there may be less resistance to paying tax on the allowances than to reducing them, and at the same time the absence of tax exemption would remove the incentive to overstate the allowance portion of total compensation.

/ Nearly all observers would make an exception for allowances esigned to cover evacuation and funeral expenses.

(b) Cost must be borne by employer. Other things being equal, an employee will not accept the same pay for the same work in two different places if living costs are much higher in one place than in the other. Other things are of course seldom equal. Different work, pleasant surroundings, useful experience and other elements of "psychic" income may induce an employee to accept a lower real income in one post than he could get in another. But on the whole it is fair to say that higher living costs must be reflected in higher compensation to attract the same quality of personnel.

Assuming that government employees will accept overseas assignments only if their real income can be maintained at the same level as when they were employed in the United States, and assuming that the allowances were revised so that they covered only the extra living costs incurred as a consequence of employment outside the United States, then taxation of the allowances would result in a reduction in their after-tax and would presumably have to be made up by higher government salaries or allowances. Unlike private sector employees overseas, government employees are not subject to foreign tax on their earnings. An increase in U.S. tax, therefore, would be felt in full by the employee, since there is no foreign tax credit to offset the U.S. tax.

(c) Tax exemption vs. higher pay. If overseas living allowances were made taxable, the ultimate result in most cases would be an increase in cost to the employer, the U.S. Government. Whether the increases in compensation would be the same or less than the increase in tax costs would depend in part on whether the allowances are for total costs of living abroad or only for the excess over the costs of living in the United States. As the Finance Committee noted in introducing the forerunner of Section 912 in 1943, tax exemption is one method of bearing the cost, a substitute for increasing the allowance directly.

Tax exemption of a particular group is a cost borne by taxpayers in general, but when the U.S. Government is the employer, paying higher salaries is also a cost to taxpayers in general. Therefore, in one sense, taxing the allowances would amount to taking money from one pocket and putting it in another. But this argument leads to the conclusion that no government employee should be taxed on his salary. Considered in this light, the logic is questionable. If government salaries were generally made tax exempt as a cost-cutting device, the result would be highly deceptive budgeting. Government agencies would have an incentive to use more labor than necessary because its cost would appear lower than it really was. Moreover, the tax free status of government salaries would appear highly inequitable to the vast majority of Americans.

These considerations also apply to the case of overseas allowances. The exemption is an incentive to paying higher allowances than are necessary, and to hiring more persons than is necessary. The actual cost incurred by each agency is understated since part of the personnel budget is reflected in lower tax collections by the Treasury Department. In fact, as mentioned earlier, the allowances themselves are not adequately reported, so that it is difficult to determine the gross pay of U.S. Government employees in different locations. Finally, the exemption of government allowances may seem inequitable to persons who, for one reason or another, incur high living costs which are not recognized in computing taxable income.

A problem caused by the taxation of allowances may occur in the case of an employee with a substantial amount of income in addition to his government salary, by comparison with a similar employee having no outside income. If the allowances are treated as marginal income and are subject to tax, then under the progressive U.S. tax system the net benefit of the allowance to the employee with outside income would be less than to the employee with no outside income. If the allowances are not taxable both would benefit equally. It may be argued that if the allowances simply reimburse the employee for differential costs of overseas employment the present exemption system gives the appropriate result. It is more difficult to sustain this argument when allowances exceed these cost differentials.

This issue highlights the general question of recognition in the tax law for differences in the cost-of-living between different locations or over time. U.S. tax law does not generally take such differentials into account. Making tax adjustments would be very complex, and would appear highly inequitable to those taxpayers not favored by the adjustments.

(d) Practical consideration: exemption vs. higher pay. If the allowances now exempt under Section 912 were to become taxable, the gross or budgeted cost to the government agencies of maintaining their foreign staffs would have to be increased in order to maintain a necessary level of disposable income for the employees. Additional appropriations would be required for the employing agencies. This would require special attention to alleviate statutory or administrative restraints on additional spending.

Under present appropriations procedure, Congress might not adequately take into account the offsetting additional tax on the increased allowances. For example, if an employee whose marginal tax rate is 33-1/3 percent has \$6,000 of allowances and the U.S. Government wants to reimburse him fully for the tax liability on those allowances, it would have to increase the allowances from \$6,000 to at least \$9,000, an increase of 50 percent, or more if he is pushed to a higher marginal tax bracket. The net cost to the U.S. Government would be zero in this case since the added tax of \$3,000 matches the added allowance of \$3,000; but the tax revenue is not credited to the agency which must pay the allowance.

To the extent that certain allowances tend to overcompensate the employee (e.g., housing, home leave, travel, rest and recreation), there could be a net budgetary gain if the allowance is not raised by the full increase in the tax. In the example mentioned above, the Government might increase the allowances from \$6,000 to only \$7,500, so that the after-tax amount would be $5,000 instead of $6,000; then the increased cost of $1,500 would be more than offset by the increased tax of $2,500. But again the net revenue gain will not be reflected in the employing agency's budget requests which must be approved by Congress.

Under present law, the personnel budgets of employing agencies are understated since they do not reflect the appropriate tax costs. A change from tax exemption of allowances to taxation as ordinary compensation would correct this situation. But such a change should be accompanied by adjustments in the budget process necessary to make this policy practical.

(e) Distinguishing overseas government employees from other employees. The principal reason for paying the allowances is to compensate for increased living costs in certain locations. Differential living costs are also encountered by private sector employees overseas and by U.S. Government employees in the United States, and are similarly reflected either in varying amounts of compensation or in difficulties filling positions in certain locations. The argument for exempting the allowances from tax is basically an argument that part of differential living costs should be borne by taxpayers in general rather than by the particular employee. This argument has fundamental shortcomings, as noted earlier.

If tax adjustments for differential living costs are not made as a matter of general policy, the question remains whether adjustments should be made for a particular group, such as

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overseas government employees. Part of the answer to this question depends on whether such adjustments seem inequitable by comparison with the tax treatment of similar groups.

In deciding to phase out the foreign earned income exemption of private sector employees, the Ways and Means Committee said:

> "Your Committee notes that some of the same reasons for repeal of the exclusion for private industry employees might be equally valid to the exclusions for governmental employees." 1/

The comparison between overseas government employees and government employees stationed in the United States is in many respects better than the comparison with private sector employees overseas. The only relevant tax for overseas government employees is the U.S. tax, whereas overseas private sector employees are affected by the foreign tax liability and foreign tax credit. However, where a government and private sector employee work side by side in a foreign country and receive the same gross pay, it is difficult to justify exempting the living allowances of one and not the other.

3. Other considerations.

(a) Official expenses. Some allowances may be viewed as representing reimbursement for official expenses. As such, they may be either excluded or included in income and allowed

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1/ House of Represenatative Report 94-658, November 12, 1975, page 200.

as a deduction. However, those expenses which are business expenses under current law would not include many important allowances, such as the cost of living, education or housing allowances. To broaden the limits of deductibility would raise a serious problem of where to draw the line for overseas government employees as well as for government employees based in the United States and private sector employees based overseas.

(b) Education expenses. The situation of government employees is parallel to that of private sector employees with respect to expenses incurred in providing elementary and secondary schooling for dependents: publicly financed schooling might be inadequate, and the families may have to rely on private schooling. The State Department regulations provide allowances to cover the cost of transportation, room and board, and tuition and other school expenses at a private school where the local facilities are judged inadequate.

H.R. 10612 provides for a duduction of $1,200 per year per child (up to 19 years old) for tuition expenses paid by private sector employees when both the taxpayer and the dependent are in one or more foreign countries for 330 days in a 12 month period. The 330 day requirement for the taxpayer may be strict for those employees, both private sector and government, who have to return to the United States on business frequently or for extended periods. The amount of the deduction deserves further review as well. The problem is to balance the extra burden borne by private and government employees abroad against the considerations that: (a) they may not pay U.S. state and local taxes, which finance most U.S. public education at the elementary and secondary levels; (b) many U.S. residents who do pay state and local taxes nevertheless use private schools for their children without being allowed a deduction for the added costs; and (c) some of the schools used by foreign service employees are church-sponsored.

(c) Housing costs. Government and private sector employees face the same problems of high cost housing in many foreign cities. However, government employees have their full housing, including utilities, provided by their employer, and are not required to report any part of that as taxable income. Table 5 gives some examples of housing allowances in various foreign cities. Private sector employers frequently pay part of the housing and utility costs of overseas employees, typically the excess over the estimated U.S. cost or the excess over some percentage of the salary, but the employer-paid portion is considered taxable income to the employee.

Some argue that housing provided by the U.S. Government for overseas employees serves the convenience of the employer and therefore should not be taxable to the employee. The standards for determining when housing is for the convenience of the employer are fairly stringent under current law. Section 119 of the Internal Revenue Code provides that if lodging is to be excluded from gross income on the grounds that it is furnished for the convenience of the employer, then the employee must be required to accept lodging on the business premises of the employer as a condition of his employment.

Table 5

Examples of State Department Housing Allowances, as of January 1976

	Annual allowances for an employee with dependents earning basic salary of $15,000-$26,999
Frankfurt	$4,300
Tokyo, (city)	4,500
Seoul	4,400
Manila	3,800
London	5,100
Rome	7,200
Bangkok	4,400
Madrid	6,500
Mexico City	6,400
Ottawa	5,600
Brussels	8,500
Paris	9,400
the Hague	6,900
Barbados	5,500
Iran	7,400
Kuwait	7,000

Office of the Secretary of the Treasury March 26, 1976
Office of Tax Analysis

Source: U.S. Department of State, Allowances Staff

The regulations explain that to be a condition of employment, residence in that lodging must be necessary to proper performance of the duties of employment and that the lodging must be furnished in kind with no option to take a cash allowance in lieu of that lodging (Reg. 1.119-1(d)(6) and (c)(2)). There are numerous rulings and court decisions interpreting these rules; but clearly in its present form the statutory tests would be difficult for the average foreign service employee to meet. The Ambassador's residence presumably would qualify as being for the convenience of the employer. Revenue Ruling 75-540 states that a Governor's mansion does so qualify. The cases where lodging furnished by the employer meets the statutory tests of being for convenience of the employer follow more from the nature of the employment than from the location of employment. In short, if Section 912 is repealed, free housing of overseas employees will almost always be taxable income to the government employee.

Congress could legislate special relief for the added burden which would result if foreign employee housing allowances were reduced by subjecting them to tax. One question then would be whether such relief should be made available to private sector employees in similar circumstances. In both cases, the principal beneficiary would be employers with overseas staff.

One possibility would be to allow a deduction for the portion of housing costs incurred for business purposes, such as official entertainment. Such a rule,however, would be difficult to administer and complicated for the taxpayer who would have to pro-rate rent and utilities by hours.

Another possibility would be to allow a deduction for the cost of foreign housing in excess of the cost incurred by similar employees in the United States. Since domestic employees do not enjoy tax relief for high housing costs, it might be desirable to limit any such relief to costs above a reasonably high U.S. base, and perhaps to provide an upper limit to minimize any incentive to acquire lavish housing by Americans overseas. In addition to determining the amount of such a deduction, there would have to be rules on what is included in housing costs (utilities, telephone, cable TV?); who is eligible (should government employees in the possessions, Alaska, Hawaii, New York be eligible?; if private sector taxpayers qualify, does this include self-employed persons, employees of foreign firms, corporate directors?);and the conditions on which housing is furnished (must it be available to all employees?). Rental value would have to be imputed in many cases.

Such a relief provision would be complex and difficult to administer. But the governmen allowances and the Section 911 exclusion are already complex and difficult to administer. Furthermore, there is precedent in the Code for allowing deductions for extraordinary personal expenses (e.g., medical expenses in excess of 3 percent of adjusted gross income). special deduction for "excess" housing costs would have the advantage of focusing relief on a particular expense related to the location of the employment and would be limited to the portion of that expense which exceeds the cost of comparable housing for employees at the U.S. headquarters.

IV.

OPTIONS

1. Retain present law. This option would put the least strain on employing agencies and affected employees. The present system of exempting from tax allowances paid to government employees outside the United States, and in some cases in Alaska and Hawaii, reduces the cost to the employing agency of maintaining U.S. citizens in those posts. It has been argued that most allowances just offset the higher living costs entailed by an overseas assignment. However, the exemption can amount to preferential tax treatment for a certain group of government employees compared to government employees in other locations and compared to private sector employees in the same locations.

2. Repeal the Section 912 exclusion entirely. This option would subject to tax all of the allowances now excluded under Section 912. Some of the allowances would not be taxable, due to offsetting expense deductions permitted under other sections of the Internal Revenue Code, but many allowances, including those for education, cost-of-living increases, and housing would become taxable. The employing agencies would need increased appropriations. If private sector employees overseas are allowed a deduction for tuition expenses of dependents, as provided in H.R. 10612, government employees in the same posts would be put at a disadvantage.

3. Substitute for Section 912 a tuition expense deduction and an exclusion for the value of employer-provided municipal type services. This option would put government employees in essentially the same position as private sector employees in foreign posts if the provisions of H.R. 10612 are enacted with respect to Section 911. It would put government employees in a worse position than under present law and would require increased budgets for salaries or allowances to attract qualified persons to fill such posts, although the necessary increases would not be as great as under option 2.

Specific statutory relief should be considered for several of the minor allowances which, though they might be treated as taxable income in the absence of Section 912, might none-the-less be considered as justifiably excludable from income or deductible. This category might include allowances for emergency evacuation from a post and allowances for preparation and transportation of remains of a deceased employee.

4. Allow a deduction for housing costs in excess of the costs of comparable U.S. housing, in addition to those listed in option 3. A deduction for "excess" housing costs above those which the employee would have incurred if employed in the United States might be appropriate to deal with the principal component of extraordinary living costs associated with foreign employment. It would significantly reduce the added tax liability of employees in areas where desirable housing is scarce, and would, therefore, relieve the budget burden on the employing

agencies. At the same time, taxing the other allowances would reduce the windfall element and permit more accurate accounting of the costs of the overseas operations. On the other hand, there would be a problem of drawing the line, particularly with respect to private sector employees overseas who encounter the same high costs in certain posts. 1/

The net revenue cost of such a deduction for government employees would be small, since housing allowances in excess of the permissible deduction would be taxable, and since in the absence of the deduction the government would have to increase the allowances to attract the same quality of personnel. The revenue cost of such a deduction for private sector employees would be greater since there would usually be no offsetting effect on outlays (there could be some offset where the allowance is a deductible expense for U.S. tax of a U.S. employer). Government employees would have an added tax liability with respect to other allowances, and salaries or allowances would have to go up by part of that increased tax liability.

5. Make Section 912 inapplicable to employees serving in Alaska or Hawaii. Although employees in Alaska and Hawaii constitute about 40 percent of Federal employees eligible for

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1/ If a distinction between private and public sector employees is not justifiable, then a deduction for extraordinary housing costs (applicable to all overseas employees) might be inappropriate. The reason is that the revenue loss from such a deduction for all employees may significantly outweigh the cost of increasing allowances to compensate Federal employees for the additional tax burden in the absence of such a deduction.

the Section 912 exemption, the revenue loss attributable to their allowances is relatively small. Nevertheless, the distinction between employees serving abroad and those serving at domestic posts (both groups encounter variable living costs) is confused by applying the exemption to Alaska and Hawaii. The increased burden on government employees in Alaska and Hawaii might be a necessary price to pay for justifying any continuation of the exemption for employees assigned to foreign countries.

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4-2-76

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ACT

June 30, 1974 --- 88 Stat. 285	increased sec. 21 limitation by $95 billion during the period beginning June 30, 1974 and ending March 31, 1975 ----------	$495,000,000,000
Feb. 19, 1975 --- 89 Stat. 5	increased sec. 21 limitation by $131 billion during the period beginning February 19, 1975 and ending June 30, 1975 ------------	531,000,000,000
June 30, 1975 --- 89 Stat. 246	increased sec. 21 limitation by $177 billion during the period beginning June 30, 1975 and ending November 15, 1975 --------	577,000,000,000
Nov. 14, 1975 --- 89 Stat. 693	increased sec. 21 limitation by $195 billion during the period beginning November 14, 1975 and ending March 15, 1976 -----------	595,000,000,000
March 15, 1976---	increased sec. 21 limitation by $227 billion during the period beginning March 15, 1976, and ending June 30, 1976 ------------	627,000,000,000

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041
THE DEPARTMENT OF THE TREASURY 1789

April 5, 1976

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BIOGRAPHY

Larry M. Buendorf was appointed a Special Agent of the United States Secret Service on June 29, 1970, in the Chicago field office. The following year he was transferred to the Intelligence Division at Secret Service Headquarters in Washington, D.C., and in December 1972, he was reassigned to the Presidential Protective Division. During the 1972 Campaign for President and Vice President of the United States, Agent Buendorf was assigned to security for the Democratic Vice Presidential Candidate.

Born in Wells, Minnesota on November 18, 1937, Buendorf received a bachelor of science degree from Mankato State College in 1959. Subsequently he served as a pilot with the U.S. Navy, a high school business teacher and coach in Blue Earth, Minnesota, and a Special Agent of the Naval Institute Service.

During his career with the U.S. Secret Service, Agent Buendorf has been the recipient of the Expert Marksmanship Award in 1973, and the Distinguished Expert Marksmanship Award in 1975.

On September 5, 1975, while providing crowd security for President Gerald R. Ford in Sacramento, California, Agent Buendorf observed a weapon aimed at the President. Without regard for his personal safety, Agent Buendorf immediately interposed himself between the assailant and the President, seized the firearm and assisted in the apprehension of the individual who was attempting to use it.

On November 25, 1975, Secret Service Director H. Stuart Knight recognized Agent Buendorf's efficient and exemplary action with the presentation of the Secret Service Valor Award.

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Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

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Contact: Herbert C. Shelley
Extension: 8256
April 5, 1976

FOR IMMEDIATE RELEASE

TREASURY DEPARTMENT ANNOUNCES COUNTERVAILING DUTY INVESTIGATION OF CERTAIN SCISSORS AND SHEARS FROM BRAZIL

Assistant Secretary of the Treasury David R. Macdonald announced today the initiation of a countervailing duty investigation against certain scissors and shears from Brazil. A "Notice of Receipt of Countervailing Duty Petition and Initiation of Investigation" will be published in the Federal Register of April 6, 1976.

Under the U.S. Countervailing Duty Law (19 U.S.C. 1303) the Secretary of the Treasury is required to assess an additional customs's duty which is equal to the amount of the "bounty or grant" that has been found to be paid or bestowed on imported merchandise.

The investigation of imports of certain scissors and shears stems from a petition received on February 9, 1976 from the National Association of Scissors and Shears Manufacturers alleging that certain scissors and shears (those valued at over $1.75 per dozen) are benefiting from possible bounties or grants within the meaning of the Countervailing Duty Law. The Treasury has until August 9, 1976 to issue a preliminary determination as to whether a bounty or grant exists. A final determination must be rendered by no later than February 9, 1977.

During calendar year 1975, imports of the subject merchandise from Brazil were valued at approximately $1.2 million.

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he Department of the TREASURY NEWS
SHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE April 5, 1976

LARRY M. BUENDORF
RECEIVES TREASURY MERITORIOUS SERVICE AWARD

Secretary of the Treasury William E. Simon today presented Secret Service Special Agent Larry M. Buendorf with the Treasury Department's Meritorious Service Award.

Special Agent Buendorf received the award for his "outstanding bravery and unusually competent action" beyond his required duties in the deterrence of an attempt on the life of President Ford in Sacramento, California, on September 5, 1976.

In presenting the award, Secretary Simon cited Buendorf's "efficient and exemplary action" when "without regard for his own safety, he immediately interposed himself between the assailant and the President, seized the firearm and assisted in the apprehension of the individual who was attempting to use it."

In recognition of his actions, Special Agent Buendorf received a silver medal and lapel emblem, a certificate and a miniature Treasury flag.

Mr. Buendorf was appinted a Special Agent of the U.S. Secret Service on June 29, 1970. He was born in Wells, Minnesota on November 18, 1937, and received a B.S. degree from Mankato State College in 1959. Special Agent Buendorf served as a pilot with the U.S. Navy and also as a Special Agent of the Naval Investigative Service.

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13-wk		26-wk
4.929	Last week	5.327
4.957	To-day	5.293
	Low since 3/22/76	5.283
4.981	High since 3/15/76	

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE April 5, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.7 billion of 13-week Treasury bills and for $3.5 billion of 26-week Treasury bills, both series to be issued on April 8, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 8, 1976			26-week bills maturing October 7, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.753 a/	4.933%	5.06%	97.333 b/	5.275%	5.50%
Low	98.744	4.969%	5.10%	97.313	5.315%	5.54%
Average	98.747	4.957%	5.09%	97.324	5.293%	5.51%

a/ Excepting 1 tender of $1,000,000

b/ Excepting 1 tender of $650,000

Tenders at the low price for the 13-week bills were allotted 18%.
Tenders at the low price for the 26-week bills were allotted 46%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 82,270,000	$ 37,170,000	$ 47,310,000	$ 30,070,000
New York	4,120,790,000	1,954,080,000	4,697,155,000	2,859,455,000
Philadelphia	21,630,000	20,810,000	44,970,000	24,970,000
Cleveland	87,705,000	36,750,000	87,380,000	67,380,000
Richmond	50,610,000	34,610,000	151,415,000	97,085,000
Atlanta	49,885,000	45,580,000	40,220,000	32,420,000
Chicago	622,115,000	336,235,000	258,785,000	152,245,000
St. Louis	69,150,000	29,150,000	62,180,000	35,180,000
Minneapolis	63,985,000	39,985,000	59,720,000	54,720,000
Kansas City	36,530,000	30,490,000	24,245,000	19,745,000
Dallas	36,620,000	16,620,000	36,505,000	26,005,000
San Francisco	355,865,000	118,925,000	220,615,000	100,975,000
TOTALS	$5,597,155,000	$2,700,405,000 c/	$5,730,500,000	$3,500,250,000 d/

c/ Includes $403,690,000 noncompetitive tenders from the public.
d/ Includes $223,580,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 11:45 A.M. April 5, 1976

TREASURY OFFERS $2.5 BILLION OF TREASURY BILLS

The Department of the Treasury, by this public notice, invites tenders for $2,500,000,000, or thereabouts, of 14- day Treasury bills to be issued April 8, 1976, representing an additional amount of bills dated October 23, 1975, maturing April 22, 1976 (CUSIP No. 912793 ZD 1).

The bills will be issued on a discount basis under competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at all Federal Reserve Banks and Branches up to 1:30 p.m., Eastern Standard time, Wednesday, April 7, 1976. Tenders will not be received at the Department of the Treasury, Washington. Wire and telephone tenders may be received at the discretion of each Federal Reserve Bank or Branch. Tenders must be for a minimum of $10,000,000. Tenders over $10,000,000 must be in multiples of $1,000,000. The price on tenders offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Settlement for accepted tenders in accordance with the bids must be made at the Federal Reserve Bank or Branch on April 8,1976, in immediately available funds.

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Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

he Department of the TREASURY NEWS
ASHINGTON, D.C. 20220 TELEPHONE 964-2041

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NOTICE TO CORRESPONDENTS: April 5, 1976

George Dixon, the recently confirmed Deputy Secretary of the Treasury, will be available for a "get acquainted" meeting with reporters in his office, room 3326, at 10 a.m. Thursday April 8. While no specific announcements will be made, the meeting will be on the record.

Bill
Bill Rhatican
Special Assistant to the Secretary
(Public Affairs)

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WS-766

the Department of the TREASURY
WASHINGTON, D.C. 20220 TELEPHONE 964-2041
NEWS

April 5, 1976

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GEORGE H. DIXON OF MINNEAPOLIS, MINNESOTA, SWORN IN AS DEPUTY SECRETARY OF THE TREASURY

George H. Dixon, former Chairman and President of the First National Bank of Minneapolis, was sworn in today as Deputy Secretary of the Treasury by William E. Simon, Secretary of the Treasury. Mr. Dixon succeeded Stephen Gardner who is now Vice Chairman of the Federal Reserve Board.

Born on October 7, 1920, in Rochester, New York, Mr. Dixon received his B.S. degree from Wharton School of Finance at the University of Pennsylvania in 1942. He attended Harvard University Graduate School of Business and received his M.B.A. in 1947. He served in the United States Army during World War II as a Captain.

In 1947, Mr. Dixon joined the Brown Brothers Harriman & Company of Boston, Massachusetts. He became a Partner in the firm of Davis and Davis of Providence, Rhode Island in 1950. From 1956 to 1968 he was the Vice President-Finance and Treasurer of Sperry & Hutchinson Company of New York, New York. He joined the First National Bank of Minneapolis as President and Chief Administrative Officer in 1968.

Mr. Dixon is married to the former Marjorie Freeman and they have three children.

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Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

April 1976

GEORGE H. DIXON
DEPUTY SECRETARY OF THE TREASURY

George H. Dixon was sworn in as Deputy Secretary of the Treasury on March 3, 1976. As Deputy Secretary, Mr. Dixon is responsible for the general supervision of all day-to-day functions of the Department and for acting for the Secretary in his absence, sickness, or unavailability.

Prior to becoming Deputy Secretary, Mr. Dixon served as Chairman, President, and Chief Executive Officer of the First National Bank of Minneapolis,which he joined in 1968. He was Vice President Finance and Treasurer of the Sperry & Hutchinson Company of New York from 1956 to 1968, and a general partner in the investment firm of Davis and Davis of Providence, Rhode Island from 1950 to 1956. He began his business career in 1947 with Brown Brothers Harriman & Company in Boston, Massachusetts.

Mr. Dixon has served as a director of the following Minnesota-based companies: First National Bank of Minneapolis, First Bank System, Inc., First Computer Corporation, Soo Line Railraod Company, International Multifoods Corporation, Donaldson Company, Inc., Fingerhut Corporation, and Honeywell, Inc. He was also a director of Brown Harriman and International Banks Limited of London, England. His professional affiliations included membership on the Federal Advisory Council representing the Ninth Federal Reserve District and serving as a director of the Association of Reserve City Bankers and as trustee of its Banking Research Fund. He is a trustee of Carleton College in Northfield, Minnesota, and was active in numerous civic and community endeavors in the Minneapolis area.

Mr. Dixon was born October 7, 1920 in Rochester, New York. He was educated at the University of Pennsylvania's Wharton School of Finance where he received a B.S. degree in 1942 and at Harvard University's Graduate School of Business where he earned a M.B.A. degree in 1947.

He is married to the former Majorie Freeman of Providence, Rhode Island and they have three children. Mr. Dixon and his wife presently reside in Washington, D.C.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

File Copy 141

FOR RELEASE ON DELIVERY

DEPARTMENT OF THE TREASURY
OFFICE OF NEW YORK CITY FINANCE

Introductory Statement of Robert A. Gerard
Deputy Assistant Secretary (Capital Markets Policy)
Department of the Treasury
For Presentation to the Senate and House
Subcommittees on Appropriations
April 6, 1976

I am pleased to describe for you this morning the activities of the Department of the Treasury under the New York City Seasonal Financing Act of 1975.

Our appropriation for fiscal 1976 is $1 million. These funds cover the six month period from enactment to June 30, 1976. For the transition quarter (June 30, 1976 to September 30, 1976) our appropriation is $315,000.

We are now requesting that you appropriate $1,250,000 to enable Treasury to carry out its responsibilities under the Act during fiscal 1977. This amount is more than the current appropriation of $1 million but substantially less, on an annualized basis, than the current year's appropriation. The amount requested is approximately equal to the annualized rate for the transition quarter.

The Act

The New York City Seasonal Financing Act of 1975 was enacted on December 9, 1975. It reflects Congress' findings that: "It is necessary for the City of New York to obtain seasonal financing from time to time because the City's revenues and expenditures, even when in balance on an annual basis, are not received and disbursed at equivalent rates throughout the year." Furthermore, Congress found that such financing, while necessary to maintain essential government services, may not be available from customary sources.

To maintain essential services, the Act authorizes the Secretary of the Treasury to loan up to $2.3 billion to the City of New York. Each loan must be repaid by the end of

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the City's fiscal year. If, and only if, such loans are repaid, they may then be renewed for the following fiscal year. Loans may be renewed through fiscal 1978. At that time, the loan must be repaid and the Act expires.

The interest rate on these loans is fixed at one percent above the interest rate paid by Treasury for loans of comparable maturity. As a result of this interest differential, the Federal Government will obtain revenue from the loan. After subtracting the $1 million appropriated to Treasury for administrative costs, the net revenue to the Federal Government in fiscal 1976 will be approximately $3.3 million. In fiscal 1977 and 1978, revenues will be substantially higher since the average amount and duration of the loans will increase sharply.

We are responsible for ensuring that the loans are repaid. To do this, we may insist upon whatever terms and conditions he considers necessary. We intend not only to seek the best collateral reasonably available, but also the maximum amount of relevant information about the financial condition of the borrower -- the City of New York. It is the task of securing, analyzing, and verifying the financial condition of the City which is the single greatest cost envisioned. I shall describe this task after describing actions which have been accomplished to date.

The Loans

We have $1.26 billion in loans outstanding. The first loan -- $130 million -- was made December 18, 1975 and will be repaid on April 20. Since then, we have made 5 loans which mature on various dates between April 20, and June 30, 1976.

On a monthly basis, the schedule calls for repayment of $270 million on April 20, $240 million on May 20, and a total of $750 million on June 20 and June 30.

At the time these loans were made, and at this time, it is our view that there is a reasonable prospect that these loans will be repaid in accordance with their terms and conditions.

The objective of the Act was to help the City to maintain essential services and deal with seasonal cash flow problems while it is implementing its Plan to eliminate its budget deficit. The Act has accomplished this. Essential services have been maintained and the City is carrying out the budgetary measures which were promised.

The Fiscal Plan

The seasonal funding provided by the Act is an integral part of the Financial Plan devised by City and State officials. The Plan's objective is to eliminate the City budget deficit by June 30, 1978 and to provide sufficient cash to allow the City to operate during the interim period when it cannot obtain financing in the public credit markets.

In September 1975. the State of New York decided to commit its own credit and resources to assisting the City, but it also mandated certain changes. The City was required to eliminate its deficit by June 30, 1978, and to submit a detailed three year plan outlining the steps it would take to this end. Furthermore, the Emergency Financial Control Board was established, chaired by the Governor, and given virtually unlimited powers over the financial affairs of the City.

In late November, we were presented with a financing plan that financed New York City's past and future deficit financing needs. It is detailed in Secretary Simon's April 1 testimony, a copy of which I am submitting for the record.

In addition, however, financing was required for meeting seasonal cash flow needs. Although the financing plan was designed to eliminate the deficit over the course of the fiscal year, revenues and expenditures did not balance on a monthly basis. Accordingly, we asked Congress for authority to make short-term seasonal cash flow loans. Such authority was granted early last December with the passage of New York City Seasonal Financing Act of 1975.

A New Resolve

It is, of course, too early to tell whether the measures taken last fall will be accompanied by all of the actions necessary to restore New York City to fiscal and financial viability. But on March 26, Mayor Beame took an important step in that direction.

He presented a detailed plan to eliminate the $986 million deficit which the City now projects for fiscal 1978, and to generate a $76 million surplus that year. While the plan relies on some assumption of costs by the State, and a $55 million increase in Federal aid under existing programs by 1978, most of the cuts are to be accomplished by the City itself.

The plan does not postpone the hard decisions by unduly backloading them into 1978. It is a serious plan and -- in the context of a city which has already pared its payrolls by 40,000 persons in the last year -- it is a realistic plan.

Even more heartening is that the plan not only proposes to make the cuts which the critics last October said could not be made, but it also identifies additional cuts. The reason for these additional cuts is that the City continued to review its data since October and concluded that its original deficit estimates were too low. The City did not try to bury the revised estimates nor plead for major new infusions of Federal funds. Instead, it frankly acknowledged that the facts now tell a different story, and promptly revised its plan to deal with them. This forthright response reflects a new spirit of resolve in the City today.

This new spirit is the result of several changes: primarily the realization that the public, as well as the capital markets, will no longer tolerate financial gimmickry as a solution to real problems. It is a result of the new team of financial experts that Mayor Beame has assembled. And, most importantly, it is a result of the Mayor's own determination to face up to New York's problems.

These developments are grounds for cautious optimism about the City's future. I say "cautious" because we are not yet home, not even half way home. But we now know what many previously doubted; the preconditions for fiscal recovery exist. There are clear signs that the City recognizes it must deal with its own problems and is resolved to do so.

Congress contributed materially to this process by imposing the firm conditions which encouraged the City to put its own house in order. But I hope that those of you who believe this prognosis too optimistic will be encouraged by the fact that we do not propose to let our guard down. The commitments have been made. That, in itself, is an important accomplishment. But the task is to make sure they are carried through.

Credit Agreement

On December 30, 1975, with the assistance of the law firm of Ropes and Gray and the accounting firm of Arthur Andersen, we completed negotiations with the City, State, Municipal Assistance Corporation, and the Emergency Financial Control Board and executed a Credit Agreement with these parties. I am submitting a copy of this document for the record.

Our first requirement was that all the parties -- the City, the Comptroller, the Control Board and, where necessary, the State -- must agree to stand by the spirit of the Agreement and the reports they make. Furthermore, they pledged in the Agreement to inform us of adverse developments, of changes in the plan, and to use maximum efforts to protect our interests.

We then insisted that each Federal loan be secured not only by the general obligation of the City but also by the pledge of a specific revenue. Furthermore, when this revenue comes due, it must be paid into a specific bank account for the benefit of the Secretary of the Treasury. To date, the City has pledged $1.944 billion in revenues, nearly all funds due from the State, to cover the $1.26 billion in loans outstanding. Each Federal loan, therefore, is secured both by specific revenues and by the general obligation of the City.

Finally, the Credit Agreement allows us to develop something which has not previously been available -- accurate financial information. By law, the City is required to develop an auditable accounting system by July 1, 1978. But, to assist us in assessing the prospects for repayment, we must have the best available information about what is happening in the interim. Consequently, the Agreement provides that the City must prepare -- and the Control Board must approve -- detailed reports, designed with the assistance of Arthur Andersen. Perhaps the most important of these is a report covering virtually every significant financial aspect of the City's activities -- revenues, expenses, cash flow, employment, etc. This report -- 65 pages filled with statistics in its latest version -- is due each month.

In addition to the protections I have enumerated, the Credit Agreement also confirms our power under the Act to audit books and records, and it provides numerous additional protections.

The Arthur Andersen Report

In the best of times, municipal finance is a complex, specialized, and difficult field. As you know, there are no disclosure requirements in municipal finance comparable to those imposed on corporations. Nor are cities required to produce a financial statement which is auditable by an independent accountant. In short, our dilemma was simple: we had neither the information, nor the expertise required to analyze it. Yet we needed such background to carry out our responsibilities.

Let me describe some of the facts known in December 1975 which led us to believe that we needed immediate expert advice to carry out our responsibilities under the Act:

-- The Municipal Assistance Corporation, established in June 1975 to assist the City in borrowing money, found itself unable to float loans on the public market by July.

-- The City had never issued a report certified by an independent public accountant.

-- A State law requires that the City balance its budget. And, each year, the City had duly certified -- in accordance with its accounting system -- that its budget was balanced. Nevertheless, its short term debt load had risen since 1961, resulting in a multimillion dollar deficit.

On December 12, 1975, we retained the accounting firm of Arthur Andersen and Company to advise us on several matters. First, we needed an overview of the City's financial situation. Second, we needed a reporting system to allow us to monitor the City's financial conditions and progress toward eliminating its deficit. Third, for both the City's benefit and ours, we needed to know the potential problems in the City's financial plan, and the state of the systems by which the City's financial data is generated.

Andersen received the complete cooperation of the City in undertaking its study, and submitted a report, as of December 29, to the Treasury. The final report was released to the public on January 14. I am submitting a copy for the record.

Later I shall discuss some of the numerous specific findings, but three points highlight the scope of the task that we faced in monitoring the City's financial condition:

-- The City does not have an auditable accounting system; it is essentially unable to determine its actual accounts payable or receivable on a current basis.

-- Consequently, it is unable to prepare a consolidated statement of financial position.

-- It will take a substantial period of time to implement an auditable accounting system.

Since December, the City has made a major effort to remedy this situation, but it is a long-term process and it would be unrealistic to expect immediate cures.

Progress Since December

Since January, we have made the loans which I described earlier, and focussed our efforts on improving the monthly reports. There are still many uncovered areas left, many qualifications and many inconsistencies which suggested that the City was either unable to provide key parts of the report, or did not understand their purpose.

We went back to the City. We discussed the omissions, pointed out the inconsistencies, and tried to indicate where the information supplied was not what the report called for.

The second monthly report, received on March 15 and covering the month of January, was a distinct improvement over the previous one. But it had some of the same problems on a smaller scale. We went back and discussed them again.

By March, we had enough experience to request Arthur Andersen to revise the monthly reports so as to provide better information. At the same time, we asked them to review the revised Financial Plan and the City's procedures for improving the systems. Andersen is presently conducting these reviews, and will submit a report to us this month.

In revising these reporting requirements, we have worked closely with the staff of the Emergency Financial Control Board in order to develop reports that will serve our joint requirements. This will simultaneously reduce the reporting burden on the City and expand the scope of our coverage.

In the course of our work, we have already learned a great deal about the City's cost and revenue structure. The Act does not authorize us to decide which action the City should take in meeting its Plan, but we felt we would be remiss in not making available our analyses about areas where costs might be cut over both the near- and long-term.

The Task Ahead

The Act has already accomplished part of its objective. The Beame Plan is a milestone, evidence that the City is able, willing, and determined to take the steps necessary to eliminate its deficit by June 30, 1978.

But the task ahead is made more difficult by the fact that, as each month passes, we must obtain better and more reliable information about the status and prospects for the City. If we cannot do this, it will become increasingly difficult to authorize loans.

More reliable data is needed because each month the margin for error grows thinner. We can confidently conclude that there is a reasonable prospect for repayment of the loans we have made this year, despite known problems with the data, because there is a comfortable margin for error. If the City finds that it has incorrectly estimated revenues or expenses, there is still more than two years to correct it. In this first year of the Plan, there is still enough flexibility in the three-year financing plan to cushion these errors while the corrections are being instituted.

But as time passes, it will become increasingly difficult for the City to make whatever corrections are necessary. Consequently, complying with statutory conditions precedent to making the loan will become increasingly difficult without greater confidence in the reliability of the facts.

To ensure that future data is sufficiently reliable to make the judgments the Act requires, we must be confident of the facts and the forecasts. We must have evidence that their reliability is improving -- and this means audits and independent analyses.

The task of auditing the nation's largest city is enormous. Apart from the City's own financial staff, the State has some 85 auditors assigned to this job. In addition, the Emergency Financial Control Board has currently established a staff of some 50 professionals, most of whom are auditors and accountants.

Even a very limited review of the City's economic progress can be time consuming in view of the complexity of the issues. In testifying before the Senate Committee on Banking, Housing, and Urban Affairs on April 2, Comptroller General Elmer Staats indicated that even the limited "oversight" role envisioned for the GAO is likely to require 12-14 staff-years annually.

Nevertheless, we believe it will be possible to carry out our responsibilities under the Act with the funds we have requested. We intend to keep the office small by relying on outside expertise for assistance during peak periods and in specialized studies. Furthermore, we will coordinate our work with the State, Control Board, and the GAO so as to take maximum advantage of the studies they are undertaking.

But our greatest asset in attempting this monitoring agreement with very limited staff is the Credit Agreement and the reports which the City must prepare in compliance with this Agreement. The Credit Agreement provides all the reports which the Secretary will normally need to authorize a loan, and allows him to request others. The job is to assure that the facts and forecasts contained in these reports are accurate.

To oversee this task, and to carry out the other administrative and monitoring functions required by the Act, we have recently established a separate organizational unit within Treasury to be known as the Office of New York Finance. We estimate that it will be composed of approximately a dozen persons under the direction of a Deputy who reports directly to the Assistant Secretary.

To verify the factual accuracy of the reports we receive, the Office will assemble a staff of professionals capable of undertaking direct audits in limited areas as well as working with outside accountants and the other auditing groups on more extensive reviews.

Our first target will probably be review of the expense reduction program. This is perhaps the single most critical area if the City is to meet its plan. We know that there has been some slippage at this point in view of the City's limited ability to enforce cuts on a monthly -- as opposed to annual -- basis. At this time, we believe that the most meaningful time to conduct a full review during the current fiscal year will be in May or June.

The December Andersen report has identified certain other areas where inadequate controls suggest that in-depth analyses may be useful. For example, the time lags in recording accounts payable, the adequacy of the reserve for uncollected real estate taxes, and the progress in reducing capital expenditures are among the key candidates for more intensive review. It would be difficult to specify the order at this time, however. We will make the decision on priorities after we receive the Andersen report due this month, and have a more precise idea of the audits which the Control Board staff plans to undertake.

The remaining staff in the office will principally be devoted to analyzing forecasts and other data which is too judgmental to be characterized as factual, but is nevertheless critical to the success of the Plan. Again, the Andersen report provides an excellent framework. Among the key areas for study, in our view, are the accuracy of the general revenue forecasts, the soon-to-be-released Shinn Commission review of pension cost adjustments, the question of welfare cost claim disallowances, and the City's projected savings from withdrawing from the social security system.

Several of these issues have implications for other cities as well. We will undertake especially detailed analyses in these areas: How New York resolves its pension funding, the benefits it derives from withdrawing from the Social Security system, the interpretation of welfare regulations affecting New York's claim for reimbursement, and other questions will be watched closely by other cities. Their resolution may well set precedents which will endure long after the last seasonal loan has been repaid.

We are requesting appropriations for the period September 30 1976, through September 30, 1977. In terms of the administration of this loan, there is no more critical period. It encompasses the last billion of financing in 1977, under the current schedule, and the first financings in fiscal year 1978. With the amount we have requested, $1.25 million to oversee a $2.3 billion loan, we believe we can carry out this task.

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Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

FOR RELEASE AT 4:00 P.M. April 6, 1976 151

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,100,000,000 , or thereabouts, to be issued April 15, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,700,000,000, or thereabouts, representing an additional amount of bills dated January 15, 1976, and to mature July 15, 1976 (CUSIP No. 912793 ZY 5), originally issued in the amount of $3,403,500,000, the additional and original bills to be freely interchangeable.

182-day bills, for $3,400,000,000, or thereabouts, to be dated April 15, 1976, and to mature October 14, 1976 (CUSIP No. 912793 B5 4).

The bills will be issued for cash and in exchange for Treasury bills maturing April 15, 1976, outstanding in the amount of $6,094,635,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $2,854,980,000 These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Standard time, Monday, April 12, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $ 500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on April 15, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing April 15, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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he Department of the TREASURY NEWS
ASHINGTON, D.C. 20220 TELEPHONE 964-2041

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Contact: Herbert C. Shelley
Extension 8256
April 6, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES FINAL MODIFICATION OF DUMPING FINDING ON LARGE POWER TRANSFORMERS FROM THE UNITED KINGDOM

Assistant Secretary of the Treasury, David R. Macdonald, announced today a final modification of the dumping finding on imports of large power transformers from the United Kingdom. This decision revokes the finding with respect to three U.K. firms. The dumping finding was published on June 14, 1972 pursuant to the provisions of the Antidumping Act of 1921, as amended. Notice of the final modification will be published in the Federal Register of April 7, 1976.

The tentative modification of the dumping finding was published on November 14, 1975 after it was determined that three firms, Hawker Siddeley Electric Export, Ltd., London, England; Ferranti, Ltd., Manchester, England; and Parsons Peebles Power Transformers, Ltd., Edinburgh, Scotland, had had no sales to the United States at less than fair value since the dumping finding. These firms additionally provided assurances that no future sales would be at less than fair value.

In addition to the announced modification of the finding, Mr. Macdonald indicated that a new policy concerning revocation of dumping findings had been established. Assistant Secretary Macdonald stated that petitioners for revocation of dumping findings would be notified that if sales at less than fair value were demonstrated subsequent to a revocation, a new investigation would be initiated. In the new investigation, however, unlike current Treasury policy, serious consideration would be given to making any withholding of appraisement issued retroactive from the date of such withholding.

Mr. Macdonald noted that "this measure will ensure our continued even-handed and equitable administration of the Antidumping Act."

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to: Charles Arnold

room: 2313 date: 4/2/76

Department of the Treasury
Office of the Fiscal Assistant Secretary

The attached Fact Sheet has been revised to broaden the third sentence of paragraph 11 to reflect all local financial organizations -- not only banks. We plan to meet with all financial organization groups.

J.T. Spahr

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FACT SHEET ON CLOSING OF CASH ROOM

For Use by Office of Public Affairs

1. The Cash Room was established in 1869 and was a part of the so-called "Independent Treasury System" consisting of the Treasury building in Washington, D.C. and nine Subtreasuries located in principal cities throughout the United States.1/

2. The function of the Cash Room and the Subtreasuries was to provide for the receipt and payment of public moneys. Thus, they accepted deposits from Government disbursing officers, redeemed and issued United States currency and coin, and cashed checks, warrants and drafts drawn on the Treasury.

3. From the time of establishment of the Independent Treasury System in 1846 until the National Banking System was established in 1863, the Subtreasuries served to decentralize the Treasury's transactions with the public -- at a time when the Charter of the Bank of the United States had been revoked and during a period when State banks were not capable of serving the Federal Government's financial needs.

4. With the advent of the National Banking System in 1863, the Treasury began to cooperate more closely with banking interests for economic and practical reasons, but retained the Independent Treasury System at arm's length from the banking system. With the establishment of the Federal Reserve System in 1913, the Independent Treasury System became obsolete for all practical purposes and the Subtreasuries were discontinued by legislation in 1920.

5. The Cash Room has continued operation, however, providing some of the services provided to the public generally by commercial banks: cashing checks drawn on the Treasury, exchanging currency and coin, issuing and redeeming U.S. Savings Bonds, and redeeming coupons on U.S. bearer obligations.

6. The services provided at the Cash Room -- principally cashing checks and receiving deposits of collections from Government agencies -- are no longer economically justified, and the operation is targeted to be discontinued on June 30, 1976.

1/ These cities were Boston, New York, Chicago, San Francisco, New Orleans, Baltimore, St. Louis, Philadelphia, and Cincinnati.

The Treasury does not perform these services at any other location in the United States, and the cost is too great merely to maintain a tradition stemming from the earlier Independent Treasury era.

7. With respect to agencies now depositing collections with the Cash Room, arrangements are being made for such deposits to be made with commercial banks in the area.

8. Over half of the checks cashed at the Cash Room are Federal salary checks for local Government employees, some 9,000 checks each month. These employees can elect to participate in either the Government's direct-deposit system or the savings allotment program and have their salaries credited in whole or in part to accounts in financial organizations of their choice.

9. Another 20 percent of the checks cashed, about 3,000, are District of Columbia welfare and unemployment checks, prepared for the D.C. Government by the Treasury's Washington Disbursing Center. When the District's home-rule charter is fully effective, these payments will be drawn on depositaries other than the Treasury and would not be cashable at the Cash Room in any event.

0. The remaining 25 percent of Cash Room encashments, or about 3,700 monthly items, are for social security and veterans disability and pension benefits; and tax refund and other Federal payments. They represent only a small portion of the checks issued under these programs to all D.C. residents -- an indication that other check-cashing facilities are widely available. Social security recipients may elect to participate in a recently installed nationwide system of direct deposits to financial organizations, and others may make similar arrangements.

The Treasury will make every effort to encourage local financial organizations to make alternative check-cashing arrangements available for affected individuals. For those individuals with chronic check-cashing problems, we will provide for individual consultations in order to be of all assistance possible. Discussions will be held with officials of financial organizations in the District of Columbia to request their organizations to encourage individuals not now having accounts to establish them for purposes of having a financial organization relationship for their financial needs -- including check-cashing privileges. All present users of

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the check-cashing services at the Cash Room will be individually notified, beginning in April 1976, of the move to discontinue the service. That announcement will also discuss possible alternative arrangements and offer the Treasury's assistance.

Office of Fiscal Assistant Secretary

March 1976

le Department of the TREASURY NEWS
SHINGTON, D.C. 20220 TELEPHONE 964-2041

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STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON AVIATION OF
THE SENATE COMMERCE COMMITTEE
WEDNESDAY, APRIL 7, 1976

Mr. Chairman and Members of This Distinguished Committee:

It is a pleasure to appear before you today to discuss legislation which I believe to be of the utmost importance: S. 2551, The Aviation Act. As the Committee is aware, the reform of government regulation is a principal goal of the Administration and, I am pleased to note, of a growing number of Members of Congress as well. In recent months, government officials and the general public have become increasingly aware of the problems created by a regulatory system which no longer serves the needs of today's dynamic economy. Many Americans have come to recognize that government regulation too often stifles the creativity and productivity of the competitive market place resulting in both lower quality of service and higher prices.

The rapid development of the U.S. economy over the years has resulted from the favorable combination of the Nation's natural resources, our productive labor force, the efficient provision of needed capital and a form of business organization which has emphasized reliance on competitive market forces and profit incentives to stimulate growth and efficiency. The allocation of human and material resources has generally been left to the market to determine rather than relying on unwanted government controls although such intervention has unfortunately increased. The resulting decisions about prices and output are not the result of central planning; instead, they reflect the long-term balance between what we want and what can be supplied. While this balance can become distorted --sometimes grotesquely as we are now witnessing in some industries -- the market system has served us well and it remains the key aspect of our productive economy.

The policies of the Federal Government have a direct influence on the private economy. It is a major purchaser of goods and services. It promulgates numerous legislative and administrative rules. Its allocation of funds to projects often determines the future course of private sector decisions. Whatever its reasons for involvement in the economy, the Government has a responsibility to encourage efficiency and fairness. To the degree that efficiency can reduce unnecessary demands for limited human and material resources, or increase output using

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the same resources, inflation pressures can be moderated.

Unfortunately, Government involvement in the economy too often restricts efficiency. Regulatory practices become obsolete as the functions originally required fail to adapt to changing economic and industry conditions. The transportation industry is a classic example. In responding to special interests the general interests may suffer. Government policies cannot be based on such fragmented reactions. We must develop a more comprehensive set of guidelines which will be more consistent with our dynamic economy. Bureaucratic enforcement of legislative and administrative rules may become unnecessarily burdensome. It is useful to periodically review Government activities to identify specific actions which can improve the efficient use of resources. The Administration and Congress have jointly recognized the great need to review the extensive regulatory functions of government. Universal agreement exists that widespread modification of regulatory practices is required to correct the many individual abuses now recognized and to provide a healthy environment for the future development of the U.S. economy which must create more jobs and become more productive to moderate inflation and use our resources more efficiently.

What are some of the ingredients of a competitive market? In a free enterprise system, companies vigorously compete with one another. As long as new businesses are able to form and enter markets and as long as there is no collusion among competitive firms as to pricing, every company will strive to maximize its efficiency in the production and marketing of goods and services to gain a competitive advantage. The incentive for such actions is potential profitability. A record of profitable operations is the fundamental factor in enabling a business enterprise to attract necessary financial capital from lenders and investors for further development.

In order to attract financial capital, a company must demonstrate an acceptable level of profit potential relative to the risk involved. Private savings are channeled directly, or indirectly through a financial institution, to investment opportunities on the basis of expected risk and return. It is the profit motive on the part of companies that results in the continual search for more efficient ways to do business. Consumers benefit from the intense competition among companies by being able to purchase a better selection of products and services at a lower price or with less inconvenience than would otherwise be the case.

In the commercial airline industry, many of the basic characteristics of competitive markets are missing. Price competition is virtually nonexistent because rates, schedules and specific route structures essentially are set by government regulation. As a result, we see competition taking the form of more flights, special meals, splashy colors and costumes, piano bars and what have you. In the final analysis, the consumer pays a significantly higher price than he need pay for air travel because of the lack of meaningful competition and the absence of consumer choice as to the travel services desired. The price mechanism is the focal point for competitive markets and efficiency in most industries. Unfortunately, the prevention of price competition in the airline industry restricts the efficiency and responsiveness of companies and leads to deteriorating service even as prices continue to rise sharply. During the last five to six years the airline industry has received eight regulated fare increases totalling 33 percent but this rapid surge of prices has not solved the basic financial problems of low profitability and strained financial positions. Increasing operating costs -- particularly fuel, labor and airport fees -- have created severe financial pressures. But airlines have not been able to seek increased volume through price competition so the increasing fares tend to be counter-productive by driving customers away.

A basic variable in promoting price competition is the absence of agreements among companies. Yet in the airline industry we witness various anticompetitive agreements dealing with such things as pool revenues, capacity limits, the price of headsets and drinks, and so forth. It is not that these agreements are illegal; the Civil Airenautics Board specifically permits them. Nonetheless, in most instances they are anticompetitive and the marketplace for air travel is compromised further.

Competitive markets also require freedom of entry. If competition truly exists then companies cannot earn excessive profits for very long before other firms will enter the market. The entry of competing firms and the resulting price competition tend to eliminate unusual advantages and cause profits to return to levels which more realistically reflect demand and supply relationships. In the process, the consumer benefits from lower prices than would otherwise prevail. The possibility of new entrants also assures innovation and new ideas. It keeps companies already established in the market on their toes so that they continually improve efficiency and service. In short, free entry is the very essence of competitive markets.

When barriers to entry are erected, as they are in the airline industry, the consumer does not have the benefit of "new blood." Existing carriers are protected from the driving forces of competition and, to a degree, can afford to be less concerned with innovation and efficiency. Barriers to entry influence not only the distribution of routes but other rigidities in the services provided. Such rigidities are completely contrary to the basic operation of free enterprise; they inevitably lead to less efficiency, less creativity, and higher prices.

It is easy to see that government regulation produces higher fares when we compare fares of CAB regulated carriers with intrastate carrier fares -- for example Southwest Airlines which operates only in Texas. In these markets, intrastate carriers which are not subject to Federal economic regulation have been allowed to enter new markets. The lower-cost service they provide has generated additional demand for air travel, permitting these carriers to fly with more passengers per plane and to offer lower prices. For example, the interstate fare from New York City to Washington, D.C., a distance of about 215 miles is now $36 according to CAB regulations. For a flight from Dallas to Houston, a comparable distance of 222 miles, the fare of Southwest Airlines is $25 on weekdays and $15 for evening and weekend travel.

In the 1930's, the "infant industry" argument was used for the economic regulation of airlines so as to give them a period of protection. After forty years, however, the industry is no longer an infant. If we keep in place present regulations well past the time an industry is an infant, a youth, or even a young adult, as we did with the railroads, the results are predictable. There will be subsidy after subsidy followed by deteriorating service and rising prices.

In the end, the government itself may have to intervene directly to prop up the entire airline industry just as it has had to pass legislation to sustain the operation of many railroads. The evidence of the disastrous impact of regulation by the Interstate Commerce Commission in disrupting the railroad industry is clear. We must not let this happen to the airline industry. It is time to allow the forces of competition to provide better service at lower costs to the consumer.

Now this is not to say that the airline industry should be entirely free of regulation. It is clear to all of us that the public interest must be protected in having high safety standards, continuity of certain route service and perhaps other things of this sort. However, the public interest is not served by inefficiency, rigidities in the services offered and by higher prices than are necessary. Areas other than those clearly identified to be in keeping with the public interest should be left to the marketplace. The cleansing forces of competition will assure greater efficiency and lower prices to the public than can be accomplished by the government.

The bill before you calls for the gradual introduction of pricing flexibility in the airline industry and the gradual relaxation of barriers to entry. It also calls for prohibiting anticompetitive agreements. These changes will not cause sudden dislocations in the industry, but rather a steady movement toward more competition, more innovation, better service, and lower prices. If ever a time was ripe for such a bill, what with the inflation we have experienced, it is now.

The Administration believes that the survival and growth of our airline system depdnds upon the industry's ability to adjust more rapidly to changing economic conditions. We have designed a program of gradual, phased reduction of government regulation as a means of achieving this goal. Specific transition measures have been built into the bill to reduce uncertainty and to permit the airlines to gradually adjust to a changed regulatory environment.

As with any fundamental change in public policy, our proposal has met with mixed reactions. Interestingly enough, airline management and aviation interest groups are among the strongest defenders of the status quo. They claim that The Aviation Act will disrupt airline service and cause public inconvenience and confusion, reduce or eliminate service to small communities, and produce market chaos which will destroy the "finest air transportation system in the world." I grow uneasy whenever the regulated grow too comfortable with the regulations imposed upon them.

The same sort of hue and cry arose last summer when competition in commission rates charged by stockbrokers was permitted for the first time in two hundred years. They were convinced that the removal of government regulation would ruin the securities industry and reduce service to the small investor. Nearly one year later, we find that the stock market is up and that the industry is strong. The rates on large institutional trades have been cut nearly in half. And the "unbundling" of rates for brokerage services has permitted the small investor the flexibility to purchase only those services which he wants and for which he is willing to pay.

I cannot believe that airline executives really want to continue a system which affords them little or no opportunity to run their own business and which has rendered them essentially unable to attract needed investment capital. And I am sure that no one in Congress, the Administration, or the public at large is willing to stand by and watch our airlines in the 1980's suffer the same problems as passenger railroads have experienced. We all have a tremendous stake in the future of this vital industry. We must overcome the natural tendency to concentrate on short-run needs at the expense of long-range consequences. The Aviation Act and these hearings provide us an opportunity to get at the substance of the matter of economic efficiency in concert with the public interest.

Thank you.

Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

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Contact: Donald Cameron
Extension 2951
April 7, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES TWO ACTIONS UNDER THE ANTIDUMPING ACT

Assistant Secretary of the Treasury David R. Macdonald announced today the issuance of a six-month withholding of appraisement in the antidumping investigation of AC Adapters from Japan, pending a determination as to whether the subject merchandise is being sold at less than fair value within the meaning of the Antidumping Act, 1921, as amended.

Under the Antidumping Act, the Secretary of the Treasury is required to withhold appraisement whenever he has reasonable cause to believe or suspect that sales at less than fair value may be taking place.

A final decision in this case will be made on or before July 8, 1976. Appraisement will be withheld for a period not to exceed six months from the date of publication of the "Withholding of Appraisement Notice" in the Federal Register.

Under the Antidumping Act, a final determination of sales in the United States at less than fair value requires that the case be referred to the U.S. International Trade Commission, which then considers whether an American industry is being, or is likely to be, injured. Both sales at less than fair value and injury must be shown to justify a finding of dumping under the law. Upon a finding of dumping, a special duty is assessed.

During the period of May 1975 through October 1975, imports of AC Adapters from Japan were valued at approximately $142,000.

Mr. Macdonald also indicated that he was issuing an "Antidumping Proceeding Notice" on clear sheet glass from Romania following a summary investigation conducted by the U.S. Customs Service after receipt of a petition alleging that sales at less than fair value are occurring in the United States.

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The petition also provided sufficient evidence of injury to the domestic industry to warrant an investigation. Imports of clear sheet glass from Romania during the period of January 1975 through November 1975 were valued at roughly $2 million.

Notice of these actions will appear in the Federal Register of April 8, 1976.

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Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE UPON DELIVERY
APRIL 8, 1976

STATEMENT OF THE HONORABLE GERALD L. PARSKY
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS
OF THE SENATE APPROPRIATIONS COMMITTEE
APRIL 8, 1976 at 10:00 a.m. EST

Mr. Chairman, last year the four international development banks made commitments for new loans totalling $8.5 billion for 377 projects in 84 countries. This total is far more than the bilateral economic development program of the U.S. or any other country. For most developing countries outside the Middle East the programs of the international development banks have become the core of their external financing. Most aid donors from both Europe and the Middle East build their bilateral programs around, and in cooperation with, the banks' programs. The U.S. contribution to this truly mammoth development effort requires appropriations of a little over a billion dollars in FY-77. About $300 million of this total is for callable capital which is unlikely to result in any outlays ever from the U.S. Treasury. Callable capital is a guarantee facilitating the sale of bonds by the banks in the capital markets of the world.

Mr. Chairman, Treasury has testified each year about these banks and I would presume not to repeat the basic details on their creation and growth which you and the committee know so well. I shall try to focus on a few of the key reasons why continued support for the banks at the level requested is in the national interest, despite the many competing domestic demands for funds, and review the current funding situation and recent developments in each bank. Detailed statements on the International Development Association (IDA), the International Finance Corporation (IFC), the Inter- American Development Bank (IDB), the Asian Development Bank (ADB) and the African Development Fund (AFDF) are annexes to this statement.

I shall do my best to answer questions on any of these institutions as well as any general questions you may have on the banks. Mr. Charles A. Cooper U.S Executive Director for the World Bank Group, Mr. John M. Porges, U.S. Executive Director at the IDB and Mr. John A. Bushnell, my Deputy at the Treasury for Developing Nations Finance are here with me today and are also available for questions.

We believe that the World Bank Group and the three regional banks provide important extra dimensions to development assistance. Economic development is not primarily a matter of external funding. While money is needed, the key factors determining the success of development efforts are the policies and priorities followed by each country. The development banks make important contributions in precisely such areas by encouraging the adoption of sound economic policies, by assisting in institution building, and by supporting successful development efforts made by the countries themselves.

The banks have developed highly competent professional international staffs which help the developing countries with the complex problems of priority setting and institution building. These international staffs bring together outstanding professionals from both developed and developing countries. In both the World Bank and the Inter-American Development Bank there are more Americans than any other nationality, and overall Americans make up about 25 percent of the development bank staffs.

The banks are cost efficient institutions. For example, the combined administrative budgets of the banks in 1975 accounted for only 3 percent of the $8.5 billion lent out that year. Moreover, included in the administrative budgets are expenses for technical assistance, training centers, etc. which are not directly associated with the cost of making loans.

From the U.S. national point of view, these banks encourage development along lines compatible with our own economy. They stress the role of market forces in the effective allocation of resources and the development of outward-looking trading economies. Through contact with the international development banks, developing countries are learning to administer large procurement programs effectively and honestly. These programs will result in increased procurement of goods and services in the United States, expanded future markets for our products, thus increasing employment in our country. Our participation in the international development banks will also provide more assured access to essential raw materials, and a better climate for U.S. private investment in the developing world.

There is clear evidence that in all of the international development banks increasing attention is being given to, and a greater volume of loans are being made for, the direct benefit of the urban and rural poor. Assistance is being directed increasingly to the poorest countries and to low income groups in all borrowing countries.

About 92 percent of IDA credits are made to countries with per capita incomes below $200, and the ADB makes loans on concessional terms only to member countries with per capita incomes of less than $300. About 50 percent of IDB's concessional loans are being made to the nine poorest countries in Latin America, and this percentage is expected to continue rising steadily in the future.

All of the international development banks are increasing their lending for projects which directly assist the rural and urban poor. In recent years the banks have placed greater emphasis on agriculture, the family farm, and cooperatives -- an emphasis we have encouraged and supported. The IDB has been the leader, for example, in lending for integrated rural development, cooperatives, farm-to-market roads, and rural water supply. The World Bank and IDA have made several loans for population projects and for sites and services to improve living conditions for the poorest groups. The IDA, as well as the African Development Fund, have made loans for the drought-stricken Sahel region of Africa. The ADB is taking the lead in loans involving light and intermediate technology which benefit the poor.

I would emphasize that the change in emphasis toward direct assistance to the poor is slower than some of us would like and we continue to press within the banks for a greater concentration to reach directly the poorest groups in each borrowing member. We must also not lose sight of the fact that basic infrastructure projects -- roads, ports, electric power and major irrigation -- are still necessary to provide the basis for overall growth of the developing country economies.

The development banks are part of an international structure in which the developed and developing countries work together to solve problems. The development banks are not debating societies which engage in seemingly endless rhetoric about restructuring of the world economy -- they are working institutions that get things done. By cooperating with other developed countries in funding these institutions we improve the effectiveness of our own efforts.

Other donor countries strongly support this cooperative approach and multilateral institutions are being used for an increasing share of the total development assistance of other industrial donor countries. The United States is no longer the leader in directing assistance through the development banks; the constraints on our support are a principal limitation on their growth as other countries, in general, are prepared to multilateralize a greater part of their assistance.

Bilateral aid remains, of course, of major importance. There are special aspects of economic assistance that require bilateral programs, especially where we have special techniques or products to impart, where we have special interests in individual projects or programs, or where security considerations are heavily involved. But U.S. support for the multilateral institutions is essential if we are to meet today's and tomorrow's challenges of improving the prospects for the millions in developing countries which our bilateral programs do not reach.

In our contributions to the international development banks, we have been trying to reduce U.S. budgetary outlays by making relatively less available to the soft loan windows of these institutions and relying more on U.S. contributions of callable ordinary capital. Callable capital does not involve budgetary outlays; thus, emphasizing callable capital fits in well with the Administration's strong efforts to achieve budgetary constraint. Moreover, since our private capital market is a major source of borrowing by the international development banks, it is appropriate that the United States provide an increased proportion of its overall contributions to these banks in the form of callable capital, while other donors with less well-developed capital markets undertake a greater share of funding for the soft loan windows of the banks. This shift in burden-sharing is illustrated by the recent trends in U.S. contributions to the concessional funds of the banks. Our contribution to the Fourth Replenishment of IDA is one-third of the total, as compared with 43 percent in our initial contribution in 1961, 42 percent of the First IDA Replenishment, and 40 percent of both IDA II and IDA III. In the case of the new IDB replenishment, our contribution to the Bank's concessional resources would be reduced to $600 million, or 57 percent of the total, as compared with $1 billion, or 67 percent of the total in the 1970 replenishment.

In the IFC, our share in the proposed total capital replenishment for FY 1977-79 would fall to about 25 percent as compared with 32 percent in the initial capitialization.

And in the Asian Fund the U.S. share will also decline, although we want to maintain our share of the ordinary ADB capital through full appropriation of the amount requested for FY-77.

One of the advantages to the United States of burden-sharing in the international development banks is that it provides us with substantial leverage in the use of our foreign assistance funds. Thus our appropriations request of about $1 billion in FY 1977 will be associated with nearly $10 billion of total lending by these banks.

Because of burden-sharing by the other donor countries, and their consequent sharing of the role in the decision-making process as members of these institutions, we do not -- as we do in our bilateral aid programs -- have complete control over the activities of the banks. These institutions, as you know, are clearly not part of the U.S. Government. What we have to weigh, therefore, is whether, on balance, the international development banks generally perform in ways which meet U.S. objectives even if, for example, they make some loans or lend to some countries that do not meet with our approval. In this connection most of the total lending by the international development banks is to countries -- such as South Korea, the Philippines, Pakistan, Tunisia, Brazil, Egypt and Colombia -- where we have strong interests nd where we now have or recently have had substantial bilateral aid programs.

Appropriations Requests

To provide for continued U.S. support of the international development banks in FY-77 we are requesting appropriations of $1,030.6 million of which $734.1 million will require Treasury outlays and $296.5 million is callable capital -- guarantees unlikely to require expenditures. The Administration is seeking:

-- $375 million for the second U.S. installment of the fourth replenishment of IDA;

-- $45 million as the first U.S. installment in the first replenishment in twenty years for the International Finance Corporation;

-- $240 million for the second installment of the fourth replenishment of IDB ordinary capital ($40 million of paid-in capital and $200 million of callable capital);

-- $200 million for the first installment of the replenishment of the resources of the IDB's soft loan window, the Fund for Special Operations (FSO);

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-- $120.6 million for the third installment of the first capital replenishment of the ADB ($24.1 paid-in and $96.5 callable);

-- $50 million for the initial U.S. contribution to the first replenishment of the resources of the soft loan window of the ADB, the Asian Development Fund (ADF).

In addition, the President has just transmitted to the Congress a request for supplemental appropriations for FY 1976. In this supplemental request the Administration is seeking:

-- $240 million for the first installment of the fourth replenishment of IDB ordinary capital ($40 million of paid-in capital and $200 million of callable capital);

-- $15 million for the initial U.S. contribution to the African Development Fund (AFDF).

These U.S. contributions are part of the multilateral effort in funding the international development banks in which the U.S. contributes only a part -- and an increasingly smaller part as can be seen in the table attached to this statement. If other donors are to continue supporting these banks, we must do our part by delivering on the amounts we agree to contribute.

The Administration is not seeking a contribution for the "Third Window" of the World Bank which lends at an interest roughly half way between that of the World Bank and that of IDA because we believe priority should be given to IDA and IFC appropriations.

Our participation in the Fourth IDA replenishment was authorized by Public Law 93-373 and our participation in the replenishment of the capital resources of the Asian Development Bank in Public Law 93-537. Authorizing legislation for participation in the replenishment of the IDB passed the House of Representatives as HR 9721 on December 9, 1975, and the Senate on March 30. A conference, necessitated by differences in the House and Senate versions of the bill is expected to be held soon. Legislation authorizing U.S. participation in the replenishment of the IFC and ADF was transmitted to the Congress in February.

HR 9721 provides for the United States to make three contributions of $400 million per year to the replenishment of the capital resources of the IDB beginning in FY 1976 and $450 million (all callable) in FY 1979. The bill also provides for U.S. membership in the African Development Fund with an appropriation in FY 1976.

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In the IDB a new class of shares, known as inter-regional capital, will be created to facilitate the entry of non-regional members. We are not requesting appropriation of the callable inter-regional capital because covenants limiting IDB borrowing to the amount of appropriated U.S. ordinary callable capital would not apply to inter-regional callable capital. This matter is explained in more detail in Annex 3 on the IDB.

We signed up for IDA IV in January 1975 without appropriations because we knew that, while other donors had made advanced contributions to allow IDA to continue making commitments, they would contribute no additional funds until the United States formally agreed to the replenishment. Such action by the other donors would have forced IDA to stop lending to the world's poorest countries. By agreeing to contribute one-third of the funds for IDA IV we assured that others would contribute the other two-thirds of the funds and IDA has continued to make commitments for projects and programs in the poorest countries.

The nature of our current arrangements concerning IDA, frankly, give me a great deal of concern. We should be aware of the implications of the procedure under which we are beginning our contributions one year late and spreading our contribution to IDA IV over four years while IDA commits the funds in three years. Under the present schedule IDA will have committed all IDA IV resources three months before the end of FY-77. Yet we shall have half of our contribution still awaiting appropriation in FY-78 and FY-79.

As you know, the Conference Committee on April 1 recommended $320 million for the first installment of the U.S. contribution to IDA IV. We will need to have the $55 million appropriated in FY 1977 in addition to the full $375 million requested if we are not to fall further behind other donors in providing funds to IDA.

To complicate matters, negotiations have already started on the next IDA replenishment. IDA hopes that the fifth replenishment will take effect by July, 1977, so that there is no period during which IDA commitments must stop. Some of you have suggested that we provide commitment authority to IDA subject to appropriation. This procedure would mean that in FY-78 appropriations would be necessary to meet not only the $375 million third payment for IDA IV but also for the first payment for IDA V. Such appropriations would total more than double the current request even if the

U.S. share of IDA V is substantially reduced. Although I would welcome your views on this problem, I do not believe we can resolve it this morning. However, this situation does emphasize the great importance of full appropriation of the $375 million plus any shortfall from FY 76 in FY-77 if the United States is to continue as an active supporter of IDA's key development role in the poorest countries. The Administration believes that for the United States to turn its back on IDA is unthinkable.

The need for funds in the other banks is also urgent. The IDB ran out of commitment authority to make new loans in late 1975 and would have had to cease lending except for a change in its regulations that allowed it to make new commitments against loan reflows and certain reserves on a temporary basis until the new replenishment becomes effective. Even after doing this the IDB had only $73 million in remaining commitment authority from ordinary capital at the end of 1975; these funds have already been allocated for a couple of pending loans. Thus the IDB is now unable to make new ordinary capital loans. The supplemental FY-76 appropriations which are obviously urgently needed will be used in part to reverse this temporary accounting change made last year. Thus the Bank will again have exhausted its commitment authority by about the beginning of FY-77. The FSO will also run out of commitment authority by the beginning of FY-77.

The Asian Development Bank has only $41 million of commitment authority remaining for soft funds, and these funds remain only because it reduced its soft lending in CY-75 to $166 million from $173 million in CY-74. The Bank has made no soft loans so far in 1976. During 1975, the United States participated in negotiations on an ADF replenishment but did not commit itself concerning the specific timing or amount of any U.S. contribution. Last December, the ADB Governors approved a resolution providing for an $830 million replenishment with a suggested U.S. share of $231 million. The United States abstained on the resolution and no final decision has yet been taken on the full amount to be requested from the Congress for a 3-year U.S. contribution. We are, however, requesting $50 million as the U.S. contribution to the ADF for FY 1977 to continue the level of U.S. support of the ADF in recent years.

The pipeline of available funds for concessional lending has been reduced below minimum levels by the delays in U.S. contributions. Soft convertible funds of the regional banks available for commitment declined from $285 million at the beginning of 1975 to only $100 million by the end of the year.

The inability to make new commitments not only delays the financing of good projects but also weakens the morale and dedication of the banks' staffs.

The $45 million appropriation request for the IFC is part of a $480 million capital increase for the Corporation. The total U.S. share is about $112 million.

We regard the IFC expansion as a major element in our program for aiding the developing countries. IFC, a member of the World Bank Group, is the only multilateral agency specifically designed to encourage private sector growth in the developing countries. It is unique among international development institutions in that it purchases equity and operates without government guarantees.

The U.S. has taken the lead in publicly supporting a major expansion of IFC capital through statements made by Secretary Simon at the annual meeting of the IBRD/IMF in September 1975 and by Secretary Kissinger at the UN Seventh Special Session in the same month. The proposal has since received widespread support from other countries and international negotiations are expected to be completed soon.

The U.S. has always stressed that the development process involves a cooperative effort between the public and private sectors -- domestic and foreign. The task is too big and resources too scarce to permit a dependence on one or the other. A high level of private investment has been a common factor behind the growth experience of three of the most successful LDCs -- Brazil, South Korea and Taiwan. Low rates of private investment have tended to be associated with low rates of economic growth. Public investments in infrastructure yield low returns if not followed up by further investment in more directly productive activities. The private sector has proven its effectiveness relative to the public sector, both in seeking out the investment opportunities that are most profitable and in using available resources efficiently.

IFC taps the private sector, both domestic and foreign, for the bulk of the investment capital in its projects, while applying a development orientation to the utilization of that capital.

The country shares of IFC's current capital represent the relative economic strength of the members in the 1950s when the Corporation was established. By using an up-to-date formula reflecting conditions in the 1970s the relative share of the United States subscription declines while those of Germany and Japan, as well as of the newly rich OPEC countries, rise.

This capital increase is the first since IFC's founding in 1956. The proposed increase is ambitious -- more than quadrupling the IFC's small capital base of $108 million. IFC's small capital base has impeded its equity operations, restricted its ability to borrow IBRD funds for relending, and resulted in IFC becoming a much more junior member of the World Bank than was contemplated when it was established 20 years ago. The capital increase will enable the IFC to play a more substantial role in the development process in association with private capital. The U.S., as the largest private enterprise economy in the world, is expected to be the leader in support of the IFC. Frankly, I wonder if we have done justice to our strongly held beliefs in the advantages of private enterprise by delaying a replenishment of the IFC in recent years while giving priority to the organizations lending mainly to governments. It is time to put the IFC at the top of our priority list.

Mr. Chairman, I must take note at this point of the actions of the Conference Committee of the Senate and House on April 1. The Committee has reduced our requests by $130 million. I should state for the record that it is present Administration thinking that we would amend the FY-77 request to include this $130 million requested but not appropriated in FY 1976. This procedure would also apply to the supplemental requests in FY 1976 for the IDB and for the African Development Fund recently submitted to the Congress.

Before closing I would like to address briefly five additional issues which are of interest to the Congress and the Administration. First, let me comment on why it is important for the United States to contribute to four international development banks.

Our past experience with the regional banks leads us to believe that smaller institutions with a predominance of local citizens can do a better job of meeting certain requirements than the much larger World Bank Group. Countries in the regions -- Latin America, Africa and Asia -- concur in this belief, since the regional institutions give them more control over the course of their own development. Moreover, the work of these institutions and that of the World Bank Group are complementary. The World Bank concentrates on larger, more complex projects utilizing expertise gained from worldwide operations. The regional banks focus on smaller-scale projects and call upon the first-hand knowledge and experience of their staffs to meet problems unique to their areas.

Let me now address the effect of the international development banks on our balance of payments. Excluding short-term funds held by the development banks in U.S. financial markets, the total of all inflows and outflows of dollars resulting from transactions from their inception through December, 1975, has resulted in a net deficit of only about $200 million for the U.S. balance of payments. Moreover, the banks maintain substantial investments in U.S. short-term financial assets.

The absolute magnitudes of the various types of flows are of course much larger; the total net outflow of capital (subscriptions paid-in plus net sales of bonds, loan participations, etc. in the U.S.) totaled almost $11 billion as of end 1975, while the development banks' purchases of U.S. goods and services, direct expenditures and long-term investments in the United States totaled over $10 billion.

Because of our overall favorable payments situation in 1975 we opened our capital markets freely to the banks for the first time in several years. As a result they raised $1.8 billion in net long-term capital. Consequently the cumulative effect on U.S. international payments was less favorable at the end of 1975 than at the end of 1974. However, at the end of 1975, the banks held about $5 billion in short-term U.S. financial assets, which, if included in the above figure, would make the effect on total inflows and outflows from the U.S. positive by a large margin.

Let me turn now to procurement. One of the major benefits we derive from our membership in the international development banks is the opportunity it affords U.S. exporters to compete for procurement financed by the banks. The rules of the banks require international competitive bidding and other safeguards which give our exporters a fair chance to compete for business in the developing countries. One of the advantages in joining the African Development Fund is that U.S. companies will become eligible to compete for contracts financed by the AFDF and thus will have a greater incentive to compete for business in Africa, which has not been a traditional market for many U.S. suppliers.

We have increased efforts in the last year to obtain a larger share of procurement in the development banks. During the past ten months Treasury has had on loan from the State Department a senior foreign service officer who has concentrated on improving the U.S. procurement record at the banks. This record, I might add, is not bad at all.

Although the U.S. share of world exports of goods and services in recent years has been approximately 17 percent, our share of bank-financed procurement has been running at 25 percent. Every $1 billion of procurement in the United States for bank-financed projects generates 47,500 man-years of employment in this country.

I know you are also interested in the foreign assistance activities of the oil-exporting countries as they relate to the international development banks. The vast increase in oil export earnings of the OPEC countries has made it possible for some of them to take on part of the development financing burden and to borrow substantially less from the international development banks thus permitting more lending to the poorer developing countries.

OPEC countries have provided co-financing totaling some $1 billion to complement 36 IBRD and IDA projects in 16 countries -- most of them over the past year or so. These projects are listed in a table attached. A substantial amount of IBRD/IDA resources was freed up for other projects and countries by this OPEC co-financing.

The pattern of lending by the development banks to OPEC countries has changed as a result of the higher incomes of these countries. Lending of soft funds from IDA, the FSO and the Asian Development Fund to these countries has been stopped with the exception of limited amounts of FSO funding for Ecuador. These FSO loans to Ecuador have been financed from sources other than the U.S. contribution, including Ecuador's own contribution to the FSO. Lending to the OPEC countries with the highest incomes such as Venezuela and Iran has stopped. However, lending to the poorer countries such as Indonesia and Nigeria has increased, partly as a result of proceeding with loans on which work had already started before the oil price increase. We have urged the banks to concentrate their limited resources on those countries with the greatest need.

My final point deals with our procedures to examine the work of these banks. We are continuously working at improving our oversight activities in regard to the banks' lending programs and project implementation. Embassy, AID and Treasury officials make visits to projects as frequently as possible. At every opportunity we encourage and facilitate project visits by members of Congress.

The primary mechanism through which the Administration sets policy on the international development banks, both on general policy questions and on each individual loan, is the National Advisory Council on International Monetary and Financial Policies (NAC). Every loan and borrowing operation and every substantial technical assistance operation is reviewed in detail by the interested U.S. agencies in the NAC before instructions are given to our Executive Directors. Through this process we assist these institutions to do an even better development job by bringing the very considerable expertise found in the Federal Government to bear in reviewing their projects. I would especially like to mention the outstanding technical work of the Department of Agriculture and the Department of Transportation in contributing highly useful inputs to these reviews. AID is one of the most active agencies participating in the NAC and contributes its immense development experience as well as its knowledge of current conditions in developing countries. The Department of Commerce and the Export-Import Bank help us to be continually vigilant that American exporters have the fullest opportunity for business. The Federal Reserve provides extremely useful analysis of the monetary and financial situation in the borrowing countries. The State Department contributes its detailed knowledge of conditions in the borrowing countries and provides the key foreign policy element in NAC deliberations. In addition to chairing the NAC, we in Treasury are particularly concerned with general bank policies such as assurance of adequate self-help, avoiding financing of cost-overruns, a consistent approach to maturities and grace periods, and increased efforts to reach the agricultural sector and the poorer people in ways that will increase output. The NAC also reviews such general U.S. concerns as expropriation of U.S. investment and arrears on debts to the United States in connection with each loan.

The annual report of the NAC should be an integral part of the documents you consider in determining appropriations for the development banks. In particular, I would call your attention to chapter IV of the FY-75 report which reviews developments in the banks and includes tables covering such matters as the sectoral breakdown of lending and membership in the regional banks and appendix C which includes the NAC evaluation of all the loans approved during the year. If this appendix were not so long -- a hundred fine-print pages -- I would suggest you might include it in your report because it brings out the real life benefits for millions of people

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around the world made possible through the work of the development banks. The purpose and benefits of each loan are given. Let me quote just one example of the sort of information in the NAC report. For a $15 million loan to Kenya, half from the IBRD and half from IDA, the following is part of the analysis of benefits:

> "The major quantifiable benefits stemming from the project are substantial increases in marketed production of wheat, maize, milk and coffee estimated at $10.1 million per year after full development. The project should also ensure employment --either permanent or seasonal and depending on the number of group owners involved-- for about 13,000 group farm owners, and will benefit farm families comprising 80,000 persons. These families are from the lower income levels of Kenya's rural population, most of which would be landless and unemployed if steps were not taken to protect their investments. At full development, the annual income of each family should have gained-- in addition to its subsistence income--$84 on the mixed farms, and $420 on the coffee estates. Currently, the average per capita income of the rural family in Kenya, including subsistence produce, is only about $70 per annum."

I know that some of you have felt the United States, especially the Congress, cannot make a sufficient review of the lending operations of the development banks in advance of loan approval. Unlike the situation for the bilateral aid program, we can not present you with a list of specific projects that will be financed with the appropriations before you today. This situation is inherent in the nature of these multilateral institutions where the United States provides only one dollar out of every three, four, or five they lend. It would obviously be infeasible for them to present their programs in advance to the governments and parliaments of all their members, or even to the 20 to 25 donor members. However, these institutions do not make sharp changes in the pattern and nature of their lending from year to year. Thus a review of last year's lending program will indicate quite accurately the nature and direction of their lending programs this year and next year.

In conclusion Mr. Chairman, I would like to apologize for having dealt so much with figures, procedures and burden-sharing. Underlying all these aspects we must keep in mind that the fundamental purpose of these institutions and of all the funds you appropriate for them is to help the people in developing countries improve their miserable living conditions. Support for the development banks is important in building and maintaining the broad framework of international cooperation that is important to continued U.S. prosperity. But this is an additional benefit. The basic justification for the appropriations has to be that these banks do a good job in using the money to help the developing countries help themselves and that this development reaches the people in these countries in a way that justifies U.S. taxpayer support.

We have not asked for the amounts of money that these institutions could use to accelerate development worldwide. Given the need for budget stringency, which we in Treasury know is so essential in the United States today, we have asked for the minimum amounts necessary to keep these institutions going in a manner consistent with the highest priority needs of the poor countries and contributions being made by others. The decisions you will make on these appropriations may receive much attention in the capitals of the world. But the practical effects of the appropriations will be spread to the poorest villages, slums, and isolated areas where little is known of the United States, burden-sharing or these institutions, but where improved seed, a well, a visiting health team, availability of credit, or a road to the market can make -- at small cost -- an immense difference in the quality of life.

ANNEX I

INTERNATIONAL DEVELOPMENT ASSOCIATION

The $375 million request for IDA in FY 1977 represents the second installment of the U.S. share of the IDA Fourth Replenishment, which was authorized by the Congress in July 1974. The IDA is the arm of the World Bank which provides concessional lending to support projects in the world's poorest countries which cannot afford to borrow at the near commercial rates which apply to standard World Bank loans. It is the largest multilateral source of assistance of this type. It follows the same rigorous standards, and enjoys the same high reputation throughout the world, as does the World Bank itself.

Sixty-six countries of Asia, Africa, and Latin America with annual per capita incomes below $375 have received IDA credits. Currently, most credits go with per capita incomes of less than $200. In FY 1975-1976, 92% of IDA credits were to these poorest countries. The greatest concentration of projects is in Asia and Africa, reflecting the fact that the bulk of the world's poorest people are living in these regions. About 60% of IDA credits go to South Asia -- where 61% of the population of all countries with per capita incomes below $200 live.

The appropriation request before you is for the second installment of IDA's ongoing Fourth Replenishment. This replenishment was negotiated with 24 other donor countries after consultation with Congressional committees. In that negotiation, we sought, and achieved, broader sharing of the burden by reducing the U.S. share. The U.S. share of the $4.5 billion IDA IV is 33 percent, or $1.5 billion, down from earlier U.S. participation levels which had averaged 41 percent since the inception of the Association in 1960.

While the IDA IV resource replenishment will support new lending commitments over the period fiscal year 1975-77, it gives donors the option of deferring their initial contribution to fiscal year 1976 and paying in four annual installments. The United States is planning to follow this course. Most other donors are making their contribution to IDA IV in three equal annual installments over the three-year replenishment period. As a result, most donors have already made two-thirds of their contributions to IDA IV while the U.S. has not yet paid its first installment.

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By the end of October 1976, all of the first U.S. installment of $375 million requested for FY 1976 will be needed to cover the U.S. one-third share of disbursements on approved credits. Subsequently, calls will be made requiring the FY 77 appropriations under discussions today. Full U.S. contributions to IDA IV are essential to insure the continued participation of the other donor countries and the continued operation of IDA at the lending levels contemplated under the IDA IV agreement. Unfortunately worldwide price inflation since the negotiation of IDA IV has reduced the real value of IDA pledges substantially below what was contemplated at the time international agreement was reached -- this makes it all the more important to provide the full amount of funding requested. Such continued financial assistance from IDA is vitally necessary if the momentum of development in the poorest countries of the world is to be maintained at anything approaching adequate levels.

The purpose of IDA lending is not relief or make work. It is rather to expand productivity, for only in this way can lasting improvement in the lives of the poor be achieved. Toward this end all IDA projects are appraised against strict rate of return standards, in exactly the same manner as projects supported by World Bank loans on harder terms.

IDA credits are extended on highly concessional terms: repayment is over 50 years at three-fourths of 1 percent. This is consistent with the fundamental purpose of IDA, which is to provide badly needed assistance to the borrower rather than yield a commercial rate of return to the lender. Most of the countries which borrow from IDA lack the capacity to service external debt on conventional terms, and even if they could, repayment on conventional terms would mean a lower rate of return for the borrowing country itself, and thus a smaller contribution to improved living standards and rising domestic savings and investment capacities.

IDA's focus, particularly in the IDA IV period, is on assistance to the poorest developing countries, and within these countries emphasis is given to projects benefiting the poorest groups of people. In FY 1974-75, about 40% of IDA lending was for agriculture and a further 25-30% for basic infrastructure -- transportation, communications, power and water supply. A complete list of IDA projects in FY 1975 and so far in FY 76 is attached to this annex.

The increased emphasis on agriculture reflects IDA's growing role in helping these countries meet their production goals. Solving the world food problem has to be achieved by increasing food output in the food deficit countries themselves -- India, Pakistan, Bangladesh, and a number of countries in Africa.

An example of a recent agricultural project is a $27 million IDA credit to Ethiopia for the development of its vast rangelands region which was hit by a severe drought during the years 1970-73. Before this drought, Ethiopia's livestock resources were the largest of any country in Africa. The true dimensions of the losses attributable to the drought are not yet certain. However, it is estimated that about 15% of the national herd was lost, largely in the rangelands areas.

The project will consist of three separate subprojects, each with its own organizational structure. Each of the sub-projects -- the Southern Rangelands, Jijigga, and the Northeast Rangelands Development Projects -- will provide an integrated program of range management and veterinary services along with improved roads and water facilities. They will help lay the foundation for a sound future development of the livestock economy in the range areas.

At full development the project is expected to result in an increased market production from the ranges of 100,000 head of cattle, 48,500 sheep and goats, and 3,000 camels annually. The project would also result in an increase in milk production of about 7.8 million liters annually. Incremental crop production from water development in the Northeast Rangelands area would total about 1.1 million kg of cotton, 320,000 kg of sorghum or maize, and 120,000 kg of groundnuts annually. The total annual value of incremental production attributable to the project would be about $11 million. Overall, the project is estimated to affect 100,000 families in the rangeland areas, raising their average per capita income significantly above its present bare subsistence level.

A number of IDA projects are also directly aimed at increasing the availability of the inputs vitally necessary to expanded food production -- seeds, extension services, fertilizer, etc. A project recently approved for India is a notable example.

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In recent years, consumption of fertilizers has increased in India. But it still remains very low relative to usage in other countries. In 1974/75, consumption stood at 2.74 million nutrient tons. Although domestic production of fertilizer has grown at an average annual rate of 16% since 1953/54, it supplies less than 60% of consumption. The level of capacity utilization is low, reaching only some 60% of the installed capacity of 2.6 million tons. The IDA credit of $105 million will allow production in existing facilities to be raised from the present industry-wide average of about 60% of capacity to 85% by 1979. The credit will assist 10 fertilizer plants in removing production bottlenecks, improving pollution control and increasing the production of industrial chemicals. The project will help to increase fertilizer production by 253,000 tons per year of nutrients.

IDA infrastructure projects typically provide key elements in the borrowing countries' national development efforts. An example is a $14 million credit to Guinea for a highway project which will help to link widely dispersed population centers and productive areas to the port of Conakry. The project, designed to enhance government efforts to revitalize the agricultural sector, will include (a) rehabilitation of approximately 2,500 kilometers of high priority roads and initiation of proper maintenance operations on these roads; (b) repair of existing equipment and plant and rehabilitation of workshops; (c) purchase of needed equipment, spare parts, and training materials; and (d) technical assistance to the Ministry of Public Works, Mining and Geology in implementing the projects and strengthening its managerial capabilities. The project is expected to insure greater transport reliability, expand the seasonal use of the most important unpaved roads and reduce transport costs.

Another example of a basic infrastructure project recently done by IDA is a $26 million credit to Nepal to help finance a $68 million hydroelectric power project. Nepal has a very large undeveloped hydroelectric power potential of over 80 Megawatts (MW). Total installed capacity is some 54 MW, of which only 33 MW is hydroelectric power. Electricity at present reaches only about 3% of the population. But demand for electrical energy has been growing at the rate of 22% a year, and existing generating capacity is insufficient to meet the demand.

The project is located about 30 kilometers southwest of Kathmandu, the nation's capital. It includes the construction of a 107-meter high rock-fill dam, a powerhouse with two 30 MW generating units and associated transmission and substation facilities. When fully utilized, the project will replace use of energy equivalent to about 65,000 tons of oil per annum, saving approximately $8 million per year in foreign exchange.

IDA lending operations have also focused increasingly on equipping the populations of the poorest countries with the skills essential to economic progress. For example, an $11.6 million credit to Malawi was made in support of a Government investment program giving priority to the growth of primary education, the improvement of secondary schools in the rural areas, and the strengthening of various non-formal education programs. The IDA project consists of the construction and equipping of 22 new model primary schools which can be easily duplicated in the rural areas, 22 rural education centers, one teacher training college including a demonstration school, and additional laboratories, workshops, dormitories and staff quarters for seven existing secondary schools.

The project will provide facilities to expand and strengthen ongoing education programs and help meet the rapidly increasing demand for basic skills. It will also reduce socio-economic disparities by increasing the enrollment of girls in secondary schools and by teaching adults, through rural development centers, the basic skills they require for productive employment.

Within these overall sector priorities, IDA's lending activities have reflected increased emphasis on projects which contribute to economic development by directly increasing the employment, productivity, and incomes of the rural and urban poor. Strategies to accomplish these objectives cut across virtually all lending sectors. In the interest of maximizing employment opportunity and widening the impact of income increasing efforts, project costs are held to a minimum and technology is adapted to local conditions and needs.

In this fiscal year IDA has approved several rural development projects embodying an integrated approach to the poverty problems. An example is a $10.7 million project for rural development in Niger. The project includes the provision of extension services, applied reesearch, and credit aimed at the improvement of groundnut, millet and cowpeas production in 15 selected areas; strengthening of cooperatives; expansion of education and training programs, including a functional literacy program, a training school for extension workers, and the provision of training scholarships for project personnel; a study of means for developing the nation's irrigation potential;

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construction of 80 kilometers of feeder roads; planting of 500 hectares of trees in fuel wood plantations; and improvement of livestock services and provision of credit for the purchase of livestock by pastoralists who lost their herds during the Sahelian drought.

It is estimated that increased production from the project will result in higher incomes for some 37,500 farm families and 14,000 pastoral families. After full development in 1982 it is expected that average yields in the project area will be close to those previously obtained only in years of most favorable rainfall. Yield increases are estimated to result in increments in annual production amounting to 18,100 tons of millet, 19,800 tons of groundnuts and 600 tons of cowpeas. In addition, new production of 500 tons of seed cotton, 900 tons of sorghum and 7,000 tons of tomatoes and other vegetables is expected to result from new irrigation facilities. An increase of about 3,000 tons per year in annual livestock production is also anticipated.

Every week the Board of Directors of the World Bank, in which voting power is weighted according to financial contribution to IDA, reviews and approves IDA credits proposed by the institution's professional Management. All such projects are first subjected to rigorous technical and economic appraisal. Firm cost estimates are made; required technical and managerial assistance is provided for; and institutional reforms essential to project success are made a condition of credit disbursement.

IDA draws upon a pool of skilled personnel, established policies, procedures and a wealth of experience in making effective use of its resources. The managerial and technical excellence of the World Bank is widely recognized throughout the world. Of the joint IBRD/IDA professional staff, roughly 27 percent comes from the United States. The remainder comes from 110 other nations.

Once a project is approved by the Board, IDA closely watches its subsequent execution. Careful supervision is exercised at the procurement stage to assure compliance with fair international competitive bidding and the award of contracts to the lowest evaluated bidder. Disbursements are only made when satisfactory documents evidencing progress of the project, in conformity with the credit and project agreements, have been received and reviewed by IDA staff. Reports on project implementation are regularly received and frequent on-site inspections by IDA officials are made. As each new credit is submitted for approval of the Board of Directors, a status report is presented on all ongoing prjects in the country to enable the Board to assess the country's capabilities for taking on further work.

Effective internal auditing and evaluation functions are also well established. The evaluation department, established a few years ago at U.S. urging, has continued to grow in stature and effectiveness. It evaluates all projects within one year after loan or credit funds have been fully disbursed with a view to strengthening future operations. It also undertakes broad country and sector program evaluation. The evaluation unit reports directly to the Board of Directors.

A number of countries which once received IDA credit have now advanced economically to the point where it is no longer necessary. Three developing countries are making contributions to IDA IV. They are Spain, Israel, and Yugoslavia.

Among the oil exporting countries, only Kuwait, which has contributed to IDA since 1960, is contributing to IDA IV, the negotiation of which preceded the dramatic increase in oil prices. The World Bank, however, is in close contact with the oil exporting countries to solicit their cooperation and efforts to assist the developing countries. The Bank is urging several of them to participate in the Fifth Replenishment of IDA as contributing members, and expects that they will. The United States strongly supports this goal and in the preliminary international meetings on this subject has stressed the importance of such OPEC participation. In the meantime, a number of Arab oil exporting countries have joined with the Bank and IDA in co-financing projects. To date, these countries have contributed financing of $1.0 billion to 35 IBRD/IDA projects. These additional resources enable the Bank and IDA to significantly expand the scope of their activities.

The Administration firmly believes that IDA has been, and continues to be, an effective and valuable instrument for the advancement of vital interests which the United States shares with other nations of the world. The President, as well as the Secretaries of State and Treasury, have all underscored IDA's continued priority importance to U.S. foreign interests, both political and economic.

The appropriation requested today will enable the United States to carry out its share of the IDA IV agreement negotiated among twenty-five governments to attack the problem of world poverty which is of direct concern and relevance to all nations. Other nations are fulfilling their promised participation and expect the U.S. to do the same. It is clear that IDA is making the kind of contribution to the world economy which is very much in the U.S. national interest to support. Consequently, prompt and favorable action on the FY 1977 appropriation request for IDA is vitally important.

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IDA credits approved, by area, country and purpose, July 1, 1974 to June 30, 1975

[Millions of dollars equivalents]

Area, country	Amount	Purpose
Total	1,576.15	
Total, Africa ...	511.55	
Cameroon	16.0	Rubber estate.
	[1] 1.0[3]	Highway.
	1.2[3]	Education.
Dahomey	4.0	Education.
Egypt	[2] 35.0	Agriculture program loan.
	30.0	Telecommunications.
Ethiopia	9.5	Agriculture development.
	32.0	Roads.
	16.0	Telecommunications.
	23.0	Education.
Ghana	13.6	Oil palm.
Guinea	7.0	Pineapple development.
Kenya	[3] 7.5	Group farming.
	[4] 8.0	Urban development.
	[5] 10.0	Forestry.
Lesotho	4.0	Education.
Malagasy Republic ...	9.6	Rural development.
	[6] 6.75	Forestry.
Malawi	10.0	Highways.
	8.5	Rural development.
Mali	13.3	Livestock.
	2.5[3]	Rice.
	8.3[3]	Highway.
Mauritania	3.0	Highway.
Mauritius	[7] 3.5	Education.
Morocco	14.0	Agriculture.
Rwanda	8.0	Education.
Senegal	15.0	Education.
	1.0	Irrigation.
	[8] 7.0	Agriculture development.
Sierra Leone	[9] 5.0	Rural development.
Somalia	8.0	Education.
Sudan	10.0	Education.
	23.0	Power.
	20.0	Irrigation.
Swaziland	5.0	Education.
Tanzania	8.5	Sites and services.
	10.0	Rural development.
	10.2	Highways.
	[10] 9.0	Sugar.
Togo	6.0	Cocoa/coffee.
Upper Volta	9.0	Livestock.
	7.5	Rural roads.
Zaire	26.0	Highways.
	26.0	Railway and river.
Total, Asia ...	1,016.10	
Afghanistan	13.0	Agriculture.
	9.0	Water supply and sewerage.
Bangladesh	75.0	Industrial imports.
	33.0	Fertilizer.
	15.0	Population.
	27.0	Irrigation.
Burma	24.0	Forestry.
	21.0	Telecommunications.
India	83.0	Canal-Rajasthan.
	91.0	Fertilizer.
	27.7	Dairy.
	16.4	Dairy.
	35.0	Drought.
	200.0	Industrial imports.
	45.0	Irrigation.
	75.0	Agriculture refining corporation.
	34.0	Rural development.
	24.0	Chemical command.
Jordan	7.5	Irrigation.
	6.0	Education.
	1.0	Potash engineering.
	5.0	Power.
Pakistan	36.0	Telecommunications.
	30.0	Development finance company.
Sri Lanka	9.0	Dairy.
	15.0	Program loan.
	4.5	Development finance company.
Western Samoa	4.4	Highways.

IDA CREDITS APPROVED,
BY AREA, COUNTRY AND PURPOSE,
JULY 1, 1975 to JANUARY 31, 1976
(millions of dollars)

Country	Amount	Purpose
Total, All Areas	915.4	
Total, Africa	196.1	
Burundi	5.2	Coffee Improvement
Cameroon	3.0	SMEI
Chad	5.0	Polders
Ethiopia	27.0	Rangelands
Gambia	4.0	Tourism
Ghana	10.0	Highway
Guinea	14.0	Highway
Liberia	6.0	Rural Development
Madagascar	5.6	Highway
Malawi	11.6	Education
Mali	10.0	Highway
Mauritania	8.0	Port
Niger	10.7	Rural Development
Rwanda	9.5	Highway
Senegal	2.0	Terres Neuves
Sierra Leone	7.3	Education
Somalia	5.2	Mogadiscio Port
Sudan	7.0	Development Finance Company
Tanzania	10.0	Dairy Development
"	6.0	Technical Assistance
"	11.0	Education
"	18.0	Maize Development
Total, Asia	677.1	
Bangladesh	4.6	Water Transport
"	100.0	Imports
"	22.0	Irrigation
Burma	7.5	Livestock
India	57.0	Rural Electrification
"	40.0	Water Supply & Sewerage
"	110.0	Railway
"	105.0	Fertilizer
"	4.0	Forestry
"	150.0	Power
"	18.0	Cotton Development

Country	Amount	Purpose
Nepal	26.0	Power
Pakistan	8.0	Tarbela Dam
Sri Lanka	25.0	Agricultural Development
Total, Europe, Middle East, and North Africa	38.2	
Afghanistan	10.0	Irrigation
Egypt	25.0	Development Finance Company
Yemen, POR	3.2	Aden Port
Total, Latin America	4.0	
Paraguay	4.0	Pre-investment

ANNEX 2

INTERNATIONAL FINANCE CORPORATION

The Administration is requesting $112 million as part of a $480 million capital increase in the International Finance Corporation of which $45 million would be appropriated for FY 77. International negotiations concerning this capital increase have not yet been completed although this proposal has received widespread support from both developed and developing countries, and formal international agreement is anticipated in the very near future. The proposal would result in a substantial reduction -- from 33% to 25% -- in the U.S. share of IFC capital.

As the Committee has not had occasion to deal with IFC for many years, the following reviews briefly the role and the activities of IFC.

Role

The IFC was established in 1956 to promote private investment in the developing countries. While it is organizationally and financially separate from the World Bank, it is affiliated to it by a common Board of Directors and President, and its 104 country members must be shareholders of the World Bank in order to join.

The Corporation's interest lies in stimulating and supporting private sector activities in developing countries. Its principal function is to stimulate the flow of private capital into productive investments by bringing together investment opportunities, domestic and foreign private capital, and experienced management. Among international development institutions, it is unique in its ability to operate without a government guarantee on its loans, or on its participation in equity investments.

The Corporation's policy is to make an investment only where sufficient private capital could not be obtained on reasonable terms and where the project will contribute to development and have the prospect of being profitable. Where it invests in capital stock, it remains a minority partner without management control. It basically supports only private enterprises although under certain conditions, IFC will participate in enterprises in which there is some government ownership provided they are managed on a business-like basis. IFC loans are made at near commercial interest rates with seven to twelve-year maturity. Where it buys stock, it expects to receive reasonable dividends.

Activities

Considering its small initial capital base of $100 million, the Corporation has had a significant impact upon development because of its success in leveraging its own funds: it has generated more than $4 of private investment for every $1 of its own invested in projects. Since its inception, the Corporation has been associated with about $6.4 billion of investments and has assisted in financing some 250 enterprises in 57 developing countries. Most of these enterprises have been medium-sized firms, controlled by local groups with local management.

After a slow beginning, IFC's commitments have grown rapidly in recent years from $51 million in 1968 to $212 million in 1975. IFC's cumulative gross commitments of $1.3 billion, as of December 31, 1975, are more than four times the 1968 level.

Some Examples of IFC Projects

IFC, through its projects, serves a number of purposes and activities. In the area of large mineral projects, IFC's key function is not the provision of capital, which large international companies can provide, but to act as the neutral intermediary between the companies who fear nationalization, and the governments of developing countries, which want to be assured that such projects will be in their long-term economic and social interests. A good example of IFC's involvement is a $620 million copper venture in Peru; a country whose relations with multinational corporations has been difficult. IFC's investment was small -- $15 million; but its presence, which has been approved by the Government of Peru, serves as an assurance of fair treatment on both sides. The project will develop the copper deposits of Cuajone in Southern Peru with reserves estimated at 468 million tons, in accordance with an agreement between the Government of Peru and the Southern Peru Copper Corporation which represents a consortium of four U.S. firms. It will produce 2,500 jobs and earn for Peru about $150 million annually in foreign exchange by 1982. In accordance with national legislation, the employees and workers will eventually own half of the project.

Another example in Kenya, a country of less than $200 annual per capital income, illustrates IFC's role in the transfer of technology. The project, the first integrated pulp and paper mill in East Africa, will introduce a technology new to the area and provide training to local workers. IFC is investing $17 million of a total cost of $50 million. Its role in assessing project feasibility and arranging financing was crucial. With the associated tree replanting, the project will result in 2,300 jobs, and produce 45,000 tons of paper annually saving Kenya $8 million per year in foreign exchange.

In the Philippines -- approximately $2 million was invested in the Maria Cristina Chemical Industries to help finance a $4.7 million electric arc furnace that will double productive capacity by producing some 21,000 metric tons of ferroalloys a year. The project, located in a depressed area on the island of Mindanao, will be supplied by more than 2,000 new backyard charcoal makers who are expected to earn well over twice the average annual family income in the region. It will also use other locally available raw materials and hydroelectric power, thus permitting production for world markets at competitive costs. Prospective annual net foreign exchange benefits were estimated at $5 million, partly through exports and partly through import substitution. In addition, ownership of the company is being broadened by including greater employee participation in the equity.

Capital Increase

The Corporation needs a capital increase now in order to maintain its growth rate of the past five years. Without the assurance of an increase, it would have to begin to restrict planned commitments beginning in fiscal 1977 and new equity investments would essentially cease by the following year.

The U.S. strongly supports such a capital increase for several reasons. International support for the private sector will make a notable contribution to accelerating the pace of development and is very much in accord with U.S. interests reflecting our own confidence in free enterprise and the private sector. Second, while IFC has done an excellent job in 20 years in utilizing its initial small reservoir of funds it seems reasonable that IFC has some catching up to do if it is to remain a significant international institution. It is worthy of note that the World Bank's capital has tripled in that same 20 year period. Third, the present capital base has become so small that it inhibits the Corporation from undertaking somewhat riskier ventures for smaller business and in poorer countries for fear of unacceptable losses. Fourth, the scale of significant investment projects has increased enormously since the '50s and the IFC should be in a position to support reasonably large projects as well as small ones.

IFC also wants to play a more active role as a intermediary in the minerals field facilitating arrangements between large private corporations and the governments of developing countries.

The U.S. share of the $480 million increase in issued capital stock is $112 million, or about 23% compared to our 33% share of current capital. This proportion reflects more accurately the current U.S. position in the World Bank than the present share which is based on the U.S. position in the late '50s. Germany, Japan and the OPEC countries will have larger shares.

The resolution governing the capital increase requires that if a country is not in a position to make a binding commitment to pay for all its subscribed shares, it must pay for at least 40% of its quota. This means that if the authorization bill is approved by the Congress, then the U.S. will need an appropriation for 40% of its subscribed shares in order to make an initial commitment to IFC. As a result the Administration is requesting a $45 million appropriation. This figure differs from the budget figure of $41.7 million because negotiations were not fully defined when the budget submission was made. The Administration expects to ask for appropriations for two additional installments in FY 1978 and 1979.

The following attachment will provide greater detail about IFC's activity, its sources of financing and the capital increase.

ATTACHMENT TO ANNEX 2

Geographical Distribution of Loans and Equity Investments

The table below indicates the geographical distribution of IFC activity. Latin America is the regional leader followed by Asia. The Southern Europe designation is mainly Turkey and Yugoslavia, as well as loans to Greece and Spain.

TABLE 1

GEOGRAPHICAL DISTRIBUTION OF IFC ACTIVITIES

(as of December 31, 1975)

	No. of Enterprises	Amount ($ Millions)
I. Regional		
Latin America	100	$ 545.1 (41%)
Asia	63	317.0 (24%)
Southern Europe	37	288.6 (22%)
Africa	37	122.3 (9%)
Middle East	14	58.2 (4%)
	251	$1,331.2 (100%)
II. Leading Countries		
Brazil	21	$262.9 (20%)
Yugoslavia	9	128.5 (10%)
Turkey	12	118.1 (9%)
Philippines	13	76.1 (6%)
Mexico	13	69.9 (5%)
Indonesia	9	58.4 (4%)
Argentina	8	53.2 (4%)
India	11	51.8 (4%)
Korea	8	44.1 (3%)
Iran	7	42.5 (3%)

Source of IFC Financing

The two tables below illustrate a) IFC's dependence on borrowing from the private sector via loan participation, and from the IBRD, and the diminishing importance of capital as a source of financing and of equity as a form of investment.

For loan operations resources, IFC relies primarily on borrowings from the World Bank. It is limited in the amounts of its borrowings by its Articles which prohibit total debt from exceeding four times IFC's net worth (unimpaired subscribed capital and surplus), so long as IFC is indebted to the Bank. As of June 30, 1975, IFC's net worth was $178 million, placing the limit upon IFC borrowings at $712 million. As of the same date, IFC had already borrowed $448 million and would reach the ceiling in early FY1979 at presently projected rate of operations.

Because World Bank loans cannot be used to purchase stock, IFC's equity investments may not exceed its unrestricted mainly capital and accumulated reserves resources. As of June 30, 1975, these resources totalled $183 million, compared to existing investments of $127 million.

TABLE 2

SOURCES OF IFC FUNDS

($ Millions)

	Actual - FY71-75
Income	42 (7%)
Capital Subscriptions and Loan Repayments	78 (13%)
IBRD and Netherlands Loans	272 (46%)
Portfolio Sales	25 (4%)
Calls on Participants	166 (29%)
	583 (100%)

TABLE 3

IFC FINANCING TRENDS

	6-30-70	6-30-75
a) Financed by 1) capital and reserves	90%	40%
2) borrowing	10%	60%
b) IFC debt outstanding as % of its disbursed loans	18%	78%
c) Equity investment as % of portfolio	30%	22%

FACTUAL SUMMARY OF CAPITAL INCREASE

(in millions of dollars)

		Proposed Increase	After Increase
1.	Authorized capital (12/31/75)		
	110	540	650
2.	Issued capital stock (12/31/75)		
	107.6	480	587.6
3.	Unallocated shares		
	2.4	60	62.4

4. Form of Commitment

a) subscribe to shares allocated, and b) make a binding commitment to pay. Exceptional procedure where a commitment to pay must be qualified because of legislative procedures: commitment for payment for a minimum of 40% must be unqualified, and, appropriate legislative action allowing an unqualified commitment to pay for the remaining 60% should be obtained as quickly as practicable. Since our commitment to pay is subject both to authorization and appropriation legislation, this is the procedure the United States will follow.

5. Payment schedule

a) August 1, 1977
20% - U.S. share of 22.5
20% unqualified commitment for additional share of 22.5

b) August 1, 1978
Unqualified commitment above is due

c) August 1, 1979
20% - U.S. share of 22.5

d) August 1, 1980
20% - U.S. share of 22.5

e) August 1, 1981
20% - U.S. share of 22.5

6. Schedule for U.S. legislation on IFC

	Date of Submission	Amount ($ Millions)
Authorization bill	March 1976	112
FY77 Appropriation	March 1976	45
FY78 Appropriation	January 1977	33
FY79 Appropriation	January 1978	33

General Data

1) Resolution approving increase will become effective on December 31, 1976, or such later date as the Directors may determine.

2) Shares related to the increase will not be issued before August 1, 1977.

3) Shares will be issued only when paid for in U.S. dollars.

4) Each share has a par value of $1,000 and is issued at par.

Annex 3

INTER-AMERICAN DEVELOPMENT BANK

The IDB is in immediate need of additional resources to finance Latin American development. Its ordinary capital commitment authority was virtually exhausted at the end of 1975. Approval of most new loans must now be made in the form of contingent commitments pending replenishment of the Bank's capital resources. The loan commitment authority of the concessionary Fund for Special Operations (FSO) will be exhausted in 1976 even if the U.S. is able to contribute $225 million as recommended by the Conference Committee on the FY 1976 appropriation bill. To allow the Inter-American Development Bank to continue to play a key role in Latin American development, the Administration is seeking funding for the U.S. participation in the replenishment of the IDB's resources for the 1976-79 period.

IDB OPERATIONS AND MANAGEMENT

Background. The Inter-American Development Bank (IDB) came into existence on December 30, 1959; it made its first loan in February 1961. Nineteen Latin American countries and the United States were charter members. Trinidad and Tobago joined the Bank in 1967, Barbados and Jamaica in 1969 and Canada in 1972.

In its fifteen years of existence, the Bank has assumed an important and growing role in Latin American social and economic development, not only from the point of view of actual project financing, but also through technical assistance, and development planning and programming. The IDB has proven to be a well-managed organization and an innovative lender continually finding new ways to improve its development impact by concentrating on the key development bottlenecks. Because it has the experience and staff to give our contributions a major multiplier effect on development, the IDB is one of our most cost effective development investments.

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The Bank carries out its financing operations through two lending windows, the ordinary capital and the Fund for Special Operations (FSO). The IDB also serves as administrator for special funds provided by several member and non-member countries. The single largest of these funds is the U.S. Social Progress Trust Fund (SPTF), which was established in 1961. With the approval of a $15 million loan for El Salvador in January 1976, virtually all of the total $525 million available on soft terms for additional social development projects in the poorest countries had been committed. In addition, the IDB and the U.S. Government are coordinating closely on programming the local currency reflows from SPTF loans so as to maximize their usefulness in financing technical assistance and appropriate activities related to FSO-funded projects. The IDB also administers a $500 million Trust Fund established by Venezuela in February 1975, from which loans totalling $83 million were extended in 1975 on terms similar to ordinary capital loans.

The ordinary capital window currently provides development loans at an 8 percent interest rate with maturities ranging from 15-30 years. It obtains its funds largely from the financial markets of the world, borrowing against callable capital, much the same as the World Bank.

The Fund for Special Operations was designed to offer financing for economic and social development when lending on conventional terms is not appropriate. FSO loans are made at 1-4 percent interest for 20-40 years. FSO loans have been extended entirely from resources provided by the Government of the United States, Canada, and the Latin American members of the Bank. Until 1973, repayment of FSO loans was in local currencies. Since then, such loans are repayable in the currencies lent.

Subscribed Share Capital. At the end of 1975, IDB subscribed capital totalled $5,965 million, of which the paid-in portion was $983 million, and callable capital $4,982 million. The U.S. share was 40 percent.

Callable Capital. The callable portion of ordinary capital is a contingent liability of the subscribing countries which can be called solely and only to the extent necessary, to meet obligations of the Bank to its bondholders. Callable capital constitutes a guarantee which makes it possible for the Bank to issue its own securities in private financial markets.

As long as the Bank is able to meet the obligations on its bonds from the proceeds of principal and interest repayments by borrowers on their loans, or from the other resources of the Bank, the callable capital will not impose any burden on member governments. Should calls be necessary they must be a uniform percentage of all member governments capital shares, although each member is liable to the full amount of its callable capital subscription.

The net income of the IDB during 1975 was $59 million, raising its total reserves to $297 million. These reserves provide assurance to the holders of the Bank's obligations regarding their financial soundness and a substantial margin against potential calls on callable capital. Because they have built up reserves against losses and continue to add to these reserves from net earnings, the IDB has never found it necessary to take recourse to callable capital. In fact recourse to callable capital is highly unlikely since it would imply massive and sustained defaults by borrowers. To date, there have been only two defaults in the IDB of which $1.8 million remains unrecovered. These were loans to private enterprises made before government guarantees were required for all loans.

Ordinary Capital Borrowing. The Bank has expanded the market for its bonds in capital markets worldwide. Less than one-half of its borrowings have been in the U.S. market. As of December 31, 1975, $633.3 million of the Bank's outstanding debt of $1,580.4 million was represented by long-term bond issues placed in the U.S. market. Borrowing in 14 non-member countries, mainly in Europe accounted for $821 million and $125.8 million has been borrowed in Latin America.

Fund for Special Operations. The Fund for Special Operations was initially established with authorized resources of $150 million. The United States provided $100 million and the Latin American countries $46.3 million, half in dollars and half in their national currencies. The resources of the FSO were increased by $3,173 million during replenishments in 1964, 1965, 1967 and 1970. To date, the United States has made available $2,765 million to the FSO, not including the $225 million recommended by the Conference Committee on April 1.

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The FSO makes loans on concessional terms primarily to finance projects with an emphasis on social development such as in health, education, and rural water supply. The small proportion of FSO loans that are extended to the more developed countries consist almost exclusively of local currencies and are reserved for projects that, while very worthwhile and socially important, are not likely to generate a stream of income sufficient to amortize an ordinary capital loan. The bulk of FSO lending is directed to the less developed borrowing countries and in those cases may be used also for income generating projects. The rationale is that the poorest countries need concessional convertible currency assistance regardless of the nature of the project.

In accordance with Bank policy, and at U.S. urging, the most developed Latin American countries (Argentina, Brazil, and Mexico), are reducing their borrowing from the FSO. FSO convertible currency commitments to these countries and Venezuela dropped from $90 million in 1973 to $67 million in 1974 and to $45 million in 1975. In 1974 Venezuela stopped all borrowing from the FSO. During the period of the replenishment these four countries plus Trinidad and Tobago have agreed not to seek convertible currency loans from the FSO. The Bank will concentrate its soft-term lending on the neediest member countries and on those sectors that have the greatest direct impact on low-income groups, such as agriculture, education, health, and water supply and sewerage.

The Latin American member countries also contribute their own currencies to the FSO. The Bank uses these local currencies primarily for loans in the contributing country. The Bank has also used the currencies of its more developed member countries -- Argentina, Brazil, Mexico and Venezuela -- to finance projects in other member countries when these countries are suppliers of Bank-financed imports. Under the terms of the proposed replenishment this arrangement for expanded use of local currencies will be extended to all currencies contributed to the FSO.

Bank Lending Activities. In its fifteen year operating history, the IDB has loaned $8.8 billion in support of Latin American economic and social development. Of this total, about $4 billion in loans were made from the Bank's ordinary capital resources and $4.1 billion from the FSO . The total amount loaned by the IDB from 1961 to the end of 1975 represents about 40 percent of the total development financing received by Latin America from the IBRD, IDA, AID and IDB. In 1975 alone the IDB accounted for 47 percent of official external capital for Latin America. IDB loans have financed projects involving a total investment of over $20 billion.

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Roughly a quarter of its loans, or $2 billion, financed high-priority agricultural development projects. An additional $1.9 billion was lent for electric power projects and $1.6 billion for transportation and communications. It also provided substantial sums in the water supply, housing and education sectors

Innovation in Lending. Among all of the international development banks, the IDB has perhaps been the most innovative lender. The following represents several types of activities in which the IDB has been in the forefront with a proven record of accomplishment:

-- The IDB has been the leader in lending for integrated rural development where organizational and logistical problems are especially difficult, such loans combining rural health services, education, small farmer credits, and feeder roads. Rural water supply is also a good example of a sector in which the IDB has played a pioneering role by providing potable water to the Latin American rural population through loans in nearly all of its member countries. Over the past five years, IDB-financed projects provided potable water for the first time to an estimated additional 10 million people. Even with this effort, only 25 percent of Latin America's rural population has access to this service.

-- IDB has taken the lead in lending through cooperatives. Availability of loans for use by cooperatives has increased to 80% of the Bank's agricultural credit loans and all of the loans for rural community development and rural electrification. In several countries loans to increase the domestic supply of fisheries have also been made through cooperatives. And in October 1975 the Bank approved a $9 million loan to the Latin American Confederation of Cooperatives to support its efforts to strengthen programs being carried out in 10 countries.

-- The IDB is in the forefront in encouraging Latin American integration projects. With a view to increasing economic efficiency, the IDB has taken a leading role in promoting individual projects that benefit more than one member country. Examples include IDB loans for the Acaray hydroelectric project in Paraguay, which delivers part of its output to Argentina and Brazil; an integrated road project that serves several countries in Central America, and the Trans-Andean highway between Argentina and Chile.

Utilization of Resources . Heavy use of callable capital and reliance on borrowing operations to raise private capital have provided needed leverage and reduced U.S. budgetary outlays, clearly very desirable results. Last year, the Inter-American Development Bank began promising major new efforts to raise additional private funds for economic development projects.

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A new "Complementary Financing" program permits commercial banks and other organizations to take up without recourse the earlier maturities of specific loans. In turn, the IDB agrees to perform the necessary technical analysis and act as collection agent for a fee. The interest rates charged by the commerrcial banks vary at a given spread above a reference rate. (Either the prime rate in the United States or the Libor in London.) This new procedure makes possible direct participation by private banks in the development process at appropriate maturities and interest rates and at reduced risk. Thus far the IDB has utilized $30 million of complementary financing. During 1976 the Bank hopes to mobilize an additional $100 million. The procedure also helps to introduce some IDB borrowers to the private capital markets. As their creditworthiness reputation develops, they will be able to borrow more in this area and eventually require less lending by the IDB.

In yet another exercise to expand usable resources, the Bank and its member countries are looking for ways to improve the "four currency agreement" in which local currency of one developing member country may be used to finance projects in another. The U.S. Executive Director recently asked Bank management for a further study of how the IDB can derive maximum benefit from the local currency contributions of its member countries.

Trends in Lending. Turning to the most recent developments in IDB lending policies, the Bank continues to channel assistance to the poorest and least developed member countries. In calendar year 1975, for example, $306 million of FSO resources went to category D borrowers which are the least-developed members of the Bank, including such countries as Haiti, Paraguay, Bolivia and Central America, exclusive of Costa Rica. Emphasis is also being placed on helping the poorest elements of the population within these countries. For some time, the IDB has led the way in financing of potable water, rural electricity, and health and education projects, and also tried to reach poor farmers with agricultural credit programs. During claendar year 1975, the Bank approved loans totalling $138.7 million to cooperatives and similar organizations. Of this total, $53.67 million came from FSO resources and $9.0 million was supplied from the Social Progress Trust Fund. Bank management estimated that more than 1.6 million individuals will benefit from the work to be undeertaken by the cooperative enterprises.

In January of this year, the IDB approved additional loans involving $12.1 million for cooperatives in programs which should benefit 110,000 more people. In the same month, the IDB also approved expenditures of $48.0 million over three years to assist the Inter-America Foundation in its programs. The

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Administration of the Bank is now preparing a proposal to provide between $10 and $20 million to the Inter-American Savings and Loan Bank. In this program, concessional funds from the Social Progress Trust Fund would be used for the benefit of lesser income participants of S and L's in Latin America.

Efforts to Increase Effectiveness of Lending Programs

The Bank also is concerned with efficiency. Last year, the IDB took the lead in establishing a new Hemispheric Committee to help promote greater agricultural production. Its membership consists of representatives from A.I.D., the World Bank and other international organizations interested in agriculture. The objective of this group is innovative and constructive change, not only in the projects, the Bank and others finance, but also in the government policies which ultimately determine how successful these individual projects will be. Greater participation by private business and application of modern methods is certainly one avenue to be followed.

Another extremely important prospect is the application of intermediate technology. The use of idle labor with new methods and simple or less sophisticated tools needs much greater emphasis as a factor for more effective utilization of scarce foreign capital. Within the Bank, particular efforts have been made in this respect in agriculture in Brazil, Colombia, the Dominican Republic and Mexico.

A recent loan to Mexico for integrated rural development, approved by the Bank's Board of Directors in October of 1975, offers especially interesting possibilities for application of intermediate technology. It is designed to provide permanent employment and raise income levels of 1.3 million people in 15 regions of Mexico. Directly productive investments under the loan include establishment of small orchards and development of quarries and industries including brick-making, garden produce processing plants, and sewing shops. Naturally, the leading objective of employment generation calls for use of the most appropriate technologies and this aspect of the program will be closely supervised. As a necessary correlative to these direct investment projects in Mexico there are such infrastructural investments such as water supply systems, home schools and health centers. Completion of the entire program is expected to double or triple annual family income in the 15 regions and to increase the total value of production by $35 million per year.

Another recently approved loan involving rural health services in Haiti presents an excellent example of how the Bank's work in a critically important field in affecting poor people in rural areas. The loan amounts to $6.3 million from FSO resources and is designed to build and equip 36 dispensaries, 23 health centers and one new health and training center. Bank management has estimated that it will benefit 1.9 million people in both the northern and southern regions of the country.

The Bank is giving steadily increasing attention to projects which directly benefit the poor. One of the best indicators of the attention given by the IDB to the needs of the poor is the percentage of concessionary loans made to the poorest Latin American countries. The percentage rose steadily from 17% in 1970 to almost 55% in 1975. This trend is continuing.

IDB REPLENISHMENT AND NONREGIONAL MEMBERSHIP

The proposed replenishment of the IDB's resources for the 1976-79 period provides for an increase of $5,303 million in the authorized capital stock of the Bank, and $1,045 million in the FSO, for a total of $6,348 million. Of this total, the U.S. would provide $2,250 million, the Latin Americans would furnish $3,588 million and Canada would provide $307 million. The proposed membership of twelve nonregional countries will also increase the Bank's capital. The nonregional countries, ten from Europe plus Japan and Israel, will contribute to the Bank about $745 million over a three-year period (1976-1978). This total would be divided equally between the Bank's hard loan and soft loan windows, providing about $373 million to subscribed capital and another $373 million to the FSO.

Proposed U.S. Subscriptions and Contributions. The U.S. share of the capital increase would be $1,650 million, of which $1,200 million is to be subscribed in three equal installments of $40 million paid-in and $360 million in the form of callable capital in FY 1976, FY 1977, and FY 1978. An additional $450 million of callable capital is to be subscribed in FY 1979. U.S. contributions to the FSO would total $600 million, to be provided in three annual installments of $200 million over the period FY 1977-79.

The U.S. share of total new resources for the IDB during this replenishment period would be 30 percent compared with the 48 percent U.S. share during the last replenishment initiated in 1970. The composition of U.S. participation would be 73 percent capital and 27 percent FSO, compared to 45 percent and 55 percent, respectively, in the 1970 replenishment exercise. The impact on budget outlays would be only $720 million, compared with $1,150 million under the 1970 replenishment.

Creation of Inter-Regional Capital Stock. The most important change in the Bank required by the entry of the nonregionals is the creation of a new series of capital stock to be designated as inter-regional capital stock. This new stock will be created to avoid certain limitations attached to ordinary capital borrowings which would reduce the utility of the new members' subscriptions. In the past, the Bank has included covenants in its bond issues which restrict the amount of total borrowings backed by its callable ordinary capital resources to the callable capital of the United States available on demand. The existence of this covenant means that contributions to the callable capital of the Bank from countries other than the United States cannot serve the purpose of supporting additional IDB borrowing. Beginning in 1975 such covenants were no longer included in the Bank's bond issues. Since such covenants were included in previous bond issues -- some of which will not mature until 1995 -- the holders of these bonds could enjoin the Bank from borrowing for its ordinary capital resources in excess of the U.S. callable capital subscription until all these bonds have been retired or redeemed. Thus, the Bank has decided to create a new category of capital under which it will be able to borrow against the callable capital of countries other than the United States.

Any member country would have the option of subscribing in whole or in part to either ordinary capital or inter-regional capital. For the 1976-78 period, one-half of the U.S. subscription would be made to inter-regional capital. In the same period, Canada and Venezuela would make 100 percent of their subscriptions to inter-regional capital, as would the nonregional countries.

For the purpose of computing voting power and preemptive rights, no distinction is to be made between ordinary and inter-regional capital. An eventual merger between ordinary and inter-regional capital is anticipated when bonds with the restrictive covenants are no longer outstanding.

Effect on U.S. Voting Power. The effect of the new memberships and the proposed replenishment would be to reduce U.S. voting power from the present 40 percent to slightly less than 35 percent. In the FSO, this voting power would preserve the veto of the United States since decisions on soft loan operations must be approved by a two-thirds majority. Moreover, one of the proposed amendments to the IDB Charter provides that the United States will have not less than a 34.5 percent voting share in the Bank as long as it wants such a share.

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Budget Impact. The impact of these requests on the U.S. budget over the next several years is substantially less then the total authorization. Of the $2,250 million authorization request, actual cash outlays would amount to $720 million ($120 million paid-in capital and $600 million FSO). This cash outlay represents 32 percent of our total participation, a reduction from the $1,150 million, which represented 64 percent of the last replenishment. Our $1,530 million subscription to callable capital is not expected to require any expenditures now or in the future because such capital would be called only in the highly unlikely event of a massive and widespread default by Bank borrowers.

Appropriation of the first $40 million of the three equal installments of paid-in capital and the first $200 million of three equal installments of callable ordinary capital would be sought in FY 1976. Since the covenants limiting borrowing to the amount of U.S. callable capital available on demand would not apply to inter-regional callable capital, we would propose not to seek appropriation of the $930 million proposed for subscriptions to inter-regional callable capital. On the basis of authorization legislation, our inter-regional callable capital would be backed by the full faith and credit of the United States. Payment of the paid-in portion would be in the form of a letter of credit, and only a part of this would result in cash outlays in FY 1976. An appropriation would be requested in FY 1977 for the first $200 million of the U.S. contribution to the FSO but only a small fraction of this amount would result in budgetary expenditures in FY 1977. Appropriations for the balance of the U.S. contribution to the FSO would be sought in FY 1978 and FY 1979.

ASIAN DEVELOPMENT BANK

The Asian Development Bank was created in 1966 to foster economic growth and cooperation in the poorer countries of Asia and the Far East. The Bank has 27 regional members providing 72% of its capital and 14 nonregional members, including the United States, Canada, and 12 West European countries providing 28% of its capital. The aggregate voting power of the developed member countries, which include all the non-regional members plus Australia, Japan, and New Zealand, represents approximately 54% of the total. The United States participated actively in the establishment of the Bank and its subscription to the Bank's capital stock currently amounts to $361.9 million or 11% of the total.

Bank Resources

The Bank's ordinary capital lending, at interest rates of 8.75 and terms of 15-25 years, is financed from its subscribed capital and the proceeds of its borrowings. As of December 31, 1975 the ADB's subscribed capital stock amounted to $3,201.5 million of which 33% was paid in and 67% was callable. Callable capital is used exclusively to guarantee borrowings from the international capital markets and represents a potential budgetary outlay only in the unlikely event that the Bank could not meet its obligations to bondholders. Through a bond covenant the ADB is restricted to borrowing an amount not more than approximately 97% of its convertible callable capital, currently $1,264.4 million. If the Bank were to limit its new commitments to amounts which could be financed without additional capital, the Bank had resources sufficient to commit only $184 million in new loans as of December 31, 1975. Given the virtual exhaustion of commitment authority, the Bank has already initiated discussions on a capital replenishment. The U.S. has not yet taken any position on the size and timing of such a replenishment, although it is clear that additional funds are needed relatively soon.

The U.S. subscribed its first of three installments to the first ADB capital replenishment in FY 1975. Most other countries completed their subscriptions to the replenishment during 1973-1975. The request for $120.6 million in FY 1977 completes the US contribution to the replenishment and is vital to the lending program of the ADB as the figures mentioned above indicate. The funds are urgently needed to permit continued ADB lending to countries such as the Philippines, South Korea, Indonesia, and Thailand -- the major 1975 ADB borrowers. These Asian rim countries have shown strong self-help efforts to achieve economic growth and are of particular importance to the United States.

Of the $120.6 million sought for FY 1977 only $24.1 million are paid-in funds which will entail budgetary outlays. The remaining $96.5 million is callable capital which is not likely to require any US outlays. In FY 1975 only the $24.1 million of paid-in was appropriated, but on the basis of authorizing legislation the US subscribed the full $120.6 million first installment. However, we subscribed to the callable capital only reluctantly because we believe callable capital for this relatively new bank should be appropriated. We are happy that the Senate/House Conference Committee on April 1 recommended appropriation of the full $120.6 million for FY 1976. The callable capital proportion of the third installment is also being requested in FY 1977 for appropriation. Appropriation of this amount does not increase Treasury outlays but it gives financial analysts and the bond market greater confidence in the ADB's bond issues and, thus, with no real cost to the United States, the ADB will be able to borrow at better rates and longer terms than otherwise. Completion of the US subscription to the first replenishment will also allow us to increase our voting power in the Bank, which is now 9.5 percent, to close to the original 16 percent.

In 1975 the ADB borrowed $322.8 million in world capital markets of which $75 million (23%) was raised in the United States. This was the first ADB issue in the U.S. since early 1971 as the Bank has been relying more heavily on the Japanese and West European markets. The U.S. notes, with an 8.5 percent coupon rate, were priced at 99 percent with full maturity in five years.

Bank Lending Activities

From its establishment through December 31, 1975 the Bank has approved 150 loans from ordinary capital resources, for projects in 15 member countries, in an aggregate amount of $1.925 billion, of which $684 million has been disbursed. In CY 1975 the Bank committed $494 million for new loans. The Bank has become an important institution in Asian development, and being a regional organization, plays a major role in mobilizing self-help resources and bringing local knowledge to Asian development problems.

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In response to suggestions by the Administration and Congress and by its own borrowers, the ADB has been paying increasing attention to the social impact of its operations. Of particular concern to the Bank are efforts to create employment opportunities and increase rural incomes. Lending for agriculture and agro-industry was over 37% of total ADB/ADF lending in 1975 compared with 24.5% in 1974. The extent of this change in sector emphasis during the past couple of years is shown by the fact that despite the 1975 lending program, cumulative Bank loans to public utilities at the end of 1975 totalled $907 million (35.1%), compared with agriculture's $589.4 million (22.8%).

Recent irrigation and land development projects have been used by the Bank to provide not only infrastructure, but also farmers' credit, seeds, fertilizer, and other inputs as well as improved marketing facilities. Additionally, more attention is being given to the development of extension services and other farmers' institutions. The objective of such integrated projects is to ensure that all the various factors needed to increase productivity are provided in the appropriate balance. An example is the Pulangui River Irrigation Project in the Philippines approved in 1975 which includes all of the following elements:

-- construction of irrigation canals, drainage system and roads;

-- establishment of two pilot farms for demonstration of extension services and the introduction of intensive rat control measures;

-- the improvement of the land tenure system;

-- other farm services such as timely supply of farm credit, fertilizer, and other farm inputs.

The benefits of the project include employment totaling 2.6 million man-days during the construction period and about 477,000 man-days after the construction of the Irrigation project and improved income distribution in the area as crop production incomes of nearly 3000 small farmers increase from $191 at present to $1,572 after 1982 for self-owners and $1,365 for leaseholders.

Many of the same concerns are also being addressed for the first time in other sectors. For example, in 1975 the Bank provided financial and technical assistance for sewerage and slum redevelopment projects. These projects, together with water supply, are a part of the ADB's efforts to increase the direct impact of its operations on lower income groups in urban areas. Under the Bandung Urban Development and Sanitation Project a comprehensive study will be conducted for the improvement of housing, roads, footpaths, water supply, sewerage, solid waste disposal, health clinics, and other facilities. The first stage of the subsequent project will improve living conditions of about 34,000 households with average incomes of less than $50 per month.

Asian Development Fund

When the Bank was established it was recognized that it would have to provide financing on concessional terms to meet the needs of its poorer developing member countries. Prior to 1973 the ADB's soft-loan special funds were contributed on an unscheduled basis through bilateral arrangements made by the Bank with donor countries.

In 1973, the ADB's Board of Governors, with United States support, adopted a resolution creating a new multilateral special fund, the Asian Development Fund, to which all contributions would be made and used on the same terms and conditions. Subsequently, agreement was reached among the Bank's developed country members on an initial resource mobilization for the new ADF of $525 million for the three-year period ending December 31, 1975. In FY 1972 and FY 1975 the Congress authorized U.S. special funds contributions totaling $150 million, of which $100 million has been appropriated and contributed to the ADF. The final U.S. contribution of $50 million to the initial mobilization is included in the FY 1976 appropriation request.

As of December 31, 1975 the ADF/SF had committed $658.8 million for concessionary loans. This left only $40.9 million remaining for new commitments in 1976, not including the $50 million U.S. contribution requested for FY 1976.

Recognizing the depletion of ADF resources, multilateral negotiations were held in 1975 with a view to replenishing the ADF's resources. During these negotiations the U.S. representative stated that he could give no indication of the amount or timing of a U.S. contribution, in part because the United States had not yet completed its contribution to the initial resource mobilization of the ADF and consultations concerning U.S. participation in a replenishment had not yet been held with Congress. The U.S. representative did indicate that the U.S. continues to be a strong supporter of the ADB and would, in principle, expect to continue contributing to the ADF.

Recognizing that the U.S. was unable to commit itself concerning the specific timing or amount of any U.S. contribution, the ADB Board of Governors on December 3, 1975, adopted a resolution providing for the replenishment of ADF resources. The resolution provides for an ADF replenishment in an amount not to exceed $830 million for the 1976-78 period. Most donor countries agreed to contributions equal to approximately 150 percent of their initial contributions. As no decision has yet been made on the total U.S. contribution to be requested for the ADF replenishment, the United States reserved its position on the $231 million proposed in the resolution for the U.S. share while commenting that such an amount seemed large. We formally abstained on the resolution.

Pending final determination of the total three year U.S. contribution level, draft legislation authorizing an initial U.S. contribution of $50 million for FY 1977 has been transmitted to Congress. Since contributions by other countries beyond the first year of the replenishment are contingent on U.S. participation, a U.S. commitment of the $50 million in FY 1977 is essential for the successful implementation of the total ADF replenishment package. This amount represents the same level appropriated in FY 1974 and FY 1975 and requested in FY 1976. The Administration has not yet determined the level of ADF appropriations to be requested for FY 1978 and FY 1979; in any case the level will be below the suggested $231 million.

Special Fund Operations

In 1975 the ADF approved concessionary loans totaling $166 million, which was considerably less than the Bank's expected program of $200 million in part because no loans were approved for South Vietnam, Cambodia, or Laos. The loans went to the poorest South Asian and Pacific states with Bangladesh, Pakistan, Burma, and Sri Lanka as principal borrowers. Agricultural and agro-industry projects accounted for 65% of the total lending and public utilities for 29%. Only Asian countries with 1972 per capita incomes of less than $300 are eligible for the loans which carry a service charge of 1% with maturities of 40 years including 10 years grace period on repayments.

Indochina

The Asian Development Bank, with strong U.S. support, made loans to South Vietnam, Cambodia, and Laos in previous years when conditions in these countries were quite different from the present situation. In April, 1975, the Bank suspended

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all loan operations in Vietnam and Cambodia. Operations have not resumed and no new loans have been considered or approved. There has been no contact by the ADB with Cambodia since last April. Although the Vietnamese have indicated some interest in the IMF, IBRD, and ADB, our attitude, and that of the ADB, is that benefits are limited to those countries willing to accept and implement the obligations and responsibilities of membership including Bank staff access to national economic data, freedom of staff entry and movement, adherence to conditions stipulated in loan agreements, and international competitive bidding for project procurement. Until the present governments of South Vietnam and Cambodia agree to follow these procedures we expect no ADB financial assistance to these countries. At this time there is no evidence that these countries are prepared to comply with ADB requirements.

In Laos the ADB is closely monitoring its operations to ensure that loan conditions are being met and the projects properly implemented. As indicated below, the actual amount of funds disbursed to suppliers for projects in Vietnam, Cambodia, and Laos as of December, 1975, was only $12 million.

ADB/ADF Indochina Loans

(U.S. millions $)

	Loans Approved	Amounts Disbursed	Paid-In 1/ Convertible Currencies
South Vietnam	$44.6	$5.7	$ 4.5
Cambodia	1.7	.6	1.2
Laos	11.7	5.7	0.2

1/ Contributed to ADB by these countries

Conclusion

As Secretary Simon pointed out in his speech at the ADB annual meeting in Manila last year, Asia has a special significance for the United States. He echoed President Ford's promise that the United States would continue to work cooperatively with others in maintaining the security and building the prosperity of the region. In an increasingly interdependent world, the United States, as a nation of the Pacific as well as the Atlantic, must remain involved. The competence of the Asian Development Bank is a strong asset in assisting our efforts to achieve these goals.

AFRICAN DEVELOPMENT FUND

Authorization for US membership in the African Development Fund (AFDF) is presently pending before Congress. The House of Representatives voted in favor of the authorizing legislation (HR 9721) on December 9, 1975 and the Senate on March 30, 1976. A conference is expected to be scheduled shortly to resolve differences in the Senate and House versions of the bill. The Administration is requesting an amendment to the FY 1976 budget or a supplemental budget to provide $15 million to be made available to the AFDF in three annual installments over the FY 1976-1978 period.

African Development Bank. The AFDF is the concessional loan affiliate of the African Development Bank (AFDB). The AFDB was established in the early 1960's to assist in the economic and social development of the newly independent African nations and to promote economic cooperation among them. The Bank's membership is exclusively African, with 41 member countries presently subscribing convertible currencies to the ordinary paid-in capital of the Bank amounting to $235 million. Through December 31, 1975, the Bank had authorized $317 million for ordinary capital loans for 107 projects in thirty-seven member countries, mainly in the public utilities and transport sectors.

The Bank faces an extremely challenging task because Africa is the world's least developed continent. Over half of the twenty-five poorest, least developed countries in the world are in Africa; thirteen of the world's eighteen land-locked developing countries are African; twenty-two of thirty-three of the United Nations' "most seriously affected" (MSA) countries are African. About 75 percent of the African population is engaged in subsistence agriculture and in half of the countries per capita income is less than $100 per year. Because of these dramatic problems many of Africa's developing states simply cannot afford to borrow at the 6% rate of interest for 8 to 20 years offered by the Bank for many of their high priority development projects. To meet the need for softer terms for these projects, the Bank decided to establish a source of concessional funds.

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<u>Establishment of the African Development Fund.</u> In 1966, in recognition of these problems and in an effort to increase the involvement of the industrial nations in African development efforts, the Bank undertook discussions with developed countries on establishing a concessional facility associated with the Bank. After six years of negotiations, and with U.S. assistance in drafting the charter, the African Development Fund was inaugurated in July 1973. The present members of the Fund are Canada, Brazil, Japan, Saudi Arabia, twelve European donors and the Bank itself representing all of its member countries.

The Fund is legally spearate from the Bank and managed by its own board of directors, six of whom are chosen by the Bank and six by the door countries. A 75 percent weighted vote is required for all operational decisions.

The Fund uses the Bank's staff and draws upon its expertise, as do the concessional funds of the other international development lending institutions. All loans bear a 3/4 of one percent service charge, with a forty-year maturity plus a ten-year grace period. The Fund directs its loan resources toward social development projects. Although all members of the AFDB are theoretically eligible for concessional loans, only the poorest recevie them in practice.

<u>Fund Resources.</u> Since the Fund's establishment, donor nations have pledged about $145 million in concessional loan resources and the Bank has contributed another $7 million. The proposed U.S. appropriation of $15 million for the African Development Fund--which represents about 9 percent of the contributions so far pledged by members would bring the level of total subscriptions to about $167 million. The United States would be the fourth largest contributor, after Canada which has pledged $25 million and Japan and Germany, each of which has pledged $16.7 million.

The AFDB recognizes the importance of concessional lending in a region as poor as Africa and is continuing to seek additional resources for the Fund, through the enlistment of new members, the increase in donor subscriptions, and bilateral loans and grants. The replenishment of the Fund's capital resources for the 1976-1978 period was discussed in Paris in November 1975, the fourth in a series of such meetings. The AFDF hopes that the current donor members will contribute twice as much in the next three years as in the last three years. The proposed U.S. contribution would be

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paid in over the new replenishment period. Thus, it is likely that the United States share would drop substantially in donor ranking.

Fund Operations. During the first two years of operation (1974 and 1975) the Fund made 40 loans totalling $140 million to finance projects, predominantly in the area of agriculture. Sixteen of these loans, for $60 million, have been for long-term development projects such as village wells, roads, earthen dams, and irrigation in the six drought-affected countries comprising the Sahel.

The Fund staff has laid out an ambitious lending program over the next three years. Management has estimated that during the 1976-78 period, the Fund will lend between $350 and $385 million. As of October 1975 the Fund's pipeline contained 93 projects, mainly in the agricultural and transport sectors, totaling $304 million.

During late November 1975, a delegation of Treasury officials, Congressmen and Congressional staff visited four West African countries in order to view at first hand the activities of the World Bank and the African Development Bank and the economic problems of the borrowing countries. In Mali, of one of the world's poorest countries which has suffered from severe drought in recent years, the group visited two projects which had benefited from AFDB/AFDF loans. One, a state-owned textile mill, manufactured printed cloth to be marketed locally from raw cotton produced in Mali. The plant not only provided much needed employment for some 850 Malians, but helped conserve scarce foreign exchange by reducing the need for importing the goods. The group was also shown a demonstration well shaft that had been dug by hand and reinforced with concrete to teach people from outlying bush areas modern well-drilling techniques. The AFDF project uses non-capital intensive or intermediate technology, which can be used in villages and on farms. This "operation wells" program designed by the Government of Mali to meet the water requirements of the rural population and livestock, is a significant example of a development project (to which the AFDF contributed $4.4 million) directly improving the daily lives of the poor.

In Liberia the delegation visited the Liberian Bank for Development and Investment (LBDI) which had received $3 million from the AFDB. The AFDB has made similar loans to national development finance corporations like the LBDI throughout Africa. In visiting a Liberian-owned chicken farm near Monrovia, the group saw an example of how the AFDB line of credit was being used effectively to extend small loans to individual Liberians, for productive purposes.

US Membership in Fund. Because the US participated in the drafting of the agreement establishing the Fund, we would have been eligible to be an "original participant" had we contributed to the Fund by December 31, 1974. This would have made our membership in the Fund automatic and entitled us to participate in the election of directors in May 1975. Because we did not meet the December 31 deadline, the terms of our membership are not at this moment defined and our entry into the Fund is subject to unanimous approval by the Board of Governors. We believe that, if the proposed appropriation is approved, we will be able to negotiate membership in the Fund under terms similar to the original charter conditions.

One aspect on which we have already held informal discussions with the Fund Management concerns Article 13 of the Fund's charter which provides for maintenance of value on currency holdings during the period after a member's contribution has been paid and before the funds are lent out or exchanged for another currency. In order to avoid being subject to this limited maintenance of value obligation, we have secured agreement from the Fund management that our contribution would be converted to another currency on receipt. According to Article 13, this procedure will free the US from any maintenance of value obligation.

Importance of Africa to U.S. Africa has a growing economic significance for the U.S. Total U.S. exports to all Africa rose from $3.7 billion in 1974 to around $5.2 billion in 1975. As a result, Africa's share of U.S. world exports grew from 3.7% in 1974 to 4.2% in 1975. Under the articles of the Fund, procurement of goods and services for projects financed by the Fund is limited to members only. Until the United States joins the Fund U.S. exporters and contractors will be unable to compete for this potentially substantial source of export earnings represented by Fund projects. Moreover, our export sector and service firms will be at a major disadvantage in terms of follow-up business and will not have incentives to establish markets in some African countries.

During the ten-year period from 1964 to 1974, U.S. investment in Africa quadrupled. Investment and trade in minerals and petroleum account for the largest share of U.S. economic activity in Africa. Three-quarters of U.S. direct investment in Africa are in these areas. In 1974, African petroleum alone accounted for 26 percent of total U.S. imports of crude oil. For the first nine months of 1975 Africa's share rose to 34 percent. During the same period we obtained the following percentages of our mineral imports from Africa: cobalt--36%; manganese--44%; antimony--40%; platinumum--39%. In addition to minerals, we obtain 21% of our coffee and 48% of our cocoa from African exporters.

Despite several problems, U.S. participation in the AFDF is consistent with our national interest. Looking at the African continent from the perspective of the long term, the extent to which we can assist, through the AFDF, in raising the living standards of Africa's poor, is clearly in the U.S. interest.

Following enactment of the authorization the Administration hopes that prompt action will be taken on the request for $15 million of appropriations in FY 1976 for the AFDF. Early action is necessary to permit the U.S. to join the Fund before the annual meeting in early May. At that meeting elections will be held for executive directors, providing what may be the only opportunity during the next three years for election of a U.S. executive director. If these appropriations are provided in FY 1976, the Administration does not plan to request additional appropriations for the AFDF in FY 1977.

TRENDS IN SHARE OF INTERNATIONAL DEVELOPMENT BANK
RESOURCES PROVIDED BY THE UNITED STATES
(% of Contributed Resources)

	IBRD	IDA	IDB		ADB	
			OC	FSO	OC	SF
Initial Contribution	41.4	42.6	43.1	68.5	20.0	28.6
First Replenishment	32.9	41.9	43.1	68.5 1/	18.2	
Second Replenishment	28.0	40.0	43.1	83.3		
Third Replenishment		39.9	41.2	75.0		
Fourth Replenishment		33.3	32.4	66.7		
Fifth Replenishment				57.4		
Cumulative U.S. Share	25.3	37.7	40.4	69.2	18.8	28.6

ANNEX 6

1/ If the SPTF is included, the U.S. provides a total of 90.7% of IDB concessional resources through the first replenishment.

OIDB
March 12, 1976

ANNEX 7

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International Development Bank Loans To OPEC Countries FY 1974 Through FY 1976 (millions of dollars)

Country	FY 1974 World Bank Bank	FY 1974 World Bank IDA	FY 1974 ADB/IDB OC	FY 1974 ADB/IDB SF FSO	FY 1974 Total	FY 1975 World Bank Bank	FY 1975 World Bank IDA	FY 1975 ADB/IDB OC	FY 1975 ADB/IDB SF FSO	FY 1975 Total	FY 1976 1/ World Bank Bank	FY 1976 1/ World Bank IDA	FY 1976 1/ ADB/IDB OC	FY 1976 1/ ADB/IDB SF FSO	FY 1976 1/ Total	Grand Total
Abu Dhabi	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Algeria	157.5	-	-	-	157.5	48.0	-	-	-	48.0	46.0	-	-	-	46.0	251.5
Ecuador	23.2	5.5	-	55.7	84.4	4.0	-	35.0	23.5	62.5	-	-	40.7*	-	40.7	187.6
Indonesia	48.0	84.0	11.78	21.54	165.32	332.0		77.1	14.2	423.3	68.0		66.05		134.05	722.67
Iran	265.0	-	-	-	265.0	52.5		-	-	52.5	-	-	-	-	-	317.5
Iraq	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Kuwait	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Libya	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Nigeria	75.0	-	-	-	75.0	173.0	-	-	-	173.0	-	-	-	-	-	248.0
Qatar	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Saudi Arabia	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Venezuela	22.0	-	-	-	22.0	-	-	-	-	-	-	-	-	-	-	22.0
Total	590.7	89.5	11.78	77.24	769.22	609.5	-	112.1	37.7	759.3	114.0	-	106.75	-	220.75	1749.27

* Includes $29.6 million from Venezuelan Trust Fund.

1/ Through March 1, 1976.

OIDB March 11, 1976

CO-FINANCING OPERATIONS BETWEEN BANK/IDA AND ARAB DEVELOPMENT BANKS
(in US$ millions equivalent)

COUNTRY AND PROJECT	FY	IBRD LOAN	IDA CREDIT	CO-FINANCING INSTITUTION	AMOUNT LENT	TOTAL PROJECT COST
Burundi- Coffee Improvement	76		5.2	Kuwait Fund	1.2	7.5
Rwanda- Highways	70		9.3	Saudi Fund	5.0	25.7
	76		9.5			
Sudan- Irrigation	73		42.0	Kuwait Fund	11.0	96.0
Supplemental	75		20.0	Kuwait Fund	39.0	148.0
				Arab Fund	14.5	
				Saudi Fund	28.0	
Tanzania- Textiles	75	15.0		Kuwait Fund	15.0	44.3
Maize	76		18.0	BADEA 1/	5.0	38.0
Zaire- Mining	75	100.0		Libyan-Arab Foreign Bank	100.7	435.0
Water Supply	76	21.5		BADEA 1/	10.0	70.4
Ghana- Cocoa	76	14.0		BADEA 1/	5.0	30.0
Mauritania- Ports	76		8.0	Kuwait Fund	8.3	27.5
Highways	75		3.0	Kuwait Fund	3.8	13.7
Nepal- Hydroelectric	76		26.0	Kuwait Fund	17.5	68.0
Algeria- Ports	74	70.0		Arab Fund	20.0	293.2
				Kuwait Investment Company	60.0	
Cement	76	46.0		Local Algerian Banks	89.8	214.4
Egypt- Fertilizer	74		20.0	Arab Fund	22.1	132.4
				Kuwait Fund	23.8	
				Abu Dhabi Fund	10.2	
				Libyan-Arab Foreign Bank	10.1	
				Qatar	3.4	
Cotton Ginning	74		18.5	Saudi Fund	25.6	40.4
Suez Canal	75	50.0		Kuwait Fund	34.5	288.0
				Saudi Fund	50.0	
				Abu Dhabi	34.5	
				Qatar	10.0	
Cement	75	40.0		Arab Fund	23.0	84.0
Railways	75	37.0		Saudi Fund	65.0	296.3
Telecommunications	75		30.0	Saudi Fund	23.0	173.4

1/ Arab Bank for Economic Development in Africa

COUNTRY AND PROJECT	FY	IBRD LOAN	IDA CREDIT	CO-FINANCING INSTITUTION	AMOUNT LENT	TOTAL PROJECT COST
Jordan - Thermal Power	73		10.2	Kuwait Fund	10.2	25.0
Power	76		5.0	Arab Fund	13.4	22.0
Syria - Thermal Power	74	25.0		Kuwait Fund	33.0	62.6
	75	8.6		Abu Dhabi Fund	15.0	
Tunisia						
Gas Pipeline	71	7.5		Kuwait Fund	2.5	14.3
Phosphate	73	23.3		Kuwait Fund	6.9	64.2
Sewerage	75	28.0		Saudi Fund	30.0	86.1
emen, A. R.						
Agriculture	73		10.9	Kuwait Fund	5.9	17.5
Water Supply	74		6.25	Abu Dhabi Fund	1.0	6.8
Agriculture	75		10.0	Abu Dhabi Fund	10.0	23.2
Highways	75		9.0	Kuwait Fund	5.0	15.7
Water & Sewerage	75		8.1	Arab Fund	21.0	31.2
emen, P.D.R.						
Highways	75		15.5	Kuwait Fund	15.3	31.8
Ports	76		3.2	Arab Fund	13.6	17.6
ugoslavia						
Oil Pipeline	76		49.0	Kuwait Fund	125.0	377.0
				Libya	70.0	
Totals		485.9	366.65		1,141.8	3,321.2

-- $240 million for the first installment of the fourth replenishment of IDB ordinary capital ($40 million of paid-in capital and $200 million of callable capital);

-- $15 million for the initial U.S. contribution to the African Development Fund.

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FOR RELEASE ON DELIVERY

STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ON S.3133
APRIL 8, 1976, 10:00 A.M.

Mr. Chairman and Members of the Committee:

Thank you for giving me the opportunity to discuss with you the subject of questionable foreign payments abroad by U. S. corporations. In my testimony today, I will touch on some broad policy issues involved in bribery and other questionable payments by (1) reviewing the current status of the Administration's initiatives in this area and (2) outlining my views on S.3133, which you are considering.

Mr. Chairman, I welcome your contribution to the efforts to deal with this very difficult problem as I share you concerns about the problem of bribery and other illicit payments outside the United States. Both government and business should unite in unequivocally condemning illegal or unethical activities by American business, whether at home or abroad. Corruption, whether it involves bribes to secure overseas government contracts, illegal contributions to political candidates here at home, or any other form of graft, is abhorrent on ethical grounds and undermines the functioning of a competitive free enterprise system. It results in higher prices and lower quality of goods and services to the consumer. Bribes and kickbacks are based on the power of an individual to allocate business in an arbitrary manner and, thereby, to interfere with the normal competitive reasons for making trade and investment decisions. Not only does this distort trade and investment flows but it also erodes the general reputation of the American business community, may adversely affect our relations with foreign governments and can contribute to a general deterioration in the climate for fair and open international trade and investment. Bribery is, therefore, not only morally wrong but is destructive of the basic economic principles on which our country was built. Accordingly, the Administration has attached the highest priority to finding solutions to the problem of corrupt practices in international economic affairs and has initiated a number of efforts toward this end.

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Domestic Actions Taken

I think that it would be useful for me to review briefly with you the initiatives currently under way within the Executive Branch.

Internal Revenue Service. Let me outline for you first some of the steps which the Internal Revenue Service can, and is, taking in this area as part of its continuing program to combat corporate tax evasion and avoidance. At my direction, the Internal Revenue Service has intensified its investigations of tax evasion and avoidance by U. S. corporations through improper deductions of bribes, kickbacks, and similar illicit payments made abroad and in the United States.

As part of the Service's efforts to uncover corporate tax evasion and avoidance wherever it exists, it has issued instructions to its Revenue Agents to:

-- make it mandatory to interview selected corporate officers and key employees regarding the use of slush funds, and to secure written affidavits in appropriate situations:

-- refer to the Intelligence Division any false statements made in connection with these affidavits for appropriate criminal action;

-- examine corporate officers' individual tax returns at the same time as the corporation return is being audited;

-- use summons to gain access to financial information;

-- make use of the IRS Office of International Operations to examine books and records of U. S. companies abroad;

-- use coordinated and simultaneous industry-wide audits of the principal concerns in a given industry furnishing similar services or products;

-- examine international transactions of multinational corporations;

-- strengthen our cooperative efforts with other nations with whom we have tax treaties.

The Internal Revenue Service is currently receiving tax-related information from the Securities and Exchange Commission. This information is being disseminated to IRS field offices where the particular corporations are being, or will be, examined by audit teams including some of its best revenue agents including international and computer specialists.

We do not keep statistics on the additional tax collected specifically from investigations of illegal payments by major corporations or for any other specific issue. Audits of such corporations usually involve a number of issues making it a difficult task to isolate the additional tax resulting from this one item. However, as a result of these intensified efforts by the IRS and other agencies to uncover tax evasion and avoidance schemes, several major corporations have disclosed that they have been making illegal payments.

In addition, the Intelligence Division is an active participant in the IRS effort in dealing with this erosion in corporate and personal integrity. Criminal prosecutions will be vigorously pursued when prosecution standards are met. The Intelligence Division is currently investigating 34 major corporations to determine whether illegal payments were fraudulently claimed as tax deductions or credits.

The Internal Revenue Service's efforts in this area cannot be viewed as a panacea in the area of improper or illegal payments, however. The Service's responsibility is to determine whether taxpayers' treatment of such payments was proper or resulted in a violation of Federal tax statutes.

Securities and Exchange Commission. As you know, the Federal securities laws which the SEC administers are primarily designed to protect investors by assuring full and fair disclosure of material facts regarding the nature of business operations of companies which have issued registered securities. The SEC is to be commended for its activities in obtaining disclosure of material facts regarding the conduct of publicly-held corporations on the foreign payments question.

To date, the Commission has brought court actions against some of this nation's largest publicly-held corporations. In each, the SEC has alleged that the defendants violated the reporting provisions of the Securities Exchange Act of 1934 by filing periodic reports with the Commission which omitted or misstated material information.

In those cases where settlements have been reached, the judgments enjoin the defendants from further violations of the Federal securities laws, and are enforceable by criminal contempt proceedings in the event of further violations. In addition, certain ancillary relief has been obtained where typically the subject company has been required to establish a special committee generally comprised of independent members of its board of directors, in order to conduct a full investigation of the irregularities alleged in the Commission's complaint. Upon the conclusion of an investigation, such special committees submit a complete report of the investigation to the board of directors, which, of course, has the ultimate responsibility for reviewing and implementing any recommendations contained in the report.

Lastly, the SEC has also instituted a voluntary disclosure program where approximately 25 publicly-held corporations have voluntarily come to the Commission's staff to discuss the existence and disclosure of improper and illegal practices in the past five years. A prerequisite for entering this voluntary program is that the board of directors declare that the company shall end all such practices and authorize a complete investigation of all related matters covering this five year period.

Departments of Defense and State. Action has also been taken by the State and Defense Departments in connection with the administration of the Foreign Military Sales Program. They are, for example, making an effort to ensure that foreign governments are fully informed of all agents' fees that are included in the price of defense goods and services sold to them under the program. In addition, if the foreign government advises that a fee is unacceptable or if the Defense Department determines that a fee is unreasonable or not bona fide, the DOD will not allow the fee under the FMS contract.

International Initiatives

Complementing these domestic actions, we have also taken a variety of initiatives in international forums aimed at cooperative action among governments to deal with this problem.

OECD. In September of last year at the annual meeting of the International Monetary Fund, the United States proposed to other industrial countries the idea of cooperative international action to curb illicit payments. They all responded positively. Two months later, a provision on ethical conduct was included in the draft Guidelines for Multinational Enterprises under negotiation in the Organization for Economic Cooperation and Development.

United Nations. Another initiative was taken by the United States early last month in the United Nations Commission on Transnational Corporations where we proposed a comprehensive international agreement to curb corrupt practices. In presenting this proposal, the United States outlined a number of principles on which we feel the agreement should be based. These include the following:

-- it would apply to international trade and investment transactions with Governments;

-- it would apply equally to those who offer or make improper payments and to those who request or accept them;

-- importing Governments would agree to (i) establish clear guidelines concerning the use of agents in connection with government procurement and other covered transactions and (ii) establish appropriate criminal penalties for defined corrupt practices by enterprises and officials in their territory;

-- all Governments would cooperate and exchange information to help eradicate corrupt practices;

-- uniform provisions would be agreed for disclosure by enterprises, agents, and officials of political contributions, gifts, and payments made in connection with covered transactions.

Although the members of the Commission were not in a position to give a definitive reaction to our proposal, we were encouraged by their initial responses. We were also pleased by the action of the Commission, which referred our proposal to its parent body, the Economic and Social Council (ECOSOC), with a recommendation that the Council take the issue up as a matter of highest priority. We anticipate that the ECOSOC will form a group of experts from member governments to draft the agreement and hope to see the results of their work within a short time.

GATT. In November of last year the Senate passed Senate Resolution 265 which called for the U.S. Government to seek an international code of conduct covering bribery, kickbacks, and other similar activities as part of the multilateral trade negotiations currently being conducted under the General Agreement on Tariffs and Trade and in other appropriate international forums. Subsequently, the United States urged our trading partners that an international code of conduct on business practices be made a major goal of the negotiations.

Information Exchange. Lastly, the State Department, the Justice Department and the SEC have developed procedures to facilitate the exchange of information on questionable payments with interested foreign governments through cooperative arrangements with their law enforcement officers.

President's Task Force

I believe that these activities represent a significant response to the problem of corrupt practices in international economic affairs. I anticipate that they will be strengthened and intensified under the coordination of the new Cabinet-level Task Force on Questionable Corporate Payments Abroad, which the President established last week. The Task Force was charged by the President, in part, with ensuring that existing government actions to deal with corrupt practices abroad will be fully coordinated. It also has a mandate to conduct an in-depth review of this matter and to recommend any new Federal Government actions as it may feel are necessary.

The Task Force is chaired by Secretary Richardson, and I am privileged to be a member. In my judgment there is no person more eminently qualified to assume this responsibility than Elliot Richardson. I intend to give him my full support in our search for effective and practical solutions to this problem, and the Committee will look forward to working closely with the Congress in this effort. As our work progresses, we will certainly do our best to promote an interchange of ideas with individuals and groups in the private business sector and other sources as well.

Private Sector Initiatives

I think it is important to emphasize, however, that the search for solutions to this problem cannot be solely the concern of governments. It is critical for the private sector to come to grips with the problem. This obligation extends not only to those firms that have engaged in corrupt practices, but also to the business community, as a whole. The sad fact is that the unethical practices of a small percentage of our business community are coloring our views of almost the entire private sector. The vast majority of businessmen are honest. What is required today, however, is more leadership from those businessmen who have deep convictions, will stand up for them and will go to the public to state the case for ethics in business, instead of keeping quiet while the free enterprise system comes under increasingly heavier attack.

As I indicated at the outset of my statement, these practices, aside from being morally wrong, cause serious distortions in the operation of the free market and have negative effects on the reputation of business in general. All firms, even those who have not indulged in illegal practices, are adversely affected as a result. All of us who want to preserve our free enterprise system find such conduct abhorent and we must join in an international effort to find ways to deal with the problem.

In this connection, I was gratified to learn last month that the International Chamber of Commerce had formed a Commission on Unethical Practices -- a blue-ribbon panel of business leaders from many nations -- to develop guidelines for promoting ethical and proper conduct in international commercial affairs. In addition, I understand that a number of individual firms have created special task forces to establish procedures to prevent unethical practices by their employees.

These actions indicate that the private sector does see the need to deal squarely and effectively with this problem. I know that such efforts will be a constructive adjunct to initiatives being taken by the United States and other countries and look forward to seeing their results.

Comments on S.3133

In the same vein, I welcome your initiative in introducing S.3133 and appreciate the opportunity to discuss it with you.

While I am strongly attracted by the general principle of greater disclosure, I do have some reservations as to the approach taken in the bill to achieve it. More specifically, I think we must also look at this bill in relation to the initiatives the United States now has underway in international organizations. Our chief concern here is that a unilateral effort like that involved in S.3133 might undercut the vital principle that cooperative action by the whole international community of nations is needed in order to deal effectively with this problem. It is a truism that it takes two to make a bribe. We must discourage those who offer bribes, to be sure, but any effective approach must also strive to deter those who solicit and accept illicit payments as well.

The bill would require that a broad range of payments made abroad be disclosed to the public, even though the vast majority of these payments would likely be legitimate payments for agents and representatives engaged to assist in the sale of goods and services to governments and government corporations. In this respect, the disclosure requirements in the bill may go too far in that (1) a great amount of paperwork associated with reporting would be required by both the private sector and the SEC and (2) a number of what are ordinary, legitimate and confidential matters relative to commercial relationships would be opened up for examination by competitors, customers and governments.

The bill would place a heavy responsibility on the Securities and Exchange Commission for enforcing both its disclosure requirements and its criminal sanctions, both of which would take the SEC into areas beyond its basic mandate of protection of investors. Whether this should be done requires further study and, of course, the views of the SEC and the Department of Justice should be taken into account. In this regard I might note that the disclosure and criminal sanctions would be applicable only to corporations which have issued registered securities and thus come within the ambit of the Securities Exchange Act. I question whether any new disclosure requirements and criminal sanctions should be limited only to corporations with registered securities, as a bribe offered by a privately-held corporation or a partnership is no different from a bribe offered by a publicly-held corporation.

The upshot of my remarks is that while I support the intent of the bill before you today, I have serious reservations as to whether it represents the optimal approach to dealing with the problem of bribery and corrupt practices in international commerce. Although domestic legislation may be needed, the problems in this area are complex and should be carefully considered before we take action. The Task Force on Questionable Corporate Payments Abroad was established specifically to give these problems and possible solutions a hard and searching analysis and evaluation before we commit ourselves to one course or another. I suggest that you give us a chance to look into these matters further before taking action on this legislation. In this process we will exclude no reasonable possibility, but we will of necessity take into account the considerations I have just outlined.

Mr. Chairman, I also have a few technical points to make with respect to specific aspects of this bill. Our staffs can get together later to explore them, so I will not spell them out in detail now. Rather, I would like briefly to mention some of these questions in order to give you an idea of where our principal concerns lie. For example, one section of the bill has the effect of automatically adopting as a part of U.S. criminal law the relevant criminal laws of all foreign nations. Do we want this? One consequence of retaining this provision might be to create a situation where a single act was punishable under the laws of two countries. Finally, enforcement of the provisions of the bill could well result in the extra-territorial application of U.S. law and might require the U.S. Government to investigate the conduct of foreign government officials, resulting in potentially serious political problems with other countries.

The Lockheed Situation

Before concluding my statement, Mr. Chairman, I would like to take a moment to bring this Committee up to date on the Lockheed situation. When I appeared before you in my capacity as Chairman of the Emergency Loan Guarantee Board (ELGB) last August and again on February 19, I indicated that the ELGB strongly condemned the payment of any type of bribe or kickback for the same basic reasons I have described today.

Since last summer, when it became aware that Lockheed had been involved in these practices, the ELGB has acted on a number of fronts to stop these activities. Initially, the ELGB insisted, as a condition to the continuance of the guarantee program, that Lockheed cease making any further questionable payments, and the ELGB worked with Lockheed to develop a definitive corporate policy to control the Company's relationship with foreign consultants. That policy expressly prohibits any foreign commissions or other payments that are not legitimate business expenses which would be deductible on the Company's U.S. tax returns. It also prohibits the maintenance of any slush fund or other fund outside normal accounting channels. The details of the plan were adopted by Lockheed's Board of Directors in a resolution that provides that any Lockheed employee who violates the policy will be dismissed immediately. During the fall of last year, Lockheed, under ELGB supervision, took steps to assure full implementation of its new policy. I might add that, at your request, copies of Lockheed's policy and the Company's plans to implement it were furnished to you last month.

The ELGB has been closely monitoring Lockheed's activity under its new policy and will continue to do so. To complement that monitoring effort, the ELGB intends, in connection with Lockheed's refinancing plan, to insist on an amendment to its Agreement with Lockheed and the lending banks that will expressly define the making of future improper payments as an event of default. These amendments also would establish a formal system of reporting to the ELGB to assure that no wrongful payments are made in the future. In addition, the

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ELGB will require a special accounting of past payments from a committee of outside Lockheed directors that has been established.

On February 19, I stated that we were in the process of negotiating with Lockheed for the names of the countries in which payments to government officials were known or suspected to have been made. We are close to completing these negotiations and in addition have obtained a substantial amount of detailed information relating to existing and potential foreign sales. Lockheed's revised 12/75 Financial Forecast will be completed within the next two weeks, at which time the ELGB staff will be in a position to finish its assessment of the impact that disclosure of foreign bribes may have on Lockheed's operations and hence the repayment of guaranteed borrowings. I would like to add that based on the ELGB's assessment of the company's latest forecast thus far, I still believe there is a reasonable prospect that Lockheed will be able to return to the private capital markets by the time the Government guarantee program ends.

Lastly, I would note that, following the February 19 hearings, the GAO made a request of Lockheed and of the ELGB for further access to Lockheed records. Lockheed has recently agreed to provide the GAO access to its records concerning foreign agents and consultants in exchange for the GAO's promise that the information obtained would be kept confidential. I am informed that the GAO sent a team out to Lockheed's headquarters last week to begin their review of those records. The Treasury Economic Analysis group has begun an update of its assessment of the impact of a Lockheed failure. Although this analysis has been delayed pending the availability of Lockheed's 1975 yearend audited financial statements, Lockheed has indicated this information will be available in the next few days, and our analysis can then be completed shortly.

Conclusion.

In sum, Mr. Chairman, I share your concern about the problem of bribery and corruption, at home or abroad. Although, I do have significant reservations as to the general approach embodied in S.3133 as well as some of its specific provisions, I agree with the objectives you are seeking. There is no room in our society for such practices. What is needed is a united effort by business and government. The fact of the matter is that no free society or free economy can long survive without an ethical base.

Since the President's Task Force on Questionable Corporate Payments Abroad has just been established, I believe we should be given some time to analyze this important area more deeply. I assure you that we are committed to finding the proper solutions. Let us work together to formulate recommendations for action.

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FOR IMMEDIATE RELEASE April 7, 1976

RESULTS OF AUCTION OF $2.5 BILLION
OF 14-DAY TREASURY BILLS

The Treasury has accepted $2.5 billion of the $7.6 billion of tenders received for the 14-day Treasury bills to be issued April 8, 1976, and to mature April 22, 1976, auctioned today. The range of accepted bids was as follows:

	Price	Discount Rate	Investment Rate
High	99.815	4.757%	4.83%
Low	99.811	4.860%	4.94%
Average	99.812	4.834%	4.91%

Tenders at the low price were allotted 56%.

WS-775

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE ON DELIVERY

STATEMENT OF DALE S. COLLINSON
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE WAYS AND MEANS COMMITTEE
APRIL 12, 1976, 10:00 A.M.

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss the status of the Airport and Airway Trust Fund.

In your press release announcing these hearings you indicate your interest in determining "whether the taxes currently dedicated to that trust fund should be continued at existing levels, reduced, or otherwise modified." In my statement I will discuss the general tax policy principles bearing on such a determination and supply current information regarding the financial condition of the trust fund. Representatives of the Department of Transportation will cover the transportation policy issues.

History of Air Transportation Taxes

Preliminary to any assessment of the propriety of the excise taxes presently levied on air transportation, it is essential, I believe, to recall the process by which we arrived at the present situation. This history is familiar to most of you, and I will, accordingly, keep my summary brief.

Since the adoption of the Air Commerce Act in 1926, the Federal Government has exercised a vital role in the development of the country's air transportation system. The Federal Government has directly subsidized air carriers, financed aircraft development and airport construction, and has maintained and operated important elements of the airway system.

Initially, the posture of the Federal Government was clearly one of subsidizing the development of airports and the airway system through general revenue appropriations. The cost of the federal programs was, thus, assessed against the populace as a whole, through general taxes, rather than the specific users of airport facilities and the airway system. Air transportation was a new industry and could not be expected to sustain, in its infancy, the full financial burden of the extensive capital expenditures that were then needed.

As the air transport industry grew and achieved maturity, it was recognized that it was no longer appropriate to defray from general revenues the Federal Government's costs for the development, operation and maintenance of airports and the airway system. Over a period of years, the Congress has, accordingly, adopted a series of air transportation excise taxes as "user charges" designed to collect those federal costs from the users of airports and the airway system. Thus, the Tax Rate Extension Act of 1962 dropped the general excise tax of 10 percent on passenger transportation, which was originally enacted during World War II as a revenue measure. But it retained a 5 percent tax on air passenger transport as a user charge. The 5 percent user tax was made permanent by the Excise Tax Reduction Act of 1965. More generally, the latter Act reflected an attempt to eliminate use of excise taxes as general revenue measures and instead, in the words of your Committee's report on the Act, to "restrict continuing Federal excises to taxes in the nature of benefit charges (primarily those devoted to the highway trust fund), sumptuary excises on alcoholic beverages and tobacco products, and items taxed for regulatory purposes."

The fullest implementation of the user charge concept as regards air transportation taxes was achieved in the Airport and Airways Development Act of 1970. This aspect of the Act was summarized in the report of the Committee on Interstate and Foreign Commerce as follows:

> "To provide additional revenue for the financing of the increased Government outlays for the expansion and development of the airport and airway system, the administration proposed new and increased air user taxes to pay for an increasing portion of the total Government expenditures for the air transportation system. Without the new and increased user taxes, the general taxpayer would be required to finance most of the cost of the system through general fund appropriations, if the need is to be met. . . . The Ways and Means Committee agreed that the users of the Federal aviation system could properly pay for a greater share of the cost than at present, and that the goal should be for the civil part of this system to eventually become self-sustaining from the air user taxes. As indicated in table 2, the civil share deficit is expected to decline from about $375 million in Fiscal 1971 to about $36 million in Fiscal 1979."

Section 208 of the Airport and Airways Development Act of 1970 created the Airport and Airway Trust Fund. Section 208(f) provided that amounts in the trust fund were to be available, as provided by appropriation acts, to defray (1) expenses incurred under Title I of the Act, (2) expenses incurred under the Federal Aviation Act of 1958 and attributable to planning, research and development, construction or operations and maintenance of air traffic control, air navigation, communications, or supporting services for the airway system, and (3) those portions of the administrative expenses of the Department of Transportation which are attributable to activities described in (1) and (2). In short, section 208(f) contemplated that the receipts of the trust fund would be broadly available to meet the civil part of the government's expenditures for the air transportation system. This was, of course, consistent with the statement of Congressional intent previously quoted from the report of the Interstate and Foreign Commerce Committee.

In fact, however, the Airport and Airway Trust Fund operated under the principles adopted in 1970 only during the 1971 and 1972 Fiscal Years. The Airport and Airways Development Act was amended in 1971 to severely restrict the expenditures that could be made out of the trust fund, and it is that change in the original provisions that is responsible for the greatest part of the present substantial surplus in the trust fund.

To see what happened, it is sufficient to examine the treatment of operation and maintenance expenses. Prior to the 1971 amendment, trust funds could be used to pay the operation and maintenance expenses of the air traffic and navigation system. Appropriations totaling $1,023 million were authorized from the trust fund for such expenses through Fiscal Year 1972. As a result of the 1971 amendment, these activities have been funded, beginning with Fiscal Year 1973, from general fund revenues.

The significance of the change for the financial condition of the trust fund is readily apparent from a comparison of the experience of the trust fund during its first two years (Fiscal Years 1971 and 1972) with that of the following three years (Fiscal Years 1973-1975).

	Fiscal Years 1971-1972 ($ millions)	Fiscal Years 1973-1975 ($ millions)
Receipts		
Net user tax receipts	$1,211	$2,561
Federal payment to fund	647	73
Transfers of general fund balances	876	- 4
Interest		124
Total receipts	$2,735	$2,759

	Fiscal Years 1971-1972 ($ millions)	Fiscal Years 1973-1975 ($ millions)
Expenditures		
Operations	$1,078	$ 80
Grants in aid for airports	167	767
Facilities and equipment	345	752
Research and development	85	198
Other	1	1
Total expenditures	$1,677	$1,800

But for the transfer to the trust fund in Fiscal Year 1971 of previously appropriated but unexpended general revenue account balances and the transfer to the fund in Fiscal Year 1972 of a federal payment from general revenues, the trust fund would have been in deficit at the end of Fiscal Year 1972. As previously indicated, it was not anticipated under the 1970 legislation that the fund would become self-sufficient until 1979, and the legislation therefore provided for just such transfers in order to bridge the gap between revenues and expenses. If operation and maintenance expenses had not been shifted from the trust fund to general revenue financing, payments into the trust fund from the general revenues would have been required during the last three fiscal years in accordance with the original plan; and there would be no significant trust fund surplus. The effect of the 1971 amendments was instead to peg expenditures below net tax receipts, with the predictable result that the trust fund is experiencing a mounting surplus.

Tax Policy

It is the existence of the trust fund surplus, which stood at over $2.3 billion at the end of February on a cash basis and which had uncommitted balances at the end of Fiscal 1975 of $890 million, that presents the question "whether the taxes currently dedicated to [the] trust fund should be continued at existing levels, reduced, or otherwise modified." But the answer to that question lies not in the financial condition of the trust fund but in the basic principles of economic and tax policy that have led over the years to the adoption of the present user taxes on air transportation.

The user charge concept, which has been reaffirmed by every President since Harry Truman, is grounded in basic principles of fair competition, fair taxation, and efficient allocation of resources.

-- Fair Competition. Air carriers compete with water, rail and road carriers for passengers and freight. Requiring each mode of transportation to bear its share of the cost of federally provided transport facilities is necessary to ensure fair competition.

-- Fair Taxation. The cost of special services and facilities should be borne by those who use them and thereby reap the benefits rather than the general taxpayer, where the persons benefitted are fully able to pay. That is, the users should pay unless there is some overriding justification for redistributing income from the general taxpayer to the users.

-- Efficient Allocation of Resources. If users of special services or facilities are not required to pay their share of the costs, the market system for matching demand and supply at a price reflecting value to the purchaser and cost to the supplier will be inoperative. The users will demand more of the services or facilities than they would if the price fully reflected the cost, and resources will be shifted from more productive activities to the special services or facilities.

These reasons for assessing air transportation user charges are independent of the existence of a surplus in the trust fund. The trust fund is a useful accounting mechanism to emphasize the direct relationship between the costs of the system and the receipts from the user charges. It also assures that the user charges are expended for the purposes for which they were collected. But the principles of fair competition, fair taxation, and efficient allocation of resources would require the levying of user charges at least at the present levels even if no trust fund had been created.

While we conclude that the existence of the trust fund surplus is not grounds for reducing the present air transportation user charges, we recognize that the existence of a very substantial and mounting surplus creates practical political problems. For one thing it makes more difficult resistence to pressures to expend larger sums for the purposes authorized under the trust fund provisions, over and above the sums actually needed or that would be justified in terms of the Nation's overall priorities.

The preferable solution would, of course, be to return to the precepts underlying the 1970 legislation and to authorize the use of trust fund monies for the operation and maintenance of the airway system. The Administration, however, is seeking only the expenditure of trust fund monies for the maintenance of the facilities of the airway system.

One final tax policy issue should be noted. This concerns the allocation of air transportation user charges among different classes of users, for example as between general aviation and commercial aviation. In principle, each user should pay his individual allocable portion of the total costs. Such exactness is, of course, impossible; it is necessary here, as elsewhere, to accommodate the competing claims of equity, simplicity and administrative convenience. The air transportation user taxes are, thus, a combination of ticket taxes, fuel taxes, annual license taxes, and international departure taxes designed to allocate the charges equitably among different classes of users. This allocation takes into account the fact that the costs of the system are partly dependent on usage and partly attributable to the necessity to have facilities available on a standby basis to meet peak demands on the system. For example, the justification for an annual license fee is that the cost of maintaining peak demand capacity should be allocated among all users, independently of the actual use of the airways by each licensed aircraft. More generally, the determination of the appropriate user tax burdens for different classes of users requires an allocation of costs among users, which presents difficult engineering and economic issues that fall mainly in the province of the Department of Transportation rather than the Department of the Treasury.

Financial Condition of Trust Fund

Attached to this statement is an analysis of the accumulated receipts and expenditures of the Airport and Airway Trust Fund through February 29, 1976. As previously noted, the cash balance in the trust fund at the end of February was in excess of $2.3 billion and the uncommitted balance at the end of Fiscal 1975 was $890 million.

Conclusion

As a result of a sustained effort over many years, your Committee in cooperation with several different Administrations has put in place a combination of air transportation user taxes that have tried to implement sound principles of fair competition, tax equity, and economic efficiency. We urge the Committee not to abandon the ground thus gained and to maintain essentially the present level of user tax revenues. The solution to the trust fund surplus lies, we believe, in returning at least part way to the precepts of the 1970 legislation by authorizing use of trust fund monies for the maintenance of the facilities in the airway system.

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AIRPORT AND AIRWAY TRUST FUND
RECEIPTS AND EXPENDITURES

CUMULATIVE THROUGH FEBRUARY 29, 1976

	Cumulative through June 30, 1975	July 1, 1975 through February 29, 1976	/ Cumulative through February 29, 1976
I. RECEIPTS:			
A. Excise Taxes (Transferred from General Fund)	$ 118,128,597.78	16,618,377.00	$ 134,746,974.78
1. Any liquid fuel other than gasoline	8,220,000.00	540,000.00	8,760,000.00
2. Tires used on aircraft	1,380,000.00	70,000.00	1,450,000.00
3. Tubes used on aircraft			
4. Gasoline:	6,200,000.00	800,000.00	7,000,000.00
a. Commercial 4 cents tax	68,221,531.76	7,578,576.00	75,800,107.76
b. Non-commercial 4 cents tax	49,878,717.73	5,681,432.00	55,560,149.73
c. Non-commercial 3 cents tax	3,009,581,797.48	520,198,798.26	3,529,780,595.74
5. Transportation by Air, seats, berths, etc	232,818,321.87	33,043,159.00	265,861,480.87
6. Use of international travel facilities	187,330,762.01	29,195,009.00	216,525,771.01
7. Transportation of property, cargo.	98,682,468.20	15,472,124.17	114,154,592.37
8. Use of civil aircraft			
Total Tax Receipts	3,780,442,196.83	629,197,475.43	4,409,639,672.26
B. Less reimbursement to General Fund-Refund of Taxes and Estimated Tax Credits:			
1. Commercial Aviation Gasoline	5,600,000.00	900,000.00	6,500,000.00
2. Non-Commercial Gasoline	917,211.21	40,475.42	957,686.63
3. Civil Aircraft	1,719,244.28	211,520.99	1,930,765.27
4. Any Liquid Fuel other than Gasoline	102,933.96	299,483.39	402,417.35
Total Reimbursement for Tax Refunds	8,339,389.45	1,451,479.80	9,790,869.25
Net Tax Receipt	3,772,102,807.38	627,745,995.63	4,399,848,803.01
C. Federal Payments	720,279,000.00	-0-	720,279,000.00
D. Transfers from the General Fund 1/	873,032,809.39	-0-	873,032,809.39
E. Interest income	124,064,291.36	68,984,674.63	193,048,965.99
Net Receipts	5,489,478,908.13	696,730,670.26	6,186,209,578.39
II. EXPENDITURES:			
A. Federal Aviation Administration			
1. Operations	1,158,667,454.04	530,861.97	1,159,198,316.01
2. Grants-in-aid for airports	934,182,023.59	215,818,107.96	1,150,000,131.55
3. Facilities and Equipment	1,098,057,298.91	128,192,666.04	1,226,249,964.95
4. Research and Development	283,121,415.28	47,488,806.96	330,610,222.24
B. Aviation Advisory Commission - Salaries and Expenses	1,940,670.19	-0-	1,940,670.19
C. Interest on refund of taxes	71,417.55	13,725.97	85,143.52
Total Expenditures	3,476,040,279.56	392,044,168.90	3,868,084,448.46
II. BALANCE END OF PERIOD	2,013,438,628.57	304,686,501.36	2,318,125,129.93

ASSETS HELD BY THE DEPARTMENT OF THE TREASURY

ASSETS:

Investments in public debt securities:			
Government account series, Treasury certificates of indebtedness, Airport and Airway Trust Fund series maturing June 30:			
6 5/8% of 1976	$1,936,148,000.00	$ 49,129,000.00	$1,887,019,000.00
6 3/4% of 1976	-0-	404,917,000.00	404,917,000.00
Total Investments, par value	1,936,148,000.00	355,788,000.00	2,291,936,000.00
Undisbursed balance	77,290,628.57	-51,101,498.64	26,189,129.93
Total Assets	2,013,438,628.57	304,686,501.36	2,318,125,129.93

1/ Unexpended balances of certain General Fund accounts transferred to the trust fund pursuant to the Airport and Airway Revenue Act of 1970, section 280(c).

U. S. Treasury Department Bureau of Government Financial Operations Trust & Revolving Funds Branch

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FOR IMMEDIATE RELEASE

Contact: S. Cox
Extension 2861

April 8, 1976

TREASURY AMENDS ELIGIBILITY REQUIREMENTS FOR PARTICIPATION IN TREASURY'S MINORITY BANK DEPOSIT PROGRAM

Secretary of the Treasury William E. Simon announced today that the Treasury has amended eligibility requirements for banks seeking to participate in the minority bank deposit program administered by the Treasury to include banks that meet the following criteria:

1. More than 50 percent of the bank's stock is owned by women;

2. The majority of the Board of Directors are women; and

3. A significant percentage of women hold senior management positions.

Heretofore, banks whose stock is more than 50 percent owned by members of minority groups or which are independently controlled by minority group members were eligible to participate in the program. Thus, today's action enlarges the universe of banks eligible to participate.

The minority bank deposit program was established in 1970 to help carry out the objectives of the Federal Minority Business Enterprise Program, that is, to provide opportunity for full participation in our free enterprise system by socially and economically disadvantaged persons. Secretary Simon said that it is clear beyond doubt women have not had the opportunity to participate fully in the ownership and management of banks and that the purpose of the new criteria for Treasury's minority bank deposit program is to build on the intent of Executive Order 11625 while also serving two other objectives. First, a bank meeting the new criteria will inherently be more likely to assure equal credit opportunities for women and thereby assist in carrying out the intent of the Equal Credit Opportunity Act (15 U.S.C. 1691). Second, while improvement in the number of women in senior banking positions has been achieved by Treasury as part of its contract compliance efforts pursuant to Executive Order 11246, the present action also serves as affirmative action in this direction.

The Secretary announced that upon adoption of the new requirements, The First Women's Bank of New York had been added to the list of banks participating in the minority bank deposit program.

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WS-777

April 12, 1976

Attached is a preliminary analysis on "U. S. Taxation of the Undistributed Income of Controlled Foreign Corporations," prepared by the Office of International Tax Affairs of the Treasury Department, for consideration by the House Ways and Means Committee Task Force on the Taxation of Foreign Income.

The analysis does not represent an Administration position and does not contain recommendations.

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WS-778

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U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations

Department of the Treasury
April 1976

PREFACE

This preliminary analysis was prepared by Gary Hufbauer and David Foster of the Office of International Tax Affairs for consideration by the House Ways and Means Committee Task Force on the Taxation of Foreign Income. The analysis does not represent an Administration position and does not contain recommendations. In the event that the Task Force recommends legislation, it is anticipated that the Treasury Department will comment on those recommendations.

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I. ISSUE

Since the introduction of the Federal income tax in 1913, the United States has employed a "classical" system of taxing corporations and their shareholders. Under a classical system, corporations and their shareholders are separately taxed. A corporation's tax liability is not affected by the amount of dividends it distributes to its shareholders, and conversely (with limited exceptions) a shareholder's tax liability depends on dividends received, and is not affected by either the amount of tax paid by the corporation or by the corporation's retained earnings and profits.

These principles extend to a U.S. shareholder in a foreign corporation. No U.S. tax is imposed on the U.S. shareholder until (and unless) the shareholder receives dividends from the foreign corporation. This consequence of a classical system of taxation is called deferral, because the U.S. tax on the income of a foreign corporation is deferred until dividends are paid.

The bulk of U.S. investment in foreign corporations is undertaken, not by individual shareholders, but by U.S. based multinational enterprises. So long as earnings are retained abroad by foreign corporate subsidiaries, the U.S. parent corporation pays no U.S. tax on the foreign

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income.[1/] If taxable corporate earnings are defined the same way abroad as in the United States, and if the host government applies a tax rate lower than the U.S. corporate tax rate of 48 percent, the difference in rates represents a temporary tax saving to the parent corporation.

Multinational firms based in the United States argue that deferral is necessary to allow them to compete on even terms with foreign firms. In their view, tax neutrality requires the same rate of taxation on all firms operating in the same country. The U.S. multinational firms suggest that the termination of deferral would bring about changes in foreign tax practices and dividend distribution rates that would erode or eliminate U.S. tax revenue gains, and that, without deferral, the foreign expansion of U.S. firms would be curbed, profits and U.S. tax revenues might decline, and U.S. exports to foreign markets might fall.

Others object that deferral enables foreign investment to enjoy tax advantages not available for domestic investment. In this view, tax neutrality requires the same taxation of investment at home and investment abroad. Expressing concern for the impact of foreign investment on American jobs, and the loss of potential tax revenue, labor groups

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1/ The foreign subsidiary may pay interest, royalties, and management fees to the U.S. parent corporation, and these types of income would, of course, be taxed currently by the United States.

in particular have questioned the continuance of deferral. This concern was expressed most strongly in the late 1960s and early 1970s. Since 1972, a system of flexible exchange rates and the DISC legislation have, to some extent, answered the concern over foreign tax advantages.

II. PRESENT LAW

1. Classical system of taxation. Under present law, a corporation and its shareholders are taxed separately. The corporation is taxed on its earnings; the shareholders are taxed on distributed dividends. This known as a "classical" or separate entity system of taxation. By contrast, under an "integrated" system of taxation, either the taxes imposed on the corporation are claimed (in whole or part) as a tax credit by the shareholder, or the corporation is allowed a reduced tax rate on dividends paid. Britain, France, Germany, Canada, Japan, and other industrial countries have adopted various types of integrated tax systems. The Administration has proposed an integrated system for the United States, and the proposal is now under Congressional consideration.

Over the years, the United States has made limited exceptions to its separate entity system of taxation. Certain exceptions are intended to recognize the economic unity of an affiliated group of corporations within the United States, to avoid double taxation when dividends are distributed from one corporation to another, or to encourage small business. Other exceptions are intended to discourage

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tax abuse by individuals investing in domestic or foreign corporations. Subpart F is principally designed to discourage tax abuse by U.S. corporations which control foreign corporations.

2. Exceptions to recognize economic reality and avoid double taxation.

(a) Consolidated return. Under specified circumstances (Section 1501), related domestic corporations are permitted to file a consolidated return. The consolidated return recognizes the economic unity of a corporate group. Through the mechanism of a consolidated return, the profits of one domestic corporation may be used to offset the losses of another. In this way, related corporations can share their investment risks.1/ A foreign corporation cannot, however, join a consolidated return.2/

(b) Dividends received deduction. Dividends distributed from one domestic corporation to another are entitled to an 85 percent or 100 percent dividends received deduction, depending on the extent of affiliation between the two corporations (Section 243). The purpose of the dividends received deduction is to avoid double taxation at the corporate level. Dividends received by a domestic corporation from

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1/ Only one surtax exemption can be claimed on the consolidated return.

2/ Certain contiguous country corporations, defined under Section 1504(d), are allowed to join a consolidated return.

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a foreign corporation are not eligible for the deduction.[1]

(c) Subchapter S. Under Subchapter S (Sections 1371-1379) certain small corporations can elect to be treated for tax purposes much like a partnership. If an election is made, there is no corporate tax, all earnings (whether or not distributed) are taxed to the shareholders, and losses can be claimed as a deduction by the shareholders. The purpose of Subchapter S is to encourage small business.

3. Exceptions to discourage tax abuse by individuals.

(a) Accumulated earnings tax. The Revenue Act of 1913 contained the antecedents of today's accumulated earnings tax (Section 531). This is a penalty tax imposed on a corporation when it unreasonably accumulates earnings for the purpose of shielding shareholders from personal income taxation.

(b) Personal holding company tax. In 1934, Congress enacted the personal holding company tax (Sections 541-547). This is a penalty tax on the undistributed personal holding company income of a corporation that receives at least 60 percent of its adjusted ordinary gross income from passive investment sources and certain types of personal services,

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1/ The dividends received deduction is available for dividends paid by a foreign corporation which earns at least 50 percent of its gross income from a U.S. trade or business (Section 245).

and is owned to the extent of more than 50 percent in value by five or fewer individuals. The tax applies to the corporation and not to the shareholders. The tax can be mitigated if the corporation declares a "deficiency dividend."

(c) Foreign personal holding company. In 1937, Congressional investigation brought to light the formation of "incorporated pocketbooks" abroad by United States citizens. These corporations, designed to collect and retain passive investment income, were domiciled in countries, such as the Bahamas and Panama with little or no corporate income tax. As foreign corporations, they could not be effectively taxed either on their accumulated earnings or as personal holding companies.

The Congressional remedy was to enact the foreign personal holding company legislation (Sections 551-558) which taxes each U. S. shareholder on his pro rata share of the foreign corporation's undistributed income. Certain tests must be met before the foreign corporation is characterized as a foreign personal holding company. At least 60 percent of its gross income must be derived from passive sources (dividends, interest, rents, royalties, capital gains, income from an estate or trust, personal service income and certain other items), and more than 50 percent in value of the stock must be owned by not more than five U.S. individuals. When these tests are met, each shareholder is deemed to receive a distribution from the foreign personal holding company, and deferral of U. S. tax liability on the foreign income is effectively precluded.1/

The foreign personal holding company legislation did not reach foreign investment companies that sold shares widely among U. S. individuals. Such companies, domiciled in low-tax jurisdictions, could thus retain their dividend and interest income free from U. S. tax. The shareholders could later realize the income in the form of capital gains, if and when the shares were sold.

The Revenue Act of 1972 abolished this device in one of two ways. Either the gains realized by the shareholder on disposition of the stock would be taxed as ordinary income to the extent of accumulated earnings (Section 1246), or the foreign investment company could enter a binding election to distribute at least 90 percent of its income annually (Section 1247).

4. Exceptions to discourage tax abuse by corporations.

(a) Section 367. The Internal Revenue Code permits numerous types of tax-free corporate reorganizations. One corporation may acquire another, a subsidiary may merge into a parent, or a corporation may divide into several

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1/ The individual shareholders are not permitted to claim a credit for any foreign corporate income tax paid. The deemed paid credit (Section 902) is only available to U.S. corporations.

parts, all without creating a taxable event. The underlying philosophy is that, so long as assets remain in "corporate solution", and are not distributed to individual shareholders, reorganization is a matter of economic convenience for the firm and need not provide an occasion for taxation.

Reorganizations that involve foreign corporations create an exception to this basic philosophy. The concern arose very early that domestic or foreign corporate income that had not previously been taxed by the United States could forever leave its tax jurisdiction through corporate reorganization. In 1932, the predecessor of Section 367 was enacted. It prevents tax-free exchanges involving foreign corporations unless "it has been established to the satisfication of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

In any reorganization involving a foreign corporation, the U.S. taxpayer must first obtain a Section 367 ruling from the Internal Revenue Service that the exchange is not in pursuance of such a plan, or the transaction will be treated as a taxable event. Often the taxpayer must pay a "toll charge", involving partial recognition of the gain, in order to receive a favorable Section 367 ruling. The ruling might also be accompanied by a closing agreement which preserves the U.S. tax base (Revenue Procedures 68-23 and 75-29).

(b) Subpart F and its exclusions. The early anti-abuse provisions were addressed to situations where an individual U. S. shareholder took advantage of lower U. S. or foreign corporate tax rates, or where a U. S. corporation took advantage of the tax-free reorganization provisions. The Revenue Act of 1962 partially terminated deferral in answer to the tax abuse which may arise when a U. S. parent corporation takes advantage of lower foreign corporate tax rates on ordinary income in tax haven countries.

The Kennedy Administration originally sought the complete termination of deferral, but Congress adopted a more focused approach. The history and drafting of subpart F (Sections 951-964) indicate that it represents a compromise between the complete termination of deferral and the classical system of taxing foreign corporate income. The purpose of subpart F is to terminate deferral in tax abuse situations, yet otherwise retain the separate taxation of a foreign corporation and its U. S. shareholders.

Subpart F, as enacted in 1962, taxes U.S. shareholders currently on the income of a controlled foreign corporation

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when the nature of the corporation and its sources of income combine to exhibit tax haven characteristics. The foreign corporation is potentially subject to subpart F if it is a controlled foreign corporation (CFC), that is to say, if the voting stock is more than 50 percent owned by U. S. "shareholders", defined as individuals or corporations each controlling at least 10 percent of the voting stock.[1/]

If the foreign corporation can establish that it did not have as one of its purposes a substantial reduction in taxes (Section 954(b)(4), it will not fall within Subpart F. The substantial reduction test is not defined with reference to U.S. taxes. Rather the test is whether taxes have been reduced by comparison with the taxes that would have been imposed by the buying or selling country, or the paying or receiving country, if a third country corporation had not been interposed in the transaction (Regulations 1.954-1(b)(4), example (1)). A company which was not organized with tax reduction as one of its significant purposes can, however, still have subpart F income on individual transactions undertaken for the purpose of tax avoidance.

A controlled foreign corporation's income is subject to subpart F if it is derived from the insurance of U. S. risks, or if it is characterized as foreign base company income. Foreign base company income includes: (i) foreign

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1/ In the case of a controlled foreign corporation that insures U.S. risks, the test is whether more than 25 percent of the voting stock is owned by U.S. shareholders. (Section 957(b)).

personal holding company income (interest, dividends-rents, and similar categories of passive income); (ii) foreign base company sales income (income derived by the CFC from selling or buying personal property to or from a related person, if the property is both produced and sold for use outside the country in which the CFC is incorporated); and (iii) foreign base company services income (income derived from the performance of technical, managerial, or similar services or on behalf of a related person outside the country of CFC incorporation).

When the foreign corporation and the composition of income meet these statutory tests, the U.S. shareholders are generally deemed to receive a distribution of retained earnings and are taxed accordingly, with provisions for a foreign tax credit (Sections 960 and 962). As a backstop to subpart F, the Revenue Act of 1962 required that when a U.S. shareholder disposes of shares in a controlled foreign corporation, the gains must be reported as ordinary income to the extent of earnings and profits accumulated after 1962 (Section 1248).[1/] This provision forestalls the

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1/ An exception was made for the disposition of shares in a less developed country corporation (Section 1248(d)(3)).

accumulation of earnings in a CFC not subject to subpart F, and the taxation of that income at more favorable capital gains rates.

The Revenue Act of 1962 provided several exclusions to the general rule of current U. S. taxation of subpart F income. The Tax Reduction Act of 1975 repealed or modified four of the exclusions and added one new exclusion.

(i) Minimum distribution. The parent corporation could elect a so-called "minimum distribution". The minimum distribution was a constructive distribution of earnings from CFCs with and without subpart F income. If the minimum distribution showed that average foreign taxes were equal to a certain percentage or within certain percentage points of the U. S. tax rate, the deemed distributions under subpart F were reduced or eliminated. The minimum distribution election was repealed by the Tax Reduction Act of 1975.

(ii) Less developed country corporations. The subpart F income of a CFC derived from and reinvested in "qualified investments" in less developed countries was excluded from the definition of foreign base company income. Less developed countries were broadly defined to include all nations outside of industrial Europe, Canada, Japan, Eastern Europe, and the Sino-Soviet bloc. This exclusion was repealed by the Tax Reduction Act of 1975.

(iii) 30-70 rule. If less than 30 percent of CFC income was characterized as foreign base company income, then a special rule provided that none of the income would retain that character and no deemed distribution was required. If between 30 and 70 percent of the income was characterized as foreign base company income, then the actual percentage would have that character and that percentage would be subject to a deemed distribution. Above 70 percent, the entire CFC income would be characterized as foreign base company income and would be deemed distributed. The Tax Reduction Act of 1975 changed the 30 percent rule to a 10 percent rule.

(iv) Shipping income. As originally enacted, subpart F provided an exclusion from foreign base company income for income derived from, or in connection with, the use of any aircraft or vessel in foreign commerce. The Tax Reduction Act of 1975 required that shipping income be reinvested in shipping operations to qualify for this exclusion.

(v) Agricultural sales. The Tax Reduction Act of 1975 modified the definition of foreign base company sales income to exclude income from sales of agricultural commodities which are not grown in the United States in commercially marketable quantities. The Tax Reform Act of 1975, H. R. 10612, passed by the House and now under consideration by the Senate, would broaden this exclusion to cover agricultural products which are significantly different in grade or type from agricultural products grown in the United States.

III. ANALYSIS

1. International tax neutrality. Tax neutrality is a broad concept which is often defined in conflicting ways. Whether foreign corporate income is taxed by the United States currently or only when dividends are distributed is one element in a definition of international tax neutrality, but it is not the only element. The relationship between deferral and international tax neutrality must be viewed in the overall context of U.S. and foreign tax rules.

Tax neutrality at the corporate level[1/] for foreign investment can be defined either with reference to the taxation of domestic profits, or with reference to the taxation of the profits of competing foreign firms. These alternative standards are usually designated as "capital-export neutrality" and "capital-import neutrality". In their pure forms, the concepts of capital-export neutrality and capital-import neutrality say nothing about the division of tax revenue between home and host country tax authorities. In principle, either type of neutrality could be reached consistent with various revenue sharing arrangements between the taxing authorities. In practice, under present international rules, each type of neutrality tends to be associated with a certain division of revenue.

1/ This paper does not analyze tax neutrality at the individual level.

Capital-export neutrality is achieved when the <u>total</u> rate of corporate tax on foreign profits is the same as on comparable domestic profits. For example, if the French subsidiary of an American firm pays 40 percent of its profits in tax to France, and if the United States corporate tax rate was a uniform 48 percent, capital-export neutrality would be served by a current U. S. corporate tax of 8 percent on the French subsidiary's profits.

In order to achieve capital-export neutrality under existing domestic tax law, several underlying conditions must be met.

> First, host country taxes paid should be credited against the home country tax liability, with the refund of excess foreign taxes; alternatively, home country taxes should be credited against the host country tax liability;
>
> Second, foreign income, including undistributed subsidiary earnings, should be taxed currently to the parent corporation by the home country;
>
> Third, the home country should employ the same accounting practices in calculating domestic and foreign profits (in particular, the same depreciation conventions should be used);
>
> Fourth, any capital subsidies provided for investment in the home country (for example, an investment tax credit) should be available for investment abroad. Similarly, preferential taxation of export earnings, such as the DISC, should be extended to foreign production;
>
> Fifth, the same treatment should apply to sub-Federal income taxes levied at home and abroad. If state and local taxes are deductible at home, then to the same extent they should be

deductible in computing taxable foreign source income;

Sixth, losses of foreign subsidiaries should be deductible to the same extent as the losses of the parent companies.

Capital-export neutrality could alternatively be achieved under a domestic tax law which was free of all corporate tax preferences, and instead taxed corporate income at a uniformly lower rate. In order to achieve capital-export neutrality under such a neutral domestic tax law, several conditions must be met, many the same as before.

First, (and this is the main difference), tax preferences for domestic corporate income must be repealed, and nominal corporate tax rates must then be lowered so that there is no net revenue change from the taxation of domestic income;

Second, host country taxes paid should be credited against the home country tax liability, with the refund of excess foreign taxes; alternatively, home country taxes should be credited against the host country tax liability;

Third, foreign income should be taxed currently by the home country;

Fourth, the home country should employ the same accounting practices in calculating domestic and foreign profits;

Fifth, the same treatment should apply to sub-Federal income taxes levied at home and abroad;

Sixth, losses of foreign subsidiaries should be deductible to the same extent as the losses of the parent companies.

A regime of capital-export neutrality, whether achieved under existing domestic tax law or under a neutral domestic tax law, would, unlike present law, encourage U.S. firms to locate their productive facilities wherever pre-tax returns promised to be greater. A firm would be indifferent between a 20 percent pre-tax rate of return on investment in Canada, in Brazil, or in the United States, for it would receive the same after-tax return in all cases. Tax considerations would play no role in investment decisions, pre-tax returns on U.S. investments of equivalent risk would ultimately be equalized around the world, and the United States capital stock would be allocated in a manner designed to maximize world production.[1/]

Capital-import neutrality for corporate investment is achieved when firms of all nationalities operating in one industry -- for example, the Italian office equipment industry -- pay the same total tax rate on profits earned in the country where the industry is located -- in this case Italy.[2/] Pure capital-import neutrality in this

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1/ This statement ignores the misallocation caused by tariffs, quotas, and other impediments to free international trade.

2/ When a host country has an integrated system of taxing corporations and their shareholders, the analysis of capital-import neutrality can become more complicated. This discussion envisages a host country with a classical separate entity system of taxation.

situation would emerge if Italian tax law made no differentiation among enterprises of diverse national origin. For example, Italy could not withhold tax on dividends, interest, and royalties paid to foreign corporations unless it also withheld tax on such payments to Italian corporations. Furthermore, foreign nations should make no attempt to impose an additional tax on corporate earnings arising in Italy. Indeed, one way of achieving capital-import neutrality is through the unilateral exemption of corporate foreign source income from domestic taxation, as is virtually done by France and the Netherlands.[1/] Under territorial taxation, as this approach is called, the home government relinquishes all tax claims, and the host government collects all the tax revenues arising from the enterprise. However, a revenue sharing arrangement between the host and home countries would equally be consistent with capital-import neutrality.

Capital-import neutrality is sometimes called "competitive" neutrality, because firms of diverse national origin compete on an equal tax basis in any particular country and industry. Because tax considerations do not distort competition, capital-import neutrality promotes the most efficient use of resources between firms in that country and industry.

1/ France and the Netherlands do tax a small portion of corporate foreign source income.

Both in legislation and in bilateral tax treaties, the United States has attempted to ensure the type of tax neutrality appropriate to different situations, while at the same time protecting U.S. sources of tax revenue. Thus, United States taxation of the foreign income of U.S. owned firms embodies a mixture of capital-export neutrality, capital-import neutrality, and revenue protection clauses.

The keystone of U.S. taxation of American enterprise abroad is the foreign tax credit. Subject to certain limits, U.S. firms may take a credit against their tentative U.S. tax for the foreign income tax levied on the repatriated earnings of foreign corporate subsidiaries[1/], on the total earnings of foreign branches, and on interest, rents, royalties and fees paid from foreign sources. The foreign tax credit essentially cedes to the host country the first slice of tax jurisdiction, and hence most of the revenue. To the extent that a U.S. firm repatriates dividends, interest, rents, royalties or fees from its foreign corporate subsidiary, or operates abroad through foreign branches, the foreign tax credit may come close to ensuring capital-export neutrality.

1/ There is both a direct credit (Section 901) for foreign withholding taxes on dividends, and an indirect credit (Section 902) for foreign taxes paid on the underlying corporate earnings.

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There are several reasons why the foreign tax credit does not achieve capital-export neutrality under existing law. The U.S. foreign tax credit limitation rules operate so that when foreign taxes exceed the tentative U.S. tax on foreign source income, the excess foreign tax credit cannot be claimed currently (but it can be carried forward or carried back to other taxable years). If the excess credit could be claimed without limit, foreign governments could erode U.S. tax revenues on domestic source income. But because the excess foreign tax credit cannot be claimed, capital-export neutrality disappears whenever the foreign tax rate exceeds the U.S. rate. Foreign investment offering a given pre-tax return then becomes less attractive than domestic investment offering the same return.

In addition to the foreign tax credit limit, other features of the law reduce the extent of capital-export neutrality. U.S. parent corporations cannot offset the losses of foreign subsidiaries against domestic income, although the losses of foreign branches of U.S. corporations may be offset against domestic income. The investment tax credit is not available for capital expenditures abroad,[1/] and the asset depreciation range (ADR) cannot be used for

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1/ Section 48(a)(2).

computing earnings and profits of a foreign subsidiary.[1/] DISC is not available for exports by foreign subsidiaries. Like the limit on applying the foreign tax credit, these measures shield the U. S. Treasury and promote domestic investment, at the expense of capital-export neutrality. Two asymmetries, however, favor foreign over domestic investment: U. S. taxation of foreign subsidiary earnings is deferred until dividends are declared, and foreign sub-Federal taxes may be credited against the tentative U. S. tax, whereas U. S. state and local taxes can only be deducted from earnings.

To the extent that the earnings of a foreign corporate subsidiary are not remitted as dividends, United States tax practice comes close to achieving capital-import neutrality. No current U. S. tax is levied on those earnings; instead U. S. taxation is deferred until repatriation. (Under the foreign personal holding company legislation and subpart F, certain kinds of tax haven income may be taxed currently, whether or not repatriated.) When earnings are retained abroad, deferral places the American-owned

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1/ The tax rules provide that guideline periods, but not the asset depreciation range, may be applied to property predominately used outside the United States (Revenue Procedure 72-10; Regulation 1.964-1(c)(i)(iii)).

foreign subsidiary on much the same tax footing as its local competitors. Pure capital-import neutrality cannot be achieved, however, unless the United States (and other countries) abandon their claim to tax foreign source income (although home countries could seek revenue sharing arrangements with host countries) and host countries pursue a strict policy of non-discrimination.

In essence, an American multinational enterprise can elect to have its foreign ventures taxed either under a modified form of capital-export neutrality (by operating through a foreign branch or by distributing the earnings of a foreign subsidiary), or under a modified form of capital-import neutrality (by operating through a foreign subsidiary and retaining the earnings abroad). In neither case is the neutrality pure, and the level of purity partly depends on the host country.

The 1976 revenue consequences of present law, and of possible changes, are summarized in Table 1 for the non-extractive industries.1/ Corporate pre-tax foreign earnings were about $24.9 billion, foreign taxes claimed about

1/ The taxation of petroleum and hard minerals involves special considerations which do not easily fit into the concepts of capital-export neutrality and capital-import neutrality. For this reason, Table 1 is confined to the non-extractive industries.

Table 1

Estimated Tax Revenue Consequences in 1976 of Achieving Alternative Standards of International Tax Neutrality with Respect to U.S. Corporations in Non-Extractive Industries
(Millions of Dollars)

	Capital-export neutrality: With extension of U.S. domestic tax preferences to foreign investment	Capital-export neutrality: With removal of U.S. tax preferences for domestic investment	Capital-import neutrality
Foreign source income of U.S. corporations, before taxes	24,900	24,900	24,900
Present total taxes on the foreign source income of U.S. corporations under current law	12,270	12,270	12,270
Net U.S. taxes	1,970	1,970	1,970
Foreign taxes	10,300	10,300	10,300
Change in total taxes on the foreign source income of U.S. corporations in non-extractive industries	-1,590	-2,990	-1,970
Remove U.S. tax preferences for foreign investment	890	890	
Western Hemisphere Trade Corporation deduction	20	20	
Non gross-up of dividends from LDC corporations	55	55	
Deferral of tax on retained profits of foreign subsidiaries	365	365	
Allowance of credit for foreign taxes comparable to state income taxes	450	450	
Allow credit (or refund) for foreign taxes in excess of overall limitation	-180	-180	
Remove U.S. tax preferences for domestic investment and reduce U.S. corporate tax rate on domestic and foreign source income to 33 percent 1/		-3,700	
Extend U.S. domestic investment tax preference to foreign investment	-2,300		
Investment tax credit	-1,000		
Asset depreciation range	-300		
Domestic International Sales Corporation (DISC)	-1,000		
Adopt territorial income tax			-1,970
Hypothetical total taxes on the foreign source income of U.S. corporations in non-extractive industries	10,680	9,280	10,300

Office of the Secretary of the Treasury
Office of Tax Analysis

April 5, 1976

1/ After the hypothetical repeal of all U.S. tax preferences for domestic investment by the non-extractive industries, the U.S. corporate tax rate could be reduced from 48 percent to about 33 percent (on a broader base) with no change in tax revenue on domestic source income. However, there would be a revenue loss on foreign source income, since the applicable tax rate on that income would also drop from 48 percent to 33 percent.

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$10.3 billion (41 percent of earnings) and U. S. tax collections were about $2.0 billion (8 percent of earnings).

A standard of pure capital-import neutrality at the corporate level would require zero U. S. tax collections on corporate foreign source income. The adoption of a territorial system would thus involve a 1976 revenue loss of nearly $2.0 billion by comparison with present collections. This revenue loss could be unilaterally absorbed by the United States, or it could be shared between the United States and various host countries. Capital-import neutrality, in whatever manner achieved, would not of course answer those critics of deferral who wish to increase U. S. tax revenues and promote domestic investment.

A standard of capital-export neutrality under existing domestic tax law would also reduce the revenue collections of U. S. and foreign tax authorities (assuming the revenue loss is shared). In 1976, the net revenue loss from a system of pure capital-export neutrality would have been almost $1.6 billion. The net loss represents a combination of revenue effects. If the law were changed to end deferral, to provide a deduction rather than a credit for that portion of foreign taxes which correspond to U. S. state and local taxes, and to eliminate certain minor non-neutralities, there would be revenue gains. But these gains would be more than offset if the law were also changed to compensate for foreign taxes in excess of the tentative U. S. tax, and to extend the investment tax credit, the asset depreciation range and DISC to investment abroad.

A standard of capital-export neutrality under a neutral domestic tax law would likewise reduce the revenue collections of U. S. and foreign tax authorities on U. S. investments abroad. After the repeal of domestic tax preferences, and a compensating reduction in rates so that the corporate tax on domestic income remained unchanged, the nominal U. S. corporate tax rate could be reduced from 48 percent to 33.2 percent. As a result, however, current U. S. revenues from foreign source income would decline by $3.7 billion. This would be partly offset by higher revenues from the termination of deferral, from the repeal of the WHTC, from gross-up of dividends from less-developed country corporations, and from other changes. But a net revenue loss of $3.0 billion on foreign source income would remain after all adjustments.

Few would argue that the United States should unilaterally implement a standard of capital-export neutrality and incur all the associated revenue costs. Such a standard would require tax cooperation between the United States and foreign governments. On the other hand, legislation by the United States to end deferral would not, by itself, move the international tax system closer to a standard of capital-export neutrality. Rather, it would reinforce the existing preferential taxation of corporate profits earned within the United States.1/

2. Constitutional problems. The taxation of a shareholder on the constructive receipt of a corporation's undistributed earnings raises constitutional issues. Can such earnings properly be viewed as "income" under the terms of the Sixteenth Amendment? This issue has recently been litigated in connection with subpart F. The court decisions upholding subpart F provide some indication of the potential reach of U.S. law if a wider termination of deferral is sought.2/

The Sixteenth Amendment gives Congress the power to impose income taxes. If a tax is not levied on "income", it would be considered a "direct tax" under the ruling in Pollock v. Farmer's Loan and Trust (157 U.S. 429, 158 U.S. 601, 1895), and would require apportionment among the states according to population. The opponents of subpart F have relied on the Pollock opinion to argue that the current taxation of each CFC shareholder's portion of undistributed

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1/ It should be emphasized that the investment tax credit or DISC can exert a very different impact on investment per dollar of revenue cost than, for example, deferral or the foreign tax credit. Therefore, an examination of total revenue gains and losses under alternative tax systems provides only a rough guide to their impact on the location of investment.

2/ Subpart F has withstood legal attacks based on the due process clause of the Fifth Amendment, the principles of international law, and the Sixteenth Amendment. The Sixteenth Amendment issues are most important, and they are the only ones discussed here. The discussion draws on a paper by Howard Liebman.

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earnings and profits cannot possibly constitute a tax on "income" and must, therefore, be apportioned among the states as a "direct tax." The basis for this reasoning lies in the decision of Eisner v. Macomber (252 U. S. 189, 1920) holding that a stock dividend on accumulated profits is not "income" under the Sixteenth Amendment. But Macomber was a close decision and has since been undercut by numerous judicial exceptions. Thus, in 1961, the Treasury Department's General Counsel concluded that, "enactment of [subpart F] is appropriately within the constitutional powers of the Congress both to lay and collect taxes and to regulate commerce with foreign nations."1/

This view has been upheld by the Tax Court:

> The Supreme Court's pronouncements have been to the effect that taxation of undistributed current corporate income at the stockholder level is within the Congressional power.2/

Although the Supreme Court has not ruled on subpart F, other courts have endorsed the Tax Court's position. There appears to be no constitutional barrier to the termination

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1/ Memorandum from Robert H. Knight to Treasury Secretary Dillion, June 12, 1961, in President's 1961 Tax Recommendations, Hearings before the House Committee on Ways and Means, 87th Congress, 1st Session (1961), Volume 1, p. 322.

2/ Estate of Leonard E. Whitlock, 59 T.C. 490, 507 (1972); affirmed 494 F.2d 1297 (10th Circuit, 1974).

of deferral for a wider class of income than that presently defined in subpart F.

A more general termination of deferral would, however, provide an incentive for U. S. shareholders to "decontrol" their existing controlled foreign corporations and to take minority positions in new ventures rather than establish new controlled foreign corporations. The incentive to escape current taxation might be mitigated if the ownership threshold used to define a controlled foreign corporation were reduced to 50 percent or less. However, a lower threshold might conflict with the "constructive receipt" doctrine underlying both subpart F and the foreign personal holding company legislation. If the U. S. shareholders are not a closeknit, controlling group that can force the declaration of a dividend, the constitutionality of a lower threshold under the Sixteenth Amendment and the due process clause of the Fifth Amendment must once again be assessed. How can the United States tax a shareholder on an undistributed gain when the shareholder lacks the degree of control required to realize the imputed gain? It may seem "patently unfair and unjust to tax anyone on income which he has not received and which is not within his control."1/

1/ Statement of Randolph W. Thrower, Hearings before the Senate Committee on Finance, 87th Congress, 2d Session (1962) part 6, p. 2251.

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The most recent cases dealing with subpart F have indicated that actual control rather than numerical control is the key issue. In Garlock (58 T.C. 423, 1972) "actual control" by U.S. shareholders in a reorganized Panamian subsidiary was found where the U.S. shareholders only owned 50 percent, and foreign investors, chosen for their sympathy towards the management, owned callable cumulative preferred stock. Hans P. Kraus (59 T.C. 681, 1973; affirmed, 490 F.2d 898, 2d Circuit 1974) presented similar facts. The court looked to substance rather than form and concluded that divestment in order to avoid the impact of subpart F must result in actual decontrol. These and other cases suggest that subpart F could be extended to situations where U.S. shareholders own less than 50 percent of the foreign corporation, provided that U.S. shareholders exercise actual control. 1/

3. Foreign reaction. Any significant change in the U.S. approach to deferral would raise tax treaty questions and might prompt offsetting foreign tax legislation.

1/ Income from the insurance of U.S. risks earned by a foreign corporation which is owned more than 25 percent by U.S. shareholders in presently taxed under Subpart F (Section 953 and 957(b)). The 25 percent test has not been litigated, and it is not clear whether it furnishes a precedent for a less than 50 percent ownership test in the absence of actual control.

(a) Tax treaties. The United States has in force tax treaties with 37 countries. (including extensions to former colonies). Four treaties have been signed and await ratification by the U.S. Senate and foreign parliamentary bodies. Eleven tax treaties are in various states of active negotiation.

The deferral of U. S. tax on the income of controlled foreign corporations is not specifically addressed in these treaties. The U. S. has made no treaty commitments which would preclude partial or total elimination of deferral. However, the classical U. S. system of taxation and the consequent deferral of U. S. taxation of retained foreign corporate earnings are well understood by foreign tax officials, and these elements of U. S. law play an important role in treaty negotiations.

Less developed countries frequently raise the issue of a tax sparing credit. The tax sparing credit is a home country foreign tax credit for taxes waived by the host country, usually through a tax holiday or preferential tax rates designed to encourage a particular industry. The United Kingdom, France, Germany, Japan, Canada and most other industrialized countries grant a tax sparing credit in their bilateral tax treaties with less developed countries. During the 1950's and 1960's, the United States negotiated seven treaties with either a tax sparing credit (Pakistan, India, Israel, and the UAR) or, as a substitute, an investment tax credit (Brazil, Thailand, Israel). In none of the seven cases, did the credit provisions receive Senate approval. The United States Treasury no longer negotiates treaties with either a tax sparing credit or an investment tax credit.

However, in negotiations with less developed countries, the United States has emphasized that deferral does not frustrate local tax incentives. If the host country chooses to reduce its corporate tax rates as an investment incentive measure, the United States will not absorb the incentive through offsetting taxation so long as the foreign subsidiary reinvests its earnings abroad. Moreover, the U.S. ordering rule for associating dividends with earnings and profits ensures that U.S. taxes need never erode the foreign tax relief, even if earnings are distributed during the post-tax relief period. The United States follows a last-in-first-out rule in tracing dividends to the underlying earnings and profits. Thus, suppose Country X grants a five year tax holiday, and in the sixth year imposes a 45 percent tax on current earnings. During the tax holiday period, the controlled foreign corporation accumulates earnings and profits of $12 million, but distributes no dividends. In the six year, the corporation earns $3.63 million (before tax), pays foreign taxes of $1.63 million, and therefore has after-foreign-tax earnings of $2.0 million. A dividend of $2.0 million is distributed to the

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U. S. parent. The entire dividend is deemed to be paid out of current earnings, and none of the dividend is deemed to be paid out of accumulated earnings. The grossed-up dividend for U. S. tax purposes will be \$3.63 million.[1/] The net U. S. tax on the dividend, after allowance for the foreign tax credit of \$1.63 million, would be \$0.11 million.[2/]

The combination of deferral and the dividend inventory rule has proven satisfactory to many of our tax treaty partners. Developed countries have not had to negotiate the U. S. tax treatment of their own tax relief provisions for particular regions or industries. Less developed countries have often dropped their initial demands for a tax sparing credit or similar provisions. If the United States were to terminate deferral, some treaty countries would no longer be satisfied

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1/ Under present law, dividends for a less developed country corporation are not grossed-up, and a different formula is used to calculate the foreign tax credit. H.R. 10612 would require the gross-up of such dividends.

2/ In this case, the deemed paid foreign tax credit is calculated as:

$$\frac{\text{Dividend}}{\text{Earnings after foreign tax}} \times \text{Foreign corporation income tax}$$

$$= \frac{\$2.0}{\$2.0} \times \$1.63 = \$1.63$$

The tentative U. S. tax before the credit would be 48 percent of \$3.63 million, or \$1.74 million. After the foreign tax credit of \$1.63 million, the net U. S. tax would be \$0.11 million.

with existing arrangements. They might seek new negotiations with a view toward provision of deferral by treaty. Alternatively, they might take unilateral statutory steps along the lines discussed below.

(b) Foreign statutory change. If the United States limits the extent of deferral, countries which provide tax relief as an incentive measure might narrow the scope of that relief to exclude companies which would be subject to current U. S. taxation. The result could be heavier foreign taxation of U. S. controlled foreign corporations, by comparison with competing firms either owned locally or by third country parent firms. In selected instances, heavier foreign taxation might serve to equalize the taxation of U. S. investment at home and abroad, but it would erode the potential gains in U. S. tax revenue from the termination of deferral, and it might put U. S. firms at a severe competitive disadvantage.

There are several ways foreign taxes on U. S. controlled foreign corporations could be selectively increased. Subsidiaries of U. S. corporations might no longer be eligibile for special tax holidays and investment tax credits. Egypt, for example, under present law provides tax relief for foreign investors only if the home country does not tax the income either when earned or distributed. Alternatively, withholding taxes could become payable on deemed dividend distributions, as well as on actual dividend distributions, and withholding tax rates could be increased.

In cases where the foreign country wished to encourage U. S. firms, methods could be found which would circumvent the U. S. termination of deferral. The foreign country could provide tax relief for joint ventures in which the U. S. corporation held a minority interest, and therefore was not subject to current U. S. taxation. Alternatively, the foreign country could provide U. S. controlled corporations with input incentives -- for example wage or energy subsidies -- while taxing the CFCs at rates close to the U. S. corporate rate. This possibility is illustrated in Table 2.

In both situations, the firm has sales of 1,000, raw material costs of 400, and wage costs of 500. In Case A, with U. S. deferral, a tax holiday in the foreign country ensures that the firm realizes after-tax income of 100. In Case B, without U. S. deferral, a wage subsidy of 100 coupled with a foreign corporate tax of 50 percent ensures that the firm still realizes after-tax income of 100.[1/]

1/ The wage subsidy cannot be conditioned on the payment of tax, or it would be regarded as a tax refund for purposes of calculating the U. S. foreign tax credit. On average wage subsidies might equal corporate tax payments for a group of firms, but (unlike the example) they would not be identical for each firm.

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Table 2

Comparison Between Foreign Tax Relief and Foreign Input Subsidies

	Case A	Case B
	U.S. taxation with deferral	U.S. taxation without deferral
	Foreign tax holiday	Foreign corporate tax of 50% plus wage subsidy
Sales	1,000	1,000
Raw materials	400	400
Wages	500	500
Less: wage subsidy	---	(100)
Income before tax	100	200
Foreign tax	---	100
Income after foreign tax	100	100
Deemed or actual dividend distribution	---	100
U.S. tax after foreign tax credit	---	---
Income after all taxes	100	100

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In the eyes of the firm, little has changed.[1/] In both cases, the foreign government collects no tax, in the second case, the wage subsidy just offsets the tax, and in both cases the United States collects no tax. It is not clear what the United States would gain by encouraging foreign countries to undertake this sort of fiscal subterfuge.[2/]

(c) Average foreign tax rates. With the termination of deferral, many foreign countries would be concerned about the U. S. tax status of subsidiaries engaged in particular industries and regions. Although national average tax rates often conceal the situation for individual industries and regions, they do perhaps indicate the most seriously affected nations.

Table 3 shows 1974 statutory and realized corporate tax rates, the withholding rate applied to dividends payments to the U. S. , and the total (corporate and withholding) realized tax rate on grossed-up dividends for more than 60 countries. Realized corporate tax rates are computed as the ratio of taxes paid to the U. S. definition of pre-tax

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1/ In the long run, however, the firm may respond differently to a wage subsidy than a tax holiday. For example, a wage subsidy might induce the firm to use more labor and less capital to produce a given level of output.

2/ It should be noted that the foreign tax credit mechanism generally encourages foreign governments to tax dividends, interest, rents, royalties, and other foreign income paid to U. S. corporations at a rate near 48 percent.

Table 3

Statutory and Realized Corporate Income Tax Rates on Manufacturing Firms, 1974

Country	Statutory Tax Rates			Realized Corporate tax rate 3/	Withholding tax rates on dividends distributed to U.S.		Total realized tax rate on grossed-up dividends
	Corporate Tax Rate 1/	Distributed profits tax rate, if different 2/	Local Income taxes		Statutory or Treaty Rate	Realized Rate on grossed-up dividends	
Canada	48.0		13.0	41.1	15.0	8.8	49.9
Europe:							
Austria	55.0	27.5	15.0	53.4	5.0	2.3	55.7
Belgium	42.0	0 4/		37.5	15.0	9.4	46.9
Denmark	36.0			32.5	5.0	3.4	35.9
France	50.0	25.0		48.0	5 0	2.6	50.6
Germany	51.0	15.0	13.0	43.0	15.0	8.5	51.5
Greece	38.2	0 4/		11.9	30.0	26.4	38.3
Ireland	50.0	27.0		12.7	5.0	4.4	17.1
Italy	43.8		5/	41.9	5.0	2.9	44.8
Luxembourg	40.0		14.0	17.1	5.0	4.1	21.2
Netherlands	48.0			36.0	10.0	6.4	42.4
Norway	26.5	0 4/	21.3	40.5	15.0	8.9	49.4
Spain	32.8			30.3	15.0	10.5	40.8
Sweden	40.0		25.0	43.1	5.0	2.8	45.9
Switzerland	8.8		28.0	27.1	5.0	3.6	30.7
United Kingdom	52.0	26.2		44.6	15.0	8.3	52.9
Oceania:							
Australia	47.5			42.9	15.0	8.6	51.5
New Zealand	45.0			51.7	5.0	2.4	54.1
Latin America:							
Mexico	42.0			42.2	20.0	11.6	53.8
Argentina	42.9			28.2	12.0	8.6	36.8

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Table 3 - continued

Country	Statutory tax rates: Corporate tax rate 1/	Statutory tax rates: Distributed profits tax rate, if different 2/	Statutory tax rates: Local income taxes	Realized corporate tax rate 3/	Withholding tax rates on dividends distributed to U.S.: Statutory or treaty rate	Withholding tax rates on dividends distributed to U.S.: Realized rate on grossed-up dividends	Total realized tax rate on grossed-up dividends
Brazil	96.7	33.5		30.3	25.0	17.4	47.7
Chile	41.7			39.4	40.0	24.2	63.6
Columbia	36.0			47.3	20.0	10.5	57.8
Ecuador	20.0	40.0		18.7	40.0	32.5	51.2
Peru	55.0			47.7	30.0	15.7	63.4
Uruguay	37.5			25.2	25.0	18.7	43.9
Venezuela	50.0			30.0	15.0	10.5	40.5
Costa Rica	40.0			33.7	15.0	9.9	43.6
El Salvador	15.0			7.6	38.0	35.1	42.7
Guatemala	52.8			21.0	10.0	7.9	28.9
Honduras	40.0			25.2	5.0	3.7	28.9
Nicaragua	30.0			1.8	0.0	0.0	1.8
Panama	50.0			15.4	10.0	8.5	23.9
Africa:							
Algeria	50.0			0.0	18.0	18.0	18.0
Morocco	48.0			54.5	25.0	11.4	65.9
Liberia	45.0			5.7 6/	15.0	14.1	19.8
Ethiopia	40.0			38.6	0.0	0.0	38.6
Kenya	40.0			19.0	12.5	10.1	29.1
Nigeria	45.0			4.7	15.0	14.3	19.0
Rhodesia	40.0			30.9	15.0	10.4	41.3
South Africa	43.0			41.9	15.0	8.7	50.6
Zambia	45.0			28.0	15.0	10.8	38.8
Middle East:							
Iran	10.0	55.0	3.4	10.5	60.0	53.7	64.2
Israel	56.5	42.0		44.7	30.0	16.6	61.3
Lebanon	42.0		15.0	15.1	10.0	8.5	23.6
Asia:							
Sri Lanka	60.0	33.3		21.2	39.3	31.0	52.2
India	60.0			57.0	25.7	11.1	68.1

Table 3 - continued

Country	Statutory Tax Rates: Corporate Tax Rate 1/	Statutory Tax Rates: Distributed profits tax 2/ rate, if different	Statutory Tax Rates: Local Income taxes	Realized Corporate tax rate 3/	Withholding tax rates on dividends distributed to U.S.: Statutory or Treaty Rate	Withholding tax rates on dividends distributed to U.S.: Realized Rate on grossed-up dividends	Total realized tax rate on grossed-up dividends
Malaysia	40.0			27.9	40.0	28.8	56.7
Pakistan	60.0			52.6	15.0	7.1	59.7
Phillippines	35.0			29.6	35.0	24.6	54.2
Singapore	40.0			26.9	40.0	29.2	56.1
Taiwan	25.0			6.0	10.0	9.4	15.4
Thailand	30.0			14.9	25.0	21.3	36.2
Hong Kong	15.0			15.5	0.0	0.0	15.5
Japan	40.0	28.0	12.0	47.4	10.0	5.6	53.0
Indonesia	45.0			36.4 6/	20.0	12.7	49.1
Other Western Hemisphere:							
Bahamas	0.0			5.1	0.0	0.0	5.1
Bermuda	0.0			0.3	0.0	0.0	0.3
Netherlands Antilles	34.0		15.0	4.5 6/	0.0	0.0	4.5
Dominican Republic	41.1			21.7	18.0	14.1	35.8
Jamaica	45.0			22.6	37.5	29.0	51.6
Puerto Rico	40.0			12.2	15.0	13.2	25.4
Trinidad & Tobago	45.0			36.7	10.0	6.3	43.0

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NOTES: 1/ For some countries, 1974 rates were unavailable and 1973 rates were used.
2/ The distributed profits tax rate reflects both split rates and imputation systems.
3/ Estimated by increasing (or decreasing) the 1968 realized corporate rate for manufacturing by the percentage change in the statutory corporate rate.
4/ Dividends are fully deductible from earnings in Greece and Norway; in Belgium, they are deductible within limits.
5/ Included in the corporate rate.
6/ This is the realized rate for all industries

SOURCES: M.E. Kyrouz, "Foreign Tax Rates and Tax Bases," National Tax Journal, March 1975; unpublished data.

earnings and profits, which is the base from which the deemed paid foreign tax credit is computed.[3/] The realized rates are estimated from 1968 data, adjusted for changes in statutory rates between 1968 and 1974.

The figures in Table 3 are confined to the manufacturing sector. Termination of deferral would have its greatest impact on manufacturing. Realized foreign tax rates on mineral income frequently exceed the U. S. tax rate, so deferred U. S. taxation makes no difference. Undistributed corporate earnings arising in the trade, finance, and insurance sectors are to some extent taxed currently under subpart F (as amended by the Tax Reduction Act of 1975). Thus, low foreign tax rates applied to those sectors are already partly offset by current U. S. taxation.

Table 3 reveals that realized corporate tax rates on manufacturing are generally well below the statutory rate. The median ratio of realized to statutory tax rates in 1974 was approximately 80 percent; in only 11 of the 63 countries did the realized rate exceed the statutory rate.

1/ The term "realized tax rate" indicates the ratio between taxes paid and earnings and profits, as reported for U. S. tax purposes. By contrast, the term "effective tax rate" often refers to the ratio between taxes paid and book income, as reported for financial purposes. Foreign effective rates for selected countries are reported in Survey of Current Business, May 1974 (Part I).

For purposes of evaluating the consequences of terminating deferral on a country-by-country basis, the correct procedure is to compare foreign total realized tax rates on grossed-up dividends with the U.S. statutory corporate rate of 48 percent. 1/ The U.S. foreign tax credit is so designed that the termination of deferral would usually result in higher U.S. taxation of retained corporate income in those countries with realized tax rates below the U.S. statutory rate. 2/ Table 3 reveals that in 1974, 26 countries imposed a total realized tax rate on grossed-up dividends above the U.S. statutory rate of 48 percent, while 37 countries imposed total realized rates below the U.S. statutory rate. The partial or complete termination of deferral would principally affect U.S. investment in the 37 countries in the latter category. 3/ Of these 37 countries, 27 were less developed countries which presumably rely on tax relief to promote development.

4. Administrative aspects. U.S. "shareholders" in a controlled foreign corporation are required to report the CFC's earnings and profits under U.S. accounting standards. This information is needed to calculate the deemed paid

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1/ The realized U.S. corporate tax rate on domestic source income was about 41 percent in 1974, but the U.S. statutory rate and not the realized rate applies to foreign source income.

2/ This generalization does not apply to U.S. firms which use the overall limitation in reporting the foreign tax credit, and also have excess foreign tax credits.

3/ This statement assumes that the termination of deferral would lead to the imposition of withholding taxes on the deemed distribution, or that companies would distribute 100 percent of their earnings. To the extent earnings are retained abroad, and no foreign withholding taxes are imposed, the better comparison is between the realized foreign corporate tax rate and the U.S. statutory rate of 48 percent.

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foreign tax credit.[1/] In most cases, therefore, the elimination of deferral would require little information not already reported for U. S. tax purposes.[2/]

However, in practical terms, the Internal Revenue Service would need to expand its auditing efforts and its staff of international specialists very substantially if deferral were terminated. The present IRS staff includes some 150 international specialists. These specialists are responsible for questions concerning international pricing and allocation of expenses, subpart F, DISC and similar special status corporations, and other international tax issues. In 1974, about 700 international audits were completed.

1/ The deemed paid credit (Section 902) is calculated as:

$$\frac{\text{Dividends}}{\text{Earnings and profits}} \times \text{Foreign income tax} = \text{Deemed paid credit}$$

The denominator of the first term on the left must be calculated according to U.S. accounting standards. Note that earnings and profits is an after-tax concept.

2/ Additional information would be required to the extent that the definition of earnings and profits for purposes of the deemed paid foreign tax credit (Sections 902 and 964) differs from the general definition of earnings and profits. Moreover, CFCs that presently distribute no income would now be required to report earnings and profits.

Under existing law, the direct and deemed paid foreign tax credits are generally more than sufficient to offset U. S. tax liability on dividends from foreign subsidiaries. From a practical standpoint, therefore, it is not rewarding for the Internal Revenue Service to examine the majority of CFC returns (in 1974, about 40,000 CFC returns were filed). But with the partial or complete termination of deferral, the exact calculation of the earnings and profits of a foreign subsidiary would become more important. The IRS would have to increase its international staff very substantially to meet the new demands.

5. Investment impact. With the termination of deferral foreign subsidiary corporations, facing a higher tax rate than competing local firms, might diminish their activities. Out of a given volume of pre-tax earnings, CFCs would have fewer funds available for reinvestment. In order to maintain the same after-tax earnings as a percentage of investment, they might sacrifice less profitable product lines and, where possible, they might raise prices. As a result, CFC sales abroad might contract. But there is a wide range of opinion on the ensuing consequences for investment in the United States.

Some observers believe that investment would be partly shifted back to the United States, thereby increasing U. S. corporate earnings. These observers contend that foreign and domestic investment are at least partial substitutes, and that, when markets and investment opportunities are lost in one area, multinational firms will reallocate their resources to another part of the globe.

Other observers contend that little or no investment would be shifted back to the United States. They argue that profitable investment and production opportunities are highly specific both in time and place, and that the loss of foreign markets abroad does little to create new investment opportunities in the United States. Indeed, the loss of foreign markets might impair the access of American producers to new foreign technology, and might impede the realization of economies inherent in large scale production and international specialization, with a consequent attenuation of domestic investment opportunities.

Professor Horst has constructed a mathematical model to simulate the impact of terminating deferral on manufacturing investment in the United States and abroad.[1/] In this model, foreign and domestic investment are assumed to be partial substitutes for one another. Investment in each location is determined both by relative after-tax rates of return, and by the firm's overall supply of

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1/ Thomas Horst, "American Multinationals and the U.S. Economy," Fletcher School of Law and Diplomacy, November 1975.

financial resources. The model assumes that a multinational manufacturing firm maximizes its global after-tax earnings. The firm invests both in the United States and in a single foreign country. Its investment can be financed out of its own retained earnings, with new equity capital, or with borrowed funds, raised either in the American or in the foreign capital market. U.S. funds can be transferred to the foreign affiliate either as equity capital or as interest-bearing debt. The division of taxable income between countries depends on investment and sales in each country, and on the level of deductibile intrafirm expenses, such as interest payments, royalties, and head-office charges.

A change in tax policy, either in the United States or abroad, will have two conceptually distinct effects: a substitution effect, resulting from any change in the after-tax rate of return on foreign or domestic investment; and a liquidity effect, resulting from any change in after-tax earnings available for reinvestment. The size of the substitution and liquidity effects depends not only on the opportunities for investing and borrowing in the two countries, but also on the firm's own internal use of debt and equity capital.

Although the model is basically simple, it requires more than thirty equations to capture the details of foreign and domestic investment opportunities and tax systems. Many parameters must be estimated before usuable results can be obtained. As in any exercise of this nature, the results are subject to a considerable margin of error.

The results are summarized in Table 4. The estimates portray the investment impact after complete adjustment to the termination of deferral. Complete adjustment could, of course, require several years. Both the substitution effect and the liquidity effect are reflected in the estimates.

The estimates in Table 4 suggest that the stock of plant and equipment investment in the United States manufacturing sector might ultimately increase by $2.2 billion (a change of 0.7 percent) with an end to deferral, while the stock of U.S. owned manufacturing assets abroad might ultimately decrease by $3.5 billion (a change of 2.3 percent). Consolidated after-tax earnings would decrease by about $980 million. U.S. corporate taxes would increase by about $1,000 million. Foreign corporate income and withholding taxes would decline

Table 4

Estimated Impact of Terminating Deferral on Selected Economic Variables for U.S. Multinational Manufacturing Firms 1/
(Millions of Dollars)

	Initial Values	Estimated Changes
Total domestic assets 2/	314,000	2,200
Total foreign assets 2/	151,000	-3,500
Consolidated after-tax earnings 3/	28,500	-980
U.S. corporate income tax on domestic and foreign income after investment tax credit and foreign tax credit 3/	13,400	1,000 4/
Foreign corporate income and dividend withholding taxes	7,700	-210 5/

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Sources: The estimated changes are adapted from estimates made by Thomas Horst, "American Multinationals and the U.S. Economy," Fletcher School of Law and Diplomacy, November 1975, and unpublished work. The initial values are derived from: U.S. Senate, Committee on Finance, Implications of Multinational Firms for World Trade and Investment and Labor, February 1973; Survey of Current Business, October 1975; Statistical Abstract of the United States, 1975; U.S. Treasury Department, Statistics of Income 1972: Corporation Income Tax Returns.

1/ The initial value figures refer to the year 1974. The estimated change figures represent the impact after complete adjustment to the termination of deferral. The figures in the estimated change column include the impact resulting from the extension of subpart F in the Tax Reduction Act of 1975.

2/ The initial value figures are based on the 1970 estimates for giant multinational manufacturing firms contained in Implications of Multinational Firms, p. 432, increased to reflect smaller manufacturing firms with overseas investment (15 percent of total overseas investment), and increased again to reflect growth between 1970 and 1974 (Statistical Abstract of the United States, 1975, p. 500; Survey of Current Business, October 1975). The foreign asset figures include investment by foreigners in U.S. affiliates. The estimated changes are based on Professor Horst's model.

3/ The initial values refer to the consolidated after-tax earnings and U.S. and foreign income taxes for all manufacturing firms claiming a foreign tax credit. The estimated changes are based on Professor Horst's model.

4/ This estimate reflects additional U.S. taxes from: (i) subpart F as expanded by the Tax Reduction Act of 1975 ($250 million); (ii) termination of deferral with worldwide pooling, an overall foreign tax credit limit, and current dividend distribution rates ($365 million); (iii) an increase in U.S. investment and the greater use of equity capital in the United States ($385 million). Detail is shown in Table 11.

5/ This estimate reflects a decline in foreign taxes resulting from: (i) a decrease in foreign investment; (ii) the greater use of debt capital for foreign affiliates.

by about $210 million. These revenue estimates, like the underlying investment impact estimates, are based on the assumptions of the particular model.[1/]

Professor Horst's model attempts to capture a variety of interactions between U.S. parent corporations and their foreign subsidiaries. Even so, the model requires many simplifying assumptions. In particular, the following complicating factors are not considered.

The model assumes that foreign and domestic investments are partial substitutes, and then proceeds to calculate the extent of substitution. Many observers would dispute the assumption of a substitute relationship between foreign and domestic investment. If the assumption is wrong, the estimates of additional investment in the United States and larger U. S. tax revenues are also wrong.

Professor Stobaugh, for example, contends that the termination of deferral could lead to a cumulative decline in the profitability and investment both of foreign affiliates and their U.S. parent corporations.[2/] The U.S. multinational

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1/ Revenue estimates made under various assumptions are presented in section 7.

2/ Robert B. Stobaugh, "The U.S. Economy and the Proposed U.S. Income Tax on Unremitted Earnings of U.S. Controlled Foreign Manufacturing Operations Abroad," Harvard Business School, 1975.

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firms would have fewer funds available for reinvestment, and in order to maintain the same after-tax rate of return, they might concede some business to competing foreign firms. With slower growth and smaller sales, they might be less able to improve techniques of production, and they would have a smaller base for spreading research, administrative, and other fixed costs. The cumulative effect could be lower profits and a decline in investment, both in the United States and abroad.

Apart from investment changes resulting from corporate decisions, foreign governments might alter their own tax rules in response to the termination of deferral. The changes could be designed not only to offset U. S. revenue gains, but also to counter any shift of investment towards the United States. For example, foreign governments might provide special investment incentives for non-American firms. Through bank financing and other avenues, these incentives could indirectly attract capital from the United States.

These considerations suggest that the changes portrayed in Table 4 should be viewed as upper limit estimates of the investment impact of terminating deferral.

6. Financial impact. Foreign subsidiaries can finance their expansion either by issuing debt or by increasing equity capital (including the retention of earnings). The funds can be provided either by the parent corporation or by unrelated investors. A change in deferral would affect the tax cost of only one source of capital, namely equity funding provided by the parent corporation. Other sources of capital would be available on the same tax terms as before. With a limitation on deferral, the foreign affiliate thus might find it more advantageous to finance expansion through external local borrowing, or through intrafirm debt, rather than through equity capital supplied by the U.S. parent corporation.[1/] The net effect is that a larger share of earnings might be paid out as interest and a smaller share might be retained or paid out as dividends.

Table 5 presents a hypothetical example to illustrate the case in which local borrowing is increased after the termination of deferral. For simplicity, a U.S. corporate tax rate of 50 percent and a foreign corporate tax rate of 25 percent are assumed. Foreign earnings before interest charges are kept constant throughout the analysis, implying

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1/ Financial shifts of this type are included in Professor Horst's model of investment decisions discussed in the previous section.

Table 5

The Effect of Deferral on the Use of Local Debt by a Hypothetical Foreign Subsidiary 1/

	With U.S. Deferral		Without U.S. Deferral	
	All Equity Finance (1)	Some Local Debt (2)	All Equity Finance (3)	Some Local Debt (4)
Foreign Subsidiary 2/				
1. Foreign earnings before interest charges	100	100	100	100
2. Interest paid locally	0	20	0	20
3. Foreign taxable income	100	80	100	80
4. Foreign corporate tax at 25 percent	25	20	25	20
5. U.S. corporate tax at 50 percent, after credit	0	0	25	20
6. Foreign income after all taxes	75	60	50	40
U.S. Parent				
7. Domestic taxable income	200	230	200	230
8. U.S. corporate tax on domestic income at 50 percent	100	115	100	115
9. Domestic income after tax	100	115	100	115
Consolidated Results				
10. Total income after tax	175	175	150	155
11. Total U.S. tax	100	115	125	135

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1/ The following assumptions are made: (a) the foreign interest rate equals 10 percent; (b) the foreign debt in cases (2) and (4) equals 200, and the addition to domestically owned assets also equals 200; (c) pre-tax earnings equal 15 percent of domestically owned assets; (d) no actual distribution of dividends is made from the subsidiary to the parent.

2/ The foreign subsidiary is 100 percent owned by the U.S. parent corporation.

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the same real level of foreign activity.[1/] No dividends are distributed from subsidiary to parent, and thus no withholding taxes are paid.

The firm can choose between raising a certain amount of debt abroad, limited to 200 in this example, or financing the affiliate entirely with equity capital. If it raises debt abroad, the parent can reduce its equity commitment to the foreign affiliate and increase its use of equity capital in the United States. The interest rate on foreign debt is assumed to be 10 percent, while domestically owned assets are assumed to earn 15 percent before tax. Domestic assets thus earn a higher pre-tax return than the cost of foreign debt. This is a crucial assumption; otherwise it would not be sensible for the firm to incur the risk of borrowing abroad.

Under present U.S. law, the firm would be indifferent between borrowing abroad and financing the affiliate entirely with equity. In both cases, its total after-tax income would be 175.[2/]

1/ In fact, foreign operations would probably contract in face of the higher tax burden on foreign earnings.

2/ The tax authorities of the two countries are not, however, indifferent to the means of finance. The substitution of local debt for equity capital would reduce foreign corporate tax from 25 to 20 and increase U.S. corporate tax from 100 to 115.

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If deferral is terminated, the picture changes. The firm's total income after tax declines, and U.S. tax collections rise. Equally important, the firm now has an incentive to borrow abroad. Consolidated income after tax is 150 with all equity financing and 155 with some local debt. The hypothetical firm can increase its after-tax income by redeploying some of its assets to the United States. The process of redeployment would increase U. S. tax from 125 to 135. The partial or complete termination of deferral could place some foreign subsidiaries in the position of this hypothetical firm. They might find it advantageous to substitute local borrowing for parent firm equity.[1/]

It is difficult to estimate the potential importance of tax-induced changes in means of finance. Many firms may have already borrowed abroad as much as they realistically can. Foreign debt has advantages, but it also has risks -- in particular the risk of credit rationing with a change in government policies abroad. Likewise, there may be administrative and other limits on intrafirm debt.

Table 6 illustrates the extent of debt and equity financing by foreign affiliates in 1972. New foreign debt

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1/ A similar example could be devised to illustrate the effect of substituting intrafirm debt for equity financing.

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Table 6

Financing of Foreign Affiliates, 1972 1/
(Percent of Total Funds)

	Petroleum	Manufacturing	Other
Source of funds:			
1. Internal funds:			
Retained earnings	15.6	45.1	23.8
2. External funds:			
Equity capital:			
U.S. owned 2/	4.5	5.5	4.1
Foreign owned	0.1	3.4	3.9
Debt capital:			
U.S. owned:			
intrafirm debt 2/	24.2	5.0	5.9
unrelated financial institutions	0.7	2.8	5.0
Foreign owned:			
related firms	1.9	1.8	20.1
unrelated financial institutions	53.0	36.4	37.2
Total	100.0	100.0	100.0

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Source: U.S. Department of Commerce, Survey of Current Business (July 1975).

Detail may not add to totals due to rounding.

1/ Estimates are based on a sample of majority-owned foreign affiliates.
2/ The apportionment of funds between U.S. owned equity and intra-firm debt was based on the ratio of net equity to total net capital outflows for 1973 reported in U.S. Department of Commerce, Survey of Current Business (October 1975), p. 47.

supplied a major part of available funds, ranging between 38 percent in the case of manufacturing affiliates to 57 percent in the case of other industries. Intrafirm debt and other debt from U.S. sources supplied between 8 and 25 percent of available funds. New equity capital from the United States only supplied between 4 and 6 percent, while retained earnings supplied between 16 and 45 percent of available funds. There appears to be little scope for the substitution of fresh debt for fresh equity capital, but fresh debt might, to a limited extent, replace retained earnings.

7. Revenue impact. In general, revenue estimates are made to indicate actual or potential U.S. tax collections resulting from the existing tax structure or a change in that structure. The focus here is on changes in tax revenue resulting from the partial or complete elimination of deferral, or the selective expansion of subpart F. Background estimates are also given for present tax revenues attributable to subpart F. The Tax Reduction Act of 1975 substantially extended the scope of subpart F, and correspondingly reduced the scope of remaining revenue gains from the termination of deferral. These effects are reflected in the comparison between estimates for 1974 and 1976 in Table 7. Note that the collateral tax changes enumerated in Table 1 which would

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Table 7

Actual Revenue from Subpart F and
Potential Revenue from Termination of Deferral,
with Overall Limitation on Foreign Tax Credit
(Millions of dollars)

	1974 Calendar Year Tax Liabilities	Changes Resulting from the Tax Reduction Act of 1975	1976 Calendar Year Tax Liabilities 1/
Total actual and potential revenue from current taxation of CFC retained earnings	615	n.a.	615
Potential revenue from the termination of deferral, total 2/	590	-225	365
Mining	0	0	0
Petroleum and Refining	0	0	0
Manufacturing	577	-215	362
Other	13	-10	3
Actual revenue from subpart F, total	25	225	250
Pre-1975 revenue	25	n.a.	25
Tax Reduction Act changes 3/		225	225

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n.a. indicates not applicable.

1/ It is assumed that there was no change between 1974 and 1976 in corporate foreign source income affected by deferral.
2/ These estimates assume: (i) dividends from less developed country corporations are "grossed up" for purposes of calculating the tentative U.S. tax and the foreign tax credit; (ii) foreign subsidiary losses are fully offset against foreign subsidiary profits; (iii) all firms use the overall limitation in calculating the foreign tax credit; (iv) no behavioral change.
3/ The Tax Reduction Act changes were: (i) eliminate minimum distribution ($100 million); (ii) eliminate the less developed country corporation exception ($15 million); (iii) change the 30-70 rule to a 10-70 rule ($75 million); (iv) repeal the shipping exclusion ($35 million).

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move the United States closer to a system of capital-export neutrality are not shown in Table 7. Instead, Table 7 focuses on the taxation of undistributed earnings viewed in isolation. The estimates of possible revenue gains from the further termination of deferral are influenced both by the policy option chosen and by possible behavioral changes.

(a) Policy options. The revenue estimates obviously depend on three important policy choices: (i) the extent to which deferral is eliminated or subpart F is extended; (ii) whether the overall or the per-country limitation is applied to the foreign tax credit; (iii) the extent to which foreign subsidiary losses are permitted as an offset against foreign subsidiary profits. The policy options are spelled out in Part IV. Tables 8 and 9 present revenue estimates for the alternative policies. The revenue estimates are based on the standard assumption of no behavioral change, discussed below.

Certain important features should be noted. The great majority of firms elect the overall limitation in calculating the foreign tax credit. Under the Tax Reduction Act of 1975, petroleum firms are required to use the overall limitation for foreign oil related income in taxable years ending after December 31, 1975. The Tax Reform Act of 1975, H.R. 10612, enacted by the House and now under Senate consideration,

Table 8

Revenue Changes from Alternative Proposals to End Deferral 1/
(Millions of Dollars)

Required Percentage Distribution 2/	1976 Calendar Year Tax Liabilities 3/			
	Earnings and Profits		Earnings and Profits Plus Branch and Royalty Income	
	Overall Limitation	Per-Country Limitation 4/	Overall Limitation	Per-country Limitation 4/
100	$ 365	$ 630	$ 365	$ 630
75	215	385	150	250
50	55	150	10	50

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1/ The estimates assume: (i) dividends from less developed country corporations are "grossed up" for purposes of calculating the tentative U.S. tax and the foreign tax credit; (ii) CFC profits and losses are consolidated on the same basis as the foreign tax credit limitation that is, either on an overall or a per country basis; (iii) no behavioral change, in particular the current dividend distribution rate is maintained.

2/ With a 100 percent required distribution, deferral is totally ended. With a 75 percent or 50 percent required distribution, U.S. parent corporations would be deemed to have received the differences between 75 percent or 50 percent of income (defined either as earnings and profits or as earnings and profits plus branch and royalty income) and the amount actually received (either dividends or dividends plus branch and royalty income).

3/ These figures represent additions to 1976 revenues collected under subpart F ($250 million).

4/ These estimates assume that the per-country limitation is already in place, and that deferral is then ended. The revenue changes refer only to the additional impact of eliminating deferral.

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Table 9

Termination of Deferral with Alternative
Consolidation Requirements and with Current
Dividend Distribution Rate 1/
(Millions of Dollars)

	1976 Calendar Year Tax Liabilities 2/
Overall limitation on foreign tax credit	
Worldwide consolidation of CFCs	365
No consolidation of CFCs	1,100
Per-country limitation on foreign tax credit 3/	
Country consolidation of CFCs	630
No consolidation of CFCs	1,300

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1/ These estimates are variants of the estimates in Table 5. The estimates assume: (i) dividends from less developed country corporations are "grossed up"; (ii) no behavioral change, in particular, the present dividend distribution rate is maintained.

2/ These figures represent additions to the 1976 revenue collected under subpart F ($250 million).

3/ These estimates assume that the per-country limitation is already in place, and that deferral is then ended. The revenue changes refer only to the additional impact of eliminating deferral.

would extend compulsory use of the overall limitation to all firms.[1/] The overall limitation permits extensive tax averaging between income from high-tax and low-tax jurisdictions. Thus, the elimination of deferral coupled with the overall limitation produces less revenue than the elimination of deferral coupled with the per-country limitation.

If losses are not allowed as an offset against profits as between related subsidiaries, the revenue estimate becomes very much larger. This reflects the substantial losses experienced by foreign subsidiaries. Contrary to popular belief, it is not true that the bulk of foreign losses are concentrated in foreign branches. Rough estimates for 1975 indicate that foreign subsidiaries experienced losses of $2.2 billion while foreign branches had losses of $0.3 billion.

(b) Behavioral change. Revenue estimates are usually based on a standard assumption of no behavioral change. The standard assumption is useful in two respects: first, it

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1/ The reason for compulsory use of the overall limitation is to prevent U.S. corporations from offsetting foreign branch losses incurred in some countries against U.S. source income, while claiming a foreign tax credit on foreign source income earned in other countries. However, transition rules would permit continued use of the per-country limitation for selected hard mineral firms. Puerto Rico and the U.S. possessions are not included in the compulsory overall limitation rule.

is helpful to know the initial impact of a tax measure before adjustment occurs; second, the nature, extent and speed of behavioral changes are not easily forecast. Yet behavioral changes usually accompany any important tax measure. In the international tax area, not only will multinational firms adjust their dividend distribution rates, investment decisions, and financing policies in response to U.S. tax legislation, but also foreign governments may modify their own tax rules.

(i) Foreign subsidiaries might increase their dividend distributions in order to ensure and accelerate recognition of the foreign tax credit for dividend withholding taxes.

(ii) The extent of investment in foreign subsidiaries might be curtailed. At the same time, U.S. parent firms might increase their investment in the United States. The financing of foreign subsidiaries might be modified to reduce reliance on intrafirm equity, and increase reliance on intrafirm debt, and more importantly, external debt.

(iii) U.S. parent firms might place greater stress on minority participation in new ventures and they might attempt to "decontrol" some existing CFCs.

(iv) Foreign governments might selectively increase their own taxation of U.S. controlled foreign corporations.

Each of these reactions would affect the revenue implications of terminating deterral. Some would increase

U.S. revenue; others would decrease U.S. revenue. The following paragraphs summarize the possible revenue consequences of these behavioral changes.

(i) Change in distribution rates. U.S. foreign subsidiaries typically distribute approximately 45 percent of their after-foreign-tax earnings. The revenue estimates in Table 7, 8, and 9 are based on this distribution rate. By contrast, Table 10 shows the revenue effect of increasing the distribution rate to 100 percent of foreign after-tax earnings. U.S. revenue gains would be substantially or completely eroded because foreign withholding taxes creditable under section 901 would be larger.1/ In fact, if the termination of deferral induced a 100 percent distribution rate, with an overall limitation on the foreign tax credit and worldwide consolidation of foreign subsidiary income, the U. S. revenue loss would be $375 million. Under a per-country limitation, the revenue loss would be $105 million. The revenue losses are calculated by reference to tax otherwise collected under subpart F, as expanded by the Tax Reduction Act of 1975. The reason for these revenue losses is that additional foreign withholding taxes would be credited against existing U. S.

1/ The same revenue effects would result if foreign governments imposed withholding taxes on deemed distributions of foreign affiliates.

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Table 10

Revenue Effect of 100 Percent Dividend Distribution Rate
(Millions of Dollars)

1976 Calendar Year Tax Liabilities	Overall Limitation	Per-Country Limitation 2/
Total actual and potential revenue from current taxation of CFC earnings	-125	145
Potential revenue from 100 percent dividend distribution rate 1/	-375	-105
Mining	-5	5
Petroleum and Refining	---	115
Manufacturing	-315	-240
Other	-55	15
Actual revenue from subpart F, total	250	250
Pre-1975 revenue	25	25
Tax Reduction Act changes	225	225

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1/ The estimates assume: (i) dividends from less developed country corporations are "grossed up" for purposes of calculating the tentative U.S. tax and the foreign tax credit; (ii) CFC profits and losses are pooled on the same basis as the foreign tax credit limitation; (iii) no behavioral change, except that all CFCs increase their actual dividend distribution rates to 100 percent.

2/ These estimates assume that the per-country limitation is already in place, and that deferral is then ended. The revenue changes refer only to the additional impact of eliminating deferral.

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taxes collected both on subpart F income and on foreign source interest, rents, royalties, fees, and branch income.

The revenue losses would be more than proportional to any increase in dividend distributions from the current rate of about 45 percent to the hypothetical rate of 100 percent. Most of the loss would occur with the first increments in the overall dividend distribution rate, since additional dividends would presumably be distributed first from CFCs paying the highest foreign taxes.

(ii) Foreign vs. domestic investment. Tables 11 and 12 present rough and conflicting estimates of the revenue consequences of changes in investment behavior resulting from the termination of deferral. The revenue estimates in Table 11 are based on Professor Horst's model which attempts to measure the investment and financial position of a multinational firm after it has fully adjusted to the termination of deferral. The model, described in section 5, assumes that the firm can to some extent choose between foreign and domestic investment, and between alternative means of financing its assets.

The estimates in Table 11 are made from two starting points: the current dividend distribution rate and a 100 percent dividend distribution rate. The dividend distribution rate affects both the division of revenue changes between the

Termination of Deferral with Assumed Changes in Investment
Location and Means of Finance
(Millions of Dollars)

	1976 Calendar Year Tax Liability	
	Current Dividend Distribution Rate	100% Dividend Distribution Rate
Total actual and potential U.S. revenue from current taxation of CFC earnings, with specified investment and financing changes 1/	1,000	260
Actual revenue from subpart F, total	250	250
Potential revenue from termination of deferral with no investment or financing changes	365	-375
Potential revenue from possible changes in investment and financing: 2/	385	385
(1) Effects on foreign source income--		
(a) Decrease in CFC earnings	-15	-15
(b) Decrease in royalties, fees, and interest repatriated to the United States	-10	-10
(2) Effects on domestic source income --		
(a) Increase in domestic investment	90	90
(b) Increase in use of equity capital in the United States and increase in use of external debt abroad	320	320
Addenda: Change in foreign revenue from corporate income and dividend withholding taxes 3/	-210	630
(1) Effect of 100 percent dividend distribution rate on dividend withholding taxes	--	840
(2) Effect of reduced size and increased use of external debt by CFCs on corporate income tax and withholding tax	-210	-210

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1/ The estimates assume: (i) dividends from less developed countries are "grossed up" for purposes of calculating the tentative U.S. tax and the foreign tax credit; (ii) worldwide pooling of CFC profits and losses, and an overall limitation on the foreign tax credit; (iii) specified behavioral changes in dividend distribution rates, investment and financing. The detail underlying these figures appear in Tables 7 and 10.

2/ The estimates represent the revenue impact after full adjustments to the current taxation of CFC earnings, including adjustments to the Tax Reduction Act of 1975. The adjustments would, in fact, take several years. The estimates are adapted from a model developed by Thomas Horst, "American Multinational and the U.S. Economy," Fletcher School of Law and Diplomacy, November 1975.

3/ The estimates assumes no change in foreign tax laws.

Table 12

Termination of Deferral with Assumed Adverse Impact on
Competitive Position of U.S. CFCs
(Millions of Dollars)

	Calendar Year Tax Liabilities	
	1976	1981
Estimated U.S. revenue from corporate taxation of all foreign source income with termination of deferral 1/	2,610	3,200
Estimated U.S. revenue from corporate taxation of all foreign source income under current law 2/	2,245	3,600
Estimated change in U.S. revenue with termination of deferral	365	-400

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1/ The 1976 figure is based on estimated 1976 revenues plus the potential revenue from complete termination of deferral. The 1981 figure is adapted from a model developed by Robert B. Stobaugh, "The U.S. Economy and the Proposed U.S. Income Tax on Unremitted Foreign Earnings of U.S. Controlled Foreign Manufacturing Operations Abroad," Harvard Business School, 1975.

2/ The 1976 figure reflects the Tax Reduction Act of 1975. The 1981 figure assumes an annual growth rate of 10 percent in the foreign source of U.S. corporations.

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United States and foreign governments, and the total amount of these changes.

The potential U.S. revenue gain from changes in the location of investment and the means of finance, after all adjustments have taken place, is very roughly estimated at \$385 million whether the dividend distribution rate remains at current levels or increases to 100 percent. The figure of \$385 million reflects a revenue loss of about \$25 million from smaller CFC earnings and reduced intrafirm payments of interest, rents, royalties, and management fees, and a revenue gain of about \$410 million from larger U.S. corporate investment and a shift in the means of finance. Foreign subsidiaries would rely to a greater extent on local debt finance, while U.S. parent corporations would use more equity capital.

These calculations do not take into account possible attempts by foreign governments to offset the shift of investment location and means of finance through modification of their own tax laws.

Under current dividend distribution rates, the model suggests that firms would pay an additional \$750 million in U.S. taxes while they would pay \$210 million less in foreign taxes. The net increase in corporate tax payments at home and abroad would thus be \$540 million. Under a 100 percent dividend distribution rate, the model suggests

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that firms would pay an additional $10 million in U.S. taxes and an additional $630 million in foreign taxes. The net increase in corporate tax payments at home and abroad would be $640 million under this assumption.

The revenue estimates in Table 12 are based on Professor Stobaugh's model which attempts to measure the long-term consequences of placing U.S. controlled foreign corporations at a competitive disadvantage through the termination of deferral. Again, these calculations do not take into account possible offsetting measures by foreign governments.

The Stobaugh model assumes that higher U.S. taxes on CFCs will, after a period of time, cause a cumulative contraction in their market share, profitability, and the remittance of interest, royalties, and management fees to the U.S. parent corporations. Moreover, CFCs will find it advantageous to distribute a larger share of earnings and rely more heavily on debt finance.[1/] The predicted result is a cumulative reduction in U.S. taxes not only on the foreign earnings of CFCs but also on the associated types of foreign income paid to U.S. parent firms. In 1981, five years

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1/ Both the Horst and Stobaugh models envisage a larger role for debt finance if deferral is terminated.

after the termination of deferral, the model estimates that U.S. taxes on all foreign source income would be $400 million less than under present law. In succeeding years, the adverse revenue impact would be even larger.

(iii) Minority participation and "decontrol". If deferral is terminated, some multinational firms might seek to minimize the impact of current U.S. taxation either by undertaking new foreign investments through minority ownership in joint venture arrangements or by "decontrolling" some of their existing CFCs. Either way, the retained earnings of the foreign corporation would not be subject to current U.S. taxation. However, decontrol of an existing CFC could entail substantial U.S. taxes on accumulated earnings and profits. Moreover, even if decontrol in the tax sense does not involve the total loss of control, it at least inhibits managerial flexibility, and makes international business decisions more difficult. A new minority ownership arrangement raises similar problems.

While the difficulties associated with decontrol and minority ownership arrangements cannot be quantified, a useful perspective may be gained by comparing the total tax burden on U.S. multinational corporations with and without deferral. In 1976, total U.S. and foreign taxes on foreign source corporate income, other than income earned by the petroleum sector, will be approximately $12.3 billion. The complete termination of deferral might increase the tax burden by as much as $0.6 billion, or by 5 percent.[1/] Because this figure is relatively modest, and because the tax costs alone of reorganization are substantial, it seems unlikely that many multinational firms would reorganize their corporate structure as a means of avoiding current U.S. taxation.[2/]

Table 13 gives the estimated structure of foreign affiliate earnings classified by the percentage of U.S. ownership in the affiliate. Only 5.2 percent of profits were earned by foreign affiliates owned less than 50 percent by U.S. parent corporations. Even if this percentage doubled or tripled, and the growth were concentrated in low-tax countries, the tax avoidance would be modest. If deferral was terminated, and if the proportion of earnings accounted for by non-CFC foreign affiliates subsequently increased to 10 percent, the revenue gain would be reduced by $50 million; at 15 percent, the reduction in revenue gain would be $100 million (Table 14).

1/ This figure, from Table 7, assumes an overall limitation on the foreign tax credit and includes subpart F revenue.

2/ J.L. Kramer and G.C. Hufbauer, "Higher U.S. Taxation Could Prompt Changes in Multinational Corporate Structure," International Tax Journal, Summer 1975.

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Table 13

Net Earnings by Extent of
U.S. Ownership in Foreign Affiliates
(Millions of Dollars or Percent)

U.S. ownership percentage	1973 net earnings 1/	Percent of net earnings
	BY AREA	
All Areas	17,495	100.0
95-100%	14,290	81.7
50-94%	2,290	13.1
25-49%	584	3.3
10-24%	285	1.6
1-9%	46	0.3
Canada	2,846	100.0
95-100%	1,904	66.9
50-94%	781	27.5
25-49%	93	3.3
10-24%	44	1.6
1-9%	21	0.7
Western Europe	5,957	
95-100%	4,742	79.6
50-94%	815	13.7
25-49%	176	3.0
10-24%	205	3.4
1-9%	11	0.2
Latin America and other Western Hemisphere	2,628	100.0
95-100%	2,387	90.8
50-94%	185	7.0
25-49%	43	1.7
10-24%	9	0.4
1-9%	4	0.1

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Table 13 - continued

U.S. ownership percentage	1973 net earnings 1/	Percent of net earnings
Africa, Asia and Australia	6,065	100.0
95-100%	5,109	84.2
50-94%	514	8.5
25-49%	321	5.3
10-24%	109	1.8
1-9%	7	0.1
	BY INDUSTRY	
Petroleum	6,183	100.0
95-100%	5,475	88.6
50-94%	560	9.1
25-49%	92	1.5
10-24%	29	0.5
1-9%	26	0.4
Manufacturing	7,286	100.0
95-100%	5,668	77.8
50-94%	1,138	15.6
25-49%	300	4.1
10-24%	160	2.2
1-9%	19	0.3
All other industries	4,026	100.0
95-100%	3,145	78.1
50-94%	592	14.7
25-49%	192	4.8
10-24%	26	2.4
1-9%	1	0.0

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Source: Based on Table B-10 of the Preliminary Draft of U.S. Direct Investments Abroad 1966 Part I: Balance of Payments Data (U.S. Department of Commerce, 1970), pp. 83-84; and Table 9 of J. Freidlin and L.A. Lupo, "U.S. Direct Investment Abroad in 1973," Survey of Current Business, (August 1974), Pt. II, pp. 16-17.

1/ Net earnings are after-foreign tax. Foreign affiliates include foreign branches, counted as 100 percent owned by the U.S. parent corporation.

Table 14

Estimated Revenue from Subpart F and Termination of Deferral with Increase of Non-CFC Earnings

	1976 Calendar Year Tax Liability		
	5% of Earnings in non-CFCs	10% of Earnings in non-CFCs	15% of Earnings in non-CFCs
Total actual and potential revenue from current taxation of CFC retained earnings	615	565	515
Actual revenue from subpart F, total	250	250	250
Potential revenue from termination of deferral, total 1/	365	365	365
Change in revenue from new minority participation or decontrol of CFCs 2/	--	-50	-100

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1/ These estimates assume: (i) dividends from less developed country corporations are "grossed up" for purposes of calculating the tentative U.S. tax and the foreign tax credit; (ii) foreign subsidiary losses are fully offset against foreign subsidiary profits and all firms use the overall limitation in calculating the foreign tax credit; (iii) no behavioral change other than the specified changes in non-CFC earnings.

2/ Assumes that incremental non-CFC earnings are taxed by the foreign government at a 20 percent rate, including withholding taxes. Non-CFC earnings are defined as the earnings of those foreign affiliates which are owned less than 50 percent by "U.S. shareholders."

The potential revenue loss could be a greater problem if foreign affiliates owned exactly 50 percent by "U.S. shareholders" generally escape classification as CFCs. Under the Garlock and Kraus decisions, U.S. ownership of exactly 50 percent of a foreign affiliate, coupled with actual U.S. control of the affiliate, will meet the test of subpart F.

(iv) Higher foreign taxes. If deferral were terminated, foreign governments could selectively increase the tax burden on U.S. controlled foreign corporations in situations where the general foreign tax rate is lower than the U.S. tax rate. Alternatively, they could raise withholding tax rates and treat deemed dividend distributions as actual dividend distributions for withholding tax purposes. Such changes in foreign tax practices would take time, and would probably not occur as an immediate response to the termination of deferral, but the long-term result of such changes would be lower U.S. tax collections and higher foreign tax collections. The revenue outcome would be similar to the estimates presented in Table 10 for a 100 percent distribution rate. U.S. taxes collected on the retained earnings of foreign subsidiaries would be diminished as a result of higher foreign taxes.

8. Summary of the analysis. Before turning to the policy options, it might be useful to restate the major issues and findings. The debate surrounding deferral has often lacked a clear definition of objectives. The termination of deferral has been urged at different times by different groups seeking at least five different objectives.

(a) To improve tax neutrality;

(b) To eliminate tax avoidance;

(c) To simplify the tax law;

(d) To discourage foreign investment;

(e) To increase U.S. tax revenues.

These different objectives can lead to conflicting policies.

(a) Tax neutrality. The termination of deferral would, of course, be diametrically opposed to the principles of capital-import neutrality. However, current taxation of retained CFC earnings is urged as a step not toward capital-import neutrality, but rather as a step toward capital-export neutrality. But the termination of deferral, would not by itself advance the standard of capital-export neutrality. With the end of deferral, the U.S. tax system would on the whole favor domestic investment even more than it does now. Collateral changes would be required in the investment tax credit, the accelerated depreciation range, DISC, and other tax practices in order to approach capital-export neutrality.

(b) Tax avoidance. In the context of foreign corporate investment, tax avoidance is sometimes very broadly defined to occur whenever the realized foreign tax rate is less than the statutory U.S. rate of 48 percent. If this broad definition is accepted, then the termination of deferral would eliminate virtually all cases of tax avoidance.

However, tax avoidance is often defined more narrowly, either with reference to realized U.S. tax rates or with reference to artificial corporate structures and business arrangements.

When tax avoidance is defined with reference to realized U.S. tax rates, then its extent is much less significant. The investment tax credit, asset depreciation range, DISC, and other domestic tax preferences all serve to reduce the realized U.S. corporate tax rate on domestic income which, in 1974, was about 41 percent. 1/ However, the termination of deferral would generally subject CFC income to a tax of 48 percent. Tax avoidance would be more than offset, and in fact, foreign corporate income would generally be taxed at a higher rate than domestic corporate income.

1/ The figure of 41 percent does not reflect the base broadening measures contemplated in Table 1.

When tax avoidance is defined with reference to artificial corporate structures and business arrangements, then the appropriate solution might involve an extension and strengthening of subpart F rather than the general termination of deferral. 1/

(c) Tax simplification. It has been argued that the termination of deferral would lead to the simplification of tax law and administration. Subpart F could be repealed, since all CFC income would be taxed currently. Moreover, there would be somewhat less pressure on arm's-length pricing rules (Section 482), on the non-recognition provisions involving transfers of capital, technology, and other property to foreign corporations (Sections 351 and 367), and on reorganizations involving foreign corporations (Section 367).

However, the partial termination of deferral would introduce numerous new complications into the tax code. These complications include the determination of a minimum percentage distribution and the allocation of a deemed distribution between CFCs (in the case of partial termination), the measurement of a subsidiary earnings and profits and taxable income according to U.S. accounting standards, the extent of consolidation of CFCs, and rules to deal with attempted avoidance through decontrol. These complications are discussed in Section 3 of part IV.

(d) Investment and financial impact. Based on one economic model, it has been calculated that the termination of

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1/ It should be noted that the overall limitation, which permits an averaging of taxes imposed by high-tax and low-tax countries, can create more potential for tax avoidance than deferral.

deferral might, over a period of time, cause U.S. corporations to reduce their foreign assets by as much as $3.4 billion, and increase their domestic assets by $2.2 billion (Table 4). These estimates depend on numerous assumptions, and may represent extreme statements of the investment impact. Other models suggest that U.S. corporations would reduce both their U.S. and foreign investment as a result of the termination of deferral. In general, the estimates do not reflect the possibility of adverse foreign reaction.

In addition to its impact on real investment, the termination of deferral might encourage firms to change their means of finance. Some firms might find it advantageous to substitute borrowing for parent firm equity. The extent of such substitution would depend on a variety of considerations, including tax rules adopted by host countries.

(e) U.S. tax revenue. The effect of terminating deferral on U.S. revenue depends on several factors. Under the standard assumption of no change in corporate or foreign government behavior, the revenue gain could be $365 million (Table 7). Other assumptions suggest lower revenue gains, or even revenue losses. For example, under the assumptions that all CFC earnings would be actually distributed following the termination of deferral, the U.S. loss could be $375 million (Table 10).

IV. OPTIONS

Legislative options on deferral can be grouped into four broad categories: (1) retain the present system; (2) broaden subpart F to include more types of income; (3) partly or completely terminate deferral by requiring that deemed and actual distributions equal some portion of all of CFC earnings; and (4) terminate deferral in the context of repealing domestic tax preferences. Option (3) involves secondary questions as to the extent of consolidation between subsidiaries, and the choice of a per-country or an overall limitation on the foreign tax credit.

1. Retain present system. It can be argued that no further legislation is needed on the deferral issue. The Tax Reduction Act of 1975 substantially extended subpart F, and as a result the principal areas of tax abuse have been closed off. Further legislative restrictions could prove counterproductive by accelerating actual distributions, triggering legislative reactions abroad, reducing the profitability and growth of American firms, adding complexity to the Internal Revenue Code and placing administrative demands on the Internal Revenue Service. Moreover, while the present tax system favors foreign

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investment in some cases, it favors domestic investment in many other cases.

2. Broaden subpart F. Subpart F could be broadened in several respects, consistent with its objective of reaching foreign income with tax abuse characteristics.

(a) The substantial reduction test. Under section 954 (b)(4), a CFC that does not have as one of its significant purposes a substantial reduction of taxes is generally excluded from subpart F.[1/] This exemption underscores the anti-tax avoidance purpose of the statute, but it has been drafted in a manner that limits the application of subpart F. The test is basically whether the effective tax rate paid by the foreign corporation equals or exceeds 90 percent, or is not less than 5 percentage points lower than, the effective foreign tax rate that would have been paid if the income had not passed through a foreign base company (Regulations 1.954-3(b)(4), example (1)). Certain foreign countries impose low rates of tax, while others exclude certain kinds of income from taxation altogether. Therefore, the CFC can meet the 90 percent or the 5 percentage point test, yet still be paying far less than the U. S. corporate tax rate of 48 percent. Moreover, the test poses substantial administrative difficulties, because it requires

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1/ Particular items of income may still be taxed under subpart F if the transaction was structured to avoid taxes.

the Internal Revenue Service agent to have an intimate knowledge of third country tax laws.

This difficulty could be eliminated in the context of subpart F by recasting the "substantial reduction" test to refer not to alternative foreign tax rates, but to the U. S. corporate tax rate. If the present "substantial reduction" test obstructs the revenue gains projected under subpart F as expanded by the Tax Reduction Act of 1975, then very large amounts of revenue could depend on an appropriate modification, perhaps as much as $100 million. However, this amount is not additional to, but rather a part of, the revenue collections already estimated for subpart F.

(b) 50 percent subsidiaries. The present language of subpart F appears to exclude foreign corporations that are owned exactly 50 percent by U. S. shareholders. However, the Tax Courts have found that 50 percent ownership, combined with actual control, will suffice for subpart F purposes. The statute could be strengthened to include foreign subsidiaries owned 50 percent by U. S. shareholders, with a rebuttable presumption of actual control. The revenue consequences of this change are estimated at less than $5 million.

(c) Shipping income. The Tax Reduction Act of 1975 included international shipping income under subpart F, to the extent it is not reinvested in shipping operations. However, the earnings of most shipping companies are likely to come within the reinvestment exclusion. Subpart F could be broadened to include all shipping income, whether or not reinvested. Such a provision should be related to other changes in the taxation of shipping income discussed in the Treasury Paper on the "Tax Treatment of Income from International Shipping," February 1976. The potential revenue gains are estimated at $70 million.

(d) "Runaway plants" and tax holiday manufacturing. In 1973, the Treasury proposed that tax haven manufacturing corporations, defined to include "runaway plants" and tax holiday operations, should be taxed currently under provisions similar to subpart F.

A runaway plant would be defined as new investment in a controlled foreign corporation which realized more than 25 percent of its gross receipts from the manufacture and sale of products to the United States, and paid a foreign effective tax rate of less than 80 percent of the U. S. corporate tax rate. A tax holiday manufacturing corporation would be defined as any controlled foreign corporation which increased its investment in excess of 20 percent during or in anticipation of a foreign tax incentive. Foreign tax incentives would be broadly defined under regulations prescribed by the Secretary of the Treasury. The tax haven manufacturing proposal would increase revenue by about $25 million.

(3) Simplification. Although subpart F was based on the earlier foreign personal holding company statute, no effort was made to combine the two pieces of legislation or enact identical statutory tests to define the controlling group or constructive ownership. As a result, there is some overlap between the two statutes, and a foreign personal holding company may also be subject to subpart F. A foreign personal holding company can also be a personal holding company, with a penalty tax imposed both on the company and on the shareholder.

These statutes could be simplified by taxing foreign personal holding companies within the framework of subpart F, and by establishing a mutually exclusive boundary between personal holding companies and foreign personal holding companies. Simplification and rationalization of the law would probably not provoke an adverse foreign reaction. The revenue effect would be minimal.

3. Partial or complete termination of deferral. Some observers contend that the separate entity system of taxing foreign corporations reduces U. S. tax revenue and encourages foreign investment at the expense of domestic investment. These observers argue that the remedy lies in the partial or complete termination of deferral.

Other observers point out that the termination of deferral might produce only short-run revenue gains, and that, as an isolated step, it would move the United States further away from a system of capital-export neutrality. Moreover, adverse foreign reaction could be intense, especially from countries such as Israel, Egypt, and Ireland which promote industrial development through tax relief.

The complete termination of deferral would clearly replace subpart F, but the partial termination of deferral would not serve the same function, since subpart F provides for current taxation of all CFC income in selected situations. Partial termination legislation would need to be carefully coordinated with existing subpart F to avoid overlapping coverage that could cause very severe administrative problems for taxpayers and the Internal Revenue Service. In any event, partial termination would require very complex legislation.

The revenue estimates for the complete termination of deferral under the standard assumption of no behavioral changes range from \$365 million to \$630 million depending on whether an overall or per-country limitation is used for the foreign tax credit. If allowance is made for behavioral change, the revenue gains would be less, and there might even be a revenue loss of up to \$375 million from the termination of deferral. The partial termination of deferral would involve both smaller revenue gains (under the standard assumption) and smaller revenue losses (under the worst case assumption).

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The partial or complete termination of deferral involves several choices as to coverage and mechanics. The important choices are outlined in the following paragraphs.

(a) Required minimum percentage distribution. The partial termination of deferral would involve a percentage test for the distribution of earnings and profits. To the extent actual distributions do not meet the minimum percentage, earnings would be distributed on a deemed basis. The percentage could be based on after-tax earnings and profits, or on after-tax earnings and profits plus other categories of foreign source income, such as interest, royalties, management fees and branch earnings. The broader the base amount, the easier it is to meet the test, as illustrated by Table 8.

(b) Allocation of the deemed distribution between CFCs. The partial termination of deferral would also involve allocation of the deemed distribution between CFCs. This allocation is both to trace the foreign tax credit associated with each deemed distribution and to maintain an inventory of deemed distributions for each CFC. The allocation could be made on a pro rata basis with respect to the undistributed earnings of all CFCs, or the allocation could be made only with respect to the CFCs not meeting the minimum percentage. The allocation rule should be consistent with the consolidation rule.

(e) The extent of consolidation. In the case of partial termination, the question arises whether the minimum percentage applies to each CFC individually, or to a U.S. parent corporation' CFCs grouped on a country, on a worldwide, or on some other basis

In the case of complete termination, the extent of consolidation is also important. The wider the grouping, the smaller the revenue impact of any given percentage test, as shown in Table 8. This relationship reflects two phenomena: first, some CFCs have losses, and these losses increase the apprent distribution rate of profitable CFCs; second, CFCs with high foreign taxes already tend to distribute a larger percentage of earnings than CFCs with low foreign taxes, and if high-tax CFCs are consolidated with low-tax CFCs, the average creditable foreign tax is increased. There are several possible consolidation alternatives.

(i) Individual foreign corporation approach. This approach would employ the present subpart F mechanism of computing the income to be deemed distributed separately for each foreign corporation. There would be no consolidation of foreign corporations either with other foreign corporations owned by the same U. S. parent, or with the U. S. parent itself. Losses and blocked currency already create problems under this system, and these problems would become more important if deferral were eliminated. Under the individual foreign corporation approach, there are two methods for computing the amount of income of a lower-tier subsidiary which is included in the income of the U. S. shareholders: the so-called "hopscotch" method; and the so-called "link-by-link" method.

(aa) Hop-scotch method. This is the mechanism by which subpart F presently attributes the income of a lower-tier CFC to its shareholders. Under this method, the income is attributed directly to the U. S. shareholders, and cannot be offset by any loss incurred by intermediate foreign corporations. Under this method there are problems concerning the source country of a deemed distribution. In addition, if the intermediate corporation is in a country which restricts the repatriation of earnings, there can be blocked currency problems.

Compulsory adoption of the overall limitation for the foreign tax credit (as proposed in H.R. 10612) would render almost moot the source problem.[1/] However, if the per-country limitation is retained, it would be necessary to establish a source rule for the deemed dividend. Under present law, actual dividends are sourced in the country of incorporation of the subsidiary paying the dividend to the U. S. shareholder. Thus, if lower-tier CFC A distributes dividends to higher-tier CFC B, which is turn distributes dividends to the U. S. parent corporation, the dividends are sourced in country B. The rule more in keeping with the intent of the per-country limitiation would require that dividends be sourced in the country of incorporation of the lower-tier subsidiary which earns the income.

1/ A problem could still arise for a CFC with U. S. source income.

Blocked currency creates a problem under subpart F, and the problem would continue if the hop-scotch method were used more widely. The problem here is the effect on the lower-tier corporation if the intermediate corporation's country of residence restricts distributions so that the lower-tier corporation cannot distribute up the chain of ownership. Thus, the U. S. shareholder might be taxed on income which he could never realize. One solution is to apply the present blocked currency rules as if the country of incorporation of the lower-tier subsidiary restricts the repatriation.

(bb) Link-by-link method. The link-by-link method was considered by the Treasury in 1962. It was rejected partly because its complexity was not justified in light of the limited goals of subpart F as then enacted. The question now is whether the complete or partial termination of deferral, with its impact on all foreign corporations controlled by U. S. persons, would justify reconsideration of the link-by-link approach.

Under the link-by-link method, the retained earnings of a lower-tier subsidiary would be constructively distributed up the chain of ownership. The profits of a lower-tier subsidiary would thus offset the losses of a higher-tier subsidiary in the same chain. However, there would be no offset of losses in the lower-tier by profits in the higher-tier, nor would there be offsets as between different chains of CFCs owned by the same U. S. parent.

If the per-country limitation of the foreign tax credit is retained and the present income source rules are not changed, the source of the deemed distribution would be the country of incorporation of the first-tier corporation. Again, this result circumvents the purpose of retaining the per-country limitation, and suggests a reconsideration of the source rules.

If the link-by-link approach is adopted, the computation of earnings and profits must be correspondingly altered. If the constructive distribution is treated as an actual distribution, the earnings and profits of the lower-tier foreign corporation should be reduced by the amount of the constructive distribution, and the earnings and profits of the foreign corporation next in the chain should be correspondingly increased. This process should continue up the chain to the domestic parent. Thus each controlled foreign corporation would keep two sets of accounts: one set would reflect actual distributions while the other set would reflect deemed distributions for U. S. tax purposes. These two sets of books are presently kept for CFCs subject to subpart F.

(ii) <u>Consolidation of foreign operations</u>. Under this method, all foreign corporations within a controlled group would file a consolidated return in a manner similar to that currently available for domestic corporations. The consolidated return would presumably reflect only the U. S. parent corporation's share of the earnings and profits of its CFCs.

If the consolidated return shows an overall profit on foreign operations, the U. S. parent corporation would receive a deemed distribution of the foreign profit. If the consolidated return shows an overall loss, the parent might be allowed to claim the loss as a deduction against domestic income, or at least carry over the loss against future foreign profits. The purpose of a rule limiting the deductibility of overall foreign losses would be to protect the U. S. tax base.

Which foreign corporations would be allowed (or required) to consolidate? Consolidation should probably be limited to foreign corporations which are members of the same affiliated group, as that term is defined in section 1504(a). However, consideration might be given to lowering the required ownership to 50 percent from 80 percent, so that most controlled foreign corporations would be includable in the consolidated return, or even to 10 percent so that all CFCs would be includable.

Consolidation could be required, or it could be provided as an elective alternative to computation of income on an individual foreign corporation basis. If an election is provided, it would seem best to make it binding for future years, revocable only with the consent of the Commissioner. Standards for allowing revocation could be included in the legislative history or in the statute.

Blocked currency would raise problems. If one of the foreign corporations in the affiliated group is prevented by its home country from making a distribution, what is the effect on the group? Should that corporation be excluded from the group, or should it be assumed that the rest of the group will be able to distribute enough to make up the difference? A percentage test might be appropriate so that if the income of the blocked currency corporation is less than a fixed percentage of the income of the group (for example, 10 percent) then that corporation will be consolidated; otherwise it will be excluded.

(iii) Consolidation of worldwide operations. Under this approach the controlled group of corporations would file a single U. S. tax return for its worldwide operations rather than separate returns for domestic and foreign activities.

Questions concerning corporations to be included, an elective as opposed to a mandatory system, and blocked currency exist here as with the consolidated foreign operations approach. Additional questions arise. Should an electing corporation still be treated as a foreign corporation for purposes of section 367? Arguably not, because most tax avoidance potential is gone. On the other hand, high overall foreign tax rates might make it advantageous to transfer income producing assets from the United States to tax havens. Worldwide consolidation clearly raises several difficult issues.

(d) The problem of decontrol. The partial or complete termination of deferral could encourage firms to decontrol their existing CFCs and to take minority positions in new joint ventures as a means of avoiding U. S. taxation.

If decontrol and minority positions are a matter of concern, the foreign tax credit for deemed paid taxes (Section 902) might be limited to those U. S. shareholders claiming "actual control" of the foreign corporation (alone or acting in concert with other U.S. taxpayers), and thus presumptively subject to current taxation of earnings retained by the foreign corporation. Minority U. S. shareholders in a foreign corporation could thus elect either current taxation coupled with the deemed paid credit, or deferral without the deemed paid credit.[1/] Under present law, the deemed paid credit is not available for passive portfolio investments, generally defined as investments where U. S. corporate shareholders have less than 10 percent ownership or investments by individuals. The rationale of the deemed paid credit is to avoid double taxation when a U. S. corporation has an active management stake in the foreign investments. An explicit link between "actual

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1/ In both alternatives, a credit for direct foreign taxes, for example, withholding taxes on dividends, would still be available under Section 901.

control" and the deemed paid credit would bring the basic purpose of section 902 into sharper focus. The estimated amount of deemed paid foreign tax credit claimed in 1976 for foreign corporations owned less than 50 percent by U. S. shareholders is about $250 million. It is uncertain how much of this amount would be claimed under an "actual control" election, and it is very difficult to predict the potential extent of decontrol following the termination of deferral.

4. Terminate deferral in the context of repealing domestic tax preferences. As Table 1 indicates, the termination of deferral as an isolated measure would move the U. S. tax system further away from a standard of capital-export neutrality for the non-extractive industries.1/ The partial or complete termination of deferral, by itself, would favor manufacturing and other non-extractive investment in the United States by comparison with investment abroad. If tax neutrality between domestic and foreign investment is the goal, then deferral should be changed only in the context of a broader program. Specifically, the termination of deferral should be accompanied by collateral tax changes.

1/ This is true whether capital-export neutrality is defined by reference to present U. S. taxation of corporate income, or by reference to U. S. taxation of corporate income in the absence of domestic tax preferences.

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Certain of the collateral changes would increase tax revenue, namely, elimination of the Western Hemisphere Trade Corporation (+ $20 million), inclusion of less developed country corporations in the gross-up requirements (+ $55 million), and provision of a deduction rather than credit for foreign taxes comparable to state taxes (+ $450 million).[1/]

Other collateral changes would substantially decrease tax revenues, namely, elimination of restrictions on the foreign tax credit (- $180 million), extension of the investment tax credit to foreign non-extractive investment (- $1,000 million), extension of the asset depreciation range to foreign investment (- $300 million), extension of the DISC to export goods produced abroad (- $1,000 million).

The net decrease in tax revenues from non-extractive industries under a system of capital-export neutrality could thus reach $1,590 million.[2/] Extensive tax cooperation and negotiation between the United States and foreign governments would be required to achieve a system of capital-export neutrality. It would not be reasonable for the United States alone to absorb the entire revenue loss. On the other

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1/ The first two changes are proposed in H.R 10612.

2/ This figure is calculated in reference to present U.S. taxation of domestic corporate income. The net figure calculated in reference to U.S. taxation of corporation income with no tax preferences would be $2,990 million (Table 1). Both figures assume no change in corporate behavior.

hand, the United States could not increase its own revenues through the termination of deferral and reasonably expect other countries to undertake all the revenue losing changes required to achieve a system of international tax neutrality.

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FOR IMMEDIATE RELEASE April 9, 1976

TREASURY REFERS COLUMBIA MINT CASE TO FEDERAL TRADE COMMISSION

David Macdonald, Treasury Assistant Secretary for Enforcement, Operations and Tariff Affairs, today referred a two-dollar bill advertising promotion by the Columbia Mint, of Washington, D.C., to the Federal Trade Commission.

"The Columbia Mint", Macdonald stated, "has run several full-page advertisements in nationally-distributed newspapers over the past two weeks, beginning March 28, advertising the sale of 'official', 'first day issue', $2 bill philatelic folio collector's items. The items offered by the Columbia Mint are in no way connected with the Department of the Treasury and the Treasury Department neither encourages nor endorses the sale of these items."

"Because the Columbia Mint's advertisements state that they are issuing the $2 bill 'through the cooperation of the Treasury Department', I have referred this matter to the Federal Trade Commission for their consideration and review of the possibility of misleading advertising."

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FOR RELEASE ON DELIVERY

STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
ON MAJOR TAX REVISIONS AND EXTENSION
OF EXPIRING TAX CUT PROVISIONS
BEFORE THE SENATE FINANCE COMMITTEE
WASHINGTON, D.C., TUESDAY, APRIL 13, 1976, 10:00 a.m.

Mr. Chairman and members of this distinguished Committee:

On March 17, 1976 I presented to this Committee a comprehensive statement on major tax revisions and the extension of expiring tax cut provisions. All of our proposals are fully spelled out in that statement. This morning, I will simply highlight briefly some of the more important aspects of our program, and answer any questions you may have.

Fairness of Tax System

In my March 17 statement, I indicated that a major issue before you concerns the way to enhance the fairness of the tax system. We are fortunate to have a highly successful tax system which over the years has commanded widespread respect and a high degree of voluntary compliance. We can be sure that Americans will continue to support this system so long as they have confidence that all are paying their fair share and as long as they feel they are getting their moneys' worth. Many people today feel that taxes are being imposed upon them without their consent, and that too many of their fellow taxpayers are escaping their responsibility through dozens of loopholes.

We all believe that our tax system should be fair and equitable, that it should be simple, and that it should promote efficient use of our resources. But we cannot move toward these goals if we continue to have a system which permits individuals with high economic incomes to pay little or no tax. Unabated, this practice not only undermines seriously the progressivity of the income tax, but equally important, undermines its perceived fairness.

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In my previous testimony, I urged you to adopt our LAL (Limitation on Artificial Losses) proposal. The House has already done so. We believe that LAL effectively limits the principal tax benefit associated with tax shelters--deferral of tax liability--by applying the fundamental concept that the income and the expenses of generating that income should be matched.

I also referred to the problem of high-income taxpayers who do not pay their fair share of the tax because of substantial exclusions from income. We renewed, in modified form, our 1973 MTI (Minimum Taxable Income) proposal to deal with this problem. MTI is an alternative tax which will subject taxpayers to progressive income tax rates.

I am, of course, aware that over the past few weeks you have received testimony on LAL and MTI. I am generally pleased that many of the witnesses have supported the MTI alternative tax concept as opposed to the present minimum tax. There have also been proposals that would apply an alternative tax such as MTI as the sole vehicle to deal with the dual problem of deferrals of tax liability and exclusions from taxable income. The claim is made that this is simpler than the combination of LAL and MTI. I am not convinced that this is the case, but in any event, this is not the real issue. The real question for you to consider is whether these proposals deal as effectively as our recommendations with the two distinct problems of deferrals and exclusions. If these proposals are not at least as effective as ours, are you willing to say to those millions of Americans who correctly perceive tax shelters to be a tax break for sophisticated and rich taxpayers that we have opted for a less effective remedy because it may be simpler?

In this context, we should not lose sight of the fact that an ineffective solution simply means that our income tax is not as fair as it should be and that low- and middle-income taxpayers are bearing a heavier tax burden than would otherwise be possible. We continue to believe that LAL, in combination with MTI, will solve effectively the two distinct problems of deferrals and exclusions which have undermined the progressivity of the tax and its perceived fairness.

Capital Formation

In the area of capital formation, I would like to emphasize again how important it is that we make some

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progress in removing the impediments to the process of investment in our economy. The rapid development of the U.S. economy over the years has resulted from the favorable combination of the Nation's natural resources, our productive labor force, and the efficient application of capital which has emphasized reliance on competitive market forces and profit incentives to stimulate growth and efficiency. The allocation of human and material resources has generally been left to the market rather than to unwanted government controls, although such intervention has unfortunately increased. The resulting decisions about prices and output are not the result of central planning; instead, they reflect the long-term balance between what we want and what can be supplied. The market system has served us well and it remains the key aspect of our productive economy. We must assure that the flow of new capital and its effective use are not hampered by the tax system for in the long-run we shall all be the losers if we do not.

Several of the proposals before you are designed to offset the drag on capital formation now built into the tax system. Among the steps which should be taken toward this objective are:

- -- Make permanent the investment tax credit at its present level of 10 percent, to increase the incentive for enterprise to invest;

- -- Reduce the top corporation tax rate from 48 to 46 percent and make permanent the other rate and exemption changes effected in 1975 to encourage investment in this sector, and to offset slightly the tax bias against corporate investment;

- -- Adopt the President's Broadened Stock Ownership Plan to reinforce the objective that all Americans participate in the free enterprise system and thereby strengthen its economic, social and political base of support;

- -- Adopt the sliding scale treatment for capital gains to increase the rate of capital formation and to reduce the "lock-in" effect which prevents investments from flowing to their most productive uses.

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-- Adopt our proposal for the integration of the corporate and personal income taxes to remove fully and permanently the tax bias against corporate investment arising from the double taxation of corporate income.

We should not neglect to make progress on integrating corporate and personal income taxes. This is a very fundamental change which directly confronts the distortive effects of the tax system on the financial structure of our corporate sector, which removes fully the bias against corporate investment and which honestly recognizes that the burden of taxes is ultimately borne by people. Let us also catch up with our competitors in the world marketplace by taking the step that most of them have already taken--integration of corporate and personal income taxes.

These measures are not designed to produce mere short-run stimulus. They should themselves be regarded as investments--investments in a prosperous future of higher wages, better jobs, and an economy with the muscle we shall need to do the things we want to do as a Nation.

Broadened Stock Ownership Proposal

More specifically, we are very enthusiastic about the prospect of adoption of our Broadened Stock Ownership Proposal which I discussed in detail on March 17. By allowing deferral of taxes on certain funds invested in common stocks, we would be encouraging broadened stock ownership by low- and middle-income working Americans and thereby enabling them to demonstrate their faith in the free enterprise system. It is only as we strengthen the public support for our free enterprise system that we can begin to find the much needed sources of capital for our corporate sector. We believe that our proposal will at once engender a greater sense of participation in the free market system by the large group of low- and middle-income Americans and give them an opportunity to build a reasonable estate for themselves and their heirs.

Capital Gains and Losses

The sliding scale proposal for the taxation of capital gains and losses which I also discussed on March 17 is designed to promote capital formation and make sure that investments flow to their most productive uses. At the same time, the proposal will reduce the unwarranted taxation of inflationary gains.

Under our proposal, the amount of capital gain which may be deducted in computing adjusted gross income will increase the longer the asset has been held by a taxpayer. If an asset has been held for less than one year, the gain would be fully taxable; if held between one year and five years, 50 percent of the gain would be taxable. If the asset has been held from five up to 25 years, the percentage of the gain which is taxable will decrease by 1 percentage point for each year that the asset has been held. Thus, if an asset has been held for 25 years only 30 percent of the gain would be taxable.

The sliding scale proposal represents a sensible rule of thumb to avoid converting the income tax into a capital levy on shifts in investments and, as I mentioned earlier, it will reduce the unwarranted taxation of inflationary gains. As I explained in my March 17 testimony, we have assumed that our proposal will not have an impact on Fiscal 1977 receipts.

DISC

With respect to DISC, I am pleased to announce that the 1974 Annual Report on DISC has now been completed by Treasury. This morning I have distributed to you copies of the report. In my March 17 statement I discussed the DISC provisions, emphasizing that the Administration supports DISC in its present form and opposes the cutbacks contained in the House Bill.

Total U.S. exports have increased dramatically in recent years, from $43 billion in 1971 to $106 billion in 1975, and the U.S. share of the exports of industrialized countries has grown from 18.2 percent to 20.2 percent in this period. DISC has contributed to this growth in U.S. exports, and has helped expand our position in world markets. Treasury estimates suggest that the total DISC effect in the period covered by the Report was an export stimulus of $4.6 billion. Projections indicate that the effect of DISC on exports in 1976 could be as large as $9 billion. The employment associated with these additional exports in 1976 is estimated at as much as 300,000 jobs. These additional exports and jobs come at a time when we are experiencing unutilized economic capacity.

The repeal or reduction of the DISC program would adversely affect exports and the associated employment. DISC has encouraged firms to invest in the United States rather than abroad and we must continue to meet foreign competition. DISC helps U.S. firms achieve this goal.

The contributions made by DISC provide persuasive arguments not only for the continuation of DISC, but also for making no changes in DISC at this time. Moreover, it must be remembered that DISC has been in place for only a short time. Many companies have made significant investments in reliance upon it. DISC, like the investment credit, should not be turned on and off, depending on the whim of the moment. We must resist the temptation to adopt stop-and-go policies which create a climate of great uncertainty for business planning.

Foreign Withholding

Finally, I would like to urge you again to eliminate the existing withholding tax provision on foreign investments in U.S. securities. Our present withholding system is counterproductive. It hampers our economy, impedes the competitive position of U.S. financial markets in the international capital markets, denies access to foreign capital markets, favors short-term foreign debt investment, and needlessly complicates our tax law, in order to raise an insignificant amount of revenue. It should be repealed promptly.

Elimination of the withholding tax will increase investment by foreigners in the United States. It will also improve the relative attractiveness of long-term securities and reduce the present imbalance favoring short-term securities and bank deposits (which are presently exempt from withholding). Access to foreign funds will permit the United States to continue its role as a capital exporter, including the recycling of funds flowing into and out of the oil producing countries. Further, elimination of the tax will assure our financial markets of maintaining their preeminence in the international capital market. The existence of this withholding tax has impeded their ability to compete. Repeal of the tax is also consistent with principles of tax equity and other rules relative to source of income. Finally, repeal of the withholding tax will eliminate what has become a complex patchwork of legislative and treaty provisions and thereby simplify one area of the tax law. The basic point is that the many benefits of eliminating the tax outweigh the small revenue loss.

Conclusion

This morning, I have merely emphasized the highlights of our tax program. As I mentioned in my March 17 testimony you have before you an extremely challenging agenda. Let us take the steps I have urged upon you in the direction of a better income tax code, but let us not stop there.

Let us have these steps represent a part of the process of continuing true tax reform which will take us eventually to a tax system which looks as though someone had constructed it on purpose, a simple progressive tax on a broad base which adequately reflects individual taxpayer's ability to pay. That is the tax break all Americans are waiting for.

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April 12, 1976

SUMMARY OF THE INVESTIGATION INTO THE HANDLING BY THE INTERNAL REVENUE SERVICE OF THE INCOME TAX RETURNS OF SENATOR JOSEPH M. MONTOYA AND RELATED MATTERS

In October, 1975, the Inspection Division of the Internal Revenue Service commenced an investigation into allegations that Senator Joseph M. Montoya had received preferential treatment by the Internal Revenue Service in connection with matters pending before the Service, as a result of directives issued by the national office. Following publication of an article in the Washington Post on October 19, 1975, Secretary of the Treasury William E. Simon directed that an inquiry into the allegations contained in the article be conducted under the supervision of the General Counsel of the Treasury independent of the Inspection Division investigation. This is a summary of the report prepared by Richard R. Albrecht, General Counsel of the Treasury, with the assistance of two staff attorneys, and submitted to Secretary Simon.

The report documents a series of instances in which our system of taxation appears to have been influenced by fears and concerns over the effect that proposed Internal Revenue Service action might have on an influential elected official. At the time of the actions that were the subject of this investigation, there existed among a number of senior IRS officials a noticeable concern for the potential power that Senator Montoya had over the IRS. This concern stemmed from the Senator's position as Chairman of the Treasury appropriations subcommittee and from the adverse publicity the Service received during oversight hearings chaired by the Senator. It was intensified during 1973 by the Watergate hearings and the publicity about IRS "enemies" lists and the Special Services staff.

Some of the actions and decisions by IRS officials may be characterized as reflecting questionable judgment. However, any conclusion that is critical of that judgment can be made only with the benefit of hindsight. Most of the actions that may now be called into question were taken in the good faith belief that they were necessary to protect the IRS from further allegations of improper conduct at that time. Those actions combined with the complex structure and procedures for administering the tax system to create results that may not have been reasonably foreseeable at the outset.

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The investigation upon which the report is based focused on six specific issues, five of which involved alleged preferential treatment accorded Senator Montoya or members of his family by the Internal Revenue Service. The sixth involved the question of improper disclosure of information from the Senator's tax returns by present or former government employees. In each of the five instances there were found examples of deference to Senator Montoya and his potential power over the Internal Revenue Service, in some instances involving a considerable number of IRS employees.

* * *

Chronologically, the first allegation of preferential treatment involved improper interference by officials of the IRS national office with attempts by the Albuquerque district office to collect delinquent taxes from two taxpayers located in Senator Montoya's home state. The report reached the following conclusions based upon the investigation of this issue:

> Following an inquiry by Senator Montoya, the Albuquerque District Director concluded, and reported to the Senator, that the seizure of a dry-cleaning business for unpaid withholding taxes was proper and should not be changed.
>
> About ten days later, after contacts with IRS officials in the Southwest Region by the Deputy Commissioner, who was scheduled to testify before Senator Montoya in a few days, the seized business was released.
>
> Further, after a subsequent discussion between regional officials and the Deputy Commissioner, action on the tax delinquency of another taxpayer in New Mexico was postponed.
>
> It appears that the release from seizure and the postponement of proceedings were directed by the Deputy Commissioner. Although the then Deputy Commissioner does not acknowledge issuing such an order, the Acting Regional Commissioner and the Albuquerque District Director reasonably interpreted his instructions as requiring the release and postponement.

Although Senator Montoya expressed the opinion to the District Director that the seizure was a mistake, the orders for its release were not the result of direct action by the Senator, but rather the result of unfavorable publicity combined with the pending appearance of IRS officials before a subcommittee chaired by Senator Montoya.

At no time did the District Director or anyone else affected by the orders to release the seizure report the fact to the Inspection Division of the IRS, although established procedures required the reporting of any improper order.

The second matter investigated concerned the alleged two-year delay by national office officials of an attempt by the Albuquerque district to audit certain of the Senator's tax returns. The report reached the following conclusions based upon the investigation of this issue:

The Albuquerque District Director wanted to pursue an Intelligence Division investigation of Senator Montoya in mid-1973.

The Commissioner and Deputy Commissioner concluded the Intelligence Division investigation should not go forward at that time and issued instructions to that effect.

Their decision was based in part on a concern that the IRS not undertake an investigation that would appear to be motivated by a desire to "punish" Senator Montoya as an "enemy" of the IRS or of the administration.

There was some justification for such a concern, based on Senator Montoya's oversight hearings, his membership on the Watergate Committee, current publicity about "enemies" lists and other accusations against the IRS, as well as the Albuquerque District Director's previous expressions of dislike for the Senator. There also existed noticeable concern among many senior officials of the IRS for any reaction the Senator might have, as a member of the IRS appropriations committee, to any IRS inquiry or investigation into his income taxes.

Although the Intelligence Division investigation was stopped because of the above concerns on the part of national officials, and this course of action was accepted by the region and district because of an inadequate development of evidence, no routine audit was commenced in its place.

Senior officials of the IRS were hopeful that the Senator's 1972 return would be selected by computer for audit review, thus providing a vehicle for initiating an audit.

Actions taken with an eye to speeding up the possible selection of the Senator's 1972 return for audit had the opposite effect and virtually assured that the return would not be selected for audit. Due to an unusual sequence of events, many of them related to technical IRS procedures for dealing with tax returns and selecting them for audit, the return was never processed through the normal audit selection procedure.

Subsequent reviews of whether the Senator's returns were improperly by-passed by the audit process did not second-guess the initial decision but considered whether an audit should have been initiated at that later time.

There are legitimate audit issues on at least two of the Senator's returns that should be reviewed.

No stigma should be attached to such a review since the purpose of an audit is to review and verify the information submitted by a taxpayer on his return.

The Senator was unaware of any proposed or threatened audit or investigation of his tax returns, and none of the actions of the IRS resulted from direct action by the Senator.

Although IRS procedures called for reporting of any improper interference with a tax matter, and several individuals believed the investigation into the Senator's taxes was being improperly thwarted, none of them reported that fact to the IRS Inspection Division.

The third series of events investigated concerned alleged improper interference by national office officials with district and regional intelligence gathering activities involving the Senator and members of his family. The report reached the following conclusions based upon the investigation of this issue:

Officers in the national office denied a request for surveillance of a meeting between an IRS confidential informant and members of the Montoya family because they believed the facts did not justify the method of surveillance requested. They also erroneously believed that the Commissioner had ordered that no action be taken with regard to the Senator without the Commissioner's prior approval, and believed this case did not warrant the Commissioner's attention.

Based upon the mistaken belief of certain officials that they had instructions to that effect, two packages of information, possibly relevant to any review of the Senator's returns, were withheld from the Albuquerque district, at least temporarily. This was done without the knowledge of either the Commissioner or Senator Montoya.

The fourth event investigated concerned the allegation that the Albuquerque District Director was transferred due to his actions in dealing with matters related to Senator Montoya. The report reached the following conclusions based upon the investigation of this issue:

There was an attempt by some IRS official or officials to arrange the transfer of the Albuquerque District Director because of his actions with respect to Senator Montoya's tax returns, but their actions did not result in his transfer.

The District Director's transfer, which occurred almost two years later, was probably based upon and justified by the personnel and managerial problems which existed then and which had long plagued the Albuquerque office. Although the Senator knew of the managerial problems in the Albuquerque office and of an IRS review of these problems, he did not request the District Director's transfer.

The fifth allegation involved interference by regional officials with the commencement of an Intelligence Division investigation by the Albuquerque district of a member of Senator Montoya's family. The report reached the following conclusions based upon the investigation of this issue:

There existed a strong difference of opinion between officials in the Southwest regional office and Albuquerque

> district office as to the proper procedure for initiating an inquiry into the tax filing status of a member of Senator Montoya's family.
>
> Regional officials eventually directed the district to use the procedures advocated by the region, in part because of concern for embarrassing the IRS and offending Senator Montoya.
>
> Although several officials in the district believed the region's actions were improper, none reported that fact to the Inspection Division as required by IRS procedures.
>
> Senator Montoya was unaware of any proposed audit or investigation of one of his family members, and none of the actions taken by IRS officials resulted from direct actions of the Senator.

The final allegation covered by the report concerned the improper disclosure to the Washington Post of income tax information from Senator Montoya's tax returns by present or former Internal Revenue Service officers or employees. The report reached the following conclusions based upon the investigation of this issue:

> The Washington Post story included information of the nature contained on tax returns. Since such information is not readily available from other sources, it is reasonable to assume there was an improper disclosure of information from Senator Montoya's tax returns.
>
> Although the investigation is continuing, it has not been possible to ascertain the persons responsible for the disclosure.

* * *

The report concludes with comments on the results of this investigation and recommendations for action.

It is imperative that the Internal Revenue Service operate in an even-handed manner, treating all taxpayers alike regardless of their station in life. It is equally important to our self-assessment tax system that the public perception of our tax system is that all will be treated alike. The IRS must not appear to show either favoritism or antagonism towards any taxpayer or group of taxpayers.

In order for the image of the IRS to be maintained on this plane, it is doubly important that the tax treatment of public figures be above reproach. The allegations in recent years that the IRS was used to reward friends and punish enemies certainly tarnished that image. It is possible that the adverse publicity resulting from those allegations has prompted some IRS officials to be overly cautious out of a genuine and well-motivated desire and concern for the Service's reputation for fair play. It would be unfortunate, however, if it appeared to the public that people in high places could receive favorable treatment because of their position or by using their influence over the IRS.

It is not only direct or conscious action that can result in uneven treatment or the appearance of a double standard. However, the Internal Revenue Service cannot tolerate any actions that result in or appear to result in anything less than objective, even-handed treatment, regardless of whether the action was intentional or unintentional.

The IRS does have procedures and systems to deal with the risks discussed above. Proper management supervision and internal controls should avoid most instances of harassment of a taxpayer by the Service. Any IRS employee who is told to do something he considers improper is under orders to report that fact to the Inspection Division. The Inspection Division is independent of the management chain of command--except at the very top--and an employee's complaint should not result in any jeopardy of his job or prospects for advancement. Investigations by the Inspection Division have effectively policed the conduct of IRS employees in prior cases.

But, in this instance, the system did not work properly. Perhaps it failed because many of the decisions were made by top management at the national office--an unusual place for decisions to be made involving the conduct of an individual tax case. The involvement of high officials may have deterred some employees from reporting to Inspection. Participation by the Commissioner may have had a particularly deterring effect because the Assistant Commissioner (Inspection) reports to the Commissioner.

But it is just this situation--involvement of senior officials--that is likely to occur when an important public figure is involved. Therefore, we recommend that consideration be given to the adoption of new techniques or systems--as well as developing a greater awareness of the present systems--to overcome the weaknesses demonstrated by this report.

We specifically recommend the following:

1. A review should be made of the organization and procedures for reporting and investigating allegations of misconduct by supervisory officials in the IRS. Such a study may be expanded to include a review of such procedures throughout the Treasury Department.

2. In the meantime, current policy should be well publicized within the IRS to encourage employees to report immediately any attempts to influence or interfere with a pending audit, investigation or review.

3. Consideration should be given to the feasibility of adopting a policy of automatic audits of all elected Federal officials and Presidential appointees periodically if they have not been selected for audit by other means. This subject should be discussed with the Joint Committee on Internal Revenue Taxation.

4. Efforts should be made to educate the public concerning the fact that an IRS audit is principally an effort to verify information submitted on a taxpayer's return, and that no stigma should be attached to being selected for audit.

5. Senator Montoya's personal income tax returns for all open years should be promptly reviewed by the IRS for audit potential. All information concerning the Senator the IRS has in its possession, from whatever source derived, should be made available to the persons in charge of the review.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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April 12, 1976

STATEMENT BY THE HONORABLE WILLIAM E. SIMON, SECRETARY OF TREASURY ON THE RELEASE OF A JUSTICE DEPARTMENT INVESTIGATION OF IRS COMMISSIONER DONALD C. ALEXANDER

Secretary of the Treasury William E. Simon today expressed pleasure at the Attorney General's announcement that the Justice Department investigation has cleared Internal Revenue Service Commissioner Donald C. Alexander of any wrongdoing. Secretary Simon said he was tremendously pleased that, after an intensive investigation by the FBI and Justice Department attorneys, they were able to conclude that there was no evidence to support any of the allegations of improper conduct by the Commissioner.

Simon noted that, although the charges turned out to be unfounded, he believed it was important that they were thoroughly investigated in order to maintain public confidence in government officials and institutions. Secretary Simon reaffirmed his prior expressions of confidence in the honesty and integrity of Commissioner Alexander and described Alexander as a dedicated, capable public servant.

Secretary Simon also released today a summary of the investigation conducted by the Treasury Department into the handling by the Internal Revenue Service of the income tax returns of Senator Joseph M. Montoya of New Mexico and related matters. The Secretary noted that some of the actions and decisions by IRS officials described in that report appear to have involved questionable judgment. He pointed out, however, that any conclusions critical of that judgment can now be made only with the benefit of hindsight, and it is clear that the very actions that might now be questioned were taken at that time in the good faith desire to avoid further allegations of improper conduct by the IRS. Simon also noted that the investigation produced no evidence that Senator Montoya at any time sought favored treatment from the IRS, and none of the matters reported resulted from direct action by the Senator.

The Treasury investigation report made a number of recommendations to the Secretary. Simon indicated that all of those recommendations have been accepted, and steps are being taken to implement them.

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Secretary Simon stated that he believes that American taxpayers are entitled to a tax administration system that is not only efficient and effective, but also has the highest integrity. He stated that he and Commissioner Alexander would continue to work to provide a tax system deserving of the public's confidence.

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FOR IMMEDIATE RELEASE April 12, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.7 billion of 13-week Treasury bills and for $3.4 billion of 26-week Treasury bills, both series to be issued on April 15, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 15, 1976			26-week bills maturing October 14, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.786 a/	4.803%	4.93%	97.449	5.046%	5.25%
Low	98.777	4.838%	4.97%	97.432	5.080%	5.29%
Average	98.779	4.830%	4.96%	97.438	5.068%	5.27%

a/ Excepting 1 tender of $100,000

Tenders at the low price for the 13-week bills were allotted 19%.
Tenders at the low price for the 26-week bills were allotted 5%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 55,665,000	$ 22,260,000	$ 38,480,000	$ 11,480,000
New York	5,004,490,000	2,296,825,000	5,367,135,000	3,086,235,000
Philadelphia	48,170,000	46,905,000	94,745,000	10,995,000
Cleveland	43,925,000	39,255,000	60,055,000	48,465,000
Richmond	53,975,000	22,455,000	49,890,000	13,540,000
Atlanta	35,440,000	31,450,000	30,955,000	21,455,000
Chicago	343,670,000	59,085,000	181,115,000	57,215,000
St. Louis	63,745,000	30,430,000	67,500,000	40,500,000
Minneapolis	40,605,000	10,365,000	58,400,000	25,400,000
Kansas City	61,915,000	43,015,000	30,475,000	22,275,000
Dallas	35,395,000	24,795,000	52,835,000	14,835,000
San Francisco	457,830,000	77,230,000	285,365,000	48,725,000
TOTALS	$6,244,825,000	$2,704,070,000 b/	$6,316,950,000	$3,401,120,000 c/

b/ Includes $411,510,000 noncompetitive tenders from the public.
c/ Includes $225,095,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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FOR RELEASE UPON DELIVERY

STATEMENT BY THE HONORABLE GERALD L. PARSKY
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WASHINGTON, D.C.
WEDNESDAY, APRIL 14, 1976, AT 10:00 A.M.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the President's proposal for an Energy Independence Authority (EIA). This initiative should be seen as part of the President's comprehensive energy policy -- a policy that is aimed at removing our country's excessive dependence on others for our energy. Specifically, the President has set as our goals:

-- In the near-term, 1975-77, halt our growing import dependence by reducing oil imports by 2 million barrels per day (MMB/D) before the end of 1977.

-- In the mid-term, 1975-85, attain energy independence by achieving invulnerability to oil import disruption; this means a 1985 import range of 3-5 MMB/D, replaceable by stored supply and emergency measures.

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In the long-term, beyond 1985, mobilize U.S. technology and resources to supply a significant share of the Free World's energy needs.

To achieve these objectives we cannot rely on government alone. We must, in large part, depend on our private sector for the large capital investment necessary to develop energy supplies. The task of mobilizing the needed private capital would be very challenging under the best of circumstances. However, the government has compounded the difficulties through its regulation and control of the energy industry; and for a variety of reasons, the private sector is having difficulty financing certain types of important energy projects. Most of these difficulties could be overcome through timely and innovative regulatory actions and through removal of other impediments to the development of oil, coal and gas and the growth of nuclear power.

The fact that we must face, however, is that these needed regulatory actions and policy decisions will be too slow in evolving. The President has determined that we can't wait and, accordingly, has proposed the EIA in order to ensure the timely development of important sectors of our energy industry. If EIA is viewed as a substitute for taking the needed regulatory reforms, or if it is seen as a substitute for the private sector, its purpose will have been defeated and it will be counterproductive. If, however, it serves as a temporary bridge to the time when regulatory impediments are removed and evolves as a supplement to the private sector, then it can play an important role in bringing a sensible energy policy to this country.

In my testimony today, I will concentrate on the financial considerations which led to the EIA proposal and some of the more important consequences of EIA operations. In particular, I would like to discuss with you (1) the expected capital requirements of our energy industry, (2) the reasons why many important energy projects may not be financed by the private sector, and (3) the capital market impacts of EIA.

Energy Industry Capital Requirements

A number of studies have been made concerning the capital requirements of the energy industry. In most cases these studies have analyzed the requirements based on several assumed scenarios, and the resulting estimates of the overall levels of capital requirements for the energy sector for 1975-85 produced by these studies range from about $480 billion to about $680 billion in 1975 dollars. A $580 billion figure would seem reasonable to us.

In order to assess the relative size of this figure, it should be compared with estimated business spending on new plant and equipment of roughly $2,000 trillion in 1975 dollars over the 1975-85 period. When viewed in this light, the $580 billion energy investment figure would constitute roughly 30 percent of estimated business fixed investment over the period, which would be well within the range of historical experience. Over the 1965-74 period, for example, energy investments as a percentage of total business fixed investment averaged 29% and ranged from 24% to 33%.

Despite the fact that capital needs for energy are not out of proportion to historical trends, an important concern is the extent to which private investors will be willing to finance the necessary investment in energy. Historically, the energy sector financed a relatively small percentage of its investment from funds raised externally. For example, it is estimated that during the early 1960's about 25% of fossil fuel investment was financed externally while the investor owned electric utilities financed about 35% of their capital needs this way.

However, over the past decade the energy sector and business in general has tended to rely more and more on external financing, especially debt. During the late 60's and early 70's the fossil fuel industry financed roughly 30-40% of its requirements externally; and the level of external financing for investor owned utilities ranged from 50-70%. The result has been that the energy sector has taken an increasing share of total funds supplied by the private capital market. Over the 1961-65 period the energy industry's share of the total amount of funds raised by business in U.S. capital markets averaged 18 percent.

The energy sector's share rose to 21 percent for the 1966-70 period and then to 28 percent in 1975, a year when other capital market demands were depressed. Estimates for the 1975-85 period suggest the U.S. capital market will provide some $1.1 trillion (in 1975 dollars) to the business sector and that the energy industry will require on average 25% of these funds.

We believe that the capital market will have the capacity to provide this level of funding to the energy industry. However, given the current uncertainties and regulatory climate, we do not believe that all of the necessary funds will actually flow to the energy sector in the needed amounts. Energy projects will have to compete with projects from other sectors; and the capital will normally flow to the most economically attractive projects--that is, where it can be most profitably employed in terms of private market criteria. Most of the needed conventional energy sector investments would be able to attract the necessary financing from private sources without Federal financial assistance such as that contemplated by EIA. There are, however, some types of projects which, for various reasons, are less likely to be able to attract funds from the private markets during the next 10 years without some form of government assistance. It's for this very reason that the President decided to propose EIA. To more fully appreciate the need for EIA, I would like to look briefly at some of the reasons why the private sector may not finance such projects.

Reasons Why The Private Market May Not Finance Certain Types of Energy Projects

There is no single all pervasive reason why certain types of energy development projects are not being financed in the private markets. In most cases where Federal assistance may be required, there is a combination of factors which create uncertainty in the minds of potential investors and prevent them from committing funds without some form of Federal participation. The most important of these reasons are the following:

(1) Some energy projects included in our national energy program are marginal and, in some cases, not economic at current market prices. For example, synthetic fuel plants are at best only marginally economic at current prices; and because of uncertainty over future world oil prices and government regulation, most synthetic fuel projects are not attractive to private investors. Federal financial assistance will be needed if we are to accelerate the commercialization of synfuels and other promising emerging energy technologies.

which is necessary to improve the financial viability of certain segments of our energy industry and to provide requisite assurances to potential investors. As a prime example of this regulatory neglect, I would cite the inadequate rate increases granted to <u>electric utilities</u> by state commissions which have resulted in straining the financial condition of these utilities and in the deferral or cancellation of large amounts of new generating capacity. Almost half of the energy sector's projected capital requirements in the 1975-85 period are in the electric utility sector. Electric utilities are faced with the need to raise more capital than the oil companies over this period, but will have less than half the revenue base of these companies. While recent regulatory actions have resulted in some improvement in the financial situation of electric utilities, these companies can be expected to face future financial difficulties unless additional action is taken to provide for adequate rates and for a stronger cash flow. Without innovative regulatory actions such as including construction work-in-progress in the rate base, we may continue to have periods during which the financial condition of the electric utilities retards the undertaking of needed investment.

In the <u>natural gas industry</u>, if private financing is to be arranged for certain needed major projects, deregulation of new gas prices and still other types of innovative regulatory actions may be needed. These include approval of "all events full cost of service" tariffs which pass some of a project's risk to gas consumers and, possibly, consumer surcharges, which could be used to help finance exploration and development of new gas supplies.

Lastly, decontrol of crude oil prices would substantially improve the ability of the petroleum industry to finance energy projects and would also provide needed incentives for conservation and for the development of new supplies. As you know we are phasing such controls out over a 40 month period. The President has made it clear that we should do whatever we can to assure decontrol takes place as rapidly as possible. We must all make sure that the 40 month program will be fully implemented so that we can once and for all do away with that set of government regulations which encourages wasteful consumption of oil and discourages needed investment that will result in additional supplies.

(3) Some energy projects have special risks which the private market may not be willing to bear without innovative regulatory devices and/or some form of government assistance. Examples of these types of projects are those involving the commercialization of technologies untested in the private market. The technological risk is often compounded by regulatory uncertainty, and private investors may not be willing

to bear these risks without Federal assistance. In many cases, these special risks are compounded by long construction lead times which also make investors reluctant to commit funds. Synthetic fuel plants, for example, have a lead time of at least five years; and the typical nuclear power plant has a 10 year lead time.

<u>Basic Federal Government and Regulatory Actions to Assure Adequate Energy Investments</u>

The basic long run solution is to move forward as rapidly as possible with policy changes and regulatory reforms which will strengthen the ability of private firms to attract needed capital. For example, decontrol of energy prices would materially assist in financing of energy projects by improving cash flow and providing needed incentives to marginal projects. In the tax area, there are a number of measures which the President has proposed which would facilitate capital formation in general or would improve in particular the financial strength of the electric utilities industry. We also need to encourage the private sector to adopt innovative approaches to arranging the financing of needed major energy projects.

These kinds of actions must be taken. The problem, however, is that many of these will take time, and we simply can't wait. As the President has repeatedly emphasized our dependence is growing and we must do whatever we can now to reverse this trend. Therefore, the President has proposed the Energy Independence Authority as a temporary measure which will assist the energy sector over the next 10 years in drawing capital to needed energy projects which might not otherwise obtain financing from the private capital markets.

<u>The Scope of the EIA</u>

As we evaluate the EIA, I think it is important to focus on precisely what EIA is designed to do and, as importantly, what it will not do. EIA is <u>not</u> intended to provide government assistance to all energy projects and it is <u>not</u> meant to substitute the government for the private sector, which will continue to provide the bulk of the funds for our energy development. It is a supplement to the private market and aimed essentially at some of the critical bottlenecks in the energy finance field which may not be overcome in a reasonable time period by the private sector without Federal assistance.

The Energy Independence Authority is designed to provide up to $100 billion of financial assistance to energy projects which:

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(1) Will contribute significantly to energy independence, and

(2) Would not otherwise be undertaken by the private sector without governmental financial assistance.

The EIA would have a limited life of ten (10) years (subject to a single three-year Presidential extension). The financial outlays and commitments of the EIA are intended to be recovered by the government and will be used in conjunction with private sector financing to the maximum possible extent. The legislation requires EIA to use loans and loan guarantees to the maximum extent practical; but EIA is also permitted to provide guarantees of price, purchase and leaseback facilities, and purchase convertible and equity securities. Grants in aid would be excluded. The projects that could be supported by the EIA range across the full spectrum of the energy field and include emerging energy technologies, energy supply infrastructure, major conventional energy projects and emerging energy conservation technologies.

In addition, through the EIA legislation, the Federal Energy Administration would be empowered to certify projects as being of critical importance to achieving national energy goals. The EIA would establish new procedures for coordinating and expediting Federal regulatory proceedings that affect energy projects and require sound and expedited regulatory responses from regulatory Commissions having authority over EIA-financed utility projects.

The Energy Independence Authority will be, in short, a Federal undertaking of large scope and magnitude and result in substantial Federal involvement in financing certain types of energy projects. Some would argue that the Federal Government should not be so involved. I would agree if I felt that the needed regulatory changes would take place in a timely fashion. However, we have not seen evidence that this will happen and because of the overriding national importance of meeting our energy policy objectives in a timely manner, some Federal involvement is necessary. In 1973, we saw what could happen to us because of our heavy reliance on foreign energy sources. That experience, coupled with the continuing control that others exert over the price of oil, has resulted in a determination to reduce our reliance on insecure supplies which create an unacceptable danger to our economic prosperity and our national security. In order for this goal to be achieved, we must increase domestic energy supplies, diversify sources of imports, create strategic stockpiles, and reduce the excessive demand for energy. EIA will provide critical assistance in meeting these objectives.

However, the EIA legislation should not be considered as a substitute for the needed regulatory and energy policy actions which,over the long run,are essential to achieving our energy objectives. This is not the intention of the EIA proposal, and we must do everything we can to assure that it will not happen. In this regard, I think that the Committee should pay special attention to those provisions of the proposed legislation which are intended to encourage and facilitate needed regulatory reform. Specifically, Section 304(c) of the Act requires, as a condition of assistance to a regulated utility, sound and expedited regulatory response from state regulatory commissions. For example, the legislation requires that the relevant regulatory commission agree with the EIA and the regulated firm to a rate covenant that assures adequate earnings to protect EIA's investment. In addition, Title VI of the legislation provides a procedure to expedite Federal regulatory decisions with respect to energy projects. By reducing the time needed for regulatory action, the legislation would help remove some of the regulatory uncertainty which prevents private capital from flowing to many energy projects.

Impact on the Capital Markets

I would now like to turn to an assessment of the impact that EIA assistance will have on our capital markets. In providing financial assistance to the energy sector through the EIA, we believe that every effort should be made to minimize the cost of the EIA program to the general taxpayer, and to maximize the efficiency of this program. Minimizing the level of financial support requires flexibility in the forms of support that can be provided. In addition, the exact form of the most appropriate financial assistance will vary from situation to situation depending on the technology, the regulatory environment, the nature of the companies involved, and competitive market considerations. Accordingly, we believe that it is desirable to allow EIA to have a broad range of methods for providing financial assistance.

Even with such flexibility, concern has been expressed about the impact of EIA on the capital markets. I believe that we must face the fact that there may be considerable market impact. The central question is whether the urgent need for energy development outweighs any adverse capital market impact. Any type of Federal financial assistance which results in projects which would not have otherwise been undertaken will lead to some redirection of resources within the capital markets. This is as true for EIA as for any other government program. If EIA is to be effective in helping to solve our energy dependence problems, the EIA will have to divert capital from other areas of our economy into the energy sector. Moreover, because the financial incentives provided by EIA will have little or no effect on the overall supply of capital, EIA loans or loan guarantees will increase the demand for capital and tend to raise both private and government borrowing costs. This is also true of other government lending and loan guarantee programs. There is nothing unique about the EIA program in this respect.

In this regard, the net annual flow of funds in the U.S. credit markets is expected to be about $239 billion in fiscal year 1976. Of this amount, $137 billion, or 57 percent, will be required to finance the federal budget deficit and net borrowings for off-budget federal programs, leaving only $102 billion to finance the private sector. Further, total government borrowings this fiscal year will have an even greater impact on the long-term securities markets. We expect that such borrowing will absorb 82 percent of funds available in the long-term securities market. The funding of the EIA would add to the already large government presence in the capital markets and have an important impact on both the overall allocation of credit and the financing costs of both government and private borrowers.

We must, however, remember that some redirection of capital flows is the intended effect of EIA and an inevitable consequence if we are to assure priority to energy development. Furthermore, the EIA assistance will be spread over a relatively long time period. The EIA would provide an average of $10 billion per year in the late seventies through the mid 1980's, with the largest part of such assistance likely to be provided in the period from 1980-1986 when the overall economy will have grown by 25-30%. This would represent roughly 13% of the projected yearly energy investments of $70-80 billion and roughly one-third of the external finance raised for energy sector investments during that period.

The precise nature of EIA's impact on interest rates and the allocation of capital is impossible to predict with any certainty. The aggregate size and the precise mix of the demand for capital will be influenced by the size of federal deficits, government fiscal and monetary policy, the rate of inflation, the strength of and duration of our economic recovery, the financing needs of the private sector and of state and local governments. Any one of these factors could have a substantially greater effect on capital markets than EIA activity.

In addition, the bill contains a number of provisions designed to minimize the impact of EIA operations on the capital markets. First, Section 303 of the bill requires the EIA to seek the maximum amount of financing from non-EIA sources in connection with any project which EIA undertakes. Second, Section 306 requires the concurrence of the Secretary of the Treasury as to the timing and substantial terms and conditions of each security issue backed by the Federal Government. This provision is, in my view, an absolutely essential part of the EIA proposal in that it not only helps minimize the impact on the capital markets but reduces the effects of EIA activities on government borrowing costs. Third, Section 314 of the proposed legislation contemplates an advisory panel which would review the effects of EIA financial activities on the functioning of the capital markets, including the effects on the volume and distribution of capital flows to and within the energy development sector of the economy. Such a panel could keep continual watch on the effect of EIA activities on our capital markets and ensure that the impact was minimized. Fourth, Section 801 of the proposed legislation gives the members of the Energy Resources Council an opportunity to comment on any financial assistance granted by EIA. This would give the Secretary of the Treasury and other members of the ERC concerned with the financial implications of the program an opportunity to give their advice on the capital market impacts of EIA assistance to any given project.

Cost of the EIA Program to the Taxpayer

The fact that EIA is designed to provide assistance to projects which are too risky for the private sector to undertake has led many to conclude that EIA will lose billions of dollars for the U.S. taxpayers. This will not be the case. The mere fact that a project involves risks greater than those which the private sector is willing to assume does not mean that the project will necessarily lose money. Many inherently sound projects are not financed by the private sector because of regulatory delays and uncertainty, or the long lead times of certain energy projects. EIA assistance in such cases does not mean that EIA would be financing a "losing project." In structuring this authority, we have tried to provide safeguards so that there will be no cost to the taxpayer from EIA operations. As you know, EIA is designed to be self liquidating. The loans it makes are expected to be repaid, appropriate guarantee fees will be charged, and EIA is expected to pay a return to the Treasury on its equity capital.

It is, of course, possible that EIA might sustain losses -- particularly in its programs to encourage new energy technologies. However, the legislation has built-in special provisions to limit certain types of riskier financial assistance. Specifically, Section 308 provides that high risk loans, direct investments, product price guarantees or other direct financial assistance may <u>not</u> be provided if reserves established to meet contingent liabilities created in connection with such assistance exceed the sum of EIA's paid-in capital, earned surplus and gains on disposition of property. In such a case, the maximum loss to the taxpayer would be the initial equity contribution, unless Congress provided further equity capital.

Conclusion

In conclusion, it is clear that EIA operations will impact on our capital markets. It is also clear that EIA will result in the reallocation of capital toward the energy industry. However, the proposed legislation contains a number of provisions to minimize adverse market effects. Furthermore, inherent in the EIA proposal is the belief that some reallocation or diversion of capital is needed if we are going to achieve our energy goals. Also central to the proposal is the belief that EIA is not a <u>substitute</u> for market solutions and regulatory reform but a temporary supplement to the private market. It is with these two objectives in mind that we are calling for the creation of EIA.

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041
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FOR RELEASE AT 4:00 P.M. April 13, 1976

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $5,900,000,000 , or thereabouts, to be issued April 22, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,500,000,000, or thereabouts, representing an additional amount of bills dated January 22, 1976, and to mature July 22, 1976 (CUSIP No. 912793 ZZ 2), originally issued in the amount of $3,392,765,000, the additional and original bills to be freely interchangeable.

182-day bills, for $3,400,000,000, or thereabouts, to be dated April 22, 1976, and to mature October 21, 1976 (CUSIP No. 912793 B6 2).

The bills will be issued for cash and in exchange for Treasury bills maturing April 22, 1976, outstanding in the amount of $10,608,010,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,081,580,000. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Standard time, Monday, April 19, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on April 22, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing April 22, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

BIOGRAPHICAL NOTES

ROBERT A. GERARD
ASSISTANT SECRETARY OF THE TREASURY
CAPITAL MARKETS AND DEBT MANAGEMENT

Robert A. Gerard signed the oath of office as Assistant Secretary of the Treasury for Capital Markets and Debt Management on April 14, 1976. Nominated to the newly established Treasury post by President Ford on March 19, his appointment was confirmed by the Senate on April 13.

Mr. Gerard joined Treasury in December 1974, as the first Director of the new Office of Capital Markets Policy. He was appointed Deputy Assistant Secretary for Financial Resources Policy in September 1975, continuing in that position until becoming Assistant Secretary.

Earlier, 1970-1974, Mr. Gerard specialized in banking and securities law as an Associate with the Washington firm of Wilmer, Cutler & Pickering. From 1969 to 1970, he was Law Clerk to Judge Carl McGowan of the United States Court of Appeals for the District of Columbia Circuit.

He is a graduate, magna cum laude, of Columbia University Law School, 1969, and cum laude, of Harvard College, 1966, and a member of the Bar Association of the District of Columbia. At Columbia he was Notes & Comments Editor of the Law Review, and a Harlan Fiske Stone Scholar.

As Assistant Secretary, Mr. Gerard is responsible for all domestic financial market matters. He serves as principal advisor to the Secretary, Deputy Secretary, and Under Secretary for Monetary Affairs on debt management, federal financing, the financing of non-federal sectors of the economy, and general capital markets policy.

In addition, Mr. Gerard oversees policy and control of Treasury operations in relation to the Federal Financing Bank. He is directly responsible for Treasury functions under the New York City Seasonal Financing Act of 1975 and for overall policies relating to state and municipal finance and capital markets.

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His other responsibilities include policy direction and control over staff work on the substance of proposed legislation on regulation, lending, investment, and deposit powers of private financial institutions, the operations of other private financial intermediaries and analysis of activity in all financial markets.

Also, his office is responsible for development of legislative and administrative principles and standards for federal credit activities, working closely with federal credit agencies in the evaluation and design of new credit programs and legislation.

Born October 19, 1944 in New York City, Mr. Gerard is married to the former Elizabeth Coolidge Gallatin. They have two children, Celia Coolidge and Robert Gallatin, and reside in Washington, D. C.

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4-14-76

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-964-2615

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SUMMARY OF LENDING ACTIVITY

March 16 - March 31, 1976

Federal Financing Bank lending activity for the period March 16 through March 31, 1976 was announced as follows by Roland H. Cook, Secretary:

The Student Loan Marketing Association (Sallie Mae) borrowed $30 million on March 16 at an interest rate of 5.235%. The loan matures June 15, 1976. Sallie Mae used the proceeds of the loan to repay a $30 million note maturing with the Bank. Sallie Mae borrowings are guaranteed by the Department of Health, Education and Welfare.

On March 17, the FFB purchased a $500 million 5 year Certificate of Beneficial Ownership from the Farmers Home Administration. The maturity is March 17, 1981. The interest rate is 7.92% on an annual basis.

The United States Railway Association borrowed against the following Notes guaranteed by the Department of Transportation:

Date	Note	Amount	Maturity	Interest Rate
3/17	5	$10,000,000	4/1/76	5.239%
3/25	6	795,000	12/26/90	8.055%
3/25	3	1,000,000	4/1/76	5.093%
3/25	5	400,000	4/1/76	5.093%
3/31	3	500,000	4/1/76	5.207%
3/31	5	242,000	4/1/76	5.207%

On March 30, the U.S. Railway Assoc. signed Note #8 with the Bank. The note allows USRA to borrow up to $228 million. The Association will loan the funds to the Consolidated Rail Corporation (ConRail) under section 211 (h) of the Railroad Revitalization and Regulatory Act of 1976. The final maturity of the note is April 30, 1979. The USRA borrowed $20 million against this note on March 31, 1976 at a semiannual interest rate of 7.328%.

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The National Railroad Passenger Corporation (Amtrak) made the following drawings from the FFB:

Date	Note #	Amount	Maturity	Interest Rate
3/19	7	12,000,000	6/14/76	5.194%
3/29	7	10,000,000	6/14/76	5.131%
3/30	6	130,000,000	6/29/76	5.207%
3/31	7	5,000,000	6/14/76	5.207%

On March 31, 1976 Amtrak borrowed $120,000,000 against Note #9, a $120,000,000 renewable line of credit with the Bank. The interest rate is 5.343%. The line is renewable on July 29, 1976. The final maturity of the line is 4/30/77. Proceeds of the loan were used to repay Amtrak Note #4.

On March 19, the Bank advanced $1,045,918.13 under a November 25,1975 agreement with Amtrak and others to finance 26 GE electric locomotives. This agreement provides for serial repayments with a final maturity date of July 15, 1989. The interest rate is 8.125%. Amtrak borrowings from the FFB are guaranteed by the Department of Transportation.

The Federal Financing Bank made the following loans to utility companies guaranteed by the Rural Electrification Administration:

Date	Borrower	Amount	Maturity	Interest Rate
3/19	South Mississippi Electric Power Association	$5,235,000	3/27/78	6.964%
3/31	Oglethorpe Electric Membership Corp.	3,855,000	12/31/10	8.065%
3/31	Associated Electric Coop., Inc.	4,000,000	12/31/10	8.065%
3/31	Southern Illinois Power Corporation	900,000	3/31/78	6.905%

Interest payments are made quarterly on the above loans.

The FFB made the following advances to borrowers guaranteed by the Department of Defense under the Foreign Military Sales Act:

Date	Borrower	Amount	Maturity	Interest Rate
3/19	Republic of Korea	$17,314,463.10	6/30/83	7.555%
3/26	Government of Argentina	1,049,700.00	4/30/83	7.524%
3/29	Government of Morocco	11,649,070.00	6/30/83	7.485%
3/29	Government of Israel	22,365,109.96	6/10/85	7.624%
3/31	Government of China	685,357.15	9/30/85	7.526%

On March 23, the Bank purchased $2,483,000 of notes from the Department of Health, Education and Welfare, The Department had previously acquired the notes which were issued by various public agencies under the Medical Facilities Loan Program. The notes purchased by the Federal Financing Bank are guaranteed by the Department of Health, Education and Welfare and mature on July 1, 2000. The interest rate is 8.081%.

On March 24, the Bank purchased the following debentures from Small Business Investments Companies:

Company	Amount	Maturity	Interest Rate
Capital Investment, Inc. (Wisconsin)	3,000,000	3/1/86	7.905%
Louisiana Equity Capital Corp.	100,000	3/1/86	7.905%

These debentures are guaranteed by the Small Business Administration.

On March 31, the Tennessee Valley Authority borrowed $140 million at an interest rate of 5.207%. The loan matures on June 30, 1976. Proceeds of the loan were used to repay $110 million of notes maturing with the Bank and to raise additional funds.

On March 23, the Federal Financing Bank entered into an agreement with the Rural Electrification Administration to purchase up to $600 million in Certificates of Beneficial Ownership in insured notes and other obligations of the Rural Electrification and Telephone Revolving Fund. The obligations in the Fund are loans made by REA pursuant to the Rural Electrification Act to entities which own or contemplate owning rural electric and telephone systems. The first CBO sale to the Bank in the amount of $166,374,000 took place on March 31, 1976. The CBO matures on March 31, 2006. The rate of interest is 8.205%.

Federal Financing Bank loans outstanding on March 31, 1976 totalled $21.7 billion.

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WASHINGTON, D.C. 20220 TELEPHONE 964-2041
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ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
SOUTHERN METHODIST UNIVERSITY
DALLAS, TEXAS, APRIL 15, 1976

Thank you, Dean Coleman, Chancellor Tate, Ladies and Gentlemen.

It is a pleasure and an honor for me to participate in this S.M.U. "vote" program and I welcome this opportunity to meet with a cross section of your outstanding student body and the community it is part of.

I also have a special sense of purpose today, as a guest speaker in the Lone Star State in an election year with a key presidential primary approaching. I thought you deserved to hear from at least one out-of-state speaker who wasn't running for President.

I am not after your votes. What I would like to engage is your shared concern and thoughts about some of the grave economic issues facing our country -- issues that will still be with us long after the dust of the 1976 campaign trail has settled and issues that will help to shape the kind of lives you live long after you have left your college days behind.

For this reason, I was glad to learn from your program sponsors that you wanted to hear about the economy. So often, in an election year, secondary issues -- everything from no-fault insurance to abortion-on-demand -- elbow the really major issues off-stage. Yet it is issues like the economy -- especially the economy -- that influence every aspect of our lives, day in and out, every year instead of once every four years.

Here, then is a capsule review of where we have been economically, where we stand today, and some of the crucial decisions we still face.

Economists generally agree that the recession hit bottom last April, that the recovery began sooner than expected, and that it has been stronger than expected. Only a few months ago, we began to see light at the end of the tunnel. Today, we are nearly out of the tunnel and on our way to recovering a full head of steam. For example:

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been cut in half to approximately 6 percent.

-- Last spring, unemployment had reached nearly 9 percent. It has now dropped to 7.5 percent and our forecasts indicate a continuing downward trend.

-- Other signs point to an economy that is regaining its vitality: Real GNP, the stock market, personal income, industrial output, housing starts, retail sales -- all are registering gains and this reflects a rising public confidence about the economy that contrasts sharply with the deep pessimism reported by polltakers only a few months ago.

But although we made considerable headway in 1975 and we are making even more in 1976, this is no time for complacency. Inflation is not yet under control and the jobless rate is still too high.

That is why the Administration is urging Congress to adhere to a broad-gauged plan to further nurture and stimulate the natural forces of growth in our private enterprise economy. An essential element of this plan is to put the brakes on the dizzying momentum of Federal spending -- to slow the rate of increase to about 5 percent this fiscal year, contrasted with 40 percent the past two fiscal years. This will allow us to continue to make progress on inflation and, at the same time, will make additional tax cuts possible for businesses and individuals and set the stage for a balanced budget within three years.

Further, the President has urged tax measures designed to stimulate job creation generally, encourage the building of sorely-needed electric power facilities, and increase construction of plant and equipment in areas where unemployment has topped 7 percent.

Finally, the Administration has proposed elimination of the unfair double taxation of dividends that retards capital formation. This is the only major proposal I know about that seeks to correct the imbalance between corporate debt and equity. We must redress this imbalance to allow the financial markets to channel society's savings more efficiently to the more promising investment opportunities. And, as you also know, improving our lagging capital investment picture is absolutely essential to meet our long-term goals of more jobs, higher incomes, greater productivity, lower inflation and sustained growth.

These steps and the balanced program we have pursued thus far are designed to fight inflation and unemployment simultaneously and strenghthen the private sector of our economy.

We firmly believe that this course is working, that it is right for the nation, and that it is leading us back to the position of robust growth and expanding opportunities.

And yet you will hear a mournful chorus of rhetoric out of Washington, especially as the election campaign draws closer, claiming that we aren't spending enough, aren't pressing hard enough, aren't pushing enough panic buttons to solve our problems. Despite our steady gains, many of these critics assume there must be a basic flaw in the system and they cast about for other remedies: governmental control over economic planning -- guaranteed jobs for everybody at government expense -- a new round of wage and price controls -- and many other encroachments on the market place.

Frankly, I believe that many of these critics suffer from what Mark Twain called "loyalty to petrified opinions." They fail to see that efforts to strengthen the public sector at the expense of the private sector are a large part of the problem, not part of the solution. They refuse to recognize that the same excessive government fiscal, monetary and regulatory policies they call for today have led to abuse of our economy and helped trigger, first, a storm of inflation in the early 1970s and, second, the severe recession from which we are now recovering. And they fail to comprehend a gathering mood in this country against the further expansion of big government. They suffer from the economic variety of Potomac Fever -- the delusion that all economic cures must originate in Washington with the Federal government. As President Eisenhower once remarked, "There are a number of things wrong with Washington, and one of them is that everybody has been too long away from home.

However, public disenchantment with big government does not mean that all Americans are necessarily immune from the superficial appeal of quick-fix government programs whose short-term benefits are well publicized but whose long-term impact in terms of inflation and economic stagnation is carefully masked from view.

It may seem strange, and it is certainly ironic, but at a time when the vast majority of Americans are enjoying such abundance and opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible.

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This is certainly not true in many countries abroad. I was reminded of this fact during my recent two-week trip to the Middle East. Israel and the Arab states have sharp differences, of course. But on one thing they are agreed. They all have a profound admiration for the achievements and performance of the American economy. The leaders of the Middle East believe, as I do, that the United States has developed the most dynamic and efficient economic system ever devised.

Largely because of this, they see the United States as the major source of strength and stability in today's unstable world.

But here in the United States, somewhere along the line there seems to have been a dangerous breakdown in communication. Secretary of Commerce Elliot Richardson put it succinctly the other day when he said that producers and consumers in this country tend to view each other as antagonists -- despite the fact that neither can thrive without the other.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the actual dynamics of prosperity in a free society.

Today, when nearly everybody takes the fruits of the free enterprise system for granted -- the abundance, the opportunities, the freedom of choice, and the chance for learning, travel and general upward mobility -- not everyone understands the basic economic facts of life that have produced these benefits.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people. And I believe that the men and women who make up our free enterprise economy -- in business, in the professions, in the factories -- must do even more than they are now if such a national dialogue is to succeed.

What is at stake is not simply the future of this or that company, or even this or that industry. At stake is the survival of the private sector, and, because of the interlocked nature of our freedoms, the survival of the individual liberties which can never long endure after the collapse of a society's free enterprise system.

This problem of communications exists, as I have had ample opportunity to observe in my job as Secretary of the Treasury, and it is getting worse, not better. It is a question of both policy and perception, for a faulty view or understanding of the economy makes faulty economic policymaking almost inevitable.

Part of the problem is a matter of image. Frequently, those who support bigger government spending and more government domination of the private sector are perceived as concerned and socially progressive individuals who "care," who are champions of persecuted underdog.

On the other hand, people who warn that the government should not and cannot effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system, are seen as either outdated ideologues or a new generation of economic exploiters -- indifferent to human suffering and only out to make a fast buck for themselves or their companies.

This stereotype wouldn't matter if it were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well-being of our citizens, especially those who are impoverished or face disadvantages because of artificial barriers of sex or color or national origin.

The central question is not who cares the most -- we all care. It is rather the <u>method</u> we choose to broaden prosperity, reduce human hardship and meet our other national goals without sacrificing our freedoms or destroying the most successful economic system that man has even known.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean much to those who do not understand what it really means and what makes it work. It's like trying to discuss the birds and the bees sensibly with with somebody who is unshakable in his belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to cue up for hours to buy a poor selection of over-priced food and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition an average shopping center found anywhere in the U.S. would represent to most of the world's people.

They have never asked themselves why a country like the Soviet Union, with some of the richest grain land in the world -- but with an agricultural system owned and operated by the government -- cannot even feed its own people without turning to American farmers who own their own land, make their own decisions and feed not only their fellow Americans but millions of others as well.

They have never lived in countries where the seemingly idealistic dream of a society witout private property or profits has turned into a nightmare reality: where the state and the state alone dictates what kind of education you will receive, whether or not you will be allowed to travel, what kind of job you can have, what you will be paid, what you can buy with your own earnings, where you will live and, ultimately, where you will be buried.

The truth is that regimented societies inflict upon their citizens not only a political regime that reduces the individual, in Churchill's phrase, to a mere fraction of the state, they also inflict an economic regime that smothers enterprise and breeds inefficiency. Let's face it: Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many fresh ideas and new improvements. Whether we like it or not, this is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and over our lives -- a road that we have been traveling for several decades -- then all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment and those who come after us will be robbed of their personal and economic freedoms. <u>That</u> is really what is at issue underneath the semantics and the misleading labels.

Let me be specific about how our private enterprise economy has been undermined by excessive government policies.

Just before the New Deal, government spending at all levels -- Federal, state and local -- was about 10 percent of our total national output. Today, because budgets have mushroomed, government accounts for almost 40 percent of the GNP. And if recent trends prevail, the government's share of the total economy will reach 60 percent before the end of this century.

Let's put present spending in dollar signs. Today, and every day during this fiscal year, the Federal Government will spend $1 billion. And this week and every week this fiscal year it will go into debt an additional $1 billion. Since 1962, when the federal budget hit the $100 billion mark, it has almost quadrupled, and has been in the red for all but one of those years.

The interest on the federal debt alone by the end of fiscal 1976 will have climbed to $36 billion. The amount in fiscal 1977 will reach $45 billion. That's more than we spent in any one year on the war in Vietnam. It is almost half of what we will be spending on total national defense next year. And it is money, I'm sure you will agree, that could better be spent on improvements in health care, public transportation, rebuilding our cities or any of a dozen other national needs.

Anyone who has ever kept a checking account or managed the smallest household budget knows that it spells disaster to borrow and spend more than you take in for too long. Heavy government borrowing has fueled inflation and driven up interest rates so that strains have developed in money and capital markets. Businessmen feel these strains when they try to get loans to expand their businesses and create new jobs: Consumers feel the pinch when they try to buy a new home without paying an arm and leg in mortgage interest, and some of you have probably realized the problem when you have tried to secure low interest student loans in a tight credit market.

Throughout the nation, we see signs that taxpayers, who have so long borne the burden of heavy government spending, are close to open rebellion. In the 1974 elections, for example, voters across the country turned down more than 75 percent of all bond issues on the ballot. And eight state legislatures, fed up with rising national debt, have now adopted resolutions calling for a constitutional amendment requiring a balanced national budget. As one state representative put it: "I don't want the government spending my grandchildren into a poorhouse."

So our major concern as we work our way to a sound and durable recovery is to avoid another dose of the same poison which brought on the recession in the first place: rampant inflation fed by runaway federal spending.

But spending isn't the whole problem. As government spending has grown by leaps and bounds, so too have government controls, regulation and red tape.

Did you realize that government agencies, with an army of 100,000 on the payroll, exercise direct regulation over 10 percent of everything bought and sold in the United States and indirect control over almost every other sector of the private economy?

The avalanche of paperwork required by this regulatory network is a tremendous burden on small and big businesses alike. Business spends an incredible $20 billion a year just to fill out government forms. General Motors recently calculated that it spent more than $1.3 billion in 1974 just to comply with existing government regulations or get ready for new ones. This is more than it cost to run the entire Federal Government for all of the first 75 years of our history -- and that includes the Louisiana Purchase.

Some of these regulations are, of course, necessary and in the public interest. But many more of them are counter-productive, wasteful, and obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Consider the case of natural gas. Because of the unwillingness of some politicans to deregulate natural gas, many areas of the country will continue to experience gas shortages that will cost them jobs, inflict individual discomfort and inconvenience and slow the pace of economic recovery. All this because a handful of politicians refuse to deregulate natural gas and let the simple but crucial free market principle of the profit motive come into play. The economic fact of life is that products which people are willing to pay for will be produced, as an adequate price will insure an adequate return. Things for which people are not willing to pay an adequate price -- or which government does not allow to be sold at an adequate price -- will not be produced. This is not only the essence, but the genius of free enterprise.

So today, when so many of America's rich energy resources remain untapped, and when the need for energy independence is greater than ever, much of our natural gas potential goes undeveloped because politicians refuse to admit that you cannot take away the incentive to produce and encourage production at the same time.

We still have the choice of acting in our own best energy interests instead of reacting to decisions made by foreign countries. We must start thinking of the energy challenge in terms of American jobs, homes, food and financial security.

Our economic well-being and national security depend upon American control of the American economy. We cannot jeopardize the future by avoiding the tough energy choices today. But we must pay the price necessary to give us command of our own economic destiny.

Let me give you another example of how big government, if allowed to get out of control, threatens the best interests not only of businesses but consumers. Today, many politicians and pundits are calling for the massive dismantling of the American petroleum industry through divestiture.

At a time when we should be encouraging domestic oil production to make America less dependent on foreign imports, they advocate a wholesale disruption of the complex and highly productive free enterprise structure that still makes it possible for Americans to drive their cars, heat their homes and turn the mighty wheels of industry at a lower cost than in any other major industrial nation.

It seems to me that those who urge divestiture have a moral obligation to show us how -- if at all -- divestiture will benefit the consumer and the nation. So far, they have utterly failed to do so, relying instead on anti-business rhetoric and the vague promise that somehow, if they are allowed to go after American oil corporations with a hatchet, the price of gas will go down.

This is illogical and self-destructive. It makes about as much sense as asserting that you can get better mileage out of your car by chopping it up into tiny pieces. In fact, you will probably get no mileage at all. And it will cost you more -- not less -- to get the mechanism repaired and back in working order again. But, in an age when imagery is often more persuasive than the facts, people sometimes lose sight of the basic truths.

Speaking in 1865, Lincoln said, "I have faith in the people... the danger is in their being misled. Let them know the truth and the country is safe." What I have been trying to emphasize here today is the need to hammer home the truth -- the economic facts of life -- to the American people, especially the young Americans like you who must lead us in the years ahead.

It is a story that cannot be vividly portrayed on television like the war in Vietnam or the urban riots of the sixties. Yet it is the one thing that affects every aspect of our lives.

And I am convinced that the American public -- and young Americans -- have not irrevocably closed their ears to this story. The polls tell us that businessmen themselves rank low in public confidence, and yet the principles of private enterprise rank high. A majority of Americans say they want more regulation of businesses, and yet business is the most popular major field of study among college students -- above education, science and the humanities. We can strike a responsive chord in telling this story to the American people if we tell it in human, comprehensible terms.

For when we talk about our free enterprise economy we are talking about food on the table, goods on the shelves and services at the counter. We are talking about medical breakthroughs that have added 10 years to our lives in the past generation. We are talking about labor-saving devices that have freed millions of women for productive careers and the pursuit of self-enlightment. We are talking about five out of every six jobs in America and wages and benefits that stagger the imagination of the rest of the world. We are talking about a productive base that pays for government support of the elderly, the jobless, the poor, the dependent and the disabled. And we are talking about basic freedoms; to choose a career, to choose what and where we buy, to choose where and how we live, and yes, to swim against the tide -- as did Fulton and Ford and Edison -- things you could never do living in the gray shadow of conformity under a regimented society.

And this is the heart of what I am trying to express to you -- the vital <u>human</u> importance behind all those gray, boring facts and figures that litter the financial page each day.

No man can be free and a slave at the same time. No society can sacrifice its economic freedoms and responsibilities and still expect to preserve the individual economic rights of its citizens. This is particularly important to those of you who are just beginning your adult lives. Whatever happens to me down the road, I have already had the opportunity to live and prosper as a free man. It is an experience that nothing can take away from me, no matter what the future may hold. So I am not very worried for my own sake.

But I do worry about what the future holds for my children -- some of whom are the same age as you. For as I have tried to show here today, there are a number of alarming economic trends already at work that are undermining your futures. They aren't inevitable and they can be stopped. But they must be recognized and understood before they can be mastered. And until they are mastered, your future freedoms are in jeopardy, along with the very essence of the independent competitive spirit that has made America the richest, freest country in the world.

In this Bicentennial year, if we keep alive the spirit that infuses our national character -- the spirit of personal freedom and free enterprise -- then we can be certain that it will endure for another 200 years and more.

But, if we let free enterprise wither away, we may be sure that our other freedoms and individual liberties will expire as well. We must not, we will not, allow this to happen.

Thank you.

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ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
HOUSTON CHAMBER OF COMMERCE
HOUSTON, TEXAS, APRIL 15, 1976

Thank you, Mr. Walbridge, Mayor Welch, distinguished members of the Chamber of Commerce committees, ladies and gentlemen:

It is a tremendous pleasure for me to be here in Houston again. The recollection of your hospitality is still warm from my visit with you last December at the 135th Annual Meeting of the Houston Chamber. That occasion was a memorable one for me and I have been looking forward to a return engagement ever since.

And on this particular occasion, I have an added sense of mission. I feel that, in this busy election year, with a key presidential primary coming up here in Texas, you deserve a little change of pace; you deserve to hear from at least one out-of-state speaker who isn't running for President.

So here I am, asking not for your votes, but for a few minutes of shared thoughts on some of the basic facts and problems facing America -- the sort of thing that sometimes gets buried in the political rhetoric of an election year.

Let me begin with a subject of enormous importance to the country and, even more so, to the Houston area -- energy. Houston is not just the sixth largest city in the nation and one of our major refining centers. It also houses our largest concentration of chemical and petrochemical industries and is our largest manufacturer and distributor of petroleum equipment. So, to a considerable extent, when we talk about energy in America, we're talking about Houston.

And, lord knows, there's been an awful lot of talk about energy lately, much of it dangerously misinformed. Particularly misinformed have been some of the loud, politically motivated cries for divestiture and further government controls in the energy field.

These cries may yield a few short-term political returns in an election year, but they are not in the best interests of the country. Our whole economic system is based on the simple market principle that products which people are willing to pay for will be produced, and an adequate price will insure an adequate return. Things for which people are not willing to pay an adequate price will not be produced. This is not only the essence, but the genius, of free enterprise. Arbitrary controls and politically motivated regulations that strangle the profit motive can only, in the long run, make the consumer as well as the producer suffer.

That is why the Administration I serve feels so strongly about deregulation in general and deregulation of natural gas in particular. It is also why we continue to oppose those who would inject more federal interference into the energy field.

For the facts show that free enterprise is the strongest force we have going for us in our efforts to meet the energy challenge. Consider the record to date. Despite inflation and the oil embargo, Americans still pay less to heat their homes, fuel their cars and keep the mighty wheels of industry turning than any other major industrial power -- thanks to our free enterprise system of energy production.

Unfortunately, this hasn't stopped some people from trying to make a scapegoat of the energy industry. Imagine, this is the only sector of our economy that is still under price controls. What a monumental con job on the part of political demagogues who have convinced a naive public that you can control prices and encourage production at the same time -- that you can take away the incentive to drill and still expect efficient development of America's untapped energy abundance.

Yet I'm sorry to say that the enemies of the free enterprise system seem to be winning the propaganda war. One recent result was the passage in Congress of energy legislation that neither I nor President Ford felt completely comfortable with. However, given the current political climate and the composition of the Congress, the president had to choose between a compromise or no energy legislation at all.

This Administration fully recognizes the dangers posed by excessive government controls. And we will continue to do everything we can to eliminate unnecessary controls and prevent the establishment of new ones.

Speaking from personal experience, I know all too well how an originally small, temporary bureaucracy can take on a life of its own and spread its tentacles. During the energy crisis I was called on to head the federal government's effort to cope with the problems raised by that national emergency.

Little did I suspect that, in becoming the so-called "Energy Czar" I would also be present at the creation of a vast new federal energy empire. The energy crisis ended and we weathered the storm. I went on to another job. But the Federal Energy Administration is still with us. It has taken on a life of its own and is still a large and growing part of the Washington scene a striking example of the cancer of big government.

Another striking example of heedless government interference is the growing chorus of politicians and pundits calling for divestiture of the oil industry.

It seems to me that those who urge the fractionalization of this complex and crucial industry have a moral obligation to show us how -- if at all -- divestiture will benefit the consumer and the nation. So far, they have utterly failed to do so, relying instead on anti-business slogans, political rhetoric, and the vague promise that somehow, if we go after the oil companies with a hatchet, the price of gas will go down.

This is illogical and self-destructive. It makes about as much sense as asserting that you can get better mileage out of your car if you chop it up into small pieces. In fact, you may get no mileage at all. And it will cost you more -- not less -- to get the delicate mechanism repaired and back in working order once the damage has been done.

So I repeat to you my personal commitment to the principles of free competition and minimum government interference in the energy field. But I also remind you that neither I nor the Administration I serve can win this battle alone.

We still have the choice of acting in our own best energy interests instead of reacting to decisions made by foreign countries. We must start thinking of the energy crisis in terms of American jobs, homes, food and financial security.

Our economic well-being and national security depend

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upon American control of the American economy. We cannot jeopardize the future by avoiding the tough energy choices today. We must pay the price necessary to give us command of our own economic destiny.

We need your help in getting our side of the story across to the public. And I hope that each of you as individuals and as businessmen and women with a strong personal stake in the energy industry, will devote more of your time and efforts to getting that story across.

If you don't do it, who will?

Energy, of course is an international as well as national matter. A few weeks ago I returned from a two-week tour of the Middle East. That fascinating and turbulent part of the world has many dangerous problems. However, I came away from my trip with one positive impression. Today, despite old animosities and conflicts, both the Arabs and the Israelis, regardless of their political opinions, realize that the United States had developed the most dynamic and efficient economic system the world has ever known. They see the United States as the major source of strength and stability -- economically as well as politically -- in an unstable world. As Secretary of the Treasury, I found this encouraging because I am convinced that the way to a peaceful world political order is through a strong stable world economic order. For the Middle East, peace and prosperity can and must, go hand in hand.

As I look around this room, I realize that there are some among you whose businesses were hard-hit by the recent recession and simultaneous double-digit inflation. Perhaps you might think that the leaders of the Middle East have the wrong impression in viewing the United States as being super-strong economically. Perhaps you would think that, on the contrary, our economy is in trouble and our economic future uncertain.

I would agree certainly, our economy has undergone some trials in the last few years that have made for some unpleasant results both in unemployment and inflation. But, despite this, our country remains the world's greatest economic power -- and, believe me, the world knows it. Even today, we are proving our basic strength by the speed and the security of our recovery from the recession as compared with other industrial nations around the world.

We still have a long way to go, but we are on the road to recovery and we can all take heart from the first round of progress that was made during 1975.

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-- Nineteen seventy five opened with inflation raging at 13 percent; we have cut that rate in half -- to about six percent.

-- During the spring of 1975, the unemployment rate reached nine percent; today it is down to 7.5 percent.

-- Over the past year over 2 million people have found work and the number of people employed today is at a record high.

-- During the third quarter of 1975, we registered the biggest single jump in the GNP in 25 years and the fourth quarter's pace, while slower, still indicates the recovery is maintaining its momentum.

Thus we made considerable headway in 1975, and we will make even more in 1976. But it's not good enough and this is certainly no time for complacency. The unemployment rate is still far higher than we can tolerate. And inflation is by no means completely under control. In fact, it remains the most dangerous enemy of real economic growth. And all of us -- especially those with a say in federal spending -- must do everything we can to prevent another inflationary spiral. The ruinous inflation that crested in 1974 was the chief cause of the severe recession of 1975; if we embark once again on excessive fiscal and monetary policies resulting in double-digit inflation, I guarantee you we will have an even worse recession than before. Let us hope that it will never be said that the pain and suffering of the 1974-75 recession were in vain because the politicians in Washington refused to face the economic facts of life.

But the problem is not confined to politicians alone. It may seem strange, and it is certainly ironic, but at a time when Americans are enjoying such great abundance and such great opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible. Somewhere along the line, there has been a dangerous breakdown in communications.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the dynamics of prosperity in a free society.

Today, when nearly everyone takes the fruits of the free enterprise system for granted -- the abundance, the opportunity, the freedom of choice, the unprecedented opportunities for learning, travel, and general upward mobility -- not everyone understands the basic economic facts of life that create all these benefits.

Small wonder then, that when economic difficulties like the recession hit, millions of otherwise reasonable people fall for the quack nostrums of politicians who are more interested in promising than performing, and for quick-fix government spending that provide some short-term relief but only aggravate the long-term economic ills of inflation and stagnation in the private sector.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people. And I believe that organizations like the Chamber must do even more than they are now doing if such a national dialogue is to succeed.

What is at stake is not just the future of this or that industry. At stake is the survival of the private sector, and the individual liberties which have never long survived the collapse of a society's free enterprise system.

Unless we get the facts across today, the America of tomorrow -- of our children and grandchildren -- will be doomed to a system of economic and political bondage that is the very opposite of all that we hold dear.

The problem already exists, as I have had ample opportunity to observe, and it is getting worse, not better. It is a question of both policy and perception, for faulty perception of the economy makes faulty economic policy almost inevitable.

And I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central, underlying problem of our times.

Part of it is a matter of image. Frequently, and especially to youthful idealists, those who support bigger government spending and more government domination of the private sector are perceived as concerned, socially progressive men and women who "care" in a nutshell, they are seen as the humane champions of the persecuted underdog.

On the other hand, those who warn that the government should not -- and cannot -- effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system are seen as either outdated theorists or a new generation of economic exploiters, indifferent to human suffering and only out to make a fast buck for themselves and their companies.

To make matters worse, surface appearances often tend to confirm this inaccurate impression. Advocates of big government are able to wax eloquent for hours about the ills they imagine they can cure by cranking out more currency and soaking up more credit through massive deficit spending. They have as many arguments as there are social, economic and political problems -- even though the spending they advocate, as we have seen with the great society's war on poverty, is often part of the problem rather than part of the solution.

Those of us who recognize the fallacy of the big government approach have only one argument. It's the right one, but, by dint of repetition, people are getting tired of hearing about it. For we constantly invoke the free enterprise system, too often without defining the freedoms and the opportunities that it, and it alone, provides. We chant a slogan, a label, without defining it in comprehensible, human terms.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean anything to those who do not understand what it really is and what makes it work. It's like trying to sensibly discuss the birds and the bees with someone who is unshakable in his belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to cue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition the average American shopping center would represent to nine-tenths of the earth's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and run agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions and feed not only our own people, but millions of others as well.

Too often they have been taught to scoff at the very profit and property motives which make our prosperity possible.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid; what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried.

They have not seen first-hand the political and social aftermath in societies where the government has destroyed free enterprise. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander Hamilton warned so long ago, "power over a man's substance amounts to power over his will."

Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many new improvements. Whether we like it or not, it is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So we have reached the point where, although the free enterprise system works, and works better than any other economic system in effect anywhere in the world -- and although it feeds, clothes and houses more people more affluently than any other while serving as the underpinning of our free society -- it is somehow losing the war to an alien philosophy of government control and economic irresponsibility that has never worked but has somehow managed to preserve an aura of idealism and altruism that attracts many young idealists.

All of these misconceptions would be unimportant if they were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in position of high public trust cares deeply about the well being of our people, especially those who are impoverished or face disadvantages because of their sex or the color of their skin.

The central question is not who cares the most, but rather how we broaden prosperity and reduce human hardship without sacrificing our freedom or destroying the most successful economic system that man has ever known.

I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and our lives -- a road that we have been moving steadily down for several decades -- then our children will be robbed of their personal and economic freedoms. And, in the meantime, all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment.

That is really what is at issue underneath the semantics and the misleading labels, and of course young Americans have an even greater stake in the outcome than the rest of us.

Let's look at a few facts about government spending. For most of our history, the Federal Budget stayed somewhere below the $100 billion mark -- usually way below it.

Then, in 1962, we finally hit $100 billion -- and that was only the beginning. Seven years later, the budget broke the $200 billion barrier and then, only four years after that, we hit the $300 billion mark. And now, in our bicentennial year, we have reached the point where the Federal Government is spending $1 billion a day.

The very size of such numbers makes them almost meaningless to the average American. But there are ways of getting the message across. For example: suppose that on the day Christ was born, a man had been given $1 billion on the condition that he or his heirs spent $1,000 every day,

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seven days a week. How long would that $1 billion last? Adding it up, I think you'll find that today, almost 200 years later, the grandchildren would still not have spent the full billion dollars. . .

Yet our Federal government is spending $1 billion every single day, and going into debt another $1 billion every week.

And as the budget grows, the government comes to occupy a more and more dominant role within our society.

In 1930, government spending at all levels -- Federal, state and local -- amounted to about 10 percent of the Gross National Product. Today, because budgets have mushroomed, government accounts for nearly 40% of our entire national output, and if recent trends prevail, the government's share of the total economy could reach 60 percent before the end of this century.

For taxpayers, the burden of paying the government's bills has become so heavy that many are now in open rebellion. In the 1974 general elections, for example, voters across the country turned down some three quarters of all bond issues on the ballot. But too many get around this public opposition by voting more federal spending without increasing taxes.

The result has been a string of Federal Budget deficits that are unparalleled in our history. In 16 of the last 17 years, the budget has been in the red. And now, just when a balanced, healthy economic recovery has begun, the advocates of big spending would have us launch another round of reckless spending and runaway inflation.

It is up to us to stop them.

I wish that there was some way for television cameras to portray this story as vividly as they did the war in Vietnam or the race riots of earlier years. For, while the visual images are less dramatic, the problem is every bit as pressing and important.

But, as the great 19th century historian Thomas Carlyle once said, political economics is the "dismal science." On the surface, it seems nothing more than a pile of charts and a jumble of numbers so large as to be incomprehensible in everyday terms. To put it mildly, economics seldom makes "sexy" news stories. And yet the economy is the one thing that affects every other aspect of American life -- the food we eat, the quality of our education, our mobility, our freedom of choice in careers, services and merchandise, and our material and personal sense of pride and independence.

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The smallest shock to the economy is felt in every limb of the body politic. And that is a big story, if only a graphic gripping way of telling it could be found.

Consider the case of the Federal debt and its impact. As the debt climbs rapidly upwards, we have to pay higher and higher interest cost on it. By the end of fiscal year 1976 we will have spent $36 billion in interest payments alone.

That's more than we spent in any single year on the war in Vietnam. It's more than a third of our national defense budget. And it is money that could be better spent on needs such as public transportation, health care or any of a dozen worthy purposes.

This heavy borrowing by the government has also aggravated inflation and increased interest rates, creating strains in money and capital markets. This, in turn, affects everyone from the businessman interested in expanding his plant to create new jobs, to the young couple trying to buy their first home without paying an arm and a leg in mortgage interest.

Reckless government spending is the basic cause of inflation, and inflation was the underlying cause of the worst recession our country has experienced in a generation -- a recession we are only now beginning to recover from.

It was inflation that cuased a loss of real income and the confidence of consumers, prompting the sharpest drop in consumer spending since World War II. And it was inflation that helped dry up the flow of savings into our thrift institutions, driving up interest rates and causing the housing industry to collapse.

So one of our prime concerns as we proceed with the economic recovery is to avoid another dose of the poison that brought the recession on in the first place - rampant inflation fed by runaway federal spending.

But spending isn't the whole problem. There is also the matter of government control and regulation for, as government spending has grown by leaps and bounds, so too has federal red tape.

Did you realize that government agencies now exercise direct regulation over 10 percent of everything bought and sold in the United States and indirect regulation over almost every other sector of the private economy?

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Did you know that it costs private industry -- and that means each one of us as consumers -- approximately $20 billion a year just to do the paper work demanded by Federal bureaucrats?

Some of these regulations are, of course, necessary. But many of them are counter-productive, wasteful, or obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Let me conclude with these few observations:

As we enter our third century as a nation, I believe the time has come not to reappraise our dedication to a better life for all -- that dedication is clear -- but to reappraise what we can pay for and how we can do it. The current plight of New York City, the disease that afflicts the British economy, and the overwhelming size of our own Federal deficits are all grave warnings to us. We can pay for what we now have and provide for the future only if our great capitalist economy does its job -- produces goods in a free market and makes a sufficient profit.

I am sick and tired of people apologizing for the free enterprise system. It has given this country the highest standard of living and the greatest prosperity ever known, and of most importance, has helped to give us the greatest freedom ever known to man. And it will continue to do that unless it is crushed by the juggernaut of big Government. What we need are not fewer but more capitalists in the United States -- more people with a real and direct stake in the profits generated by a productive economy. We cannot continue to have more and more of our citizens involved only in receiving benefits from the government and fewer and fewer people responsible for paying for the benefits. We must broaden the base of those who work and narrow the base of those who are able but don't want to work.

President Ford urged that we strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our private enterprise system.

-- A balance that favors greater honesty and realism in dealing with the challenges of our time.

These are great goals -- goals worthy of the greatest nation on earth. We should not begin our Bicentennial year by retreating into the past, but by going forward into the future with a common combination of patience, realistic hope, courage and common sense.

If we work together with common purpose and conviction -- with pride in ourselves and our nation -- the goals we share today can become the first achievements of our third century together.

President Ford has set a course which points us in the right direction and will permit us to get a grip on these problems, but it will take several years, not months, to bring this about. Unfortunately, the election is only a bit over seven months away. There will be calls from the opposition for "sweeping changes" and "broad new initiatives" which will really mean bigger spending, bigger deficits and ultimately bigger governmental control of the economy. We must persuade the American people that this course is wrong and that the other approach is much sounder in the long run.

The real choice is between greater government control or greater individual freedom. That is the decision before us.

Thank you.

13-wk		26-wk
4.830	Last week	5.068
4,763	To-day	5.089
	Low since	
4,763	1/26/76	
4,668	11/6/72	
	High since	
	4/5/76	5,293

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FOR IMMEDIATE RELEASE April 19, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.5 billion of 13-week Treasury bills and for $3.4 billion of 26-week Treasury bills, both series to be issued on April 22, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 22, 1976			26-week bills maturing October 21, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.802	4.739%	4.86%	97.442	5.060%	5.26%
Low	98.793	4.775%	4.90%	97.420	5.103%	5.31%
Average	98.796	4.763%	4.89%	97.427	5.089%	5.30%

Tenders at the low price for the 13-week bills were allotted 27%.
Tenders at the low price for the 26-week bills were allotted 36%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 19,435,000	$ 16,435,000	$ 10,500,000	$ 8,000,000
New York	4,526,525,000	2,159,480,000	4,510,680,000	2,866,880,000
Philadelphia	84,745,000	28,615,000	5,805,000	5,805,000
Cleveland	59,995,000	28,345,000	87,885,000	41,485,000
Richmond	32,110,000	20,700,000	39,080,000	34,065,000
Atlanta	53,740,000	44,740,000	31,525,000	29,225,000
Chicago	259,280,000	47,815,000	305,270,000	181,410,000
St. Louis	73,915,000	35,065,000	66,890,000	48,890,000
Minneapolis	46,310,000	11,310,000	47,065,000	37,065,000
Kansas City	33,700,000	27,725,000	18,665,000	18,665,000
Dallas	34,260,000	14,260,000	25,185,000	18,685,000
San Francisco	277,280,000	68,170,000	217,890,000	109,890,000
TOTALS	$5,501,295,000	$2,502,660,000 a/	$5,366,440,000	$3,400,065,000 b/

a/ Includes $353,295,000 noncompetitive tenders from the public.
b/ Includes $181,005,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

WS-788

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-964-2615

FOR IMMEDIATE RELEASE April 19, 1976 418

SUMMARY OF LENDING ACTIVITY

March 16 - March 31, 1976

Federal Financing Bank lending activity for the period March 16 through March 31, 1976 was announced as follows by Roland H. Cook, Secretary:

The Student Loan Marketing Association (Sallie Mae) borrowed $30 million on March 16 at an interest rate of 5.235%. The loan matures June 15, 1976. Sallie Mae used the proceeds of the loan to repay a $30 million note maturing with the Bank. Sallie Mae borrowings are guaranteed by the Department of Health, Education and Welfare.

On March 17, the FFB purchased a $500 million 5 year Certificate of Beneficial Ownership from the Farmers Home Administration. The maturity is March 17, 1981. The interest rate is 7.92% on an annual basis.

The United States Railway Association borrowed against the following Notes guaranteed by the Department of Transportation:

Date	Note	Amount	Maturity	Interest Rate
3/17	5	$10,000,000	4/1/76	5.239%
3/25	6	795,000	12/26/90	8.055%
3/25	3	1,000,000	4/1/76	5.093%
3/25	5	400,000	4/1/76	5.093%
3/31	3	500,000	4/1/76	5.207%
3/31	5	242,000	4/1/76	5.207%

On March 30, the U.S. Railway Assoc. signed Note #8 with the Bank. The note allows USRA to borrow up to $228 million. The Association will loan the funds to the Consolidated Rail Corporation (ConRail) under section 211 (h) of the Railroad Revitalization and Regulatory Act of 1976. The final maturity of the note is April 30, 1979. The USRA borrowed $20 million against this note on March 31, 1976 at a semiannual interest rate of 7.328%.

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The National Railroad Passenger Corporation (Amtrak) made the following drawings from the FFB:

Date	Note #	Amount	Maturity	Interest Rate
3/19	7	12,000,000	6/14/76	5.194%
3/29	7	10,000,000	6/14/76	5.131%
3/30	6	130,000,000	6/29/76	5.207%
3/31	7	5,000,000	6/14/76	5.207%

On March 31, 1976 Amtrak borrowed $120,000,000 against Note #9, a $120,000,000 renewable line of credit with the Bank. The interest rate is 5.343%. The line is renewable on July 29, 1976. The final maturity of the line is 4/30/77. Proceeds of the loan were used to repay Amtrak Note #4.

On March 19, the Bank advanced $1,045,918.13 under a November 25,1975 agreement with Amtrak and others to finance 26 GE electric locomotives. This agreement provides for serial repayments with a final maturity date of July 15, 1989. The interest rate is 8.125%. Amtrak borrowings from the FFB are guaranteed by the Department of Transportation.

The Federal Financing Bank made the following loans to utility companies guaranteed by the Rural Electrification Administration:

Date	Borrower	Amount	Maturity	Interest Rate
3/19	South Mississippi Electric Power Association	$5,235,000	3/27/78	6.964%
3/31	Oglethorpe Electric Membership Corp.	3,855,000	12/31/10	8.065%
3/31	Associated Electric Coop., Inc.	4,000,000	12/31/10	8.065%
3/31	Southern Illinois Power Corporation	900,000	3/31/78	6.905%

Interest payments are made quarterly on the above loans.

The FFB made the following advances to borrowers guaranteed by the Department of Defense under the Foreign Military Sales Act:

Date	Borrower	Amount	Maturity	Interest Rate
3/19	Republic of Korea	$17,314,463.10	6/30/83	7.555%
3/26	Government of Argentina	1,049,700.00	4/30/83	7.524%
3/29	Government of Morocco	11,649,070.00	6/30/83	7.485%
3/29	Government of Israel	22,365,109.96	6/10/85	7.624%
3/31	Government of China	685,357.15	9/30/85	7.526%

On March 23, the Bank purchased $2,483,000 of notes from the Department of Health, Education and Welfare, The Department had previously acquired the notes which were issued by various public agencies under the Medical Facilities Loan Program. The notes purchased by the Federal Financing Bank are guaranteed by the Department of Health, Education and Welfare and mature on July 1, 2000. The interest rate is 8.081%.

On March 24, the Bank purchased the following debentures from Small Business Investments Companies:

Company	Amount	Maturity	Interest Rate
Capital Investment, Inc. (Wisconsin)	3,000,000	3/1/86	7.905%
Louisiana Equity Capital Corp.	100,000	3/1/86	7.905%

These debentures are guaranteed by the Small Business Administration.

On March 31, the Tennessee Valley Authority borrowed $140 million at an interest rate of 5.207%. The loan matures on June 30, 1976. Proceeds of the loan were used to repay $110 million of notes maturing with the Bank and to raise additional funds.

On March 23, the Federal Financing Bank entered into an agreement with the Rural Electrification Administration to purchase up to $600 million in Certificates of Beneficial Ownership in insured notes and other obligations of the Rural Electrification and Telephone Revolving Fund. The obligations in the Fund are loans made by REA pursuant to the Rural Electrification Act to entities which own or contemplate owning rural electric and telephone systems. The first CBO sale to the Bank in the amount of $166,374,000 took place on March 31, 1976. The CBO matures on March 31, 2006. The rate of interest is 8.205%.

Federal Financing Bank loans outstanding on March 31, 1976 totalled $21.7 billion.

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Review of

ECONOMIC AND FINANCIAL DEVELOPMENTS

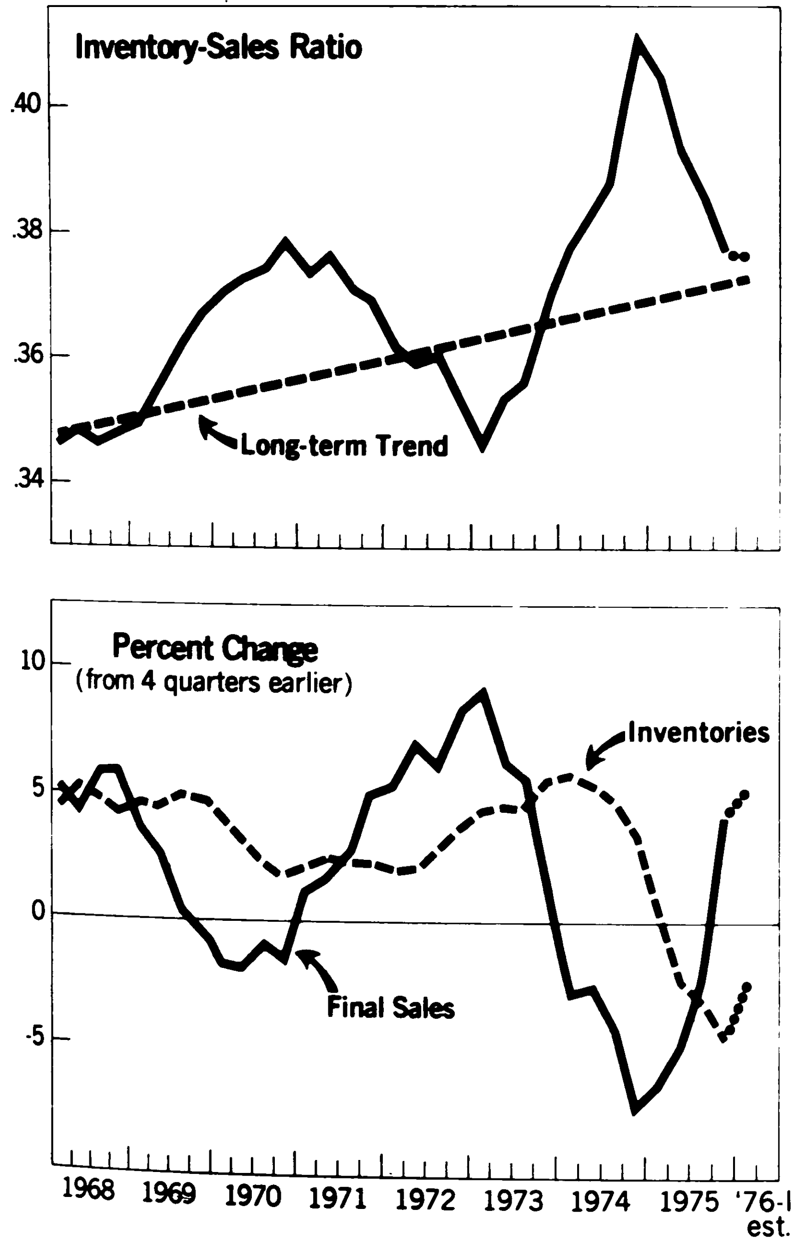
April 9, 1976

THE COMING INVENTORY BOOM

On top of the continuing strength in consumer spending (the primary force in the current economic expansion), prospects now point to an inventory boom -- one that might carry the economy to higher economic growth rates later this year and next than were officially forecast last January.

Indeed, the prospective huge volume of inventories that businesses may wish to accumulate to achieve a desired relationship with sales might be frustrated -- because of limited resource capability. Otherwise, an "inventory explosion" could well develop.

Real Nonfarm Inventories and Final Sales of Goods and Structures



Changes in inventory investment typically represent an important swing element in rates of change in GNP during economic contractions and expansions. During periods of decline in economic growth, inventories accumulate because production cannot be curtailed quickly enough in reaction to the decline in "final sales" (i.e., GNP less inventory change). In contrast, periods of economic upswing typically are characterized by under-accumulation of inventories -- because production cannot be expanded quickly enough to provide for the deficiency of stocks resulting from rapid advances in final sales.

That pattern is being repeated in this latest business cycle experience. As real final sales declined during the course of 1974, the inventory-sales ratio for the economy reached a postwar high by the end of that year, as shown in the chart on page one. In the subsequent economic expansion that has now proceeded into the first quarter of 1976, real final sales rose dramatically, an increase that has not only absorbed the inventory overhang which had developed, but also has created shortages in stocks in some areas.

During this period, the inventory-sales ratio (the real value of stocks in relationship to the real value of final sales of goods and structures) plummeted from a postwar high of .41 in the fourth quarter of 1974 to an estimated .38 in the first quarter of 1976. Allowing for trends in this ratio, the estimated first quarter 1976 value indicates, at the very least, the restoration of some balance in the aggregate. (As indicated below, the ratio appears low at retail and somewhat high at the manufacturers' level.)

The decline in the inventory-sales ratio primarily registered an advance in final sales for the economy at large at a rate of about 4 1/2% from the first quarter of 1975 to the first quarter of 1976 (consumer spending increased at a more rapid pace over this period -- about 5 1/2%, while other elements of final sales, business fixed investment, net exports and Government, rose somewhat less).

It was this accelerated rate of expansion in final sales that has erased much of the inventory overhang and set the stage for 1976 as a year of an inventory boom.

The magnitude of that boom that might be expected is indicated by the experience of other postwar expansions. Advances in inventories have roughly matched increases in final sales of goods and services (though on occasion the change of stocks might lag the change in sales by a few quarters).

This has been the invariable postwar pattern -- swings in real inventory holdings roughly follow swings in real final sales, as shown in the lower panel of the chart on page one; the magnitude of the fluctuations in inventories over most of the post-Korean war period has roughly matched that of final sales of goods and services.

It is this relationship which promises to provide the basis for an inventory boom later this year and in 1977. Real final sales might be expected to rise 5%, or somewhat more, over the four quarters of 1976. This expectation would rely on the average experience in the rate of growth in final sales during the four previous economic recoveries; and on an analysis of expected demands by the consumer and business sectors.

If this rate of final sales is realized, then inventory accumulation could be expected to be very sizeable. In 1972 dollars, inventory investment that would be associated with this rate of final sales increase would average in the neighborhood of $16 billion per quarter.

If that $16 billion were to be realized, real economic growth in 1976 would amount to 7% -- nearly 1% more than had been projected in the Budget and the Economic Report.

However, that rate of accumulation in inventories would appear unlikely because:

- Acceleration of production could not feasibly proceed quickly enough to satisfy an already rapid rate of consumer spending, as well as to build inventory.

- Inventory accumulation may be limited by business caution, due to memories of the excesses in stock building in 1974.

- Some overhang of excessive inventory remains -- especially in the metals.

- For a while, the composition of expected output would be weighted toward consumer goods, which requires relatively less time in production than capital goods or defense equipment, which means that a smaller buildup of goods-in-process inventories might be expected.

Nevertheless, some markup in the rate of real growth from the January 1976 projections appears in order.

That correction might be in the neighborhood of an accumulation of $10 billion -- which would raise total GNP real growth in 1976 by additional 1/2 percent more than in the January estimates.

The principal source of that correction might be expected at retail. As shown in the chart on the next page, the level of inventories in relation to retail sales has been pared drastically. Despite the strong rebound of retail sales in 1975 and early 1976, merchants' ordering to restock shelves has been extremely cautious. By the last quarter of 1975, the constant dollar value of retail inventories to consumer goods purchases had reached the lowest level since 1969, while early reports for the first quarter of this year point to a further decline. If retailers do not restock soon, sales gains will be smaller than they otherwise would be. Presumably, ordering for re-stocking will grow stronger, contributing to the inventory expansion to be expected in 1976 and 1977.

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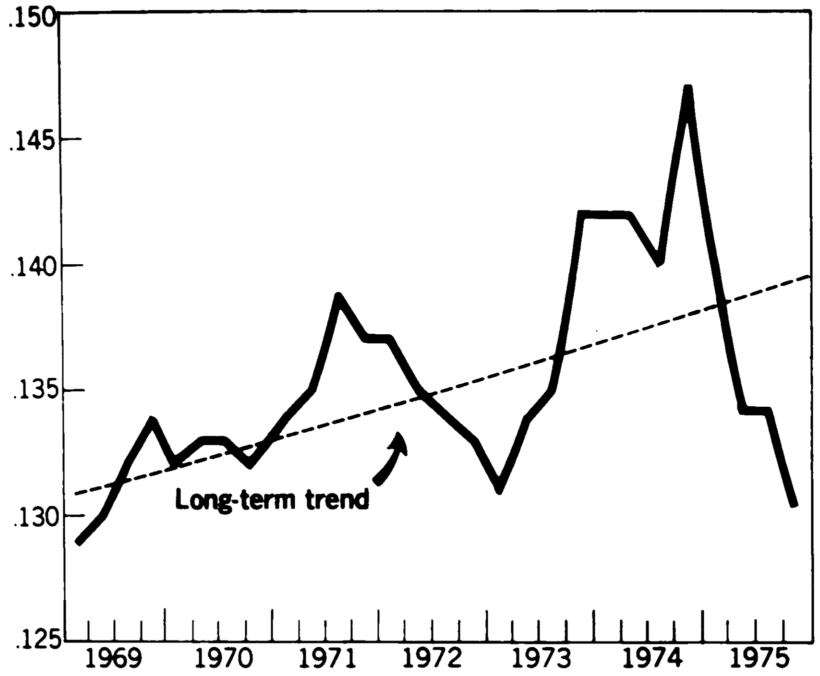
Ratio of Retail Store Inventories to Consumer Purchases of Goods
(Constant dollars)



In contrast, some overhang of production materials and supplies still exists at the manufacturing level, especially among durable goods manufacturers. (Some of this overhang has been masked by shifts in accounting methods, which have distorted the commonly cited ratios of book value inventories to sales.)

Expectations of an inventory boom in 1976 rest on the assumption that some balance of stock-sales ratios, in the aggregate, had been reached by the end of the first quarter of this year; and that re-ordering has begun and will be showing up in figures not yet calculated. Already, some indicators which normally lead swings in inventory stocks would suggest that the boom will be developing. Among them are:

- The proportion of manufacturers reporting inventories to be too high had fallen by the fourth quarter of 1975 to that averaged during 1972, prior to the inventory scramble of 1973.

- By year-end 1975, manufacturers who characterized inventories as too low were about the same proportion as in mid-1973. Only 1.1% of the dollar value of manufacturers' inventories were reported as in excess, about the same as late 1973, and down from 4.4% in late 1974.

- In the first quarter of this year, the proportion of companies reporting 60 day or more commitments to purchase production materials had already returned to rates of early 1973.

- The proportion of firms reporting slower deliveries has mounted sharply to 50% midway in the first quarter of this year, up sharply from 16% a year ago, which was the lowest level since just prior to the Korean War.

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All these indicators would appear to signal that rebuilding of stocks is ahead. Indeed, the return of many of these indicators to late 1972 or early 1973 levels may foreshadow the eventual emergence of some market congestion should the recovery proceed at too rapid a pace.

Initiator: Russel Reviewer: Liebling

OFFICE OF THE SECRETARY OF THE TREASURY
OFFICE OF FINANCIAL ANALYSIS

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FOR IMMEDIATE RELEASE
FRIDAY, APRIL 23, 1976
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The amount of General Revenue Sharing money to be paid each of nearly 39,000 states and local governments for the period 7/1/76-12/31/76 (Entitlement Period Seven) was announced by the U.S. Treasury Department's Office of Revenue Sharing today. A total of $3.3 billion will be distributed to all general governments in the United States in two quarterly payments, in October 1976 and January 1977.

These allocations of shared revenues in the General Revenue Sharing Program have been made using data provided by the U.S. Bureau of the Census, the Bureau of Indian Affairs, the Bureau of Economic Analysis and the Internal Revenue Service as required by law. Fiscal year 1975 data on local tax effort and intergovernmental transfers and estimated 1973 population and 1972 per capita income figures were used in making the new allocations for local governments. Data used for the interstate allocations were: 1975 population; 1970 urbanized population; 1972 per capita income; FY 1974 state and local taxes; 1974 general tax effort factor; 1975 state individual income taxes; and 1974 Federal individual income tax liabilities. These data have been published and are available from the Office of Revenue Sharing today, as well.

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Amounts to be paid for Entitlement Period Seven also reflect adjustments to fiscal year 1976 amounts, based on calculations made with verified and improved data obtained during the current year.

The amounts that states and local governments may expect to receive have been printed on Planned Use Report forms mailed today to each recipient State, county, city, town, township, Indian tribe and Alaskan native village in the United States.

On the Planned Use Report form, due to be returned to the Office of Revenue Sharing by June 25, 1976, the Chief Executive Officer of each recipient government must report that government's plans for uses of the revenue sharing money it will receive in October and January. The Planned Use Reports must be published locally in newspapers of general circulation. In addition, the news media in each area -- including bi-lingual news media -- must be informed about the report. A copy of the report and supporting documentation must be made available for public inspection at a location announced on the published report form.

The publication requirement in the revenue sharing law was intended to provide citizens with information about the General Revenue Sharing Program as it affects their communities. Citizens may suggest changes in proposed uses of the money before it has been spent.

Governments that fail to file Planned Use Reports with the Office of Revenue Sharing will not receive their quarterly checks on schedule. The funds will be held by the Office of Revenue Sharing until the forms have been properly published and filed.

Title I of the State and Local Fiscal Assistance Act of 1972 authorized and appropriated $30.2 billion to be distributed to all units of general government in the United States over a five year period, from January 1972 through December 1976. Thus far, the Office of Revenue Sharing has made payments totaling $25.1 billion.

President Ford has requested the Congress to renew General Revenue Sharing past its present deadline of December 1976.

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Attachment (Summary of amounts by state)

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GENERAL REVENUE SHARING

ENTITLEMENT PERIOD 7

R E V E N U E   S H A R I N G   S U M M A R Y

NAME	REVENUE SHARED EP1 - EP 6	REVENUE TO BE SHARED EP 7	TOTAL
ALABAMA	447,662,946	53,655,635	501,318,581
ALASKA	35,954,661	6,163,852	42,118,513
ARIZONA	270,566,622	31,568,833	302,135,455
ARKANSAS	277,650,786	35,184,413	312,835,199
CALIFORNIA	2,833,814,830	355,937,060	3,189,751,890
COLORADO	283,428,418	36,952,898	320,381,316
CONNECTICUT	344,574,611	42,338,167	386,912,778
DELAWARE	80,389,615	10,593,740	90,983,355
DIST OF COLUMBIA	117,663,975	13,937,679	131,601,654
FLORIDA	797,944,296	100,068,236	898,012,532
GEORGIA	559,788,105	70,155,647	629,943,752
HAWAII	117,813,980	15,093,313	132,907,293
IDAHO	107,452,155	12,106,000	119,558,155
ILLINOIS	1,364,075,943	171,003,774	1,535,079,717
INDIANA	561,025,278	70,477,608	631,502,886
IOWA	371,152,194	41,020,818	412,173,012
KANSAS	253,986,584	29,780,133	283,766,717
KENTUCKY	435,773,556	55,764,577	491,538,133
LOUISIANA	604,741,704	73,221,373	677,963,077
MAINE	165,105,844	20,362,152	185,467,996
MARYLAND	530,112,786	66,700,249	596,813,035
MASSACHUSETTS	851,644,962	105,127,729	956,772,691
MICHIGAN	1,133,423,308	136,985,459	1,270,408,767
MINNESOTA	537,702,337	66,863,683	604,566,020
MISSISSIPPI	429,362,420	50,541,781	479,904,201
MISSOURI	504,773,499	62,791,007	567,564,506
MONTANA	104,415,853	12,314,508	116,730,361
NEBRASKA	188,283,919	20,996,442	209,280,361
NEVADA	59,492,524	8,341,504	67,834,028
NEW HAMPSHIRE	85,349,603	11,111,869	96,461,472
NEW JERSEY	839,008,455	104,703,165	943,711,620
NEW MEXICO	168,696,409	21,475,863	190,172,272
NEW YORK	2,992,504,147	377,918,901	3,370,423,048
NORTH CAROLINA	678,628,827	83,446,756	762,075,583
NORTH DAKOTA	99,761,666	9,427,804	109,189,470
OHIO	1,073,421,551	134,452,879	1,207,874,430
OKLAHOMA	298,880,685	36,356,454	335,237,139
OREGON	269,272,210	35,843,413	305,115,623
PENNSYLVANIA	1,409,223,986	176,000,540	1,585,224,526
RHODE ISLAND	119,201,645	14,321,168	133,522,813
SOUTH CAROLINA	368,988,870	46,187,186	415,176,056
SOUTH DAKOTA	115,804,732	10,631,185	126,435,917
TENNESSEE	505,594,183	62,208,572	567,802,755
TEXAS	1,275,788,212	165,025,582	1,440,813,794
UTAH	157,659,236	18,748,068	176,407,304
VERMONT	77,094,882	8,817,077	85,911,959
VIRGINIA	532,979,151	67,500,587	600,479,738
WASHINGTON	386,953,353	50,782,459	437,735,812
WEST VIRGINIA	258,028,119	30,607,715	288,635,834
WISCONSIN	673,921,526	80,488,915	754,410,441
WYOMING	47,702,700	5,424,767	53,127,467
* NATIONAL TOTALS *	26,804,241,859	3,327,529,195	30,131,771,054

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WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE

Remarks of David F. Bradford
Deputy Assistant Secretary of the Treasury for Tax Policy
at the National Association of Manufacturers Conference
Washington, D. C.
April 20, 1976

Feedback Effects and Tax Policy Analysis

The title of this conference, "The Economic Impact of Tax Proposals: Are Revenue Estimates Enough?" is, I hope, a rhetorical question. Certainly academic students of the economics of public finance will find it a curious one. I'm sure one would have difficulty finding the subject of revenue estimating on a course syllabus, or discovering any significant writings on the subject in the vast volume of economic literature about taxes.

In saying this, I do not intend to belittle the importance of high quality analysis of the revenue consequences of tax policy choices. Clearly this is a proper component of intelligent decision-making, and the skill with which this function is carried out by the Treasury staff members is extraordinary. However, the economic analysis of tax policy by and large treats the revenue aspects as secondary, a matter of the constraint within which the objectives of fairness and efficient resource use are to be pursued.

In the legislative process, however, revenue effects of tax law changes seem to have a disproportionate importance. Often whether or not a proposed tax change is accepted turns on the estimated revenue consequences, and revenue effects are often used as a measure of the degree to which a reform serves the objective of equity, which is essentially unrelated to revenues.

WS-790

I am not sure why this is so, but I can suggest two reasons.

One is the budgetary setting within which tax law changes are necessarily made. While year by year budget balance is no longer considered necessary, the terms in which budget objectives are set tend to emphasize the revenue total. The budget represents an important component, perhaps the most important one, of the plan of action by which resources are directed to government use. And because the Federal Government is such a large actor in the system this plan must account as well for the influence of government actions on the private economy. In the budget-making context this means especially the consequences for the level of employment of labor and capital resources and the rate of price inflation.

We all know, or we should know, that the budgetary aggregates -- spending and receipts -- represent very imperfect measures of the influence of the government on the private economy, even on such gross aggregate measures of the performance of the private economy as the level of employment and rate of inflation. Tax policy is bound to affect differentially different sectors of the economy. Further, policy alternatives which have the same tendency to stimulate or retard the aggregate level of activity are bound to have different implications for tax receipts in a given period.

However, it is exceedingly difficult to describe a budget's total effects, and I think most people regard it as a heartening advance that Congressional procedures have been developed which attempt to deal with this issue at all. Still the principal instrument by which budget control is exercised in that procedure is the overall <u>revenue</u> constraint. That is, the main method by which Congress attempts to coordinate its fiscal program to the budget horizon is an aggregate which cannot recognize the subtleties of the effect of the composition of the revenue picture.

In my view, given the state of the forecasting art, the dullness of this instrument of control is not very serious. However, it does put a tremendous burden on the revenue estimates of tax alternatives, since these estimates have a crucial bearing on the package of tax proposals which "fits" the revenue target in the budget.

I noted that two possible reasons for the great emphasis on revenue estimates in the legislative process had occurred to me. The first is the budgetary setting of tax legislation. The second is the considerable ignorance that exists about the functioning of the market system and the way in which taxes impinge on it. The result is a tendency to regard revenue effects as the most important ones. The ignorance is by no means confined to legislators, and I do not wish to exaggerate the accomplishments of economic science. However, I think it is clear that economists have thus far failed to communicate persuasively what they have learned, at least about the appropriate questions which should be raised in making tax policy choices.

It is useful to distinguish several types of responses of the economy to tax changes. First, changes in total revenue may result in a change in total spendable income, thereby altering total demand for goods and services and the rate of unemployment. Second, altered tax rules may cause changes in behavior directly by reducing the incentive to pay dividends, to hire construction labor, to buy particular products, and the like. Third, changes in the structure of the tax system may alter the future potential productive capacity of the economy by affecting, throughout the economy, the desire to accumulate new capital, to undertake education and advanced training, or to employ labor and capital efficiently.

Income and Employment Effects of Tax Changes

The first type of feedback is the short-run consequence of tax changes for unemployment, inflation, and revenues that accompany budgets in preparation. A good part of the recent attention paid the subject of feedback effects, or secondary, tertiary, and "ripple" effects of tax proposals on the national economy has concerned revenue estimates in the context of budgeting for Fiscal Year 1977. It has been said that traditional estimates made by Treasury staff of the revenue gains and losses of various proposed tax revisions are poor guides to policy because they fail to account for the changes in income and employment which occur as the private economy adjusts to these tax changes. If a proposal to broaden the tax base, for example, causes consumers to spend less and businesses to curtail capital expansion, these behavioral responses will tend to reduce the tax base. The result, the argument goes, is a smaller increase in revenues than revenue estimators had predicted. In extreme cases, it is argued that tax revenues will actually fall, and, more importantly, there will be a waste of resources through unemployment.

For example, the question is asked, does the estimate of $3.3 billion of revenue pick-up in FY 1977 attributable to the increase in social security tax rate proposed by President Ford take into account the dampening effect such a tax increase will have on the economic recovery? The answer is "sort of."

To explain that answer, let me refer to the revenue estimates included in the <u>Budget of the United States Government for Fiscal Year 1977</u>. According to the projections there, the total receipts in FY 1977 under existing and Administration-proposed legislation were anticipated to be $351.3 billion. The budget document provides, as well, the effects on tax receipts of each of a series of legislative changes, such as the proposed social security tax rate increase ($+3.3 billion) or the already-enacted Revenue Adjustment Act of 1975 ($-1.3 billion). An example of such a breakdown is given by the following table, taken from the budget document.

Changes in Budget Receipts
[In billions of dollars]

	1977 estimate
Receipts under tax rates and structure in effect January 1, 1974	371.3
Increase in import fee on petroleum products administrative action	--
Enacted legislative changes:	
Social security taxable earnings base increases:	
$13,200 to $14,000 effective Jan. 1, 1975	+2.1
$14,100 to $15,300 effective Jan. 1, 1976	+2.4
$15,300 to $16,500 effective Jan. 1, 1977 1/	+.8
Tax Reduction Act of 1975	+.4
Revenue Adjustment Act of 1975	-1.3

Liberalized deduction for individual contributions to pension plans	-.5
Reduction in telephone excise tax	-.9
Increase in SMI (medicare) premium	+.3
Total, receipts under existing legislation	374.6
Changes due to tax proposals:	
Individual and corporation income tax reduction effective July 1, 1976	-28.1
Financial Institutions Act	-.3
Stock ownership incentives	-.3
Accelerated depreciation on investment in high unemployment areas	-.3
Social security tax rate increase from 11.7% to 12.3% effective Jan. 1, 1977 1/	+3.3
Unemployment tax rate and base increase Jan. 1, 1977	+2.1
Other	+.1
Total, receipts under existing and proposed legislation	351.3

Source: Budget of the United States for Fiscal Year 1977. Some figures are revised.

1/ The effect of the taxable earnings base increase is calculated using a tax rate of 11.7%. The effect of the tax rate increase is calculated using a taxable earnings base of $16,500.

The meaning of the revenue aggregate for FY 1977 is clear enough, but to what questions are the other numbers the answers? I think most of us would like them to be of the following sort:

"Question: What will be the effect on FY 1977 social security tax receipts if the rate increase proposed by the President (from 11.7 to 12.3 percent) is not adopted and if the Government does everything else as planned in the budget?" (The underlined phrase is often left unstated, but something of the sort must be assumed.)

Unfortunately, the answer is "It depends." It depends on the meaning of "everything else as planned."

-- Will the Federal Reserve make no adjustment to the change in Government debt outstanding?

-- If revenues are reduced after accounting for feedbacks, how is the greater deficit to be financed? Will an offsetting change be made in some other tax? Will debt be retired or expenditures increased?

Thus, the question of the effect of making changes in apparent isolation is not well specified--some assumption must be made about the decisions made about other policy instruments available to the Government, (including for this purpose the Federal Reserve System).

What are the assumptions about other policy instruments underlying Treasury projections? While they are not spelled out, they amount to this: that Government will tend to adjust its plans in light of developments to keep the economy on the path set as the objective in the budget. Thus, Treasury methods of projecting tax receipts do take into account the effect of tax law changes on the course of the economy in the short run.

The question to which such estimates are addressed is of the following kind:

"Question: What will be the effect on FY 1977 receipts from the social security tax if the increase from 11.7 percent to 12.3 percent proposed by the President is not adopted by Congress and if instead the Government takes other measures to assure the attainment of the path of the economy projected in the budget?"

"Answer: A decrease of $3.3 billion."

As we have seen, such estimated receipt changes do incorporate feedback effects in that they are consistent with the path of the economy expected to result from adopting the budget.

To calculate the effect of the entire "package" of tax and expenditure plans contained in the budget requires a kind of simultaneous determination--we cannot estimate receitps until we know GNP; we cannot know GNP until we know receipts and expenditures (which are also sensitive to GNP). The approximation to this simultaneous determination is carried out by coordinated staff work of the so-called "Troika," consisting of the Office of Management and Budget, the Council of Economic Advisors and the Treasury.

The expected course of the economy under a variety of alternative fiscal and monetary options is calculated in the course of developing overall economic policy recommendations by the Administration and the Congressional budget committees. However, it seems most appropriate that decisions about the structure of taxes assume that the overall objectives of fiscal policy are realized. With respect to the structure of taxation, i.e., deductions, depreciation rules, credits, and the like, we should aim for a system which we regard as fair and which promotes the efficient use of the nation's resources. The level of taxes can in principle generally be adjusted in a way which does not alter any given desirable structure.

Price Effects of Tax Changes

The second of the feedback effects, the price effects, consist of changes in behavior attributable to the direct impact of the tax. While often there is no sound empirical basis for calculating these effects, traditional revenue estimates incorporate such responses in those selected cases where there is broad agreement on the direction and size of the change. Examples of such estimates are (1) the change in purchases of gasoline that would accompany a change in the gasoline excise tax rate, (2) induced dividend payout accompanying the corporate integration proposals or (3) projected use of a new statutory plan, such as DISC or the proposed BSOP, which did not exist before the change in the tax law. These estimates could be improved, given more resources and greater knowledge of the relationships, and this is one source of "feedback" controversy.

Considerable interest is often focused on these allocative effects of tax changes. For example, the application of proposed tax shelter limits to investment in real estate may be expected to alter the amount of such investment, affecting first the construction industry and then the level and price of real estate services. Another example is the investment tax credit. By making this feature of the tax system permanent at the 10 percent level we can anticipate that the level of investment in machinery and equipment will be somewhat larger than would otherwise be the case, and we may be interested in estimating the effect of this on employment in the capital goods construction industry and on the division of output between sectors more or less favored by this incentive.

The methods available for this analysis are different from those used in projecting aggregate output and the associated employment and tax receipts. Short-run forecasting models, which have been designed to give the best possible estimates of the aggregate effects, have not been refined to the point where they can be used to give reliable forecasts about the composition of income and employment. As a result, the short-run projections made by Treasury staff are generally developed by starting with a long-run analysis and then using estimates of the rate at which the adjustment to the long run takes place.

However, the rate of unemployment and near term level of tax collections do not depend upon these sectoral changes alone, as some other estimates of feedback effects imply. Unemployment and other measures of short-term economic health depend upon the overall fiscal and monetary posture. If that posture is unchanged, reduction in demand for output in one sector will be offset, perhaps completely, by increased demand elsewhere.

Long-Run Analysis

The emphasis of long-run analysis is on questions of the level and composition of productive potential in the economy, since the degree of slack cannot be forecast very far into the future. The long-run questions are also significant, however, and the tax system profoundly affects the answers.

Asking "long-run" questions also makes certain guides to tax policy more clear. It is not the real object of tax policy to minimize or maximize revenue flows. The basic long-run fiscal policy issue is the fraction of the nation's resources which should be devoted to collective consumption and how much of the resources left in the private sector should be redistributed through welfare and similar transfer programs. The tax system to finance this policy should be designed to harmonize with the distribution objectives while interfering as little as possible with the efficient allocation of resources. The fact that a tax change would raise $X of increased revenue in 1985 is not necessarily a virtue. What is important is whether it improves the functioning and fairness of the economic system.

The central concern of long-run analysis is with the effects of the fiscal system on the rate of capital accumulation and the efficiency with which the available capital stock and labor force are used. Economic analysis provides us with some presumptions about the relative effects of different policies on capital formation and efficiency.

For example, because an income tax introduces a differential between the total yield from an investment and the "after tax" yield on which the investor bases his decision there is a presumption that the capital stock is "too small." In the choice between consumption and investment, the balance is tilted toward consumption. There are investment opportunities with yields sufficiently attractive to induce people to forego some consumption, but these go unexploited because of the tax.

Another and equally serious problem is the effect of the tax system on the allocation among sectors of the investment which is made. For example, it has long been recognized that the existence of a separate corporation income tax results in a differential between the before tax yield on investment in this and the noncorporate sector. By reallocating the present investment from the lower yield noncorporate to the higher yield corporate form, a gain in output could be obtained at no cost to the economy.

Let me give some examples of the sort of conclusions which have been reached by economists who have studied these questions. In a 1966 study Professor Arnold Harberger concluded that the extra tax on income from corporate capital resulted in the equivalent of a loss of approximately one-half percent of GNP per year due to the divergence between the before tax yield in that sector compared to the noncorporate sector. More recently, in a calculation similar in spirit, Professor Martin Feldstein concluded that the result of shifting the tax on capital income fully onto labor income would lead to an increase of about one percent in effective output. This gain would be due to closing the gap between before tax and after tax yield on investment.

Such calculations are surrounded with qualifications by their authors, and I run a danger of misrepresenting them by presenting their carefully derived and largely illustrative results as "conclusions." One qualification which these and other authors would strongly emphasize is that such calculations do not attempt to evaluate the distributional consequences of the changes being analyzed.

However, even here the work of economists suggests that apparenetly obvious propositions may be incorrect. For example, by now many people recognize that "good jobs" require the support of capital investment in the form of machines, education, etc. But it would come as a surprise for most that a shift of taxes from capital to labor income could lead to an <u>increase</u> in the after-tax earnings from labor. A parameter of the economic system, known in the jargon as the "elasticity of substitution of capital for labor," plays a crucial role in this possibility. Michael Boskin has recently estimated the value of this parameter for the United States economy to be around .5, a value which makes distinctly possible such an apparently paradoxical result.

Calculations of the sort just described provide reason to think about redesign of our tax system to achieve some of the long term gains they suggest are possible. Unfortunately, at this point we do not have at our disposal quantitative models of the U.S. economy which permit us to trace with confidence the path of productive capacity over time under different tax policy consequences. However, I think we know enough about the economy to conclude it is not a perpetual motion machine. To decrease the rate of tax on capital income will require us to finance the change with other taxes (e.g., by a move toward a consumption-based tax) or by a reduction in the trend of government spending.

To obtain a sense for the alternatives which might be available we constructed a highly simplified model of the growth of the United States economy. It incorporates specific relationships:

- between the fraction of income saved and the rate of returns to the saver,
- between the after-tax wage and labor effort supplied,
- between the rate of saving and net accumulation of capital,
- between the taxes levied on wages and capital income and government outlays,
- between input of labor and capital services and GNP.

To this model economy we applied a $30 billion cut in taxes on income from capital. This cut was financed by an equal decrease in government expenditure. The resulting effect on the path of the economy is described in the following table:

Estimated Changes Due to $30 Billion Initial Tax Reduction on Capital Income -- As Compared to 1976 Levels

	Low Estimate				High Estimate			
	1977	1978	1979	Full Effect	1977	1978	1979	Full Effect
Capital stock ($ billion)	5.7	11.2	16.4	119.6	13.8	27.1	39.5	278.2
GNP ($ billion)	0.5	1.0	1.5	10.5	1.6	3.2	4.7	32.3
Employment (thousands)	0	0	0	0	31.2	60.3	82.8	602.3
Revenue ($ billion)	-29.9	-29.7	-29.6	-27.0	-29.5	-29.1	-28.7	-20.9

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A model of this kind, while fitted with parameters which are intended to be "realistic" serves much more importantly the function of enforcing consistency. In thinking about the effects of tax change over the long run on such variables as capital stock, it is essential that <u>all</u> of the relationships just summaried be taken into account.

I draw two lessons from the exercise:

(1) Even a fairly large reduction in tax on capital income may have a relatively modest effect on the long-run capital stock. The change in this example is about 1/6 in the tax and leads to a change of between 3 and 6 percent in the ultimate stock (relative to trend).

(2) Even under optimistic estimates of the responsiveness of saving and labor force participation, the induced changes in revenues do not come close to covering the initial cut.

Conclusions

From all this I draw two basic conclusions about feedback. First, on the negative side, I believe that there has been too much attention paid to the revenue estimating aspects of this subject. If, on the other side, discussions such as this one will lead all of us to refocus on the real issues of long run tax analysis--the effect of the tax system on the distribution of the output of the economy and the efficiency of resource use--I think we shall have been well served by the debate.

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Contact: J.C. Davenport
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April 20, 1976

FOR IMMEDIATE RELEASE

ANTIDUMPING INVESTIGATION INITIATED ON METAL-WALLED ABOVE-GROUND SWIMMING POOLS FROM JAPAN

Assistant Secretary of the Treasury David R. Macdonald announced today the initiation of an antidumping investigation on imports of metal-walled above-ground swimming pools from Japan.

Notice of this action will be published in the Federal Register of April 21, 1976.

The Treasury Department's announcement followed a summary investigation conducted by the U.S. Customs Service after receipt of a petition alleging that dumping was occurring in the United States. The information received tends to indicate the prices of the merchandise exported to the U.S. are less than the constructed value of such or similar merchandise produced in Japan.

The imported merchandise usually consists of three components sold together as a package: a wall, a frame (composed of a seat and uprights), and a liner. The wall and the frame are generally made of steel or aluminum, and the liner is made of vinyl. The larger units are referred to as "family pools" and the smaller pools as "splashers."

Imports of the subject product are dutiable under a basket provision of the Tariff Schedules of the United States. Imports from Japan are believed to amount to at least $4.5 million annually.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
BETTER BUSINESS BUREAU LUNCHEON
ROCHESTER, NEW YORK
APRIL 21, 1976

Thank you Representative Conable, Congressman Horton, members of the head table, ladies and gentlemen:

I am delighted to be with you today and to learn first hand of some of the efforts your organization is making to stimulate a climate of economic development in the Rochester area. I'm fully aware that your town has earned the reputation of being an economic leader with a strong and diversified industrial base. Being here also affords me the pleasure of seeing again my good friends, Representatives Barber Conable and Frank Horton, both men of outstanding talent, a credit to their constituencies, and valued friends of this Administration.

As I look around this room, I realize that among you are many whose businesses were hard-hit by the recent recession and simultaneous double-digit inflation. Perhaps I can cheer you with some words of optimism. For, although I will be the first to warn that we still have a way to go, we are now well into a period of economic expansion.

-- 1975 opened with inflation raging at 13 percent, we have now cut that rate in half.

-- During the spring of 1975, the unemployment rate reached nine percent, today it has fallen to 7.5 percent.

-- And earlier this week we learned that real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

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-- Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects rising public confidence about the economy that contrasts sharply with the deep pessimism reported by the polltakers the middle of last year.

Thus we made considerable headway in 1975, and the outlook for 1976 remains encouraging. But that's still not good enough, and this is certainly no time for complacency. Unemployment is still intolerably high, and inflation is by no means under complete control. In fact, it remains the most dangerous enemy of real economic growth. The ruinous inflation that crested in 1974 was the chief cause of the recession of 1975. Let us learn from history so that it will never be said that the pain and suffering of the 1974-75 recession were in vain -- that the politicians in Washington again ignored the national interest and refused to accept economic reality.

Of course when I speak of economic reality, I mean to emphasize the difference between performance and promise. There is already a tendency on our national scene, which shows every sign of intensifying as the elections draw closer, to look with great alarm upon the current unemployment and inflation figures. There is a seemingly endless stream of political rhetoric about the insensitivity of this Administration for not spending massively enough and acting decisively enough to solve all our problems. But for once, let us not fall prey to those who tour the country, their bags brimming with instant quack cures -- self-proclaimed compassionate people whose spending proposals promise everything, but deliver us only one thing: more inflation.

Indeed I urge you, as intelligent and objective citizens to ask yourself a few fundamental questions. How could the most dynamic economic system in the world become infected with the diseases of inflation and unemployment at the same time? As a people where did we lose our way?

I believe it is imperative to decide how we got ourselves into this mess if we're really sincere about getting out of it permanently. Economists argue about this a good deal. Many politicians are ignoring the question entirely, seeking instead to capitalize on the effects of the problems. But to me there is no real mystery about how we got there, nor what we must do.

To an objective observer, the first and most glaringly obvious fact is that our economic problems do <u>not</u> stem from a lack of compassion, concern or vision on the part of the Federal government. Since President Eisenhower left office:

-- The number of domestic spending programs has increased tenfold.

-- The American people have spent over one trillion dollars on social programs for people and communities that needed help -- a commitment that now equals 73% of our entire budget.

-- The staple of our national life has become politicians with grand visions and even grander promises of what can be accomplished if they can just spend more of our money and be given greater authority over our lives.

So over the past 15 years, the government has tried many, many solutions. Yet the problems persist and our people are now more frustrated, disillusioned, and cynical. This doesn't mean there are no answers. It means only, I would suggest, that we have been taking fundamentally the wrong approach. We suffer not from a lack of government action, but from an excess of government action. The trouble with the Federal government is that it is trying to do more than its resources permit, to do many things that it cannot do very well, to do some things that it should not do at all, and to do all these things at the same time. Excesses in governmental action have been most damaging to three critical areas affecting the economy:

-- fiscal policy

-- monetary policy

-- regulatory policy

No one who has followed the pattern of Federal spending in recent years can fail to be impressed by its explosive growth.

-- The Federal budget has quadrupled in 15 years;

-- We have had 16 budget deficits in 17 years;

-- And we have doubled the national debt in just 10 years time. It took 75 years for our national debt to reach one billion dollars. Today government spending is causing the debt to grow by one billion dollars every week.

The Federal Government today is the nation's biggest single employer, its biggest consumer, and its biggest borrower. And if present trends continue until the end of the century,

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Government at all levels will account for almost 60% of our gross national product. Once government achieves that degree of dominance over your lives, much of the economic and political freedom you now take for granted will have been lost.

The alarming fact is that in every country in which this percentage has increased there has been a tendency to move toward instability, toward minority government and toward a threat to a free society. The only outstanding exception that I know of at the moment is Sweden, and I am somewhat mystified why it is an exception. Britain is the outstanding current demonstration with government spending equalling 60 percent or more of the national income.

The issues involved are by no means narrowly economic. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good those intentions which underlie the growth, those intentions are not achieved, that instead the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

Partly to accomodate the federal government's borrowing needs in the private markets, there has been a significant shift in monetary policies. From 1953 to 1965 the money supply of the United States was growing at approximately 2-1/2% and we enjoyed relative price stability. From 1965 to the present, however, the average rate of growth o f the money supply has more than doubled and it is no accident that during this same period we have had spiraling inflation.

This past decade has also witnessed an excessive growth in the regulatory responsibilities of the federal government. This is an area of particular concern to you in Rochester, as well it should be. Government agencies now directly regulate over 10% of everything bought and sold in the United States and indirectly regulate almost every other industry of the private economy. The power of the army of more than 100,000 government regulators has become incredibly strong. Just to fill out the necessary forms, the American people must now spend over 130 million work hours a year.

This regulatory process has become so burdensome, for all business big and small, that it is threatening the continued viability of free enterprise. General Motors for example, recently estimated that it spent more than 1.3 billion dollars in 1974 just to comply with existing government regulations and get ready for new ones. That is more than it cost to run the entire Federal government for all of the first 75 years of our history. But, as bad as that is, at least GM can live to fight another day. Smaller businesses have not been so lucky.

Consider the case history of one Ed Sohmers, a typical American businessman, who honestly and conscientously tried to comply with Federal rules and regulations.

Ed Sohmers was general manager of Marlin Toy Products, Inc., a Wisconsin company that made a toy cited as unsafe in November 1972 by the U.S. Food and Drug Administration. The toy, a plastic ball containing colored pellets, was declared unsafe, the FDA said, because if it broke open a child could swallow the pellets. No matter that Marlin had been marketing the toy since 1962 and had received no complaints.

Mr. Sohmers recalled the toy at a cost of $95,000, removed the pellets and thought his problems were over.

But, as he and his 85 employees were preparing for the 1973 holiday season making the toy and other products, a new Federal Agency -- The Consumer Product Safety Commission -- took over the safety regulation of toys and other products. In the process, some of the paperwork on the Marlin plastic toy went astray. Shortly thereafter, the Commission published a banned products list and sure enough, the Marlin plastic toy was on the list.

Ed Sohmer's protest fell on deaf ears. The erroneous list has been distributed to thousands of toy shops and the Commission refused to recall its 250,000 copies "Just to take one or two toys off the list," as they put it.

Predictably, the incorrect list caused order cancellations from all over the country. Marlin found itself with a $1.3 million loss and had to lay off all but ten of its 85 workers, many of whom were handicapped.

As Marlin's toy business plummeted, its paperwork problems skyrocketed:

-- Mr. Sohmers had to write more than 700 letters in an effort to obtain enabling legislation that would permit him to sue for damages.

-- He spent two weeks and $15,000 gathering documents for an appraisal company to prove the loss of business.

-- Three employees had to work two seven-day weeks pouring through documents that went back to the founding of the business in a household kitchen in 1947, in order to answer government inquiries.

-- And while all this was going on, the Justice Department, pleading a heavy workload, was able to obtain delays on the company's court action against the government.

Today, Marlin is out of the toy business.

Marlin's Toys' difficulties are just one example of the thousands of bureaucratic bungles that have taken their toll in both human and financial terms. In this case, government regulatory overkill took a tragic economic toll on human beings. Many of Marlin's discharged employees, especially the handicapped, could not find other jobs.

It finally managed, through the intervention of the U.S. Congress, to bring its case against the government to court.

I recently came under criticism from the Consumer Product Safety Commission for having told Marlin's story as an example of "bureaucratic bungling" to a group of small businessmen in Dallas.

The Commission's chairman, Richard O. Simpson, wrote me and I quote: "Although your statements accurately reflect the allegations Marlin Toy Products, Inc. have made, I believe it inappropriate for you to publicize them when those very allegations are being contested in court."

The government's position, wrote Mr. Simpson, "is that the principal cause of company's problems results from its own mismanagement."

When I got that letter, naturally I did a little more checking of the facts. I discovered by Mr. Simpson's own admission in letters to Mr. Sohmers of Marlin in March 1974, and to Senator Eastland in July 1974, that the Commission's listing was indeed an error -- an error committed by the Commission and not one that was the result of Marlin's mismanagement.

Was it inappropriate of me to speak of Marlin's plight in a public forum in the first place? I submit that it was not. Was it inappropriate to mention thatthe all-mighty U.S. Government made a mistake? I submit that it was not.

And I submit finally, that we need more, not less, public discussion of regulatory and other matters that directly affect businesses and individuals throughout the country.

Just recently I learned the Agriculture Department probably spent several hundred thousand dollars of the taxpayers money and employed four judges just to determine whether a man with a trained dog and pony act could ply his trade without a 25 dollar federal license. It turns out he cannot.

When you objectively add up all these facts of excessive government spending, excessive expansion of the money supply and excessive governmental regulation, one conclusion seems inescapable, our inflation and our resulting unemployment were made in Washington, D.C. Here's just part of what the bill now adds up to. Our current federal budget is equivalent to about $2,000 a head for every man, woman, and child in this country. Our national debt equals almost $3,000 for every citizen. And government regulation adds approximately $2,000 to the costs of purchases made by each American family every year. How can anyone make the case that the increase in government benefits has in any way kept up with the increase in government costs?

The fact is that governmental excesses of the past 15 years have become the strong underlying cause of inflation during the 1960's. They remain so today. The rise in spending has added enormously to the aggregate demand for goods and services in the economy, thus forcing up prices. And the government's heavy borrowing needs require it to soak up 80% of all new long-term loanable capital, leaving only 20% to the entire private sector, which nevertheless must produce virtually all our goods and services and employ 83% of our workforce.

This increasingly massive governmental presence has been an important factor in the persistent rise in interest rates, and the strains in the financial markets. Moreover, it is clear that the cumbersome regulatory procedures of the government have too often only stifled competition and added billions of dollars to the price of consumer goods.

Now I am not saying that governmental excesses are the sole cause of our inflation and recession that followed in its wake. The recent quadrupling of oil prices and rising food prices have also played a significant part. But it is the recklessly explosive growth in government that has reaped the greatest destruction.

The evidence is in and it proves conclusively to me that government, far from being our greatest source of prosperity

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and material security as some people would have us believe, has now become a direct threat to our survival as a free society. And so that is why I must appeal to you this afternoon, not only for your support, but also for your direct participation in a massive effort to preserve the economic freedoms that have given this country both the greatest prosperity and the greatest freedom ever known to man. For what is at stake now is not just the survival of this or that industry. What really is hanging in the balance is the survival of our private sector, and the individual liberties which have never long survived the collapse of a society's economic freedoms.

The problem is a matter of both policy and perception. Bad perception leads inevitably to bad policy, and I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times. Unfortunately the perception of what is right or wrong is too often inaccurate, because it is described inaccurately as a superficial division between those who "care" and those who are "callous."

Many of today's youth view those who consistently advocate bigger government as the savior of the modern world out to rescue the persecuted underdog. On the other hand, those who advocate less government and the strengthening of free enterprise are often dismissed out of hand as greedy exploiters out to make a fast buck for themselves or their companies. And -- because image is so all important and bad news is big news -- those who supposedly "care" are often afforded greater media exposure to expound about all our social ills and to claim they cure them by just cranking out more currency and soaking up more credit through massive deficit spending. In reality, of course, this is no cure at all. It is this same destructive approach that is at the very root of the problems we are struggling with today. Big government isn't the solution; it's a large part of the problem.

We who insist on the superiority of the free enterprise system, emphasizing its competition, efficiency, and profitability are nevertheless losing our argument. We tend to converse in slogans and labels, while the proponents of big government speak in more appealing, seemingly more humane terms. This is unfortunate, and to me it would be difficult to imagine any greater irony. For even the most cursory glance at history shows us that the American economy is the most successful the world has ever known -- <u>precisely</u> because it is an essentially humane creation of the people, by the people, and for the people.

The performance of our economy proves this. In the period since the early 1960s -- a period during which one abuse after another has been inflicted upon our private sector, it has nevertheless managed to outperform all others.

-- In the last 15 years, real purchasing power of Americans has jumped by 40 percent, average family income has risen to over $13,000 a year, 20 million new jobs have been created, and we have cut in half the number of people below the poverty line.

-- Our farmers harvest more than twice as much grain with fewer workers compared to a generation ago.

-- Medical science has added 10 years to our lives over this period.

-- And Americans today have more leisure time for study, recreation and self-improvement than any society in recorded history. We continue to spend about 90 percent of our personal disposable income on ourselves.

No other country -- no other system -- has achieved so much for its people. Yet these tremendous achievements are the product of the same free-market system that now finds itself under attack.

Where does the Free Enterprise System stand today? For all the talk about excessive profits, it's a system that, on the average, offers a profit incentive of less than five cents on the dollar, a small reward for all the effort and risk-taking that goes into developing and operating a successful business.

Nevertheless, it remains the real productive source of our nation's wealth, as well as that of each individual American.

Despite the growing influence of government over our lives, the private sector produces the food we eat, the goods we use, the clothes we wear, the homes we live in.

It is the source of five out of every six jobs in America, and it provides directly and indirectly, almost all the pressure for the rest of the jobs in our all-too-rapidly expanding public sector.

It is the foundation for defense security for ourselves and most of the Free World.

It is the productive base that pays for government spending to aid the elderly, the jobless, the poor, the dependent and the disabled. Indeed, far from being the anti-human caricature painted by political demagogues, the American private sector is in reality the mightiest engine for social progress and individual improvement ever created.

In a nutshell, all of the material and spiritual values that make our country unique and make us so proud to be Americans could not exist without the free enterprise system. Yet many people still fail to understand the crucial link between our economic and our political freedom. Destroy one, and the other will soon disappear.

I can assure you that this administration is fighting to ensure the survival of your economic freedoms. But to succeed, we must have the active participation of business leaders like yourselves in reopening the lines of communication to the American people. It's been said that communication is the web that holds civilization together, perpetuating its values and traditions.

Never has that function been more important than today. We must -- all of us -- communicate the great story of freedom.

-- We must dispell the confusion that has made free enterprise a dirty word, and convince them that business, profits and people are all mutually interrelated.

-- We must let our lawmakers and leaders in government know that they cannot continue to work at cross purposes with the very system that generates our wealth, our strength and our freedom.

-- We must make people aware that runaway spending and unending deficits are sopping up much needed capital for productive jobs, and are only fueling inflation -- a silent thief that picks every American's pocket, undermines confidence, and turns the desperate to government for still more illusory help.

But words are certainly not enough, the living example is much more meaningful. That is why I urge each of you:

-- To set a high moral and ethical standard by eliminating any practices in your organizations and operations that may be questionable.

-- To square practices with principles by supporting deregulation across the board, not just selectively; by helping to end government subsidies, quotas and handouts, bailouts or other inducements that offer a superficial empty promise of security in exchange for sacrifices of freedom and,

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ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
UNIVERSITY OF TULSA
TULSA, OKLAHOMA
APRIL 22, 1976

Thank you Senator Bartlett, Mayor LaFortune, President Twyman, ladies and gentlemen:

It's wonderful to be in Oklahoma, and I'm especially pleased to be here for a number of reasons:

-- To see first hand the remarkable progress underway here in Tulsa, situated in your dynamic Southwest, the fastest growing region in the country.

-- To meet with the people whose hard work, self reliance, and leadership are making this modern day success story possible.

-- To visit with the officials and students of this university which is well known outside the state for its fine school of petroleum engineering, and other energy research and development courses.

-- And finally of course, to have the chance to see operate on their own home turf your talented Senators Dewey Bartlett and Henry Bellmon.

I'm blessed with somewhat of a unique opportunity tonight in that this audience is so diverse, consisting of students, faculty, business leaders and members of the general community. I want to be sure to address my remarks to all of you.

I also have a special sense of purpose tonight. With the 1976 presidential race heating up I thought you deserved to hear from at least one out-of-state speaker who wasn't running for President.

I am not after your votes. But what I would like to engage is your shared concern and thoughts about some of the grave economic issues facing our country -- issues that will

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still be with us long after the dust of the 1976 campaign trail has settled and issues that will help to shape the kind of lives the students among you live long after you have left your college days behind.

Here, then is a capsule review of where we have been economically, where we stand today, and some of the crucial decisions we still face.

Economists generally agree that the recession hit bottom last April, that the recovery began sooner than expected, and that it has been stronger than expected. Only six months ago, we began to see light at the end of the tunnel. Today, we are nearly out of the tunnel and on our way to recovering a full head of steam. For example:

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been cut in half at approximately 6 percent.

-- Last spring, unemployment had reached nearly 9 percent. It has now dropped to 7.5 percent and our forecasts indicate a continuing downward trend.

-- And earlier this week we learned that real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

-- Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects a rising public confidence about the economy that contrasts sharply with the deep pessimism reported by polltakers the middle of last year.

But although we made considerable headway in 1975 and we are making even more in 1976, this is no time for complacency. Inflation is not yet under complete control and the jobless rate is still too high.

That is why the Administration is urging Congress to adhere to a broad-gauged plan to further nurture and stimulate the natural forces of growth in our private enterprise economy. An essential element of this plan is to put the brakes on the dizzying momentum of Federal spending -- to slow the rate of increase to about 5 percent this fiscal year, contrasted with 40 percent the past two fiscal years. This will allow us to continue to make additional tax cuts possible for businesses and individuals and set the stage for a balanced budget within three years.

Further, the President has urged tax measures designed to stimulate job creation generally, encourage the building of sorely-needed electric power facilities, and increase construction of plant and equipment in areas where unemployment has topped 7 percent.

Finally, the Administration has proposed elimination of the unfair double taxation of dividends that retards capital formation. This is the only major proposal I know about that seeks to correct the imbalance between corporate debt and equity. We must redress this imbalance to allow the financial markets to channel society's savings more efficiently to the more promising investment opportunities. And, as you also know, improving our lagging captial investment picture is absolutely essential to meet our long-term goals of more jobs, higher incomes, greater productivity, lower inflation and sustained growth.

These steps and the balanced program we have pursued thus far are designed to fight inflation and unemployment simultaneously and strengthen the private sector of our economy.

We firmly believe that this course is working, that it is right for the nation, and that it is leading us back to the position of robust growth and expanding opportunities.

And yet you will hear a mournful chorus of rhetoric out of Washington, especially as the election campaign draws closer, claiming that we aren't spending enough, aren't pressing hard enough, aren't pushing enough panic buttons to solve our problems. Despite our steady gains, many of these critics assume there must be a basic flaw in the system and they cast about for other remedies: governmental control over economic planning -- guaranteed jobs for everybody at government expense -- a new round of wage and price controls -- and many other encroachments on the market place.

Frankly, I believe that many of these critics suffer from what Mark Twain called "loyalty to petrified opinions." They fail to see that efforts to strengthen the public sector at the expense of the private sector are a large part of the problem, not part of the solution. They refuse to recognize that the same excessive government fiscal, monetary and regulatory policies they call for today have led to abuse of our economy and helped trigger, first, a storm of inflation in the early 1970's and, second, the severe recession from which we are now recovering. And they fail to comprehend a gathering mood in this country against the further expansion of big government. They suffer from the economic variety of Potomac Fever --

the delusion that all economic cures must originate in Washington with the Federal government. As President Eisenhower once remarked, "There are a number of things wrong with Washington, and one of them is that everybody has been too long away from home."

However, public disenchantment with big government does not mean that all Americans are necessarily immune from the superficial appeal of quick-fix government programs whose short-term benefits are well publicized but whose long-term impact in terms of inflation and economic stagnation is carefully masked from view.

It may seem strange, and it is certainly ironic, but at a time when the vast majority of Americans are enjoying such abundance and opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible.

This is certainly not true in many countries abroad. I was reminded of this fact during my recent two-week trip to the Middle East. Israel and the Arab states have sharp differences, of course. But on one thing they are agreed. They all have a profound admiration for the achievements and performance of the American economy. The leaders of the Middle East believe, as I do, that the United States has developed the most dynamic and efficient economic system ever devised.

Largely because of this, they see the United States as the major source of strength and stability in today's unstable world.

But here in the United States, somewhere along the line there seems to have been a dangerous breakdown in communication. Secretary of Commerce Elliot Richardson put it succinctly the other day when he said that producers and consumers in this country tend to view each other as antagonists -- despite the fact that neither can thrive without the other.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the actual dynamics of prosperity in a free society.

Today, when nearly everybody takes the fruits of the free enterprise system for granted -- the abundance, the opportunities, the freedom of choice, the chance for learning, travel and general upward mobility -- not everyone understands the basic economic facts of life that have produced these benefits.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people. And I believe that the men and women who make up our free enterprise economy -- in business, in the professions, in the factories -- must do even more than they are now if such a national dialogue is to succeed.

What is at stake is not simply the future of this or that company, or even this or that industry. At stake is the survival of the private sector, and, because of the inter-locked nature of our freedoms, the survival of the individual liberties which can never long endure after the collapse of a society's free enterprise system.

This problem of communications exists, as I have had ample opportunity to observe in my job as Secretary of the Treasury, and it is getting worse, not better. It is a question of both policy and perception, for a faulty view or understanding of the economy makes faulty economic policy-making almost inevitable.

Part of the problem is a matter of image. Frequently, those who support bigger government spending and more government domination of the private sector are perceived as concerned and socially progressive individuals who "care," who are champions of the persecuted underdog.

On the other hand, people who warn that the government should not and cannot effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system, are seen as either outdated ideologues or a new generation of economic exploiters -- indifferent to human suffering and only out to make a fast buck for themselves or their companies.

This stereotype wouldn't matter if it were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well-being of our citizens, especially those who are impoverished or face disadvantages because of artificial barriers of sex or color or national origin.

The central question is not who cares the most -- we all care. It is rather the method we choose to broaden prosperity, reduce human hardship and meet our other national goals without sacrificing our freedoms or destroying the most successful economic system that man has ever known.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean much to those who do not understand what it really means and what makes it work. It's like trying to discuss the birds and the bees sensibly with somebody who is unshakeable in his belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours to buy a poor selection of over-priced food and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition an average shopping center found anywhere in the U.S. would represent to most of the world's people.

They have never asked themselves why a country like the Soviet Union, with some of the richest grain land in the world -- but with an agricultural system owned and operated by the government -- cannot even feed its own people without turning to American farmers who own their own land, make their own decisions and feed not only their fellow Americans but millions of others as well.

They have never lived in countries where the seemingly idealistic dream of a society without private property or profits has turned into a nightmare reality: where the state and the state alone dictates what kind of education you will receive, whether or not you will be allowed to travel, what kind of job you can have, what you will be paid, what you can buy with your own earnings, where you will live and, ultimately, where you will be buried.

They have not seen the erosion of incentive and opportunity -- the general lowering of morale -- in democracies that have given themselves over to pursuit of the welfare state and the controlled economy at all costs. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander

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Hamilton warned so long ago, "Power over a man's substance amounts to power over his will."

The truth is that regimented societies inflict upon their citizens not only a political regime that reduces the individual, in Churchill's phrase, to a mere fraction of the state, they also inflict an economic regime that smothers enterprise and breeds inefficiency. Let's face it: Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many fresh ideas and new improvements. Whether we like it or not, this is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So I submit to you tonight that if America continues down the road toward greater governmental spending and greater governmental control over our economy and over our lives -- a road that we have been traveling for several decades -- then all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment and those who come after us will be robbed of their personal and economic freedoms. That is really what is at issue underneath the semantics and the misleading labels.

Let me be specific about how our private enterprise economy has been undermined by excessive government policies.

Just before the New Deal, government spending at all levels -- Federal, state and local -- was about 10 percent of our total national output. Today, because budgets have mushroomed, government accounts for almost 40 percent of the GNP. And if recent trends prevail, the government's share of the total economy will reach 60 percent before the end of this century.

The alarming fact is that in every country in which this percentage has increased there has been a tendency to move toward instability, toward minority government and toward a threat to a free society. The only outstanding exception that I know of at the moment is Sweden, and I am somewhat mystified why it is an exception. Britain is the outstanding current example with government spending equaling 60 percent or more of the national income.

The issues involved are by no means narrowly economic. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good the intentions which underlie the growth, those intentions are not achieved, that instead, the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

Let's put present spending in dollar signs. Today, and every day during this fiscal year, the Federal government will spend $1 billion. And this week and every week this fiscal year it will go into debt an additional $1 billion. Since 1962, when the Federal budget hit the $100 billion mark, it has almost quadrupled, and has been in the red for all but one of those years.

The interest on the Federal debt alone by the end of fiscal 1976 will have climbed to $36 billion. The amount in fiscal 1977 will reach $45 billion. That's more than we spent in any one year on the war in Vietnam. It is almost half of what we will be spending on total national defense next year. And it is money, I'm sure you will agree that could better be spent on improvements in health care, public transportation, rebuilding our cities or any of a dozen other national needs.

Anyone who has ever kept a checking account or managed the smallest household budget knows that it spells disaster to borrow and spend more than you take in. Heavy government borrowing has fueled inflation and driven up interest rates so that strains have developed in money and capital markets. Businessmen feel these strains when they try to get loans to expand their businesses and create new jobs: Consumers feel the pinch when they try to buy a new home without paying an arm and leg in mortgage interest, (and some of you have probably realized the problem when you have tried to secure low interest student loans in a tight credit market).

Throughout the nation, we see signs that taxpayers, who have so long borne the burden of heavy government spending, are close to open rebellion. In the 1974 elections, for example, voters across the country turned down more than 75 percent of all bond issues on the ballot. And eight state legislatures, fed up with rising national debt, have now adopted resolutions calling for a constitutional amendment requiring a balanced national budget. As one state representative put it: "I don't want the government spending my grandchildren into a poorhouse."

So our major concern as we work our way to a sound and durable recovery is to avoid another dose of the same poison which brought on the recession in the first place: rampant inflation fed by runaway Federal spending.

But spending isn't the whole problem. As government spending has grown by leaps and bounds, so too have government controls, regulation and red tape.

Did you realize that government agencies, with an army of 100,000 (on the payroll), exercise direct regulation over 10 percent of everything bought and sold in the United States and indirectly regulate almost every other sector of the private sector?

The avalanche of paperwork required by this regulatory network is a tremendous burden on small and big businesses alike. Business spends an incredible $20 billion a year just to fill out government forms. General Motors recently calculated that it spent more than $1.3 billion in 1974 just to comply with existing government regulations or get ready for new ones. This is more than it cost to run the entire Federal government for all of the first 75 years of our history -- and that includes the Louisiana Purchase.

Some of these regulations are, of course, necessary and in the public interest. But many more of them are counter-productive, wasteful, and obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Consider the case of natural gas. Because of the unwillingness of some politicians to deregulate natural gas, many areas of the country will continue to experience gas shortages that will cost them jobs, inflict individual discomfort and inconvenience and slow the pace of economic recovery. All this because a handful of politicians refuse to deregulate natural gas and let the simple but crucial free market principle of the profit motive come into play. The economic fact of life is that products which people are willing to pay for will be produced, and an adequate price will insure an adequate return. Things for which people are not willing to pay an adequate price -- or which government does not allow to be sold at an adequate price -- will not be produced. This is not only the essence, but the genius of free enterprise.

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So today, when so many of America's rich energy resources remain untapped, and when the need for energy self-sufficiency is greater than ever, much of our natural gas potential goes undeveloped because politicians refuse to admit that you cannot take away the incentive to produce and encourage production at the same time.

We still have the choice of acting in our own best energy interests instead of reacting to decisions made by foreign countries. We must start thinking of the energy challenge in terms of American jobs, homes, food and financial security.

Our economic well-being and national security depend upon American control of the American economy. We cannot jeopardize the future by avoiding the tough energy choices today. But we must pay the price necessary to give us command of our own economic destiny.

Let me give you another example of how big government, if allowed to get out of control, threatens the best interests not only of businesses but consumers. Today, many politicians and pundits are calling for the massive dismantling of the American petroleum industry through divestiture.

At a time when we should be encouraging domestic oil production to make America less dependent on foreign imports, they advocate a wholesale disruption of the complex and highly productive free enterprise structure that still makes it possible for Americans to drive their cars, heat their homes and turn the mighty wheels of industry at a lower cost than in any other major industrial nation.

It seems to me that those who urge divestiture have a tremendous obligation to show us how -- if at all -- divestiture will benefit the consumer and the nation. So far, they have utterly failed to do so, relying instead on anti-business rhetoric and the vague promise that somehow, if they are allowed to go after American oil corporations with a hatchet, the price of gas will go down.

This is illogical and self-destructive. It makes about as much sense as asserting that you can get better mileage out of your car by chopping it up into tiny pieces. In fact, you will probably get no mileage at all. And it will cost you more -- not less -- to get the mechanism repaired and back in working order again. But, in an age when imagery is often more persuasive than the facts, people sometimes lose sight of the basic truths.

Speaking in 1865, Lincoln said, "I have faith in the people...the danger is in their being misled. Let them know the truth and the country is safe." What I have been trying to emphasize here today is the need to hammer home the truth -- the economic facts of life -- to the American people, especially the young Americans who must lead us in the years ahead.

It is a story that cannot be vividly portrayed on television like the war in Vietnam or the urban riots of the sixties. Yet it is the one thing that affects every aspect of our lives.

And I am convinced that the American public -- and especially young Americans -- have not irrevocably closed their ears to this story. The polls tell us that businessmen themselves rank low in public confidence, and yet the principles of private enterprise rank high. A majority of Americans say they want more regulation of businesses, and yet business is the most popular major field of study among college students -- above education, science and the humanities. We can strike a responsive chord in telling this story to the American people if we tell it in human, comprehensive terms.

For when we talk about our free enterprise economy we are talking about food on the table, goods on the shelves and services at the counter. We are talking about medical breakthroughs that have added 10 years to our lives in the past generation. We are talking about labor-saving devices that have freed millions of women for productive careers and the pursuit of self-enlightenment. We are talking about five out of every six jobs in America and wages and benefits that stagger the imagination of the rest of the world. We are talking about a productive base that pays for government support of the elderly, the jobless, the poor, the dependent and the disabled. And we are talking about basic freedoms; to choose a career, to choose what and where we buy, to choose where and how we live, and yes, to swim against the tide -- as did Fulton and Ford and Edison -- things you could never do living in the gray shadow of conformity under a regimented society.

And this is the heart of what I am trying to express to you -- the vital <u>human</u> importance behind all those gray, boring facts and figures that litter the financial page each day.

No man can be free and a slave at the same time. No society can sacrifice its economic freedoms and responsibilities and still expect to preserve the individual economic rights of its citizens. This is particularly important to those of you who are just beginning your adult lives. Whatever happens to me down the road, I have already had the opportunity to live and prosper as a free man. It is an experience that no one can take away from me, no matter what the future may hold. So I am not very worried for my own sake.

But I do worry about what the future holds for my children -- some of who are the same age as you students here in this audience. For as I have tried to show here tonight, there are a number of alarming economic trends already at work that are undermining your futures. They aren't inevitable and they can be stopped. But they must be recognized and understood before they can be mastered. And until they are mastered, your future freedoms are in jeopardy, along with the very essence of the independent competitive spirit that has made America the richest, freest country in the world.

In this Bicentennial year, if we keep alive the spirit that infuses our national character -- the spirit of personal freedom and free enterprise -- then we can be certain that it will endure for another 200 years.

But, if we let free enterprise wither away, we may be sure that our other freedoms and individual liberties will expire as well. We must not, we will not, allow this to happen.

Thank you.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
WILL COUNTY BAR ASSOCIATION
JOLIET, ILLINOIS, APRIL 21, 1976

(Off the cuff) You know, I have heard our National Anthem sung many times in the last few years, but I have never heard that song rendered as beautifully and movingly as it was tonight by Juliet King. I only hope I speak about America half as well as she sings about it.

Congressman O'Brien, Mr. Garrison, Miss King, Father Niles, Mr. Mahoney, ladies and gentlemen:

It gives me great pleasure to be here tonight to share with you your 29th annual Law Day Dinner.

Our legal heritage has given us standards of democracy and justice that are unequalled in the rest of the world. It is our balanced system of law that keeps us from the brink of chaos on the one hand and tyranny on the other. In short, our system of law helps to guarantee us our liberty. Two hundred years ago when our founding fathers framed the original Constitution, they knew that a fair system of national law would protect us from the excesses of both the Right and the Left. As we honor that system of law here tonight, with the theme of "Law and Liberty," I am reminded of a poll taken several years ago. The polltakers read an anonymous document to a number of citizens asking them their opinion of it. A majority did not like it -- said it was too far out. What they did not know was that the document was a paraphrase of the Bill of Rights.

By relating this story, I do not mean to imply that many Americans disapprove of our guiding principles of freedom as written by the founding fathers. On the contrary, more Americans are demonstrating their patriotism in this Bicentennial year than ever before, and reaffirming their faith in -- if not their knowledge of -- our legal system. While they believe in our laws and our Constitution, many have never read them.

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For a time, law can survive -- on the basis of tradition, trust and sheer weight of habit. But ultimately, without a proper knowledge of the law, people can be too easily led astray. Knowledge and understanding are the only ultimate guarantees for the survival of any system; legal, social or economic.

I cite this particular case about the Constitution only as one example. I could also point to examples of popular ignorance about the free enterprise system, our legislative process, government regulations, our tax laws, and a host of others. Such misinformation breeds unfortunate misunderstandings. That is what I believe is happening in America today: Too many people do not know the political, legislative and economic laws that govern our country, and that ignorance threatens the structural soundness of our nation. In my own area of responsibility, this misunderstanding and ignorance abound.

Now it may seem strange, and it is certainly ironic, that at a time when Americans are enjoying such great abundance and such great opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible. Somewhere along the line, there has been a dangerous breakdown in communications.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the dynamics of prosperity in a free society.

Today, when nearly everyone takes the fruits of the free enterprise system for granted -- the abundance, the opportunity for learning, travel, and general upward mobility -- not everyone understands the basic economic facts of life that created all these benefits.

Small wonder then, that when economic difficulties like the recent recession hit, millions of otherwise reasonable people fall for the quack nostrums of politicians who are more interested in promising than performing, and for quick fix government spending programs that provide some short term relief but only aggravate the long-term economic ills of inflation and stagnation in the private sector.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people.

What is at stake is not just the future of this or that industry. At stake is the survival of the private sector, and the individual liberties which have never long survived the collapse of a society's free enterprise system.

Unless we get the facts across today, the America of tomorrow -- our children and grandchildren -- will be doomed to a system of economic and political bondage that is the very opposite of all that we hold dear.

The problem already exists, as I have had ample opportunity to observe in my job as Secretary of the Treasury. And it is getting worse, not better. It is a question of both policy and perception, for faulty perception of the economy makes faulty economic policy almost inevitable.

And I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central, underlying problem of our times.

Part of it is a matter of image. Frequently those who support bigger government spending and more government domination of the private sector are perceived as concerned, socially progressive men and women who "care" -- in a nutshell, they are seen as the humane champions of the persecuted underdog.

On the other hand, those who warn that the government should not -- and cannot -- effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system are seen as either outdated theorists or a new generation of economic exploiters indifferent to human suffering and only out to make a fast buck for themselves and their companies.

To make matters worse, surface appearances often tend to confirm this inaccurate impression. Advocates of big government are able to wax eloquent for hours about the ills they imagine they can cure by cranking out more currency and soaking up more credit through massive deficit spending. They have as many arguments as there are social, economic and political problems -- even though the spending they advocate, as we have seen with the Great Society's War on Poverty, is often part of the problem rather than part of the solution.

Those of us who recognize the fallacy of the big government approach have only one argument. It's the right one, but, by dint of repetition, people are getting tired of hearing about it. For we constantly invoke the free enterprise system, too often without defining the freedoms and the opportunities that it, and it alone, provides. We chant a slogan, a label, without defining it in comprehensible, human terms.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean anything to those who do not understand what it really is and what makes it work. It's like trying to sensibly discuss the birds and the bees with someone who is unshakable in their belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition the average American shopping center would represent to nine-tenths of the earth's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and run agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions and feed not only our own people, but millions of others as well.

Too often they have been taught to scoff at the very profit and property motives which make our prosperity possible.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid; what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, **ultimately, where** you will be buried.

They have not seen the erosion of incentive and opportunity -- the general lowering of morale -- in Democracies that have given themselves over to pursuit of the welfare state and the controlled economy at all costs. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander Hamilton warned so long ago, "Power over a man's substance amounts to power over his will."

Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many new improvements. Whether we like it or not, it is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So we have reached the point where, although the free enterprise system works, and works better than any other economic system in effect anywhere in the world -- and although it feeds, clothes and houses more people more affluently than any other while serving as the underpinning of our free society -- it is somehow losing the semantic war to an alien philosophy of government control and economic irresponsibility that has never worked but has somehow managed to preserve an aura of idealism and altruism that attracts many wishful thinkers.

I am simply saying that those of us who believe in the free enterprise system have got to do a better job of getting our story across.

All of these misconceptions would be unimportant if they were not so misleading -- so blatantly phony. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well being of our people, especially those who are impoverished or face disadvantages because of their sex or the color of their skin.

The central question is not who cares the most, but rather how we broaden prosperity and reduce human hardship without sacrificing our freedom or destroying the most successful economic system that man has ever known.

I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and our lives -- a road that we have been moving steadily down for several decades -- then our children will be robbed of their personal and economic freedoms. And, in the meantime, all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment.

Let's look at a few facts about government spending. For most of our history, the Federal budget stayed somewhere below the $100 billion mark -- usually way below it.

Then, in 1962, we finally hit $100 billion -- and that was only the beginning. Seven years later, the budget broke the $200 billion barrier and then, only four years after that, we hit the $300 billion mark. And now, in our bicentennial year, we have reached the point where the Federal Government is spending $1 billion a day and going into debt another $1 billion each week.

As the budget grows, the government comes to occupy a more and more dominant role within our society.

In 1930, government spending at all levels -- Federal, state and local -- amounted to approximately 10 percent of the Gross National Product. Today, because budgets have mushroomed, government at all levels accounts for almost 40% of our entire national output. And if recent trends prevail, the government's share of the total economy could reach 60 percent before the end of this century.

The alarming fact is that in every country in which this percentage has increased there has been a tendency to move toward instability, toward minority government and toward a threat to a free society. The only outstanding exception that I know of at the moment is Sweden, and I am somewhat mystified why it is an exception. Britain is the outstanding current demonstration with government spending equalling 60 percent or more of the national income.

The issues involved are by no means narrowly economic. They concern fundamental principles of equity and of social stability. ...the problem of growing government spending is that however good the intentions which underlie the growth, those intentions are not achieved, that instead the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

For taxpayers, the burden of paying the Government's bills has become so heavy that many are now in open rebellion. In the 1974 general elections, for example, voters across the country turned down some three quarters of all bond issues on the ballot. But we in the Federal Government get around this public opposition by voting more Federal spending without increasing taxes.

The result has been a string of Federal budget deficits that are unparalleled in our history. In 16 of the last 17 years, the budget has been in the red. And now, just when a balanced, healthy economic recovery has begun the advocates of big spending would have us launch another round of reckless spending and runaway inflation.

It is up to us to stop them.

I wish that there was some way for television cameras to portray this story as vividly as they did the war in Vietnam or the race riots of earlier years. For while the visual images are less dramatic, the problem is every bit as pressing and important.

But, as the great 19th century historian Thomas Carlyle once said, political economics is the "dismal science." On the surface, it seems nothing more than a pile of charts and a jumble of numbers so large as to be incomprehensible in everyday terms. To put it mildly, economics seldom makes "sexy" news stories. And yet the economy is the one thing that affects every other aspect of American life -- the food we eat, the quality of our education, our mobility, our freedom of choice in careers, services and merchandise, and our material and personal sense of pride and independence.

The smallest shock to the economy is felt in every limb of the body politic. And that is a big story, if only a graphic, gripping way of telling it could be found.

Consider the case of the Federal debt and its impact. As the debt climbs rapidly upwards, we have to pay higher and higher interest costs on it. In fiscal year 1976 we will have spent $36 billion in interest payments alone. The amount in fiscal 1977 will reach $45 billion or $125 million per day.

That's more than we spent in any single year on the war in Vietnam. It's more than a third of our national defense budget. And it is money that could be better spent on needs such as public transportation, health care or any of a dozen worthy purposes.

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This heavy borrowing by the government has also aggravated inflation and increased interest rates, creating strains in money and capital markets. This, in turn, affects everyone from the businessman interested in expanding his plant to create new jobs to the young couple trying to buy their first home without paying an arm and a leg in mortgage interest.

Reckless government spending and credit policies are the basic causes of inflation, and inflation was the underlying cause of the worst recession our country has experienced in a generation.

It was inflation that caused a loss in real income and the confidence of consumers, prompting the sharpest drop in consumer spending since World War II. And it was inflation that helped dry up the flow of savings into our thrift institutions, driving up interest rates and causing the housing industry to collapse.

So one of our prime concerns as we proceed with the economic recovery is to avoid another dose of the poison that brought the recession on in the first place -- rampant inflation fed by runaway Federal spending.

But spending isn't the whole problem. There is also the matter of government controls and regulation, for as government spending has grown by leaps and bounds, so too has Federal red tape.

Did you realize that government agencies now exercise direct regulation over 10 percent of everything bought and sold in the United States and indirectly regulates almost every other sector of the private economy?

Did you know that it costs private industry -- and that means each one of us as consumers -- an estimated $20 billion a year just to do the paper work demanded by Federal bureaucrats?

Some of these regulations are, of course, necessary. But many of them are counter-productive, wasteful or obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

As the Yale historian, Charles Reich, described the nefarious end purpose of over-regulation:

"We cannot safely entrust our livelihoods and our rights to the discretion of authorities, examiners, boards of control, character committees, regents, or license commissioners. We cannot permit any official or agency to pretend to be the sole knowledge of the public good. We cannot put the independence of any man... wholly in the power of other men."

As we celebrate "Two hundred years of liberty and the law" here tonight, it is wise to remember that economic independence goes hand in hand with individual political freedoms. If we forfeit our economic freedom, all too soon we may find ourselves bereft of our political liberties as well.

In closing, I'd like to remind you of what President Eisenhower said on the first U.S. Law Day: "The clearest way to show what the role of law means to us in everyday life is to recall what has happened when there is no rule of law. The dreaded knock on the door in the middle of the night."

If the Bar Association continues its struggle to uphold the principles of liberty in this country of ours by preventing the knock on the door in the middle of the night, then I can do no less by pledging to struggle to prevent another symbol of the end of economic freedom: the wheelbarrow full of inflated, worthless money.

America can continue to be the citadel of freedom and justice for all only if each of us does our share.

Thank you.

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ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
JACKSONVILLE UNIVERSITY COMMENCEMENT
JACKSONVILLE, FLORIDA - APRIL 24, 1976

Dr. Spiro, Mr. Botts, Mr. Hadlow, members of the Bicentennial Graduating Class, Ladies and Gentlemen.

It is a particular pleasure for me to participate in Jacksonville University's Graduation this year and to accept this honorary degree. Not only has this University been selected as a Bicentennial College, but it has the further distinction of operating in the black -- no mean accomplishment in these days. In fact, to someone like myself who must agonize daily over our national debt, Jacksonville University is like an oasis in the desert.

It is a melancholy truth that more commencement addresses have been listened to more patiently, delivered more solemnly and forgotten more promptly than any other form of human discourse. Although I try desperately, I am unable to recall what was said at my graduation from Lafayette College in 1951. The distinguished speaker doubtless oozed sage advice, but he was merely looked upon by my classmates as the last remaining roadblock separating us from our diplomas.

Today I would like to talk with you for a few moments about a challenge that faces us all: how to deal with a rapidly changing way of life. An ancient philosopher once observed that "there is nothing permanent except change." This observation has always been accurate, but it is particularly pertinent today. Why even the failure to read one day's newspapers or watch the evening news on television can literally leave you several Cabinet members behind.

In the four years that each of you has spent here at this University, amazing social and scientific developments have taken place around the globe. And they have come at a rate guaranteed to cause what was popularly become known as "future shock." It is up to each of us to deal with this new reality in the best possible way. Some of you will choose an area of specialization and make that your career. Others will dedicate yourselves to creating a strong family life. It is obvious the spectrum upon which you can imprint your achievements is infinite.

Your academic studies have ranged from anatomy to zoology. There is little that I can add to your studies except to make this point: You will discover in every field of endeavor that the world is very different now than what it was when you parents were in school; indeed, it is already very different from when you entered college. Few people foresaw only a few years ago that oil-producing nations of the Middle East would suddenly rise to world power, that the United States would be engulfed in the worst economic difficulties in a generation, or that a President of the United States might resign from office. Rapid change has come not only in the economic and political spheres but in others as well, as environmentalists have begun to study possible limits to industrial growth and scientists fathom more deeply the use of the world's resources.

It is important that you learn and understand the contours of these changes in our civilization, but it is perhaps even more important that you learn a more fundamental lesson: How to cope with change and become the master of it. Some of the leaders of our society argue that because we are living in a new age, we must adopt new values and new lifestyles. I would urge you instead that before you make such a choice, you re-examine the old values and the old lifestyles.

The progression of the Western life has not followed an even, upward course -- it has certainly had its zigs and zags -- but over the years certain values have endured and stand ready to serve you now during an age of turmoil and confusion. Beliefs in a higher being and in the dignity of man, the primacy of the individual over the State, love of family and of mankind -- these are the foundation blocks of our civilization.

At this stage of your lives, you are not expected to have all of the answers, but you are expected to ask many of the right questions. Certainly one of the most important questions is one of basic purpose. What do I really want to do with my life: How can I -- in some big or small way -- make a contribution to my country and the world I live in?

Each of us serves in some way. Our relations with our family and friends inevitably cast us in the role of influencing their lives. The question is whether we serve as a positive force or a negative one. And the question also is whether we are willing to stretch our horizons to the limit, learning to be of service not only in the home and on the job also in the community and the Nation.

Serving the country has become one of the great challenges of our time. Many of our public leaders in Washington labor long hours, and not one of them has ever received a dozen long-stemmed roses with a card reading "Thanks, the United States of America." We usually receive more complaints than compliments, because we all know how hard it is to please all of the people all of the time. But let me assure you: Just as the work may often be thankless on a day-to-day basis, the rewards of knowing you are helping your fellow countrymen are greater than the pleasures of a handshake, a dozen roses, or a plaque on the wall. Patriotism in times of peace is a quiet blessing without neon lights. Its supporters usually remain nameless. As the late Adlai Stevenson described it, "Patriotism...is not short, frenzied outbursts of emotion, but the tranquil and steady dedication of a lifetime.

In recent years there has been an unfortunate groundswell of people who shirk their responsibilities to come to the aid of their country. People have lost much of their faith in government at all levels, nationally as well as locally. Many of our brightest young people have dropped out altogether. There is a widespread feeling of frustration, of skepticism, and even of despair. As a result the Nation suffers because leadership at all levels finds it increasingly difficult to meet the needs of our day.

Even more disheartening, the refusal of people to serve others destroys the commitment to others which is a cornerstone of America's greatness. Such withdrawal from public service and the mood of cynical despair will not destroy the Nation overnight, but the corrosive mood may eventually erode the strength of our public institutions and our desire for social, economic, political and spiritual progress.

Our history books show us that nations begin to fail when their citizens lose their interest in the Nation's welfare. The late historian Arnold J. Toynbee believed that the decline of the great nations of the past can be directly attributed to a lack of spiritual faith during changing times. The Roman Empire lasted almost six hundred years. If you had been alive then, would you have been able to imagine the end of the Roman Empire? Never, because power breeds a mask of self-confidence where the people in power and the citizens they represent shield themselves from any savage truths pointing to the fissures in the foundation of their power.

America is only two hundred years old, quite young when compared to the longevity of ancient Rome. Yet in those two centuries we have significantly changed the world through the contributions of our scientists, our inventors, our artists, our laborers, and all those who have dedicated their lives to serving the public good. Can you imagine all that we can create in another 400 years? Inventors say, close your eyes and imagine the world as it might be. I would add: open your hearts and your minds and then go forth in the great pioneering spirit of the past to create the new world as it should be.

I am deeply troubled today because I believe that many of the difficulties we have in this country are of our own making -- and that not enough people have yet awakened to the dangers we are continuing to create for ourselves.

Let us ask for a moment: What has made this a great Nation? What has made people across the globe talk about the American Dream?

Has it been the land and our natural resources? To be sure, we have been blessed with an abundance of resources, but in the Soviet Union we see a land mass that is much larger than our own, is equally well endowed, and yet the Soviet land yields a much smaller harvest of goods to its people. Today the Soviets turn to the United States for the grain they so badly need.

Does our secret lie in the talents of our people? To be sure, we are blessed with one of the largest and most talented populations that the world has ever known, but in China today we see a population that is four times as large as our own, whose civilization was developed far in advance of our own, and yet today their standard of living is far below ours.

So our land and our people, while they have both been essential parts of the American story, are not the whole story. A third ingredient -- the ingredient that is missing in the Soviet Union and China, the ingredient that has always made us different -- has been our commitment to human liberty.

For two hundred years people have streamed to our shores in search of freedom -- freedom of religion, freedom of speech, freedom of the press, freedom of assembly, and freedom to seek their fortunes without fear or favor of the Government. Each of these freedoms was planted firmly in our Constitutional soil; each grew and thrived in the climate of freedom. But each has become such a familiar part of our landscape that I wonder whether we now take them too much for granted.

There is nothing plastic or artificial about freedom, nor is there any guarantee of its permanency. As Dwight Eisenhower once said, "Freedom has its life in the hearts, the actions, and the spirit of men, and so it must be daily earned and refreshed -- else like a flower cut from its life-giving roots, it will wither and die."

Early in this century the idea began to take hold in the United States that the problems of our society were growing so large that individuals could no longer cope with them. Instead, people began asking the Government to assume responsibility for solving our problems -- and to do things for them that they once did for themselves. Government gradually became a beneficent protector against the evils of modern day life.

That trend sharply accelerated during the 1960's as we were promised that through the powers of Government, we could fight a land war in Asia, create a Great Society, achieve permanent prosperity, abolish the business cycle, eradicate pollution, and put a man on the moon -- all at the same time. It just couldn't be done, even by the most powerful nation on earth.

What the 1960's has left us is a residue of disillusionment and distrust. The grand promises of the 60's have become the broken promises of today. Young people like yourselves in particular have soured on politics and politicians -- and I can't say that I blame you.

In my work at the Treasury Department and in the energy field, I have also found that the decade of the 1960's and on into the 1970's has also left us with a very unhappy legacy of economic problems -- potentially ruinous inflation and extremely high levels of unemployment.

There is no question in my mind that one of the chief villains of our economic troubles has been the enormous growth of the Federal government itself in recent years, growth that has witnessed:

-- A quadrupling of the Federal budget in just 15 years;
-- A string of 16 budget deficits in 17 years;
-- And a doubling of the national debt in just 10 years time.

Of course, the energy crisis, food shortages, wage and price controls and the like have contributed significantly to higher and higher rates of inflation and unemployment. But the underlying momentum has been built up by the excessive economic policies of the Federal Government for more than a decade.

The tragedy of such misguided policies is that they were sold on the mistaken notion that they would help the poor, the elderly, the sick and the disadvantaged. Yet when those policies trigger inflation and unemployment, who gets hurt the most? The same ones the politicians claimed they were trying to help -- the poor, the elderly, the sick and the disadvantaged.

Even more fundamentally, the decade of the 1960's accelerated the trend toward Big Government and the diminishing of economic and personal freedoms in the United States. The Federal Government has now become the most dominant force in our society: It is the biggest single employer, the biggest consumer, and the biggest borrower. Fifty years ago, Government at all levels spent 10 cents of every dollar spent in this country. Today is spends almost 40 cents of every dollar, and if current trends prevail, it will be spending as much as 60 cents of every dollar by the year 2000 -- when most of you will be in the prime of life. When Government exercises such enormous authority in our economy, it also exercises control over many of the economic decisions of its citizens -- and when economic freedom disappears, you can be certain that your personal and political freedoms will not be far behind.

The inextricable relationship between economic freedom and personal freedom is sometimes overlooked by those who constantly seek to expand the powers of government, but it is plain to see in countries such as the Soviet Union and China today. It was also plain to our forefathers. Let me read to you from letters that Thomas Jefferson wrote to three of his friends:

-- "I...place economy among the first and most important of republican virtues, and public debt as the greatest of the dangers to be feared."

-- "I am not among those who fear the people... To preserve their independence, we must not let our rulers load us with perpetual debt. We must make our election between economy and liberty, or profusion and servitude."

-- "If we can prevent the government from wasting the labors of the people, under the pretense of taking care of them, they must become happy."

Those were the thoughts of Jefferson, and they are as relevant now as they were then.

It distresses me today that America has wandered so far from its original moorings. Our society is in the state of apparent drift and the direction is not encouraging.

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To me, looking at our economic problems, the answers are relatively clear. We are now in the midst of a healthy economic recovery, and we know what to do to make it lasting. It won't be easy and it won't be fast; the sins of a decade cannot be paid for by a year of penance. But we can do it if we have the wisdom and the courage.

We must strive to reduce our chronic budget deficits in Washington, to begin living within our means and to scale down our mounting demands on the Government. Please do not misunderstand me: There are many good and noble goals that the government must continue to serve. It would be foolhardy to dismantle many of the programs now in place. But the time has come to show a greater sense of moderation and self-restraint, learning to trust more to our own ingenuity and initiative and less to those in positions of official power.

To accomplish these great goals of the future, I would suggest, we urgently need a continuing infusion of fresh new blood in our political and economic systems -- young men and women who understand both the glories as well as the mistakes of the past, who have a sense of the enduring values of our civilization, and who share an ardent desire to shape a better world for themselve and their children.

We must drawn upon young people from every walk of life -- rich and poor, East and West, professionals and laborers. And surely you are in the forefront of those who can serve this Nation -- young men and women who can master the changes in our society because they are firmly anchored in a lasting set of beliefs.

Some critics claim that the familiar institutions of family, church, schools, and democratic political processes are no longer pertinent in today's atmosphere of change. To contrary, they are even more important than ever and represent our only real hope of overcoming the confusion and cynicism that pervades every layer of our society.

As the ancient philospher Mencius stated 2,000 years before Thomas Jefferson and John Adams, "The men of old, wanting to clarify and diffuse throughout the empire that light which comes from looking straight into the heart and then acting, first set up good government in their own states; wanting good government in their own states they first established order in their families; wanting order in their families they first disciplined themselves; desiring discipline in themselves they first rectified their hearts."

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We must become personally involved to preserve and strengthen the virtues of our civilization. Families will not be strengthened unless we care enough to make them better. Churches will not provide spiritual leadership unless they affect the lives of people who are participating in their programs. Our schools will not produce educated and committed graduates unless students and teachers participate more effectively. Finally, our democratic political institutions will not function effectively unless there is increased personal involvement. In the Congressional elections of 1974 only 37 percent of the Nation's eligible voters participated. The media and pessimistic leaders constantly tell us that respect for public leaders and institutions has fallen to very low levels and that people feel that withdrawal is the only proper response. This approach, of course, is the worst thing that could happen. If the American people withdraw from public affairs we will never be able to correct the mistakes of the past or solve the problems of the future.

In years to come I do not want the last third of this century to be remembered as a time of lost opportunities and lackluster leadership in America. I want this time to be recalled as the era when our energy was equal to the emergency and our commitment equivalent to the challenge. And that is where you come in.

Today marks the beginning of a new chapter in each of your lives -- the beginning of a new voyage of discovery, adventure, struggle and achievement. But in beginning this great personal adventure of life, I urge you not to lose sight of the bigger picture -- of the people and the problems that make up the world around you.

Twenty, thirty or even forty years from now, when you look back on your lives and careers, you will find that the most satisfying things of all are not those you have accumulated for yourselves but those you have left behind for others -- achievements, inspirations and examples to your fellow men and women.

Good luck and God's blessings to each and every one of you -- not only for the individual lives you will lead in the years ahead, but for the contributions that each of you can make to building a better country and a better world.

Thank you.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON

SECRETARY OF THE TREASURY

BEFORE

THE OKLAHOMA CITY CHAMBER OF COMMERCE

OKLAHOMA CITY

APRIL 23, 1976

Thank you, Dean McGee, President Jim Harlow, Mr. Lyon, Mr. Knotts, members of this distinguished organization, and ladies and gentlemen:

I greatly appreciate your warm welcome and I am delighted to be in one of the biggest, friendliest and most progressive cities in the United States.

Having seen your rising skyline and other visible signs of your growth and diversified economy, it's almost impossible to believe that less than 90 years ago, there stood on this spot only a railroad depot and a few modest homes. Oklahoma City has been mushrooming ever since -- a city with a spirit of self-reliance and promise that many older cities in the nation would do well to copy.

It is small wonder that the Southwest is the fastest growing region in the country. Everything out here points ahead to tomorrow rather than back to yesterday. And it is individuals like yourselves and organizations like the Oklahoma City Chamber of Commerce that have kept this spirit alive.

On this particular occasion, I have an added sense of mission. I feel that, in this busy election year, the people of Oklahoma deserve a little change of pace; you deserve to hear from at least one out-of-state speaker who isn't running for President.

So here I am, asking not for your votes, but for a few minutes of shared thoughts on some of the basic facts and problems facing America -- the sort of thing that sometimes gets buried in the political rhetoric of an election year.

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Let me begin with a subject of enormous importance to the country and, even more so, to your state -- energy.

There's been an awful lot of talk about energy lately and much of it dangerously misinformed. Particularly misinformed have been some of the loud, politically motivated cries for divestiture and further government controls in the energy field.

These cries may yield a few short-term political returns in an election year, but they are not in the best interests of the country. Our whole economic system is based on the simple market principle that products which people are willing to pay for will be produced, and an adequate price will insure an adequate return. Things for which people are not willing to pay an adequate price will not be produced. This is not only the essence, but the genius, of free enterprise. Arbitrary controls and politically motivated regulations that strangle the profit motive can only, in the long run, make the consumer as well as the producer suffer.

That is why the Administration I serve feels so strongly about deregulation in general and deregulation of natural gas in particular. It is also why we continue to oppose those who would inject more federal interference into the energy field.

For the facts show that free enterprise is the strongest force we have going for us in our efforts to meet the energy challenge. Consider the record to date. Despite inflation and the oil embargo, Americans still pay less to heat their fuel their cars and keep the mighty wheels of industry turning than any other major industrial power -- thanks to our free enterprise system of energy production.

Unfortunately, this hasn't stopped some people from trying to make a scapegoat of the energy industry. Imagine, this is the only sector of our economy that is still under price controls. What a monumental con job on the part of political demagogues who have convinced a naive public that you can control prices and encourage production at the same time -- that you can take away the incentive to drill and still expect efficient development of America's untapped energy abudance.

Yet I'm sorry to say that the enemies of the free enterprise system seem to be winning the propaganda war. One recent result was the passage in Congress of energy legislation that neither I nor President Ford felt completely comfortable with. However, given the current political climate and the composition of the Congress, the President had to

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choose between a compromise or no energy legislation at all.

This Administration fully recognizes the dangers posed by excessive government controls. And we will continue to do everything we can to eliminate these unnecessary controls as fast as possible and prevent the establishment of new ones.

Speaking from personal experience, I know all too well how an originally small, temporary bureaucracy can take on a life of its own and spread its tentacles. During the energy crisis I was called on to head the Federal government's effort to cope with the problems raised by that national emergency.

Little did I suspect that, in becoming the so-called "Energy Czar" I would also be present at the creation of a vast new federal energy empire. The temporary hysteria ended and we weathered the storm. The crisis continued and I went on to another job. But the Federal Energy Administration is still with us. It has taken on a life of its own and is still a large and growing part of the Washington scene -- a striking example of the cancer of big government.

Another striking example of heedless government interference is the growing chorus of politicians and pundits calling for divestiture of the oil industry.

It seems to me that those who urge the fractionalization of this complex and curcial industry have a tremendous obligation to show us how -- if at all -- divestiture will benefit the consumer and the nation. So far, they have utterly failed to do so, relying instead on anti-business slogans, political rhetoric, and the vague promise that somehow, if we go after the oil companies with a hatchet, the price of gas will go down.

This is illogical and self-destructive. It makes about as much sense as asserting that you can get better mileage out of your car if you chop it up into small pieces. In fact, you may get no mileage at all. And it will cost you more -- not less -- to get the delicate mechanism repaired and back in working order once the damage has been done.

So I repeat to you my personal commitment to the principles of free competition and minimum government interference in the energy field. But I also remind you that neither I nor the Administration I serve can win this battle alone.

We still have the choice of acting in our own best energy interests instead of reacting to decisions made by foreign countries. We must start thinking of the energy crisis in terms of American jobs, homes, food and financial security.

Our economic well-being and national security depend upon American control of the American economy. We cannot jeopardize the future by avoiding the tough energy choices today. We must pay the price necessary to give us command of our own economic destiny.

We need your help in getting our side of the story across to the public. And I hope that each of you as individuals and as businessmen and women with a strong personal stake in the energy industry, will devote more of your time and efforts to getting that story across.

If you don't do it, who will?

Energy, of course is an international as well as a national matter. A few weeks ago I returned from a two-week tour of the Middle East. That fascinating and turbulent part of the world has many dangerous problems. However, I came away from my trip with one positive impression. Today, despite old animosities and conflicts, both the Arabs and the Israelis, regardless of their political opinions, realize that the United States had developed the most dynamic and efficient economic system the world has ever known. They see the United States as a major source of strength and stability -- economically as well as politically -- in an unstable world. As Secretary of the Treasury, I found this encouraging because I am convinced that the way to a peaceful world political order is through a strong stable world economic order. For the Middle East, peace and prosperity can and must, go hand in hand.

As I look around this room, I realize that there are some among you whose businesses were hard-hit by the recent recession and simultaneous double-digit inflation. Perhaps you might think that the leaders of the Middle East have the wrong impression in viewing the United States as being super-strong economically. Perhaps you would think that, on the contrary, our economy is in trouble and our economic future uncertain.

I would agree certainly, our economy has undergone some trials in the last few years that have made for some unpleasant results both in unemployment and inflation. But, despite this, our country remains the world's greatest economic power -- and, believe me, the world knows it. Even today, we are proving our basic strength by the speed and the security of our recovery from the recession as compared with other industrial nations around the world.

We still have a long way to go, but we are on the road to recovery and we can all take heart from the progress that was made during 1975.

-- 1975 opened with inflation raging at 13 percent; we have cut that rate in half -- to approximately six percent.

-- During the spring of 1975, the unemployment rate reached nine percent; today it is down to 7.5 percent.

-- Over the past year over 2 million people have found work and the number of people employed today is at a record high.

-- And earlier this week we learned that real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

Thus we made considerable headway in 1975, and we will make even more in 1976. But it's not good enough and this is certainly no time for complacency. The unemployment rate is still far higher than we can tolerate. And inflation is by no means completely under control. In fact, it remains the most dangerous enemy of real economic growth. And all of us -- especially those with a say in federal spending -- must do everything we can to prevent another inflationary spiral. The ruinous inflation that crested in 1974 was the chief cause of the severe recession of 1975; if we embark once again on excessive fiscal and monetary policies resulting in double-digit inflation, I guarantee you we will have an even worse recession than before. Let us hope that it will never be said that the pain and suffering of the 1974-75 recession were in vain because the politicians in Washington refused to face the economic facts of life.

But the problem is not confined to politicians alone. It may seem strange, and it is certainly ironic, but at a time when Americans are enjoying such great abundance and such great opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible. Somewhere along the line, there has been a dangerous breakdown in communications.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the dynamics of prosperity in a free society.

Today, when nearly everyone takes the fruits of the free enterprise system for granted -- the abundance, the opportunity, the freedom of choice, the unprecedented opportunities for learning, travel, and general upward mobility -- not everyone understands the basic economic facts of life that create all these benefits.

Small wonder then, that when economic difficulties like the recession hit, millions of otherwise reasonable people fall for the quack nostrums of politicians who are more interested in promising than performing, and for quick-fix government spending that provide some short-term relief but only aggravate the long-term economic ills of inflation and stagnation in the private sector.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people. And I believe that organizations like the Chamber must to even more than they are doing if such a national dialogue is to succeed.

What is at stake is not just the future of this or that industry. At stake is the survival of the private sector, and the individual liberties which have never long survived the collapse of a society's free enterprise system.

Unless we get the facts across today, the America of tomorrow -- of our children and grandchildren -- will be doomed to a system of economic and political bondage that is the very opposite of all that we hold dear.

The problem already exists, as I have had ample opportunity to observe, and it is getting worse, not better. It is a question of both policy and perception, for faulty perception of the economy makes faulty economic policy almost inevitable.

And I am firmly convinced that, taken together, misunderstandings and misdirection of the American economy have become the central, underlying problem of our times.

Part of it is a matter of image. Frequently, and especially to youthful idealists, those who support bigger government spending and more government domination of the private sector are perceived as concerned, socially progressive men and women who "care." In a nutshell they are seen as the humane champions of the persecuted underdog.

On the other hand, those who warn that the government should not -- and cannot -- effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system are seen as either outdated theorists or a new generation of economic exploiters, indifferent to human suffering and only out to make a fast buck for themselves and their companies.

To make matters worse, surface appearances often tend to confirm this inaccurate impression. Advocates of big government are able to wax eloquent for hours about the ills they imagine they can cure by cranking out more currency and soaking up more credit through massive deficit spending. They have as many arguments as there are social, economic and political problems -- even though the spending they advocate, as we have seen with the Great Society's War on Poverty, is often part of the problem rather than part of the solution.

Those of us who recognize the fallacy of the big government approach have only one argument. It's the right one, but, by dint of repetition, people are getting tired of hearing about it. For we constantly invoke the free enterprise system, too often without defining the freedoms and the opportunities that it, and it alone, provides, we chant a slogan, a label, without defining it in comprehensible, human terms.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean anything to those who do not understand what it really is and what makes it work. It's like trying to sensibly discuss the birds and the bees with someone who is unshakable in his belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition the average American shopping center would represent to nine-tenths of the earth's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and run agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions and feed not only our own people, but millions of others as well.

Too often they have been taught to scoff at the very profit and property motives which make our prosperity possible.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid; what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried.

They have not seen the erosion of incentive and opportunity -- the general lowering of morale -- in democracies that have given themselves over to pursuit of the welfare state and the controlled economy at all costs. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander Hamilton warned so long ago, "Power over a man's substance amounts to power over his will."

Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many new improvements. Whether we like it or not, it is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So we have reached the point where, although the free enterprise system works, and works better than any other economic system in effect anywhere in the world -- and although it feeds, clothes and houses more people more affluently than any other while serving as the underpinning of our free society -- it is somehow losing the war to an alien philosophy of government control and economic irresponsibility that has never worked but has somehow managed to preserve an aura of idealism and altrusism that attracts many young idealists.

All of these misconceptions would be unimportant if they were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well being of our people, especially those who are impoverished or face disadvantages because of their sex or the color of their skin.

The central question is not who cares the most, but rather how we broaden prosperity and reduce human hardship without sacrificing our freedom or destroying the most successful economic system that man has ever known.

I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and our lives -- a road that we have been moving steadily down for several decades -- then our children will be robbed of their personal and economic freedoms. And, in the meantime, all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment.

That is really what is at issue underneath the semantics and the misleading labels, and of course young Americans have an even greater stake in the outcome than the rest of us.

Let's look at a few facts about government spending. For most of our history, the Federal Budget stayed somewhere below the $100 billion mark -- usually way below it.

Then, in 1962, we finally hit $100 billion -- and that was only the beginning. Seven years later, the budget broke the $200 billion barrier and then, only four years after that, we hit the $300 billion mark. And now, in our bicentennial year, we have reached the point where the Federal Government is spending $1 billion a day.

The very size of such numbers makes them almost meaningless to the average American. But there are ways of getting the message across. For example: suppose that on the day Christ was born, a man had been given $1 billion on the condition that he or his heirs spent $1,000 every day,

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seven days a week. How long would that $1 billion last? Adding it up, I think you'll find that today, almost 2000 years later, the grandchildren would still not have spent the full billion dollars. In fact, the money would not run out until 2716, 740 years from now.

Yet our Federal government is spending $1 billion every single day, and, more importantly, going into debt another $1 billion every week.

And as the budget grows, the government comes to occupy a more and more dominant role within our society.

In 1930, government spending at all levels -- Federal, state and local -- amounted to about 10 percent of the Gross National Product. Today, because budgets have mushroomed, government accounts for nearly 40% of our entire national output, and if recent trends prevail, the government's share of the total economy could reach 60% before the end of this century.

The alarming fact is that in every country in which this percentage has increased there has been a tendency to move toward instability, toward minority government and toward a threat to a free society. The only outstanding exception that I know of at the moment is Sweden, and I am somewhat mystified why it is an exception. Britain is the outstanding current demonstration with government spending equalling 60 percent or more of the national income.

The issues involved are by no means narrowly economic. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good the intentions which underlie the growth, those intentions are not achieved, that instead the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

For taxpayers, the burden of paying the government's bills has become so heavy that many are now in open rebellion. In the 1974 general elections, for example, voters across the country turned down some three quarters of all bond issues on the ballot. But the Federal Government gets around this public opposition by voting more federal spending without increasing taxes.

The result has been a string of Federal Budget deficits that are unparalleled in our history. In 16 of the last 17 years, the budget has been in the red. And now, just when a balanced, healthy economic recovery has begun, the advocates

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of big spending would have us launch another round of reckless spending and runaway inflation.

It is up to us to stop them.

I wish that there was some way for television cameras to portray this story as vividly as they did the war in Vietnam or the race riots of earlier years. For, while the visual images are less dramatic, the problem is every bit as pressing and important.

But, as the great 19th century historian Thomas Carlyle once said, political economics is the "dismal science." On the surface, it seems nothing more than a pile of charts and a jumble of numbers so large as to be incomprehensible in everyday terms. To put it mildly, economics seldom makes "sexy" news stories. And yet the economy is the one thing that affects every other aspect of American life -- the food we eat, the quality of our education, our mobility, our freedom of choice in careers, services and merchandise, and our material and personal sense of pride and independence.

The smallest shock to the economy is felt in every limb of the body politic. And that is a big story, if only a graphic gripping way of telling it could be found.

Consider the case of the Federal debt and its impact. As the debt climbs rapidly upwards, we have to pay higher and higher interest costs on it. By the end of fiscal year 1976 we will have spent $36 billion in interest payments alone. In fiscal 1977 it will come to approximately $45 billion, or $125 million a day.

That's more than we spent in any single year on the war in Vietnam. It's more than a third of our national defense budget. And it is money that could be better spent on needs such as public transportation, health care or any of a dozen worthy purposes.

This heavy borrowing by the government has also aggravated inflation and increased interest rates, creating strains in money and capital markets. This, in turn, affects everyone from the businessman interested in expanding his plant to create new jobs to the young couple trying to buy their first home without paying an arm and a leg in mortgage interest.

Reckless government spending is the basic cause of inflation, and inflation was the underlying cause of the worst recession our country has experienced in a generation -- a recession we are only now beginning to recover from.

It was inflation that caused a loss of real income and the confidence of consumers, prompting the sharpest drop in consumer spending since World War II. And it was inflation that helped dry up the flow of savings into our thrift institutions, driving up interest rates and causing the housing industry to collapse.

So one of our prime concerns as we proceed with the economic recovery is to avoid another dose of the poison that brought the recession on in the first place -- rampant inflation fed by runaway federal spending.

But spending isn't the whole problem. There is also the matter of government control and regulation, for as government spending has grown by leaps and bounds, so too has federal red tape.

Did you realize that government agencies now exercise direct regulation over 10 percent of everything bought and sold in the United States and indirect regulation over almost every other sector of the private economy?

Did you know that it costs private industry -- and that means each one of us as consumers -- approximately $20 billion a year just to do the paper work demanded by Federal bureaucrats?

Some of these regulations are, of course, necessary. But many of them are counter-productive, wasteful, or obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Let me conclude with these few observations:

As we enter our third century as a nation, I believe the time has come not to reappraise our dedication to a better life for all -- that dedication is clear -- but to reappraise what we can pay for and how we can do it. The current plight of New York City, the disease that afflicts the British economy, and the overwhelming size of our own Federal deficits are all grave warnings to us. We can pay for what we now have and provide for the future only if our great capitalist economy does its job -- produces goods in a free market and makes a sufficient profit.

I am sick and tired of apologizing for the free enterprise system. It has given this country the highest standard of living and the greatest prosperity ever known, and of most importance, has helped to give us the greatest freedom ever known to man. And it will continue to do that unless it is crushed by the juggernaut of big Government. What we need are not fewer but more capitalists in the United States -- more people with a real and direct stake in the profits generated by a productive economy. We cannot continue to have more and more of our citizens involved only in receiving benefits from the government and fewer and fewer people responsible for paying the benefits. We must broaden the base of those who work and narrow the base of those who are able but don't want to work.

President Ford urged that we strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our private enterprise system.

-- A balance that favors greater honesty and realism in dealing with the challenges of our time.

These are great goals -- goals worthy of the greatest nation on earth. We should not begin our Bicentennial year by retreating into the past, but by going forward into the future with a combination of patience, realistic hope, courage and common sense.

If we work together with common purpose and conviction -- with pride in ourselves and our nation -- the goals we share today can become the first achievements of our third century together.

President Ford has set a course which points us in the right direction and will permit us to get a grip on these problems, but it will take several years, not months, to bring this about. Unfortunately, the election is only seven months away. There will be calls from the opposition for "sweeping changes" and "broad new initiatives" which will really mean bigger spending, bigger deficits and ultimately bigger governmental control of the economy. We must persuade the American people that this course is wrong and that the other approach is much sounder in the long run.

The real choice is between greater government control or greater individual freedom. That is the decision before us.

Thank you.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
NATIONAL ASSOCIATION OF BUSINESS ECONOMISTS
TULSA, OKLAHOMA, APRIL 22, 1976

Senator Bartlett, Ladies and Gentlemen:

It is always a pleasure to come to the Southwest and to Tulsa in particular. This town and this region blend the best qualities of two frontiers. There is a venturesome and confident attitude here that reflects the spirit of the old frontier. The virtues of hard work, self-reliance and individual enterprise are still happily in evidence here in Tulsa and the Southwest. And today you stand on a new technological frontier as an advanced computer center and an integral part of the domestic energy complex which means so much to the future of the American economy.

Other speakers on your program this morning will be dealing with the hard details of the energy situation and some aspects of the capital availability problem in the economy generally. My own remarks will center on the role of government in our recent economic past and the potential threat this poses for a secure economic future.

As I look around this room, I realize that among you are many whose businesses were hard-hit by the recent recession and simultaneous double digit inflation. Perhaps I can cheer you with some words of optimism. For, although I will be the first to warn that we still have a way to go, we are now well into a period of economic expansion.

-- 1975 opened with inflation raging at 13 percent, we have now cut that rate in half.

-- During the spring of 1975, the unemployment rate reached nine percent, today it has fallen to 7.5 percent.

-- and earlier this week we learned that real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

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-- Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects rising public confidence about the economy that contrasts sharply with the deep pessimism reported by the polltakers the middle of last year.

Thus we made considerable headway in 1975, and the outlook for 1976 remains encouraging. But that's still not good enough, and this is certainly no time for complacency. Unemployment is still intolerably high, and inflation is by no means under complete control. In fact, it remains the most dangerous enemy of real economic growth. The ruinous inflation that crested in 1974 was the chief cause of the recession of 1975. Let us learn from history so that it will never be said that the pain and suffering of the 1974-75 recession were in vain -- that the politicians in Washington again ignored the national interest and refused to accept economic reality.

Of course when I speak of economic reality, I mean to emphasize the difference between performance and promise. There is already a tendency on our national scene, which shows every sign of intensifying as the elections draw closer, to look with great alarm upon the current unemployment and inflation figures. There is a seemingly endless stream of political rhetoric about the insensitivity of this Administration for not spending massively enough and acting decisively enough to solve all our problems. But for once, let us not fall prey to those who tour the country, their bags brimming with instant quack cures -- the self-proclaimed compassionate people whose spending proposals promise everything, but deliver us only one thing: more inflation.

Indeed I urge you, as intelligent and objective citizens to ask yourselves a few fundamental questions. How could the most dynamic economic system in the world become infected with the diseases of inflation and unemployment at the same time? As a people where did we lose our way?

I believe it is imperative to decide how we got ourselves into this mess if we're really sincere about getting out of it permanently. Economists argue about this a good deal. Many politicians are ignoring the question entirely, seeking instead to capitalize on the effects of the problems. But to me there is no real mystery about how we got here, nor what we must do.

To an objective observer, the first and most glaringly obvious fact is that our economic problems do not stem from a lack of compassion, concern or vision on the part of the Federal government. Since President Eisenhower left office:

-- The number of domestic spending programs has increased tenfold.

-- The American people have spent over one trillion dollars on social programs for people and communities that needed help -- a commitment that now equals 73 percent of our entire budget.

-- The staple of our national life has become politicians with grand visions and even grander promises of what can be accomplished if they can just spend more of our money and be given greater authority over our lives.

So over the past 15 years, the government has tried many, many solutions. Yet the problems persist and our people are now more frustrated, disillusioned, and cynical. This doesn't mean there are no answers. It means only, I would suggest, that we have been taking fundamentally the wrong approach. We suffer not from a lack of government action, but from an excess of government action. The trouble with the Federal government is that it is trying to do more than its resources permit, to do many things that it cannot do very well, to do some things that it should not do at all, and to do all these things at the same time. Excesses in governmental action have been most damaging in three critical areas affecting the economy:

-- fiscal policy
-- monetary policy
-- regulatory policy

No one who has followed the pattern of Federal spending in recent years can fail to be impressed by its explosive growth.

-- The Federal budget has quadrupled in 15 years;
-- We have had 16 budget deficits in 17 years;
-- And we have doubled the national debt in just 10 years time. It took 75 years for our national debt to reach one billion dollars. Today government spending is causing the debt to grow by one billion dollars every week.

The Federal Government today is the nation's biggest single employer, its biggest consumer, and its biggest borrower. And if present trends continue until the end of the century, Government at all levels will account for almost 60 percent of our gross national product. Once government achieves that degree of dominance over your lives, much of the economic and political freedom you now take for granted will have been lost.

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The alarming fact is that in every country in which this percentage has increased there has been a tendency to move toward instability, toward minority government and toward a threat to a free society. The issues involved are by no means narrowly economic. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good the intentions which underlie the growth, those intentions are not achieved, that instead, the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

Partly to accomodate the federal government's borrowing ieeds in the private markets, there has been a significant shift in monetary policies. From 1953 to 1965 the money supply of the Jnited States was growing at approximately 2-1/2 percent and we enjoyed relative price stability. From 1965 to the present, iowever, the average rate of growth of the money supply has more :han doubled and it is no accident that during this same period 'e have had spiraling inflation.

This past decade has also witnessed an excessive growth in he regulatory responsibilities of the federal government. Governent agencies now directly regulate over 10 percent of everything ought and sold in the United States and indirectly regulate almost very other industry of the private economy. The power of the rmy of more than 100,000 government regulators has become ncredibly strong. Just to fill out the necessary forms, the merican people must now spend over 130 million work hours a year.

This regulatory process has become so burdensome, for all usiness big and small, that it is threatening the continued iability of free enterprise. General Motors, for example, ecently estimated that it spent more than 1.3 billion dollars n 1974 just to comply with existing government regulations and et ready for new ones. That is more than it cost to run the ntire Federal government for all of the first 75 years or our istory. But as bad as that is, at least GM can live to fight nother day. Smaller businesses have not been so lucky.

Consider the case history of one Ed Sohmers, a typical American businessman, who honestly and conscientiously tried to comply with Federal rules and regulations.

Ed Sohmers was general manager of Marlin Toy Products, Inc., a Wisconsin company that made a toy cited as unsafe in November 1972 by the U. S. Food and Drug Administration. The toy, a plastic ball containing colored pellets, was declared unsafe, the FDA said, because if it broke open a child could swallow the pellets. No matter what Marlin had been marketing the toy since 1962 and had received no complaints.

Mr. Sohmers recalled the toy at a cost of $95,000, removed the pellets and thought his problems were over.

But, as he and his 85 employees were preparing for the 1973 holiday season making the toy and other products, a new Federal Agency -- The Consumer Product Safety Commission -- took over the safety regulation of toys and other products. In the process, some of the paperwork on the Marlin plastic toy went astray. Shortly thereafter, the Commission published a banned products list and sure enough, the Marlin plastic toy was on the list.

Ed Sohmer's protest fell on deaf ears. The erroneous list has been distributed to thousands of toy shops and the Commission refused to recall its 250,000 copies "Just to take one or two toys off the list," as they put it.

Predictably, the incorrect list caused order cancellations from all over the country. Marlin found itself with a $1.2 million loss and had to lay off all but ten of its 85 workers, many of whom were handicapped.

As Marlin's toy business plummeted, its paperwork problems skyrocketed:

-- Mr. Sohmers had to write more than 700 letters in an effort to obtain enabling legislation that would permit him to sue for damages.

-- He spent two weeks and $15,000 gathering documents for an appraisal company to prove the loss of business.

-- Three employees had to work two seven-day weeks pouring through documents that went back to the founding of the business in a household kitchen in 1947, in order to answer government inquiries.

-- And while all this was going on, the Justice Department, pleading a heavy workload, was able to obtain delays on the company's court action against the government.

Today, Marlin is out of the toy business.

Marlin Toys' difficulties are just one example of the thousands of bureacratic bungles that have taken their toll in both human and financial terms. In this case, government regulatory overkill took a tragic economic toll on human beings. Many of Marlin's discharged employees, especially the handicapped, could not find other jobs.

It finally managed, through the intervention of the U.S. Congress, to bring its case against the government to court.

I recently came under criticism from the Consumer Product Safety Commission for having told Marlin's story as an example of "bureacratic bungling" to a group of small businessmen in Dallas.

The Commission's chairman, Richard O. Simpson, wrote me and I quote: "Although your statements accurately reflect the allegations Marlin Toy Products, Inc. have made, I believe it inappropriate for you to publicize them when those very allegations are being contested in court."

The government's position, wrote Mr. Simpson, "is that the principal cause of the company's problems results from its own mismanagement."

When I got that letter, naturally I did a little more checking of the facts. I discovered by Mr. Simpson's own admission in letters to Mr. Sohmers of Marlin in March 1974, and to Senator Eastland in July 1974, that the Commission's listing was indeed in error -- and error committed by the Commission and not one that was the result of Marlin's mismanagement.

Was it inappropriate of me to speak of Marlin's plight in a public forum in the first place? I submit that it was not. Was it inappropriate to mention that the all-mighty U. S. Government made a mistake? I submit that it was not.

And I submit finally, that we need more, not less public discussion of regulatory and other matters that directly affect businesses and individuals throughout the country.

Just recently I learned the Agriculture Department probably spent several hundred thousand dollars of the taxpayers' money and employed four judges, just to determine whether a man with a trained dog and pony act could ply his trade without a 25 dollar federal license. It turns out he cannot.

When you objectively add up all these facts of excessive government spending,excessive expansion of the money supply, and excessive governmental regulation, one conclusion seems inescapable. Our inflation and our resulting unemployment were made in Washington, D. C. There's just part of what the bill now adds up to. Our current federal budget is equivalent to about $2,000 a head for every man, woman and child in this country. Our national debt equals almost $3,000 for every citizen. And government regulation adds approximately $2,000 to the costs of purchases made by each American family every year. How can anyone make the case that the increase in government benefits has in any way kept up with the increase in government costs?

The fact is that governmental excesses of the past 15 years have become the strong underlying cause of inflation during the 1960's. They remain so today. The rise in spending has added enormously to the aggregate demand for goods and services in the economy, thus forcing up prices. And the government's heavy borrowing needs require it to soak up 80 percent of all new long-term loanable capital, leaving only 20 percent to the entire private sector, which nevertheless must produce virtually all our goods and services and employ 83 percent of our workforce.

This increasingly massive governmental presence has been an important factor in the persistent rise in interest rates, and the strains in the financial markets. Moreover, it is clear that the cumbersome regulatory procedures of the government have too often only stifled competition and added billions of dollars to the price of consumer goods.

Now I am not saying that government excesses are the sole cause of our inflation and recession that followed in its wake. The recent quadrupling of oil prices and rising food prices have also played a significant part. But it is the recklessly explosive growth in government that has reaped the greatest destruction.

The evidence is in and it proves conclusively to me that government, far from being our greatest source of prosperity and material security as some people would have us believe, has now become a direct threat to our survival as a free society. And so that is why I must appeal to you this afternoon, not only for your support, but also for your direct participation in a massive effort to preserve the economic freedoms that have given this country both the greatest prosperity and the greatest freedom ever known to man. For what is at stake is not just the survival of this or that industry. What really is hanging in the balance is the survival of our private sector, and the individual liberties which have never long survived the collapse of a society's economic freedoms.

The problem is a matter of both policy and perception. Bad perception leads inevitably to bad policy, and I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times. Unfortunately the perception of what is right or wrong is too often inaccurate, because it is described inaccurately as a superficial division between those who "care" and those who are "callous".

Many of today's youth view those who consistently advocate bigger government as the saviors of the modern world out to rescue the persecuted underdog. On the other hand, those who advocate less government and the strengthening of free enterprise are often dismissed out of hand as greedy exploiters out to make a fast buck for themselves or their companies. And -- because image is so all important and bad news is big news -- those who supposedly "care" are often afforded greater media exposure to expound about all our social ills and to claim they can cure them by just cranking out more currency and soaking up more credit through massive deficit spending. In reality, of course, this is no cure at all. It is this same destructive approach that is at the very root of the problems we are struggling with today. Big government isn't the solution; it's a large part of the problem.

We who insist on the superiority of the free enterprise system, emphasizing its competition, efficiency, and profitability are nevertheless losing our argument. We tend to converse in slogans and labels, while the proponents of big government speak in more appealing, seemingly more humane terms. This is unfortunate, and to me it would be difficult to imagine any greater irony. For even the most cursory glance at history shows us that the American economy is the most successful the world has ever known -- <u>precisely</u> because it is an essentially humane creation of the people, by the people, and for the people.

The performance of our economy proves this. In the period since the early 1960s -- a period during which one abuse after another has been inflicted upon our private sector, it has nevertheless managed to outperform all others.

-- In the last 15 years, real purchasing power of Americans has jumped by 40 percent, average family income has risen to over $13,000 a year, 20 million new jobs have been created, and we have cut the number of people below the poverty line in half.

-- Our farmers harvest more than twice as much grain with fewer workers compared to a generation ago.

-- Medical science has added 10 years to our lives over this period.

-- And Americans today have more leisure time for study, recreation and self-improvement than any society in recorded history. We continue to spend about 90 percent of our personal disposable income on ourselves.

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No other country -- no other system -- has achieved so much for its people. Yet these tremendous achievements are the product of the same free-market system that now finds itself under attack.

Where does the free enterprise system stand today? For all the talk about excessive profits, it's a system that, on the average, offers a profit incentive of less than five cents on the dollar, a small reward for all the effort and risk-taking that goes into developing and operating a successful business.

Nevertheless, it remains the real productive source of our nation's wealth, as well as that of each individual American.

Despite the growing influence of government over our lives, the private sector produces the food we eat, the goods we use, the clothes we wear, the homes we live in.

It is the source of five out of every six jobs in America, and it provides directly and indirectly, almost all the pressure for the rest of the jobs in our all-too-rapidly expanding public sector.

It is the foundation for defense security for ourselves and most of the Free World.

It is the productive base that pays for government spending to aid the elderly, the jobless, the poor, the dependent and the disabled. Indeed, far from being the anti-human caricature painted by political demagogues, the American private sector is in reality the mightiest engine for social progress and individual improvement ever created.

In a nutshell, all of the material and spiritual values that make our country unique and make us so proud to be Americans could not exist without the free enterprise system. Yet many people still fail to understand the crucial link between our economic and our political freedom. Destroy one, and the other will soon disappear.

I can assure you that this Administration is fighting to ensure the survival of your economic freedoms. But to succeed, we must have the active participation of business leaders like yourselves in reopening the lines of communication to the American people. It's been said that communication is the web that holds civilization together, perpetuating its values and traditions.

Never has that function been more important than today. We must -- all of us -- communicate the great story of freedom.

-- We must dispell the confusion that has made free enterprise a dirty word, and convince them that business, profits and people are all mutually interrelated.

-- We must let our lawmakers and leaders in government know that they cannot continue to work at cross purposes with the very system that generates our wealth, our strength and our freedom.

-- We must make people aware that runaway spending and unending deficits are sopping up much needed capital for productive jobs, and are only fueling inflation -- a silent thief that picks every American's pocket, undermines confidence and turns the desperate to government for still more illusory help.

But words are certainly not enough, the living example is much more meaningful. That is why I urge each of you:

-- To set a high moral and ethical standard by eliminating any practices in your organizations and operations that may be questionable.

-- To square practices with principles by supporting deregulation across the board, not just selectively; by helping to end government subsidies, quotas and handouts, bailouts or other inducements that offer a superficial empty promise of security in exchange for sacrifices of freedom and,

-- To initiate and in some cases intensify our efforts to inform and educate the public about the benefits and realities of private enterprise.

This, ladies and gentlemen, is the crucial theme that must be communicated broadly and deeply into the national consciousness: The American production and distribution system is the very wellspring of our nation's strength -- the source of present abundance and the basis for our hopes of a better future. America can solve its pressing problems if it preserves and continues to improve this immensely productive system. And in this process, we'll also be preserving the freedoms that made it all possible. Let us make that our common resolve.

Thank you.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
CARBONDALE CHAMBER OF COMMERCE
CARBONDALE, ILLINOIS
APRIL 29, 1976

Thank you, . Congressman Simon , Mayor Eckert, President Brandt, Mr. Emerson, distinquished guests, Ladies and Gentlemen:

It's a pleasure to join you in this well-deserved tribute to Senator John Gilbert and a very special pleasure to be among so many good friends here in Carbondale.

When Paul Simon, your able Congressman, and my good friend, invited me to join you here tonight I responded most enthusiastically for two reasons. First, I want to get in on record once and for all that the Simon who is spearheading the Draft Hubert Humphrey movement and the Simon who is Secretary of the Treasury are not related. And second, I always enjoy coming to Illinois, a great state of great sons who have given much to our nation. Abe Lincoln, Everett Dirksen, Adlai Stevenson, Charles Percy and others too numerous to mention all have in common a unique spirit. It is a spirit that stems directly from this heartland of America -- a spirit of vitality, self-reliance, individuality and dignity.

And it is a spirit that is too rare these days in Washington -- the city that subscribes to Ben Franklin's dictum that "three may keep a secret if two of them are dead."

After more than three years in Washington, one other thing is also apparent to me. Washington is full of politicians -- present company excepted, of course -- who tend to be obsessed with our immediate problems and with creating instant formulas and overnight panaceas to solve them. It is almost a cardinal sin in that city to look beyond November in an election year.

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As a non-politician, I am going to commit that sin tonight and I ask your indulgence as we take a longer-term view of where we have been and where we are going as we confront our economic problems.

There is a strong irony in the fact that when the need for long-term vision about our economy has never been greater, we are being deluged with a series of suggestions of quick fixes for our economic ills. Those who call for these magic cures claim that we aren't spending enough, aren't pressing hard enough, aren't pushing enough panic buttons to solve our problems.

Despite our steady economic gains many of these critics say there is some basic flaw in our system and they bombard us with countless sleight-of-hand remedies: governmental control over economic planning -- guaranteed jobs for all at government expense -- a new round of wage and price controls -- and other so-called solutions.

Frankly, I believe that many of these critics suffer from what Mark Twain called "loyalty to petrified opinions." They fail to see that efforts to strengthen the public sector at the expense of the private sector are a large part of the problem, not part of the solution. They refuse to recognize that the same excessive government fiscal, monetary and regulatory policies they call for today have led to abuse of our economy and helped trigger, first, a storm of inflation in the early 1970s and, second, the severe recession from which we are now recovering. And they fail to comprehend a gathering mood in this country against the further expansion of big government. They suffer from the economic variety of Potomac Fever -- the delusion that all economic cures must originate in Washington with the Federal government. As President Eisenhower once remarked, "there are a number of things wrong with Washington, and one of them is that everybody has been too long away from home."

But before we look at where we are going, I'd like to take a moment to look at where we have been in the recent past -- and to itemize our recovery from the worst recession in more than a generation and the worst inflation in our peacetime history.

As we work our way out of one of the most severe economic slowdowns of the entire post-war experience, I believe that the decisions we have had to make, and are making, will serve as an instructive guide to the future.

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Many of you in this room who are small businessmen and women may still be feeling the effects of the recent double-digit inflation and severe recession. Perhaps some of you fear that our immediate economic future is uncertain and that you may wake up tomorrow to face a new round of inflation, tighter credit and more unemployment.

Let me put things into perspective. We have had extensive and impressive evidence that our national economy is on the road to a healthy recovery. Economists generally agree that the economy began to recover a year ago, that the recovery began sooner than expected, and that it has been stronger than expected. This is not to say that everything is fine. But for 12 months the U.S. economy has been expanding rapidly, and the benefits of a reviving private sector have already accomplished much in unwinding the severe inflation and unemployment caused by the stop-go policies of the past decade.

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been sharply reduced to approximately 6 percent. In fact, over the last three months for which we have statistics, December through February, consumer prices have only risen at an annual rate of 4.4 percent. Over the last five months, wholesale prices have actually declined. We do not expect those experiences to continue. But we have made significant progress already and more can be expected if responsible policies are followed.

-- Last spring, unemployment had reached nearly 9 percent. It has now dropped to 7.5 percent and our forecasts indicate a continuing downward trend toward 7 percent by the end of the year.

-- And last week we learned that real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

-- Other signs point to an economy that is gaining increasing momentum: personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects a rising public confidence about the economy that contrasts sharply with the deep pessimism reported by polltakers the middle of last year.

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But although we made considerable headway in 1975 and we are making even more in 1976, this is no time for complacency. Inflation is not under complete control and the jobless rate is still too high. Right here in Jackson County, unemployment is running above the national average -- and this translates into hardship and suffering for many families. And per capita family income in this area and in many other areas of the Nation is still too low. Let me assure you that we will not be content until the rising vigor of the economy nationally is reflected in communities that have been hardest hit by recent economic conditions.

But there is another basic consideration we must not lose sight of. Inflation remains the most dangerous enemy of future economic growth, and we must do nothing to unleash another inflationary spiral. Ruinous inflation was the chief cause of our recent recession. Inflation hits everyone,

rich, poor and middle class alike, the small business owner, the college professor, the college student and Caterpillar Tractor. It erodes the value of our dollars, stifles profits and real earnings, drives up interest rates and puts the pinch on investment and expansion. In short, it drains the life-blood and vitality from our society.

We can indeed take comfort from the fact that the symptoms of inflation are receding for now; but the root cause of the disease remains. I refer to the excessive governmental fiscal, monetary and regulatory policies that we have pursued over part of the past 40 years, particularly over the last decade. These policies, the legacy of the Great Depression of the 1930's, could lead to even worse recessions and more ruinous inflation in the future if we do not learn from history and act now, before it is too late.

Let us just look at a few economic trends and facts:

In 1930, government spending at all levels amounted to approximately 10 percent of the GNP. Today government accounts for almost 40 percent of our entire national output, and if this trend continues, the government's share of the economy will reach 60 percent within 25 years.

-- In just 15 years time the Federal budget has quadrupled.

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-- We have failed to balance the budget for 16 of the past 17 years.

-- And in just ten years time, we have doubled the national debt. It took 75 years for our national debt to reach one billion dollars. This year, government spending is causing the debt to grow by one billion dollars every week.

-- And the average American bears a tax burden of over 30 percent of his earnings -- that means working for the government instead of yourself from January to May.

The Federal Government today is the nation's biggest single employer, its biggest consumer, and its biggest borrower. Partly to accommodate the Federal Government's borrowing needs in the private markets, there has been a less noticed but equally significant shift in monetary policies. From 1955 to 1965, the money supply of the United States was growing at approximately 2-1/2 percent a year. During that period we enjoyed relative price stability. But from 1965 to the present, the average rate of growth in the money supply has more than doubled. It is no accident that during this same period we have also had spiraling inflation.

The alarming fact is that in every country that has given way to these trends, there has been a tendency to move toward instability, toward minority government and toward a threat to a free society. The important point here is that the issues involved are by no means narrowly economic. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that, however good the intentions which underlie the growth, those intentions are not achieved; that, instead, the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

This past decade has also seen tremendous growth in the regulatory apparatus of the government. Government agencies now exercise direct regulation over 10 percent of everything bought and sold in the United States and indirectly regulate almost every other sector of the private economy. Just to fill out the necessary Federal forms, the American people now spend over 130 million work hours a year. Indeed the regulatory process has become so burdensome, for all businesses big and small, that it is threatening to strangle much of free enterprise in red tape. Consider the staggering costs involved. Last year, business spent an estimated $20 billion just to do the paper work demanded by Federal bureaucrats. Of course, it is you and I and every other consumer who pay for this in the form of higher prices and higher taxes.

This is not to say that some government regulations are not necessary and even desirable. We must control the quality of the air we breathe, the food we eat and water we drink. These are all desirable regulatory objectives. But do we really need government telling businessmen what the height of their office washrooms should be?

It is the case history of one Ed Sohmers, a typical American businessman, who honestly and conscientiously tried to comply with Federal rules and regulations.

Ed Sohmers was general manager of Marlin Toy Products, Inc., a Wisconsin company that made a toy cited as unsafe in November 1972 by the U.S. Food and Drug Administration. The toy, a plastic ball containing colored pellets, was declared unsafe, the FDA said, because if it broke open a child could swallow the pellets. No matter that Marlin had been marketing the toy since 1962 and had received no complaints.

Mr. Sohmers recalled the toy at a cost of $95,000, removed the pellets and thought his problems were over.

But as he and his 85 employees were preparing for the 1973 holiday season making the toy, a new Federal Agency -- the Consumer Product Safety Commission -- took over the safety regulation of toys and other products. In the process, some of the paperwork on the Marlin plastic toy went astray. Shortly thereafter, the Commission published a banned product list and, sure enough, the Marlin plastic toy was mistakenly included on the list.

Ed Sohmer's protest fell on deaf ears. The erroneous list had been distributed to thousands of toy shops and the Commission refused to recall its 250,000 copies "just to take one or two toys off the list," as they put it.

Predictably, the incorrect list caused order cancellations from all over the country. Marlin found itself with a $1.2 million loss and had to lay off all but ten of its 85 workers, many of whom were handicapped.

As Marlin's toy business plummeted, its paperwork problems skyrocketed.

-- Mr. Sohmers had to write more than 700 letters in an effort to obtain enabling legislation that would permit him to sue for damages.

-- He spent two weeks and $15,000 gathering documents for an appraisal company to prove the loss of business.

-- Three employees had to work two seven-day weeks pouring through documents that went back to the founding of the business in a household kitchen in 1947, in order to answer government inquiries.

-- And while all this was going on, the Justice Department, pleading a heavy workload, was able to obtain delays on the company's court action against the government.

Today, Marlin is out of the toy business.

Marlin Toys' difficulties are just one example of the waste and suffering caused by over-regulation and bureaucratic bungling. In this case, over-zealous government regulation took a tragic economic toll on human beings.

I recently came under criticism from the Consumer Product Safety Commission for having told Marlin's story as an example of "bureaucratic bungling" to a group of small businessmen in Dallas.

The Commission's Chairman, Richard O. Simpson, wrote me and I quote: "Although your statements accurately reflect the allegations Marlin Toy Products, Inc. have made, I believe it inappropriate for you to publicize them when those very allegations are being contested in court."

The government's position, wrote Mr. Simpson, "is that the principal cause of the company's problems results from its own mismanagement."

When I got that letter, naturally I did a little more checking of the facts. I discovered by Mr. Simpson's own admission in letters to Mr. Sohmers of Marlin in March, 1974, and to Senator Eastland in July, 1974, that the Commission's listing was indeed an error -- an error committed by the Commission and not one that was the result of Marlin's mismanagement.

Was it inappropriate of me to speak of Marlin's plight in a public forum in the first place? I submit that it was not. Was it inappropriate to mention that the all-mighty U.S. Government made a mistake? I submit that it was not.

And I submit finally, that we need more, not less public discussion of regulatory and other matters that directly affect businesses and individuals throughout the country.

It is not just Mr. Sohmers and other victims of over-regulation that suffer the consequences of big government. We all pay the bill, and it's getting bigger every year. Look at the figures. Our current Federal budget is equivalent to about $2,000 for every man, woman and child in America. Our national debt equals almost another $3,000 for every citizen. And government regulation adds about $2,000 to the costs of purchases made by each American family every year. How can anyone make the case that government benefits have in any way kept up with government costs?

Indeed, is it any wonder that if present trends continue, government at all levels could account, as I pointed out earlier, for almost 60 percent of our GNP by the end of the century?

If we ever let government become such a dominant part of our society, I have no doubt that most of our economic freedoms will disappear. And when that happens the precious individual freedoms we enjoy will soon erode after them.

Thomas Jefferson understood this close link between individual and economic freedom. To preserve our independence, he once wrote, "We must not let our rulers load us with perpetual debt. We must make our choice between economy and liberty, or profusion and servitude."

When you add up all these facts of excessive government spending, excessive expansion of the money supply and excessive governmental regulation, one conclusion seems inescapable. If there is such a thing as truth in packaging, both our inflation and our resulting unemployment should bear the label "Made in Washington, D.C."

The fact is that governmental excesses of the past 15 years were the strong, underlying cause of inflation during the 1960s. They remain so today. The rise in government spending has added enormously to the aggregate demand for goods and services in the economy, thus forcing up prices. And the government's heavy borrowing requirements means that this year it will soak up 80 percent of the capital in the capital markets, leaving only 20 percent to the entire private sector, which nevertheless must produce virtually all our goods and services and employ 83 percent of our work force.

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This increasingly massive governmental presence has been an important factor in the persistent rise in interest rates and the strains we have seen in the financial markets. Moreover, it is clear that the cumbersome regulatory procedures of the government have too often stifled competition which has inevitably added billions of dollars to the price of consumer goods.

The evidence is in and it proves conclusively to me that government, far from being our greatest source of prosperity and material security as some people would have us believe, has now become a direct threat to our survival as a free society.

As we enter our third century as a nation, I believe the time has come not to reappraise our dedication to a better life for all -- that dedication is clear -- but to reappraise what we can afford to pay for this goal and how we can best achieve it. The current plight of New York, the malaise affecting many other state-controlled economies and the overwhelming size of our Federal deficits are all grave warnings to us. We can pay for what we now have and provide for the future only if our great free enterprise economy is allowed to do its job -- to produce goods and jobs in a free market at a fair price.

I am sick and tired to apologizing for free enterprise. It's our profit system that has given this country a prosperity that is now the envy of the entire world. If we were to listen to some of our critics and run our businesses the way they would run the government, there would be no profits to tax, no revenues to collect, and thus no programs to fund.

This great country of our has the human resources, the economic resources, and a productive and creative economic system to keep going and growing if we will only look at the facts as they are. At the height of the energy crisis, the doom peddlers pounded away at an inventory of disasters -- dollar gas, dollar bread, dollar sugar, and even dollar toilet paper. The disasters never came.

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During the debate of New York City's fiscal problems, many of the same voices joined together in a chorus of doom promising that, unless President Ford wrote New York a blank check, there would be a collapse of the international finance system. It never happened.

If each of us will just act responsibly and consider the facts calmly in deciding the political and economic issues of the day, we have every reason to be optimistic about our country's future. The free enterprise ideals and principles that have guided this nation for 200 years will be true to us as long as we are true to them.

That is why the Administration is urging Congress to adhere to a broad-gauged plan to further nurture and stimulate the natural forces of growth in our private enterprise economy. An essential element of the plan is to put the brakes on the dizzying momentum of Federal spending -- to slow the rate of increase to about 5 percent this fiscal year, contrasted with a jump of 40 percent from Fiscal Year 1974 to Fiscal Year 1976. This will allow us to continue to make progress on inflation and, at the same time, will make additional tax cuts possible for businesses and individuals and set the stage for a balanced budget within three years.

Further, the President has urged tax measures designed to stimulate job creation generally, encourage the building of sorely needed electric power facilities, and increase plant and equipment construction in areas where unemployment has topped 7 percent, which includes virtually every major job market in Illinois and many other parts of the Mid-West.

Finally, the Administration has proposed elimination of the unfair double taxation of dividends that retards capital formation. This is the only major proposal I know about that seeks to correct the imbalance between corporate debt and equity. As you well know, we must redress this imbalance to allow the financial markets to channel society's savings more efficiently into promising investment opportunities. And, as you also know, improving our lagging capital investment picture is absolutely essential to meet our long-term goals of more jobs, higher incomes, greater productivity, lower inflation and sustained growth.

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These steps and the balanced program we have pursued so far are designed to fight inflation and unemployment simultaneously and strengthen the private sector of our economy.

We firmly believe that this course is working, that it is right for the Nation, and that it is leading us forward towards robust growth and expanding opportunities.

One hundred and one years ago, Lincoln said, "I have faith in the people. . .The danger is in their being mislead. Let them know the truth and the country is safe."

The truth is what I have tried to emphasize here tonight. As business and professional people, each of you benefits from our great free enterprise system. Each of you knows first-hand -- sees every day -- the strengths of a free economy.

And each of you knows, as I do, that while the free enterprise system is not perfect, it has provided us with the highest standard of living ever known to man, unparalleled national wealth, and individual freedoms that are the envy of the world.

For when we talk about our free enterprise economy, we are talking about food on the table, goods on the shelves and services at the counter. We are talking about medical break-throughs that have added 10 years to our lives in the past generation. We are talking about labor-saving devices that have freed millions of women for productive careers and the pursuit of self-enlightenment. We are talking about five out of every six jobs in America and wages and benefits that stagger the imagination of the rest of the world. We are talking about a productive base that pays for government support of the elderly, the jobless, the poor, the dependent and the disabled. And we are talking about basic freedoms, freedom to choose a career, to choose what and where we buy, to choose where and how we live, and yes, to swim against the tide -- as did Fulton and Ford and Edison -- things you could never do living in the gray shadow of conformity under a regimented society.

And so I would like to ask each and every one of you here tonight to help preserve that system. If we work together, with pride in ourselves and in our past, the goals we share for the future can become the first great achievements of America's third century.

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But if we allow those who call for "sweeping changes and broad new government initiatives" to prevail (and their cries are louder in this election year), it will mean higher spending, higher deficits, higher taxes and greater control by the government over our lives.

As Daniel Webster once said, "God grants liberty only to those who love it, and are always ready to guard and defend it." For more than two centuries, Americans have met that challenge. If we keep alive the spirit that infuses our national character -- the spirit of free enterprise that each of you personifies -- then we can be certain that it will endure for many centuries to come.

Thank you.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 4:00 P.M. April 20, 1976

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,100,000,000 , or thereabouts, to be issued April 29, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,600,000,000, or thereabouts, representing an additional amount of bills dated January 29, 1976, and to mature July 29, 1976 (CUSIP No. 912793 A2 2), originally issued in the amount of $3,501,865,000, the additional and original bills to be freely interchangeable.

182-day bills, for $3,500,000,000, or thereabouts, to be dated April 29, 1976, and to mature October 28, 1976 (CUSIP No. 912793 B7 0).

The bills will be issued for cash and in exchange for Treasury bills maturing April 29, 1976, outstanding in the amount of $6,305,065,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $2,616,620,000. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Monday, April 26, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

WS-799

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on April 29, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing April 29, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

Contact: J.C. Davenport
Extension 8585
April 22, 1976

FOR IMMEDIATE RELEASE

WITHHOLDING OF APPRAISEMENT ON TANTALUM ELECTROLYTIC FIXED CAPACITORS FROM JAPAN

Assistant Secretary of the Treasury David R. Macdonald announced today a withholding of appraisement on tantalum electrolytic fixed capacitors from Japan pending a determination as to whether they are being sold at less than fair value within the meaning of the Antidumping Act of 1921, as amended.

This decision will appear in the Federal Register of April 23, 1976.

Under the Antidumping Act, the Secretary of the Treasury is required to withhold appraisement whenever he has reasonable cause to believe or suspect that sales at less than fair value may be taking place.

A final Treasury decision in this investigation will be made within three months. Appraisement will be withheld for a period not to exceed six months from the date of publication of the "Withholding of Appraisement Notice" in the Federal Register.

Under the Antidumping Act, a determination of sales in the United States at less than fair value requires that the case be referred to the U.S. International Trade Commission which would consider whether a United States industry is being or is likely to be injured, or is prevented from being established, by reason of such sales. Both sales at less than fair value and injury must be found before a finding of dumping can be issued. Upon a finding of dumping, the applicable merchandise is then subject to the assessment of special duties.

Imports of the subject merchandise from Japan amounted to $1.3 million during January-October 1975. Tantalum electrolytic fixed capacitors are dutiable under item 685.80 of the Tariff Schedules of the United States.

WS-800

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

Contact: Richard Self
Extension 2951
April 22, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES FINAL COUNTERVAILING DUTY DETERMINATION ON BEEF IMPORTS FROM THE EC

Assistant Secretary of the Treasury David R. Macdonald announced today a final determination under the Countervailing Duty Law that bounties or grants are being paid on imported frozen boneless beef from European Community Countries. Notice to this effect will be issued in the FEDERAL REGISTER of April 23, 1976.

A notice of initiation of investigation coupled with a preliminary countervailing duty determination was published in the April 1, 1976, FEDERAL REGISTER. Information before the Treasury indicates that exports of frozen boneless beef to the U.S. receive export restitution payments under the European Community's Common Agricultural Policy.

During 1975 imports of frozen boneless beef from European Community Countries were approximately $3.6 million.

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WS-801

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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STATEMENT BY THE HONORABLE JAMES J. FEATHERSTONE
DEPUTY ASSISTANT SECRETARY (ENFORCEMENT) OF THE TREASURY
before the
PRIVACY PROTECTION STUDY COMMISSION

April 22, 1976 2:00 P.M.

Mr. Chairman and Members of the Commission:

The Treasury Department appreciates this opportunity to comment upon its role and responsibilities with respect to Titles I and II of Public Law 91-508, commonly referred to as the Bank Secrecy Act. We are grateful to the Commission for having scheduled hearings at this time to enable us to develop the underlying history and purposes of the law and the implementing regulations, and to clear up some misunderstandings about government access to bank records.

The Treasury Department firmly supports the purpose of the Act now just as it did when Chairman Patman introduced the initial legislation. The bank recordkeeping requirements and the reporting provisions contained in the regulations issued to implement the Act have assured the public that the basic financial records essential to the proper investigation of white collar crime, corruption, and tax evasion will generally be available when the appropriate government authorities need them. Furthermore, we believe that we have been able to accomplish this primary objective without sacrificing our interest in observing the Constitutional prohibition against unreasonable searches and seizures and in avoiding unnecessary incursions into the privacy of individuals. Our desire to attain these goals is well documented in the legislative history of the Act.

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LEGISLATIVE HISTORY

Foreign bank secrecy and bank recordkeeping legislation was introduced in the House of Representatives on December 3, 1969 (H.R. 15073) by Congressman Wright Patman. It was aimed at the prevention of the use of secret foreign financial facilities for illegal purposes by persons subject to U.S. laws. Hearings were held before the House Banking and Currency Committee on December 4, 6 and 9 of 1969, and February 10, March 2 and 9, 1970. Testimony by representatives of the Department of Justice, Department of the Treasury, and the Securities and Exchange Commission revealed the growing use of secret foreign bank accounts for a wide variety of illegal purposes by U.S. citizens and residents.

Thus, this legislation grew initially out of concern over the use by criminal elements and others of secret foreign bank accounts to evade income taxes and hide the fruits of their illegal activities. However, the bill also reflected Congressional concern over the availability of records maintained by domestic financial institutions relating to those engaged in organized and "white collar" crime. As introduced, the House bill required U.S. banks to copy checks and certain other instruments, maintain certain records, and permit the Secretary to have access to such records; it required U.S. financial institutions and those dealing with them to report certain U.S. currency transactions to the Treasury; and it required citizens, residents, and persons doing business in this country to report certain transactions with foreign banks.

When the House Subcommittee on Financial Institutions held hearings on this bill a Treasury spokesman testified that we supported the objectives of preventing the use of foreign bank accounts for illegal purposes, but that we felt that the proposed bill went too far, that additional work was required to determine the best way to achieve its objective without hampering commerce, injuring the status of the dollar, creating undue administrative burdens, and infringing upon the traditional freedoms of American life. We were particularly critical of the provisions of H.R. 15073 which would have given the Internal Revenue Service unlimited access to private bank records. We opposed any such broad "survey" power.

We also were critical of the provisions of the bill which made mandatory the photocopying of all checks. A Treasury task force was studying the international banking transactions area and had developed certain proposals for legislative action similar to those in the House bill. In the domestic area, however, we observed that the bill as drafted provided the Secretary with little or no flexibility with respect to the implementation of its requirements.

As a result of our efforts, the provision giving Treasury broad access to bank records was deleted from the bill. However, the House Committee disagreed with us that the domestic recordkeeping area required further study. The bill reported out by the Committee contained the following Congressional findings and statement of purpose:

> "Sec. 21. (a)(1) The Congress finds that adequate records maintained by insured banks have a high degree of usefulness in criminal, tax, and regulatory investigations and proceedings. The Congress further finds that photocopies made by banks of checks, as well as records kept by banks of the identity of persons maintaining or authorized to act with respect to accounts therein, have been of particular value in this respect.
>
> "(2) It is the purpose of this section to require the maintenance of appropriate types of records by insured banks where such records may have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.

The House Report justified these positions as follows:

> "In recent years a few sizeable banks have abolished or limited the practice of photocopying checks, drafts and similar instruments drawn on

them and presented to them for payment. This failure to maintain photocopies of checks has frustrated law enforcement personnel in securing evidence necessary to criminal, tax, and regulatory investigations and proceedings. Many cases have either been dropped or their conclusion has been long delayed because of the difficulty or impossibility of obtaining photocopies or records of essential checks, drafts or similar instruments." (p. 11)

* * *

"The importance of photocopies of checks to effective law enforcement, especially where white collar crimes are concerned, simply cannot be overestimated. The recipient of a direct or indirect bribe, for example, will make no record of his receipt of the money, and the person who wrote the check will take pains to see that it is totally destroyed after cancellation. In many instances, payments by check which are not necessarily illegal in and of themselves may constitute the only way that the prosecution can establish the existence of a relationship or pattern of conduct which may be essential to making its case.

Finally, the maintenance of check photocopy records by banks raises no constitutional issues and poses no threat to individual liberty. As has been pointed out, banks have wide experience with maintaining these records, and the banking industry has a creditable record of maintaining their confidentiality. There is nothing in this bill which would make such records any more accessible to law enforcement officers, much less anyone else, than they now are." (p. 16)

The House Report also commented:

"Read in conjunction with the findings set forth in section 21(a) and the requirement in section 21(b) that the Secretary 'shall prescribe regulations to carry out the purposes of this section,' the statement of purpose leaves the

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Secretary little choice but to request upon the effective date of the legislation, that banks photocopy all checks except for those exempt under subsection (i), discussed below." (p. 16) Subsection (i) provided that "this section shall not apply to domestic financial transactions involving less than $500."

Senate Action

Thereafter, Senator Proxmire introduced S. 3678. Title I of that bill contained the same findings, purpose clause, and photocopying requirements as H.R. 15073, with the exception of the exclusion for checks under $500. When this bill was being considered by this Subcommittee, Treasury made the following comments concerning governmental access to bank records:

"We decided against seeking specific statutory authority extending the rights of the Internal Revenue Service to survey the records of international transactions in banks and other financial institutions. In deciding this, we considered the constitutional prohibition against unreasonable searches and seizures and the need to avoid unnecessary incursions against the right of privacy. While it is clear that obtaining records by established discovery procedures from the banks and other institutions in connection with the examination of a particular taxpayer would not violate these rights, provision for a survey of such records raises a much more serious question. We are also concerned that surveys or information returns could have an adverse effect on legitimate foreign investment in the United States. It has been the tradition overseas to place great emphasis on the privacy of financial transactions and a breach of this tradition could adversely affect the flow of foreign funds to the United States."

We also indicated our concern that the Senate bill could be interpreted as requiring the Secretary of the Treasury to issue regulations providing that all banks photocopy all checks drawn on them, or under the House bill, all checks of less than $500 used in domestic financial transactions. The Senate Committee Report makes no mention of this issue but simply discusses the domestic recordkeeping requirements as follows:

> "Many of these records are already kept by financial institutions and it is not the committee's intent to encumber these institutions with a substantial volume of additional paperwork. The committee has, however, received testimony from law enforcement officials on the high degree of importance of having access to copies of checks drawn on commercial banks. Mr. Will Wilson, Assistant Attorney General, has testified that copies of bank checks are 'very important' to law enforcement activities and 'very helpful' in the collection of income taxes. The U.S. Attorney for the southern district of New York has said that the availability of copies of bank checks is 'an indispensable tool of law enforcement.' A former IRS agent testified that the microfilming of checks 'is really a vital tool'.
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> "According to Assistant Attorney General Wilson, microfilm copies of checks are important because they are frequently the direct evidence of a financial transaction which would otherwise be difficult to prove. Copies of checks are valuable in investigating domestic crimes as well as those involving secret foreign bank accounts. For example, a single microfilmed check in the amount of $5.20 helped in the conviction of Frank Costello.
>
> "While most commercial banks maintain copies of checks as a normal business practice, some of the larger banks have stopped microfilming in recen years. This has placed a burden on law enforcement officials and has made it more difficult to obtain evidence of financial transactions. The cost of microfilming has been estimated to range between one-half of a mill and 1 1/2 mills per check, a cost that does not appear to be unduly onerous compared to the normal service charge of 10 cents per check." (p. 5)

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Conference Committee Action

The Conference Committee report notes that the House passed bill required the microfilming of checks, and that the Senate bill amended this congressional purpose by requiring the maintenance of such records only where the Secretary determined their usefulness in the various proceedings.

This difference in views was resolved in conference by preserving the House purpose clause (new sec. 21(a)(2) of the Federal Deposit Insurance Act) and relegating the Secretary's authority to a subordinate clause (new sec. 21(b)). The Conference Committee also deleted the $500 exclusion from the recordkeeping requirements in the House bill and amended sec 21(c) to require that any exemptions granted by the Secretary from the recordkeeping requirement must be "consistent with the purpose of this section." This Conference Committee bill was approved by both Houses and enacted into law.

FINANCIAL RECORDKEEPING AND REPORTING REGULATIONS

In March, 1972, the Treasury Department issued regulations as Part 103 of Title 31 of the Code of Federal Regulations to implement Titles I and II of Public Law 91-508 effective July 1, 1972. The provisions can be classified into the following categories:

(1) Those pertaining to the recordkeeping practices of banks and other financial institutions.

(2) Those requiring reports of currency transactions, foreign financial accounts, and the international transportation of monetary instruments.

(3) Those requiring financial institutions to identify their customers.

(4) Those requiring persons having foreign financial accounts to report them and to maintain records of them.

Banks, savings and loans, securities brokers, dealers in foreign exchange, agents of foreign banks, and certain other financial institutions are required to retain the original or a copy of the following records:

(1) Each extension of credit in excess of $5,000 except for those secured by real estate.

(2) Records of instructions given or received concerning the transmission of more than $10,000 in credit, funds, currency or other monetary instruments, checks, or securities out of the United States.

Bank and bank-type institutions, such as savings and loans, credit unions, and agents of foreign banks must also retain a copy of the following records:

(1) Documents granting signature authority over each deposit or share account.

(2) Statements of account.

(3) Checks and other charges in excess of $100 that are posted to accounts. (Checks drawn on certain high volume accounts are exempt.)

(4) Each check or other item in excess of $10,000 transmitted outside the United States.

(5) Each check or draft in excess of $10,000 drawn on or issued by a foreign bank which is paid by the domestic bank.

(6) Each check in excess of $10,000 received directly from a foreign financial institution.

(7) Records of each receipt of currency, other monetary instrument, securities, checks, or credit received from a foreign financial institution.

(8) Records necessary to reconstruct a checking account and to furnish an audit trail for each transaction over $100.

Securities brokers within the jurisdiction of the SEC have been subject to recordkeeping regulations for many years, even before Treasury issued 31 CFR 103. The Treasury regulations, however, added the requirement that brokers obtain a signature card of similar document establishing trading authority over an account and that they make a reasonable effort to obtain a Social Security number for each account.

The reporting requirements are a mixture of the old and the new.

There is a requirement that financial institutions file a report with the IRS concerning any unusual, domestic transaction involving more than $10,000 in currency. This is only a modification of a similar provision that was in effect for more than 25 years before it was repealed by the current regulations. The previous regulations required banks to report any unusual customer transaction involving more than $2,500. The major differences are that there has been no attempt to conceal the current reporting requirement from the public and that penalties have been provided for the willful failure to file the reports.

One of the new reporting requirements calls for reports of the international transportation of currency and certain monetary instruments in excess of $5,000. A traveller carrying a reportable amount must file a report with the Customs Service at the time he enters or leaves the United States. If the monetary instruments are transported in some other manner, the report must be filed with Customs before the shipment enters or leaves this country. A United States resident who receives a shipment from overseas is required to file a report with Customs within 30 days after the shipment is received in the United States.

There is a third reporting requirement that actually went into effect before the regulations were issued. The IRS included a question concerning the ownership or control of foreign financial accounts on the Federal income tax returns for 1970. Persons with a financial account were also required to file an additional report furnishing additional information about the account. Under the regulations, they are, in addition, required to retain certain records pertaining to the account.

The regulations reinforce the precept "know your customer" which is widely accepted in financial circles. A financial institution is required to verify and record the identity of any person for whom it handles a transaction that is required to be reported. Verification of the identity of a non-depositer may be made by examination of a drivers license, passport, or other document normally accepted as a means of identification. There is also a requirement that financial institutions make a reasonable effort to obtain a Social Security or other taxpayer identification number for each deposit account. These provisions establish a minimum identification requirement.

Financial institutions have a vital interest in knowing their customers. Each year banks and brokers routinely guarantee the authenticity of the endorsements on checks and stock certificates worth billions of dollars. While the risk resulting from this service is occasionally dramatized by an incident similar to the Clifford Irving-H. Hughes affair, most of us are unaware of the tens of thousands of attempted forgeries that occur each year. The Secret Service alone investigated more than 75,000 check cases last year.

PENALTIES

The Act and the regulations provide a variety of penalties and enforcement measures that include seizure and forfeiture, cease-and-desist orders, fines, and imprisonment. For example, currency or other monetary instruments that are imported or exported without being properly reported are subject to seizure and forfeiture. In lieu of the forfeiture, a civil penalty up to the amount of the currency or monetary instruments involved may be assessed.

The usual civil and criminal penalties available for willful violations of the regulations are limited to a $1,000 fine and, in addition for criminal violations, 1 year in prison. However, a criminal violation of any of the provisions authorized by

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Title I of the Act that is committed in furtherance of the commission of a violation of Federal law punishable by imprisonment for more than 1 year may result in a fine of as much as $10,000 and imprisonment up to 5 years. Furthermore, anyone who willfully violates a reporting requirement in furtherance of another violation of Federal law may be fined $500,000 and imprisoned for 5 years. This penalty would be applicable to the failure to report an interest in a foreign financial account, if, for example, that failure were related to a tax fraud scheme. We believe that, as these penalties become more widely known, they will become a powerful deterrent to persons using secret foreign bank accounts to violate our laws.

DELEGATION OF RESPONSIBILITY FOR SECURING COMPLIANCE

Responsibility for assuring compliance with the requirements of the regulations is delegated as follows:

(1) To the Comptroller of the Currency, with respect to national banks and banks in the District of Columbia;

(2) To the Board of Governors of the Federal Reserve System, with respect to State bank members of the Federal Reserve System;

(3) To the Federal Home Loan Bank Board, with respect to insured building and loan associations, and insured institutions as defined in section 401 of the National Housing Act;

(4) To the Administrator of the National Credit Union Administration, with respect to Federal credit unions;

(5) To the Federal Deposit Insurance Corporation, with respect to all other banks except

agents of foreign banks which agents are not supervised by State or Federal bank supervisory authorities;

(6) To the Securities and Exchange Commission, with respect to brokers and dealers in securities;

(7) To the Commissioner of Customs with respect to reports of transportation of currency or monetary instruments and forfeiture of currency or monetary instruments;

(8) To the Commissioner of Internal Revenue except as otherwise specified in this section.

Overall responsibility for coordinating the procedures and efforts of the agencies listed herein and assuring compliance with this part, is delegated to the Assistant Secretary (Enforcement, Operations, and Tariff Affairs).

USEFULNESS OF THE REQUIRED RECORDS AND REPORTS

We think of the regulations as providing a system for detecting and documenting the overwhelming majority of the crimes committed for economic gain. Of course, the records banks are required to keep are the heart of the system. Most sizeable payments are made by check today. Although charge cards are gaining in popularity they are ultimately reflected in a charge to a bank account. Except for cash transactions and the physical movement of currency abroad, most substantial transactions by U.S. persons will be reflected in some way in domestic bank accounts. The currency transactions reports and the reports of the international transportation of currency were intended to fill the recording gap resulting from the use of cash.

In addition, the reports are designed to alert law enforcement officials to unusual transactions that might warrant investigation. In the U.S. today, the use of cash for sizeable transactions is very limited. The Federal Reserve banks no longer circulate bills in denominations over $100, and the bankers have been talking about not only a cashless, but a checkless society. More and more payments are being handled through credit cards and computers. Our experience has shown that large cash payments have a relatively high probability of being connected with some tax evasion, or drug trafficking.

It is apparent that most organized crime, white collar crime and tax evasion is undertaken for economic gain. Law enforcement agents who are required to document such gain must rely on the records of financial institutions in many instances. Without the record retention requirements established under the Bank Secrecy Act there would be no assurance that the necessary records would be maintained by the banks and other institutions.

In the majority of criminal tax cases, the suspect does not make his books and records available to the IRS special agent. The agent must reconstruct the suspect's financial transactions to determine his taxable income. A large percentage of IRS recommendations for prosecution are based on two indirect methods of proof that depend heavily on records of the subject's bank account. One, the net worth and expenditures method requires an analysis of all checks issued for personal living expenses, entertainment, travel, etc. The other procedure requires deposit slips to establish the subject's income and checks to reconstruct his allowable expenses and deductions.

The following summaries illustrate the importance of bank records and reports in IRS cases:

(1) The St. Louis District is presently conducting an investigation that was assisted in part by the fact that the provisions of 31 CFR 103 were adhered to. During the course of the investigation the special agent came into possession of a Form 4789, Foreign Currency Transaction

Report, which indicated that the taxpayer had negotiated approximately $100,000 in cash. This discovery led the agent to additional sources of income, unknown bank accounts and new leads. The Form 4789 was required under 31 CFR 103.

(2) A prominent Midwest druggist was sentenced to three years in prison for a tax evasion scheme involving extensive use of cashier's checks. He purchased stock in his name using cashier's checks in the name of professional athletes. Various sports figures testified that the taxpayer induced each of them to buy cashier's checks and to open safe deposit boxes. The taxpayer then gave them large amounts of currency to buy cashier's checks payable to stock brokers on behalf of the taxpayer. The scheme was discovered when an athlete's name was used as the payee, rather than the stockbroker. Additional taxes and penalties were in excess of $550,000. The availability of bank records of cashier's checks and safe deposit box rental accounts was essential to the successful conclusion of this case.

(3) On December 9, 1974, a corporate president was fined $4,000 after a plea of Nolo Contendere to filing a false income tax return in violation of Section 7206(1). Since the taxpayer had refused to turn over any of his personal records it was necessary to reconstruct financial transactions through extensive use of bank records. The bank furnished microfilm records of his transactions which made possible the discovery of unreported sources of income. The taxpayer made regular use of cashier's checks. The bank records made it possible to identify these checks and, thereby, uncover hidden assets and savings accounts. Bank records also were

valuable in refuting the taxpayer's defense that the funds were being held for his children. The defense was negated by the reconstruction of the children's income and expenses through bank records and tax returns which proved that the children did not have funds available to give their father. Unreported income was in excess of $150,000.

(4) On May 20, 1975, Hawaii's crime syndicate boss was sentenced to 24 years in prison for violations of Sections 7201 and 7206(1), IRC. During the trial the Government proved that the syndicate collected nearly a million dollars of extortion money during three years. The money was invested through front men into legitimate businesses. Bank records were used extensively to trace the flow of money from one corporation to another. This analysis enabled those persons involved to be identified and to testify as Government witnesses. Personal expenditures of approximate $400,000 were uncovered through this method.

(5) A former IRS revenue agent and his business partner were sentenced to prison terms of four years and one year, respectively, for tax evasion. The case was worked using the bank deposit method of proof. The taxpayers' records were destroyed making it necessary to rely heavily on bank records for reconstruction of income. All unreported receipts of the business were converted to cash. Extensive use was made of money orders and cashier's checks. Checks which had been cashed rather than deposited, were traced by examining bank microfilm of the checks and tracing funds to the purchase of money orders and cashier's checks, many times in fictitious names. The bank documents placed the funds in the hands of the partner and led to testimony which revealed the ex-revenue agent's involvement.

In drug enforcement cases involving large scale, international conspiracies, the use of bank records is constantly increasing. Many of the large payments and the sizeable profits associated with an organized narcotics smuggling and distribution ring must be reflected in the bank records in some way.

In one case currently under investigation, at least 15 banks, located in the U.S. and seven other countries, were used by members of the ring. The records of the domestic banks involved will play an important role in establishing the nature of the alleged violations and information gained from the domestic banks may facilitate access to the foreign bank accounts.

The IRS Form 4683, U.S. Information Return on Foreign Bank, Securities, and Other Financaal Accounts, was initially designed to provide the IRS audit personnel with additional information concerning a foreign financial account that a taxpayer disclosed on his income tax return. When a return reporting a foreign bank account is considered for audit, the information on the Form 4683 is taken into consideration with other available data in making a decision concerning its disposition. If the return is assigned to a revenue agent for examination, the revenue agent is alerted to the location and the nature of the account.

Since the 1975 tax returns no longer carry a question concerning foreign financial accounts, the Forms 4683 provide the primary indication that a taxpayer has an interest in or control over a foreign bank account.

The domestic currency transaction reports that are required to be filed with the Internal Revenue Service on Forms 4789 are matched with tax related allegations and open cases. Those that are not immediately selected to be used in a criminal investigation are made available to the Audit and Collection Divisions for possible use in a tax examination or a delinquency investigation.

One of the principal benefits from this reporting requirement is that it presents an additional obstacle to drug traffickers. The illegal traffic in drugs generates enormous quantities of currency. The industry, which is largely cash and carry, is generally estimated to amount to billions of dollars annually. At some point, this currency must enter the banking system and be recirculated. The requirement that large and unusual currency transactions be reported presents a problem to the criminal and makes his crimes more difficult to conceal.

The IRS Form 4790, which is used to report the international transportation of currency and monetary instruments to the Customs Service, was intended to discourage illegal schemes involving the international transportation of large amounts of currency or negotiable instruments in bearer form. Just as sophisticated tax evasion, large scale drug trafficking, and political or commercial corruption frequently entail large domestic currency transactions they are also the types of violations that are likely to entail international movement of monetary instruments. At the time the law was enacted, Treasury officials did not fully anticipate its potential in the fight against drug traffickers. This reporting provision was seen principally as a measure to discourage the skimming of untaxed income from gambling casinos and similar sources. Today, we believe that this requirement can be used very effectively against drug smuggling activities.

Although the need for some of the provisions of 31 CFR 103 pertaining to security brokers is questionable in view of their similarity to many of the SEC regulations, it is still essential that brokers be subject to certain provisions of the regulations. One reason is that SEC regulations do not require brokers to secure signature cards or similar account authorities from their customers. In addition, since the securities industry is often used as a channel for the investment of funds from questionable sources, brokers should be required to file the reports concerning currency and securities that are specified by the regulations.

EXPERIENCES IN IMPLEMENTING THE ACT

The implementation of the regulations by those Federal agencies having the responsibility for ensuring compliance with their provisions appears to have been quite effective.

We have received only a small number of reports concerning apparent violations from law enforcement agencies, and the bank examiners have reported relatively few violations of the major recordkeeping provisions. A surprising number of smaller banks, however, have failed to inquire concerning the purpose of loans in excess of $5,000 as required by the regulations.

The IRS has received over 40,000 Forms 4789 reporting unusual currency transactions since the regulations went into effect in July 1972. In addition the IRS has detected a number of apparent criminal violations of the requirement to file Forms 4789.

In one metropolitan area, employees of a bank were alleged to have assisted drug traffickers by accepting bills of smaller denominations in exchange for $50 and $100 bills. Millions of dollars were involved. The bank employees received a commission for agreeing not to file the required Forms 4789. This investigation has also resulted in 11 income tax investigations.

More than 43,000 Forms 4790, the reports of the international transportation of currency and monetary instruments, have been filed with the Customs Service since the regulations went into effect. Through January 31, 1976, 360 seizures were made, 118 persons were arrested, and 23 convictions were obtained. More than 50 cases are pending. The following is a representative sample of some of the cases that Customs has initiated:

(1) The subject was a courier between various cities in the U.S., Canada, and the Bahamas. In 1973 he flew a private airplane into Florida from the Bahamas and executed a Form 4790 for $66,000. Verification disclosed that he was carrying $100,000. He was tried in U.S. District Court for criminal violations of 31 CFR 103 and 18 USC 1001. He was found not guilty

on all charges. The issues raised during the trial were without precedent and contributed to the apathy of the jury. The subject, however, paid a substantial administrative penalty to the District Director of Customs.

(2) In 1973, the subject drove a private automobile into the U.S. at Detroit and gave a negative Customs declaration. He denied possession of currency which would require reporting. Secondary search of the vehicle disclosed $17,850 in a package concealed behind the instrument panel. Subject was charged with currency violations and subsequently was tried and found guilty by jury in U.S. District Court. He fled while on bail and is at present a fugitive.

(3) In December 1973, the subject drove a private vehicle into the U.S. at Champlain, N.Y. and when stopped by a Customs inspector, denied possession of currency which would require reporting. Subsequent search of the vehicle disclosed 32 cloth bags containing Canadian silver coins valued at $27,500. Subject subsequently entered a plea of guilty to violation of 18 USC 545 and was sentenced to a fine of $500 and one year probation.

(4) In 1974, the subject arrived at JFK International Airport and was accorded a continued Customs examination. A personal search revealed $80,000 in one-hundred dollar bills concealed in his socks. He admitted that the currency was the result of an illegal ticket discounting operation involving an airline and a travel agency. The subject was arrested.

(5) In 1974, the subjects arrived by commercial air at Atlanta from Mexico City. Routine examination of luggage disclosed one of them to be in possession of negotiable common stock certificates valued at $530,000. He denied ownership of the certificates and accused his companion, who also denied ownership. They subsequently admitted that the certificates were stolen in the U.S. The subjects had unsuccessfully tried to dispose of them in Mexico. At the time they were apprehended, the subjects were returning to the U.S. with the certificates. They were arrested for currency violations and conspiracy and, after a hearing before the U.S. Magistrate, were bound over for grand jury action.

(6) In 1974, the subject arrived at Anchorage International Airport from Japan and responded negatively to the currency question on his baggage declaration. During a continued examination, an envelope containing $9,000 was found in his coat pocket, and after questioning he produced four additional envelopes containing a total of $35,000. The subject, a U.S. resident and self-employed importer, was arrested and charged with a currency violation and 18 USC 1001.

(7) In 1974, the subject drove a private automobile into the U.S. In response to direct questioning, he stated that he had less than $5,000 in currency on his person, yet a search of the vehicle disclosed $34,000 in U.S. and Canadian currency concealed under the floor carpet. Subject claimed to be a money speculator; however, subsequent investigation disclosed him to be an associate of known major narcotics suspects in Canada.

He was charged with currency violations and admitted to $50,000 bail pending disposition of the case.

(8) In 1974, the subject, travelling alone, arrived by commercial air from Europe and was accorded a continued examination by Customs patrol officers who discovered $80,000 in U.S. and foreign currency and bearer instruments concealed on her person, in the lining of her purse, and in her luggage. The money was seized. She was a U.S. citizen, married to an alien, and had been residing in Europe. She claimed the currency and instruments were jointly owned with her husband and represented earnings from their business in Europe. The subject was subsequently charged with violation of 18 USC 1001, but she has fled the United States and is at present a fugitive.

According to information developed in Rome the subject's husband was an associate of "Lucky" Luciano, and he had been ordered to travel to the U.S., marry a U.S. citizen, and remain available. Subsequent to his original entry into the U.S., the husband was granted a voluntary deportation. Later his application for reentry was denied under a provision relating to suspected narcotic traffic, and he opened a business in Europe.

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The California Bankers Case

In June of 1972, complaints were filed in the U.S. District Court of San Francisco against the Secretary of the Treasury by Fortney H. Stark, Jr., and others, and by the California Bankers Association challenging the constitutionality of the Bank Secrecy Act, and as a preliminary action the court on June 30, 1972, issued a temporary restraining order preventing the Treasury Department from implementing the reporting provisions of the regulations which were due to become effective on the following day.

On September 11, 1972, a three-judge Federal Court by a two-to-one decision granted a preliminary injunction against enforcement by the Treasury Department of the provisions of the Act requiring reports of domestic financial transactions involving the payment, receipt or transfer of United States currency or monetary instruments. The Court, however, unanimously upheld the sections of the Act requiring reports of foreign financial transactions and the sections imposing record-keeping requirements on financial institutions.

The portions of the Act struck down by the District Court related to the Secretary of the Treasury's authority to require financial institutions and individuals to report on domestic financial transactions whenever he finds that such reports would have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. The court stated that the mere general possibility that these reports would help in such investigations was insufficient to justify the invasion of one's rights to privacy in his financial affairs. The District Court concluded that these provisions of the Act violated the Fourth Amendment of the Federal Constitution, which protects the people against unreasonable searches and seizures. The other provisions of the Act were upheld.

Without expressly saying so, the District Court appeared to hold that, (1) bank customers have a reasonable expectation of privacy in their financial transactions; (2) that it is reasonable for the drawer of

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a check to regard himself as the real owner of checks on his account with the bank; (3) information shown on his checks may not be transferred to government agencies without at least some notice, summons, subpoena or warrant in connection with a legitimate pending inquiry; and (4) the Fourth Amendment protects the bank customer's right of privacy in his financial affairs.

On appeal to the Supreme Court of the United States, the plaintiffs conceded that the Fourth and Fifth Amendments do not prevent Congress from requiring businesses to maintain adequate records. They also concede that privacy rights of third parties under the Fourth and Fifth Amendments are not violated when businesses produce such records for governmental use pursuant to lawful subpoena or summons, but they argued that such recordkeeping requirements are limited to situations in which the records are necessary to determine tax liability or to ensure proper regulation of an industry. They pointed out that the Act requires banks to maintain records needed to ensure compliance by others with provisions of federal law. Yet neither the Fourth nor the Fifth Amendment contains any such limitations on the authority of Congress to require maintenance of records. Numerous provisions of the Internal Revenue Code and the Treasury regulations thereunder require financial institutions and other third parties to maintain records of the financial transactions of their customers, employees, and others with whom they deal.

Moreover, the recordkeeping provisions of the Act raise far less serious Fourth and Fifth Amendment questions than those in Couch v. United States, 409 U.S. 322 (1973), where the Supreme Court upheld the right of the Internal Revenue Service to require production of a taxpayer's own financial records in the possession of his accountant. Indeed, unlike such taxpayer records, which remain the property of the taxpayer, title to the financial records here resides in the financial institutions themselves. Bank records have traditionally been subject to summons or subpoena by governmental officials. Therefore, it cannot be said that bank customers have a reasonable expectation of privacy which would call forth any Fourth or Fifth Amendment protection for the records. Couch v. United States, supra; United States v. Cleveland Trust Co., 474 f.2d 1232 (6 Cir. 1973).

Nothing in the cases or in logic would indicate that a different rule should apply in the case of records needed for regulatory or criminal law enforcement purposes. It is no less important to achieve effective enforcement of the norms of conduct set forth in the regulatory and criminal laws than in those relating to revenue. It has long been established that records maintained for tax purposes may be utilized in the investigation and prosecution of other laws, including the criminal laws. Indeed, virtually all records maintained pursuant to one statute may be used in the enforcement of other statutory schemes. United States v. Silverman, 449 F.2d 1341 (2d Cir. 1972).

The Supreme Court held that the Bank Secrecy Act was a valid attempt to detect illegal use of secret foreign bank accounts and the "heavy utilization of our domestic banking system by the minions of organized crime." In upholding the recordkeeping requirements, the Supreme Court held them to be a proper exercise of congressional power to deal with crime in interstate and foreign commerce. The court also said that the requirement for reporting foreign transactions was within Congress' authority to regulate foreign commerce.

Mr. Chairman, since the enactment of the Bank Secrecy Act we have been confronted with various legislative proposals to amend substantively not only P.L. 91-508 but also the entire body of Federal law regarding law enforcement access to records. Our foremost concerns have been the possible legislative creation of a probable cause standard where it has never before existed and the establishing of a business customer's standing to receive notice of requests for access to records and to intervene in the criminal investigative process which seeks such records.

The creation of a probable cause standard for access to the financial records of a banking institution would have a very detrimental impact upon law enforcement, interfering with quite ordinary investigative techniques, and leaving investigators with a scarcity of preliminary informational resources. What is involved in the investigative process was described succinctly by the Department of Justice in tesitmony concerning H.R. 214, the Bill of Rights Procedures Act, before the House Judiciary Committee's Subcommittee on Courts Civil Liberties and the Administration of Justice:

> "A criminal investigation must begin somewhere. Many, if not most, criminal investigations are instituted upon the basis of allegations and suspicions. Federal agents do not usually start out with probable cause to believe that a certain person committed a certain offense, and that certain items of real evidence, or the fruits of crime, or contraband can likely be found at a certain location. Investigations ordinarily proceed by inquiring of a large number of people in the hope of developing evidence amounting to probable cause. When investigators go to written records, they are not doing anything essentially different from when they ask questions of the persons who made or were involved in making the records, except that the records preserve memories that may be lost."

The financial records maintained by banks regarding their account holders are often reviewed as an essential preliminary step in criminal investigations and are likely to be of particular significance in investigations of organized crime figures, narcotics traffickers, corrupt public officials, and other white collar criminals. A probable cause standard for examination of bank records would be a shield for criminals with large movements of money and complex financial maneuvers but would constitute a crucial impediment to the public's right to protection from criminal enterprises flourishing through predations concealed in our financial system.

Basic to the legislative initiatives for a probable cause standard for access to financial records is the presumption that a customer of financial institution has a Fourth Amendment right, enforceable by him, in records of his financial transactions with others, when those records are the property of another party to the transaction. Yet nearly every Federal court to consider this issue has declined to recognize any proprietary interest by a customer in such records and has ruled that a bank customer has no standing to challenge reasonable access by Federal investigators to such records. Harris v. United States, 413 F2d 316 (9th Cir. 1969); Dosek v. United States, 405 F2d 405 (8th Cir. 1968); Galbraith v. United States, 387 F2d 617 (10th Cir. 1968); DeMasters v. Arend, 313 F2d 79 (9th Cir. 1963); and Foster v. United States, 265 F2d 183 (2d Cir. 1959).

Again, Mr. Chairman, I direct the Commission's attention to the Justice Department's testimony on H.R. 214:

> "The Fourth Amendment protection to which a person is entitled ought not to be extended solely because the person wishes something to be private. As the Supreme Court said in Katz v. United States, 389 U.S. 347, 351-52 (1967), the Fourth Amendment:
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> . . . protects people, not places. What a person knowingly exposes to the public, even in his own home or office, is not a subject of Fourth Amendment protection. [Citations omitted.] But what he seeks to preserve as private, even in an area accessible to the public, may be constitutionally protected.

> The Katz case then raised the matter of the person's reasonable expectation of privacy. Many of the kinds of transactions that would be covered under [such legislative proposals] are indeed "private" transactions, in that they are not displayed for general public consumption. But they are hardly "private" transactions in any other sense. Records kept of these transactions, especially when owned and maintained and used by the other parties to the transactions, are records that are commonly inspected by or at least exposed to a number of people. For instance one expects that when a check is written, records of its progress through the clearinghouses and eventually on the books of the drawee bank will be seen by many people. No expectation of privacy in such records, at least as the phrase is used in Katz, would appear to exist.
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> It is our view that a warrantless search is not unreasonable unless the Government, without probable cause or exigent circumstances, intrudes into an area in which the "proprietor" has a reasonable expectation of privacy. See Katz v. United States 389 U.S. 347 (1967). Those things which an individual exposes to public scrutiny, things which he does not himself safeguard from third parties, are not protected by the Fourth Amendment. It follows that records of transactions of an individual which, in the normal course of events, can be viewed or obtained by persons whom that individual evidences no desire to select or restrict are not items in which the individual has an expectation of privacy."

Those legislative proposals which envision notification of and standing to oppose requests by law enforcement officials for access to financial records are clearly in conflict with the cases and would make records sacrosanct far beyond what is now the law. We cannot find a reasonable justification for granting such privileges to account holders.

Certainly, before creation through legislation of rights which may adversely impact on the alleged beneficiaries of such rights is undertaken, the proponents of such "rights" should present clear and convincing examples of actual abuses of the access process. Equally essential would be proof that the demonstrated wrongs are of such volume and impact that the public interest in a remedy will clearly outweigh the advantages to the public which already inhere in the present system of access. We are confident that the advocates of such changes cannot sustain their burden of proof.

We are unaware of any record of measurable abuse by law enforcement officials resulting from their undisclosed access to financial records even though such access has been employed routinely over many years. However, we believe it is abundantly clear that the American public will suffer substantially from these unnecessary hindrances to criminal investigations. Clearly, notice to an account holder that law enforcement officials wish to review bank records concerning him will frequently sabotage the ongoing investigation. Since access to financial records is commonly an initial element in developing a criminal case, exposure of the Government's interest in those records will allow a suspect to alter his operations, to falsify or destroy evidence (including witnesses), or to flee the jurisdiction even before an indictable case can be developed or an arrest made.

Even if an investigation survived notice to the account holder, it would be equally vulnerable from the delay caused by the account holder's "right" to contest the disclosure. Delay would be much more than a time-consuming burden upon and an additional physical hazard for a Federal agent; it would be another opportunity for a criminal suspect to alter his operations or take other evasive and escape actions as described above.

The Duty to Give Evidence

This brief exposition of the case law has shown that bank customers have no proprietary interest within the scope of the Fourth Amendment in records maintained and owned by financial institutions simply because information about the customers is physically embodied in them. The records are the property of the financial institutions maintaining them, and the Fourth and Fifth Amendments do not bar reasonable inspections of those records by law enforcement officials. Federal cases also hold that whatever duty, if any, a financial institution has to keep customers' account records confidential, it is outweighed by the greater duty to give evidence.

This obligation to give evidence is deeply rooted in the common law as imperative to the administration of justice, and it underlies the rejection of a "right of privacy" for customers regarding the records of financial institutions. Professor Wigmore has cogently stated the rule, thus: "For more than three centuries it has now been recognized as a fundamental maxim that the public (in the words sanctioned by Lord Hardwicke) has a right to every man's evidence." And while claims are made for exemption from this duty, those few which are recognized "are distinctly exceptional, being so many derogations from a positive general rule."

The duty to give evidence flows from fundamental requirements of justice in a society of ordered liberty. The administration of justice must be a search for truth regarding which men can, hopefully, exercise wisdom. From Hellenic antecedents, through the history of the English common law, to our own Constitution, men have recognized that civilized society must be more than an amalgam of free individuals but, on the other hand, it is not merely an ordered community. Justice has, thus, been made an institution of our society requiring that the knowledge of all men be made available to its instruments with allowance for only the most clearly drawn and strongly reasoned exceptions. Without the imposition of such an obligation, truth cannot be sought and justice cannot be done.

That special interests in some states have managed to achieve some legislative immunity from the duty to give evidence does not diminish the wisdom of the common law obligation or its recognition by the courts. Nor has its concomitant, that privileges are "derogations from a positive general rule .. /and/ therefore, to be discountenanced" lost its standing before the courts. Rather, the principles of the testimonial duty and the rejection of insufficiently based privileges have received recent reinforcement by two history-making decisions of the Supreme Cout, Branzburg v. Hayes, 408 U.S. 665 (1972) and United States v. Nixon, 418 U.S. 683 (1974).

Branzburg dealt with a group of appeals from different journalists who had been subpoenaed by grand juries to provide information regarding criminals and extremist groups with whom the reporters had met, in one manner or another, in gathering material for exclusive stories. Various claims were made by the appellants including First Amendment assertions that a privilege necessarily attached to communication between newsmen and their "confidential news sources." In addressing the case of one petitioner who had asserted a claim of a "newsman's" privilege, the Court cited with approval Professor Wigmore's description and analysis of the duty to give evidence and the strong argument against exemptions (408 U.S. at 690). In flatly rejecting the concept of a First Amendment reporter's privilege, the Court stated:

> "Until now the only testimonial privilege for unofficial witnesses that is rooted in the Federal Constitution is the Fifth Amendment privilege against compelled self-incrimination. We are asked to create another by interpreting the First Amendment to grant newsmen a testimonial privilege that other citizens do not enjoy. This we decline to do. Fair and effective law enforcement aimed at providing security for the person and property of the individual is a fundamental function of government and . . . we perceive no

> basis for holding that the public interest in law enforcement and in ensuring effective grand jury proceedings is insufficient to override the consequential, but uncertain, burden on news gathering that is said to result from insisting that reporters, like other citizens, respond to relevant questions . . . of a valid grand jury investigation or criminal trial." (408 U.S. at 689).

More recent, of course, is the Supreme Court's discussion in United States v. Nixon of the presumptive privilege of the President described therein as having "all the values to which we accord deference for the privacy of all citizens [as well as] the necessity for protection of the public interest in candid, objective, and even blunt or harsh opinions in Presidential decision-making." (418 U.S. at 682). Stated succinctly, the Presidential privilege is "fundamental to the operation of government and inextricably rooted in the separation of powers under the Constituion."

Yet despite the impelling bases for the Presidential privilege, the Supreme Court balanced it against "our historic commitment to the rule of law," and found that the "very integrity of the judicial system and public confidence in the system depend on full disclosure of all the facts . . ." (418 U.S. at 683). In reciting for comparison some of the other "weighty and legitimate competing interests" protected by privileges -- Fifth Amendment self-incrimination protection, attorney-client and priest-penitent communications -- the Court restated the rule that "exceptions to the demand for every man's evidence are not lightly created nor expansively construed, for they are in derogation of the search for truth." (418 U.S. at 710). Following this principle, the Court then found that, in the absence of military, diplomatic or national security secrets, even the extraordinary presumptive privilege of the President was outweighed by the need for information in the fair administration of justice.

These two landmark cases have again emphasized the compelling claim to "every man's evidence" which inheres in our constitution and the precepts of justice. Strong arguments were made in Branzburg that the First Amendment guarantee of a free press demands the recognition of a "reporter's privilege" and in Nixon that the separation of powers doctrine and the need for confidentiality of high level communications establish privileges transcending the needs of our criminal justice system. In each instance the Court recognized the historically preferred status of the asserted privilege; and in each case the Court rejected the incursion on the criminal justice system. Should we, in the face of such decisions, now accept a claim of privilege for records of a business relationship which, is at best, tenuously associated with another person's expectation of privacy? Let us examine this further.

If a privilege were to be recognized for protecting the banker-customer association against examination of transactional records, it would have to meet the four fundamental conditions described by Wigmore as the recognized prerequisites to establishment of a communications privilege:

> "(1) The communications must originate in a <u>confidence</u> that they will not be disclosed.
>
> "(2) This element of <u>confidentiality must be essential</u> to the full and satisfactory maintenance of the relations between the parties.
>
> "(3) The <u>relation</u> must be one which in the opinion of the community ought to be sedulously <u>fostered</u>.
>
> "(4) The <u>injury</u> that would inure to the relation by the disclosure of the communication must be <u>greater than the benefit</u> thereby gained for the correct disposal of litigation." (emphasis in original).

Test Number One is certainly debatable since neither American case law nor Public Law 91-508 can reasonably serve as a predicate for banks to offer customers any assurance of confidentiality from authorized law enforcement officials. Furthermore, the movement of financial papers through ordinary channels of commerce necessarily involves the imposition of others into the association between customer and financial institution. An expectation of non-disclosure would be less than reasonable in the circumstances of today's business practices.

Test Number Two clearly cannot be met by the relationship of financial institution-to-customer. Confidentiality is patently not essential to the full and satisfactory maintenance of such a relationship. This is demonstrated by the practice of the financial community itself which, as a business convenience and precaution, exchanges information from records of customers seeking services from different institutions. Today's booming credit industry also involves intrusion by credit bureaus and other businesses upon bank information about customers. Yet no diminution in the public's use of checking accounts and credit arrangements has resulted.

Number Three is controverted by the line of court decisions holding against the assignment to financial records of a confidential status from Federal law enforcement officials. In addition, our credit-oriented society has continuously fostered more expeditious and accurate mechanisms for financial transactions rather than the confidentiality of information concerning the bank-customer relationship.

Test Number Four cannot be met because the public suffers no measurable injury from law enforcement access to records of financial institutions while it benefits greatly in the administration of justice. As I hope this testimony and the record of previous hearings on bank secrecy have made clear, society gains significantly from the availability to law enforcement authorities of relevant financial records but forfeits no rights.

Of course, many other associational relations have been claimed to have such a privilege and in some cases, privilege has been granted in whole or in part by legislative enactment. But the fundamental requirements which have historically limited the privilege to a few highly justified relationships have been left unexplored by legislatures confronted with strong advocacy from special interests who seek advantage over other members of society iwthout meeting the hard tests described by Wigmore and looked to by the courts.

We submit, Mr. Chairman, that the impetus for establishing a privilege for the records of financial institutions is the result both of supposed benefits to the financial community and also of attributing the status of a "right" to circumstances for which there is no reasonable expectation of privacy, thus capturing new adherents despite the lack of demonstrable abuses. Who, after all, wants to advocate the violation of peoples' privacy?

What we <u>do</u> advocate is the continuation of the non-privileged status of financial records and the applicability of Public Law 91-508 to financial transactions. We are not seeking expansion of powers regarding official access to records of financial institutions. Yet in merely asking that the law not be changed, the Government is too often characterized as seeking to violate a right which does not even exist.

In the "privacy rights" campaign we are constantly met by the example of foreign bank secrecy laws. One recent article claims that Americans are "much more subject to government investigation and intimidation" than foreign nationals who are protected "through the use of many national referendums and banking privacy."

Interestingly, that article notes in passing, but makes no further comment upon, the strong differences between the civil law systems with their placing of the burden of proof upon the accused and our common law legal system and the presumption of innocence. But these differences bear greatly upon the need, or lack thereof, for access to financial records.

In the United States, an arrest warrant cannot be issued without a finding of probable cause to believe a crime has been committed and that the defendant has committed it. A search warrant also may issue only upon a finding of probable cause. In our system the accused is presumed to be innocent, and the Government bears the burden of proof to the contrary beyond a reasonable doubt.

Thus, limited in the manner in which the Government can bring a suspected criminal to account, we must rely upon each citizen for evidence and must be able to examine bits and pieces of information which are not constitutionally imbued under the Fourth and Fifth Amendments with confidentiality. Only by this process of sifting and examining information which often proves to be irrelevant can we develop cases against criminals involved in complex illegal schemes.

Furthermore, under our Fifth Amendment a citizen is secure against compulsion to appear before police authorities and account for himself. We must develop our case from witnesses and physical evidence. But the civil law system will demand a personal explanation of charges even if the result is self-incriminatory.

For civil law countries therefore, the investigatory-accusatory process is simpler. An individual under suspicion bears the burden of proof to justify his actions and, thus, to prove himself innocent. Under such circumstances, the liberty of "bank secrecy" need not be breached to achieve the government's end, a prosecutable case against a criminal, since the suspect himself is bound to produce his own refutation of accusations against him.

The point here is that the recurring calls for "bank secrecy" like that of some civil law countries, ignore the crucial distinctions between our common law traditions of criminal justice and the civil law systems of most of Europe.

I am certain that none of us wish to exchange our form of criminal justice for the possible enhancement of a privacy interest in records of financial institutions. Yet if financial records were to be accorded a confidential privilege regarding law enforcement officials, it would encourage a system like that of the civil law nations in order to continue to enforce the criminal laws against major organized crime figures, narcotic traffickers, and white collar criminals engaging in sophisticated and complex illegal financial maneuvers.

CONCLUSION

Mr. Chairman, under current case law and Public Law 91-508, we have the means in our free society for the reasonable examination of records of financial institutions without undue burdening of the institutions possessing such records or unfair intrusions upon the persons to whom such records may relate. The availability of such information is a logical companion to our country's goal of achieving justice for all. Were we now to create a "right of privacy" where it has never existed, which strongly conflicts with society's right to evidence, and which has not been demonstrated to be needed, we will have taken a significant step toward inducing atrophy in the criminal investigative process. If expanded to other related business contexts, such as hotel records or gasoline stations receipts, effective law enforcement would cease.

We urge the Commission to balance the strong need for law enforcement officials to gain evidence from financial institutions against the manufactured right of privacy in such information which the courts have rejected. Having done so, we are confident that you will join us in strong support of the Financial Transactions and Currency Reporting Act.

Mr. Chairman, that concludes my statement. I will be happy to answer any questions you may have.

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Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 4:00 P.M. April 22, 1976

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for $3,185 million, or thereabouts, of 364-day Treasury bills to be dated May 4, 1976, and to mature May 3, 1977 (CUSIP No. 912793 D4 5). The bills will be issued for cash and in exchange for Treasury bills maturing May 4, 1976.

This issue will provide $750 million of new money for the Treasury as the maturing issue is outstanding in the amount of $2,435 million, of which $1,092 million is held by the public and $1,343 million is held by Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities. Additional amounts of the bills may be issued to Federal Reserve Banks as agents of foreign and international monetary authorities. Tenders from Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities will be accepted at the average price of accepted tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value) and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Wednesday, April 28, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without

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deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on May 4, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing May 4, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE April 23, 1976

RALPH M. FORBES LEAVES TREASURY POST

Secretary of the Treasury William E. Simon today announced the resignation of Ralph M. Forbes as Special Assistant to the Secretary for Debt Management effective May 8, 1976.

Mr. Forbes was appointed by Secretary Simon on April 2, 1975. Since that time Mr. Forbes has had primary responsibility for the formulation of public debt financing policy. Additionally, Mr. Forbes served as Vice President of the Federal Financing Bank.

"Ralph Forbes joined the Treasury a year ago," Secretary Simon said, "at what was a particularly difficult time in the history of public debt management. The Treasury this past year borrowed more than at any time since World War II. To borrow on the average almost $2 billion a week in new money and to refinance the hundreds of billions in maturing securities without totally disrupting the capital markets has been one of the great challenges Treasury has faced in recent years. Ralph Forbes' expertise and dedication in this area have been essential in meeting this challenge."

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The Department of the TREASURY NEWS
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FOR IMMEDIATE RELEASE April 23, 1976

CORRECTION OF TREASURY'S 52-WEEK BILL ANNOUNCEMENT

The auction date in yesterday's offering announcement of 52-week bills was incorrectly stated as Wednesday, April 28.

The auction will be Thursday, April 29.

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WS-805

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE
9:00 P.M. EST, APRIL 22, 1976

STATEMENT OF JOHN A. BUSHNELL
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE NINTH ANNUAL MEETING OF THE
ASIAN DEVELOPMENT BANK BOARD OF GOVERNORS
JAKARTA, INDONESIA - APRIL 23, 1976

Mr. Chairman, Fellow Delegates, and Distinguished Guests.

On behalf of President Ford and Secretary Simon my delegation wants to stress our continuing deep concern with accelerating development in Asia. We also want to repeat our wholehearted support for the Asian Development Bank -- the key regional development finance institution. As a nation of the Pacific as well as the Atlantic, the United States has a vital interest in continued development and improved living standards for all the people of Asia. In our increasingly interdependent world increased peaceful cooperation among nations enhances the welfare of all.

International Economic Situation

At the Eighth Annual Meeting of the Bank last year Secretary Simon identified three central economic issues facing the world in 1975:

-- First, to restore economic growth and price stability around the world.

-- Second, to adapt to the energy shock in ways that will provide more secure sources of energy and will support a pattern for orderly growth; and

-- Third, to adjust our financial policies to accommodate massive shifts in international flows of funds.

Fortunately, today we can already see substantial progress on each of these economic problems. The pace of economic activity is already picking up rapidly in a number of countries. In the United States our economy has now been growing for nearly a year and we are already seeing the effects of this growth on the demand for the imports of the regional members of the ADB. With the completion of the downward adjustment of inventories in the United States along with similar favorable indications from other countries, we expect the faster growth in the developed countries will have a much more apparent effect on demand for the exports of developing countries.

Most countries have also made substantial progress in reducing price inflation. Some regional members of the ADB have set an example for all of us in bringing price inflation under control. However, for many countries, including the United States, inflation rates are still higher than we would expect during a period when productive capacity is not strained. Clearly continuing progress in reducing inflation rates is one of the greatest challenges we face over the next year as productive capacity is more fully utilized throughout the world.

Considerable progress has been made in many countries in adapting to the energy shock. In the United States we still have much to do to supply our energy needs more fully from domestic sources. As our oil consumption rises and production falls, we expect the increase in our oil import bill in 1976 to be almost as large as our current account surplus in 1975, assuming no change in oil prices.

We welcome the greatly increased emphasis the ADB has given to helping member countries develop indigneous energy sources as a major contribution to their own development and to a better energy balance in the world. Over 20 percent of ADB lending was in the enermy field last year and most of this was for domestic energy sources such as the power project in Thailand based on lignite and the Garung Hydroelectric project here in Indonesia. Just last month the Bank approved a project to expand Korean coal production. This ADB emphasis should continue.

Finally, private financial markets have done an outstanding job of moving funds from surplus to deficit countries. We expect that the private markets will continue to play this critical role. We tend to look only at the net borrowing or lending of countries. Thus we overlook the fact that many countries have both large inflows and large outflows of long-term capital. Many of the countries which provide support for the Asian Development Bank have been large net borrowers in recent years even while they have been providing capital to the Bank. This year the United States will be in a similar position as it is unlikely that our current account surplus will be nearly as large as our capital outflows to support development in the poorer countries. It should be recognized that this situation makes it harder to build popular support for development assistance. In most cases the interest and other terms on the borrowing of donors are far harder than the terms of our support to the ADB and other development programs.

Despite the many strains of the past year I believe we can all take pride in the fact that most countries have maintained their commitment to open trading arrangements and a relatively free international flow of funds. I am particularly impressed by the fact that developing countries have relied heavily on aggregate monetary, fiscal and exchange policies in adjusting to recent difficulties. They have also made excellent efforts to maintain relatively open markets for imports. These policies suggest that most developing countries are increasingly understanding the advantages to their development of more intensive participation in an interdependent world connected by increasing links of trade and financial flows.

Moreover, we have made substantial progress in improving the international system to deal with the sort of problems faced in the past couple of years as well as to assist with longer term development problems.

-- The IMF has agreed on amendments to provide for improved longer term stability in international trade and payments and for a substantial increase in quotas, particularly for developing countries.

-- The Compensatory Financing Facility of the IMF has been enlarged to assist in financing shortfalls in export earnings for reasons beyond a country's control.

-- A trust fund is being established in the IMF that will use profits from the sale of a portion of the IMF's gold to provide concessional assistance to overcome temporary balance-of-payments problems.

-- Agreement appears to be near on the creation of the International Fund for Agricultural Development to help increase food production in developing countries.

-- My own country has initiated a system of generalized tariff preferences as part of our efforts to liberalize imports from developing countries.

-- Negotiations are virtually completed for a World Bank capital increase and discussions have started on the fifth replenishment of the International Development Association. We expect agreement within the next few days on a fivefold increase in the capitalization of the International Finance Corporation. This general increase -- the first since IFC was founded in 1956 -- will permit substantial additional capital assistance to private firms in Asia. With an increase in capital, the IFC can play an even more important role than in the past in helping to build a strong private sector which is essential to economic growth in developing countries.

The Role of the International Development Banks

The international development banks remain the primary multilateral source of capital for long-term economic growth. These banks last year made new commitments of $8.5 billion for nearly 400 projects in over 80 countries. However, economic development is not primarily a matter of money. While money is needed, the key factors determining the success of development efforts are the policies and priorities followed by each country. The development banks make important contributions in precisely such areas, and in institution building. In recent years the banks have accelerated the process of spreading development benefits to the poorer people by placing greater emphasis on agriculture, the family farm, and cooperatives -- an emphasis we encourage and support. The regional banks in particular have an important role to play, because they reflect the desires and needs of their regional members and have an expertise and understanding of local conditions and problems.

Role of ADB

The role of the ADB is to bring its special expertise and local knowledge to the development problems of Asia. The Bank has done this well, due in large part to the leadership of President Inoue. I would like to take this occasion to express my country's appreciation for his dedicated service to the Bank.

The Bank's growing impact on Asian economic progress is reflected in its activities last year:

-- Lending for agriculture and agro-industry was over 37% of total ADB/ADF lending in 1975 compared with 24.5% in 1974; we believe the 1975 proportion is about the right emphasis on agriculture.

-- The Bank has given greater emphasis to the use of intermediate technology in Bank-financed projects. Recognizing that traditional capital-intensive projects are often neither the most cost effective nor the most appropriate, the Bank has focused attention on the basic use of labor, combined with less capital intensive technology, by supplying labor with appropriate tools -- be it a wheelbarrow, a 4 or 5 horsepower hand tiller, or a hand operated water pump. In this way the Bank is able to make use of idle manpower in its developing member countries and at the same time, spread its limited resources such that it reaches many more people. We hope the Bank will greatly expand its use of appropriate intermediate technology in the future.

-- The Bank also deserves credit for its efforts to mobilize co-financing for development projects. The Bank's cooperation with OPEC nations in financing fertilizer projects is well known. Co-financing in cooperation with private banks and other private financial institutions has the potential to be a major source of development finance. Such arrangements increase private sector involvement in the development process and stretch the Bank's scarce resources. We congratulate the Bank on opening a a new horizon through the recent water supply loan to Singapore in which the ADB arranged co-financing with a private financial institution. We hope there will soon be many such loans involving co-financing. Such arrangements also help to introduce developing countries to the international capital market and thereby initiate the process of establishing on-going financial relations for further access to private financial markets. Through the mechanism of co-financing, smaller banks and other financial institutions may also begin to lend to developing nations by benefiting from the project appraisals carried out by the development banks.

-- In order to maximize the development impact of ADB operations, we continue to believe that it should reduce its financing of cost overruns. The Bank should use its financial and human resources to develop new projects, instead of allocating additional scarce resources to projects already underway.

With the rapid growth in lending from $254 million in 1971 to $660 million in 1975 it would be prudent in the period immediately ahead for the Bank to concentrate on improving the quality of new loans and on continuing to seek more effective implementation of loans underway. To further this effort, the Bank must work toward a system of more intensive project supervision. As the Bank becomes stronger it should also become more active in the difficult sectors where innovative lending is needed -- such as in rural development and other projects to reach lower income groups.

Another area to consider should be equity investments by the Bank in productive, employment-creating enterprises. Such investments could encourage policies and institutions which would further promote and broaden participation in the development process. The Articles of Agreement of the Bank authorize the Bank to make equity investments. I would urge that the Bank actively study how it might make equity investments and that the Board of Directors consider the matter in the near future.

To finance its rapidly rising disbursements on loans the Bank borrowed more in 1975 than in all previous years combined. In 1976 it has already borrowed more than in all of 1975. However, much of the Bank's borrowing is still relatively short-term in comparison with the maturities of its lending. Greater effort may be needed to increase the average maturity of the Bank's borrowing. The confidence the markets are now showing in Bank obligations suggests that longer terms are becoming feasible.

During the past year there appear to have been more interruptions in meeting financial obligations to the ADB and the proportion of Asian Development Fund resources tied up in inactive loans has increased. My government feels that the Bank should exercise its normal responsibility by taking action to collect amounts due and to assure that funds which are not being used are reprogrammed where appropriate so that the 1976 ADF program can be implemented to the maximum extent possible.

U.S. Support for the ADB

Speaking for my Government, I want to emphasize that the Administration will continue its strong support for the ADB. Subject to final Congressional action we will soon subscribe our second installment of $120.6 million to the first replenishment of the Bank's ordinary capital and make a further contribution of $25 million to the initial resource mobilization of the ADF. I hope we will complete this financing commitment to ADF and also subscribe to the remainder of our share of the capital increase by October or November after approval of our FY-77 budget.

The United States supports the replenishment of the ADF. I would hope shortly to be able to announce a U.S. contribution target for the replenishment which will be higher than our previous contribution.

The United States also supports a replenishment of the Bank's ordinary capital. We believe that in laying out the criteria for replenishment it is appropriate for the Bank to review its lending, borrowing and financial policies. The ADB is entering a stage of rapidly increasing loan disbursement and borrowing requirements. It is a period when the ADB must move from financing its loans from paid-in capital to relying primarily on private capital markets.

The increased reliance of the Bank on private capital markets, in turn, makes it all the more important for the Bank to maintain a solid financial position. An improvement in its financial indicators and its general creditworthiness will reduce the cost of money to the Bank and help lengthen the maturities of its issues. The Bank's financial position could be strengthened by some modifications in various ADB financial policies. This is important because bond purchasers will look not only at the degree of governmental support for the Bank, whether through paid-in or callable capital, but also at the financial operations and management of the Bank itself. In this regard I note with concern that the Bank's income in 1975 did not increase from the level in 1974, even though the scale of the Bank's operations increased substantially. The Bank's financial statements for 1975 indicate that this was due to sharply increased borrowing and administrative costs, changes in currency values, and increased funding of grant technical assistance.

Specific policies which we believe are necessary to improve the financial strength of the Bank include: (1) that the Bank's lending rate more fully cover the costs of its borrowings and operations, (2) that the effective commitment fee charged on undisbursed loans more closely parallel the practices in the other international development banks, (3) that the Bank make efforts to find ways other than use of Bank income to fund grant technical assistance, and (4) that the Bank restain the growth of administrative expenses.

Our goal, and the goal of all friends of the Bank is a financially viable and strong regional institution that is secure in international capital markets, requiring decreasing amounts of paid-in capital, and building reserves sufficient to set aside portions to help finance ADF operations. It is our hope these can be achieved over the course of the next few years.

Before I close I want to express our great appreciation to the Government of Indonesia for hosting this Ninth Annual Meeting of the Asian Development Bank. We have looked forward to visiting this dynamic and growing city of Jakarta and to this opportunity to discuss the challenges and opportunities facing Asia and the ADB.

In closing, I think it is worth remembering that the fundamental purpose of the ADB, and of all the development lending institutions, is to help the people in developing countries improve their living conditions. The basic justification for U.S. support of the ADB and of the other development banks has to be that they do a good job in using money to help the developing countries help themselves and that this development reaches the people in these countries in a way that justifies U.S. taxpayer support. The practical effects of our contribution will be spread to the poorest villages, slums, and isolated areas in Asia where little is known of the United States or the ADB, but where improved seed, a well, a visiting health team, availability of credit, or a road to the market can make -- at small cost -- an immense difference in the quality of life.

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FOR RELEASE UPON DELIVERY

STATEMENT BY THE HONORABLE GERALD L. PARSKY
ASSISTANT SECRETARY OF THE TREASURY

BEFORE THE
SUBCOMMITTEES ON

INTERNATIONAL RESOURCES, FOOD AND ENERGY;
INTERNATIONAL ECONOMIC POLICY;
INTERNATIONAL ORGANIZATIONS;
AND INTERNATIONAL TRADE AND COMMERCE
OF THE HOUSE COMMITTEE ON INTERNATIONAL RELATIONS

WASHINGTON, D.C.
MONDAY, APRIL 26, 1976, AT 3:30 P.M.

UNCTAD IV: THE U.S. APPROACH TO CURRENT ECONOMIC ISSUES

Mr. Chairman, members of the Committee, I welcome this opportunity to discuss the range of international economic issues that will be the subject of intense debate and negotiations during the fourth session of the United Nations Conference on Trade and Development (UNCTAD IV).

We approach this meeting sympathetic with the aspirations of the developing countries. We want to work with them in seeking practical, realistic solutions to their problems.

Although each country is different, presenting unique problems which require individual solutions, there are certain needs that are shared and in turn there are certain priciples which should apply to all.

All of the developing countries want to improve the economic conditions of their peoples, and they want the help of the developed countries in undertaking this effort. We wish to see the growth and stability of the economies of these countries. It is clear to us all that this world cannot indefinitely endure half rich and half poor. The United States has played, and must continue to play a leadership role. We have given significantly of our resources, both financial and human, to help in this process, and we will continue to do so. I believe the basic question is not one of commitment to help, but rather one of process. How can we best get the job done? As such, I believe there are several basic principles that we should bear in mind:

-- A country's economic growth rate will be determined by the skill with which it utilizes its own resources, not its status as an industrial or less developed country. Foreign aid can make an important contribution to development, but what developing countries do for themselves will determine how they will grow.

-- Investment is the central propellant behind economic development. While we must be sensitive to the need to provide direct aid to those who face drastic immediate problems, over the long run the best way to assist developing countries significantly is by helping them to create a better climate for increased investment in their country. We must keep this goal in mind when initiating new programs of bilateral and multilateral assistance.

-- The development of a strong private sector is essential. In the United States and other industrial countries, the private sector has the technology and management expertise to help developing countries. We must not adopt policies that will undermine maximum use of this sector.

-- The free market may not be perfect but no other system has been devised which will increase production, improve efficiency and stimulate growth in a better way. Our efforts should be aimed at helping other countries improve conditions for the better operation of the market system by removing government controls. We must resist the erection of additional impediments to market forces.

With these principles in mind, I believe the United States must continue to lead others away from political rhetoric to practical solutions. Simplistic analysis and overstatement, no matter how well intended, will simply not help move us forward. I do not believe that calls for controlled commodity markets, massive transfers of resources, and wholesale debt rescheduling or moratoria are either realistic, or indeed necessary.

As we approach the problems of the developing countries, we must not let the emotions of the international political arena distort the economic realities. For example, some have expressed the view that "all of the developing countries" are facing disastrous balance of payments difficulties requiring blanket solutions by the developed countries. The recent world-wide recession has certainly impacted the developing countries severely, but they are not all teetering on the brink of economic disaster, nor do they all share the same problems. In fact, although a large number of developing countries have been experiencing abnormally large current account deficits as the result of the increased prices of their oil imports and weakened export markets, the deficits have been financed without disrupting existing institutional arrangements. A number of developing countries have proven creditworthy for substantial borrowings of private capital, while other countries have benefitted from increased aid flows. There is reason to be optimistic that financing will again be adequate in 1976, particularly in view of lower requirements as a result of increased exports and the new resources provided for by the Jamaica meetings. Some individual developing countries will encounter particularly difficult problems meeting their balance of payments financing requirements, and we must find ways to properly assist them, but we do not believe that this will be a general problem requiring blanket solutions.

This brief discussion of the realities of the LDC balance of payments situation is only meant to illustrate the dangers of oversimplification, and I will more thoroughly discuss this issue later. But I want to make clear that we have attempted to shape our policies and proposals on an objective analysis of the realities of the economic situations of the individual developing countries, not on the basis of misleading generalities that could result in inappropriate, even harmful solutions.

UNCTAD IV in Perspective

Before turning to the specific issues which will arise at UNCTAD IV, let me briefly review the events leading up to this Conference. The past two years have seen a considerable change in the relations between the developed and developing world. In 1974, elements of confrontation dominated the scene and certain relations became strained, as the LDCs put forward their initial proposals for a "New International Economic Order," which was elaborated in the Charter of Economic Rights and Duties of States adopted in December 1974, over the strong opposition, and negative votes, of the U.S. and several other industrial countries.

Such an atmosphere was truly counterproductive for all, and in 1975 there was a major change in our relations with the developing world. At the Seventh Special Session of the United Nations last September, Secretary Kissinger put forth a broad range of positive proposals and consensus was reached on an approach to a number of major economic issues that will be dealt with at UNCTAD IV. Agreement was also reached last fall to begin a serious dialogue between the Western industrial nations, the oil-producing developing countries, and the oil-importing developing countries at the Conference on International Economic Cooperation (CIEC).

The CIEC has resulted in an unparalleled, intense dialogue between the developed and developing world. Representatives from eight industrialized and nineteen OPEC and non-oil developing nations are meeting each month in Paris in the four commissions on energy, raw materials, development, and financial affairs which form the CIEC.

UNCTAD IV will be another important part of this dialogue. This meeting, which brings together almost all countries, including socialist states, will help determine whether or not the North and South can continue a serious joint effort to identify and solve problems relating to our economic relations and avoid the nonproductive confrontation of the past.

A broad range of vitally important issues will be discussed at UNCTAD IV, including commodities, trade, debt, official development assistance, transfer of technology, and the future role of UNCTAD. A primary focus, will certainly be on commodities, where UNCTAD advocates an "Integrated Program" that includes many features we find unacceptable, and on the financing problems of the developing countries, where UNCTAD seeks generalized relief measures.

I would now like to describe our approach to these two important areas, as well as the other important issues with which UNCTAD IV will be concerned.

Commodities

We expect that the commodities issue will be one of the most important issues at UNCTAD IV.

It's difficult to predict precisely what the developing countries really want, but if we look at the Manila Declaration formulated last February and the UNCTAD Secretariat's documentation for UNCTAD IV, I think we can get a pretty good idea. It would appear that they are seeking endorsement of a so-called "Integrated Program" -- a series of simultaneously negotiated commodity agreements which would use buffer stocks as a price regulating mechanism. The buffer stocks would be financed by a Common Fund, which would at the outset command about $3 billion in resources, with $1 billion from governments, of which UNCTAD suggests roughly ten percent be contributed by the U.S. In addition, the LDCs want prices of their raw materials to be indexed to the prices of manufactured goods, they want the availability and concessionality of compensatory finance improved, and they are anxious to improve their access to developed country markets for raw materials and processed and semi-processed goods.

The most controversial aspect of the UNCTAD commodity program is the Integrated Program and its central mechanism, the Common Fund. The UNCTAD Secretariat and many developing countries appear to be seeking at UNCTAD IV an agreement with the developed countries to:

-- hold a series of individual commodity negotiations between producers and consumers which would lead to commodity agreements for those commodities. At a minimum UNCTAD would hope to get such negotiations underway for a "core" of ten products, including cocoa, copper, cotton, hard fibers, iron ore, jute, rubber, sugar, tea, tin.

-- agree in principle to the creation of a Common Fund and establish a negotiating conference to determine the precise structure and modalities of such a fund.

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The Common Fund is the glue which holds the Integrated Program together. It is intended to be more than a buffer stock financing mechanism. UNCTAD hopes that such an institution would actively perform the role of a catalytic agent to prod producers and consumers to agree on specific commodity agreements. UNCTAD envisages that producers in particular would be stimulated by the availability of funding for buffer stocks to overcome their own differences and push hard for an agreement.

The United States has made clear in the past that we cannot endorse this aspect of the UNCTAD approach to commodity problems, and we will do so again at UNCTAD IV. We do not believe that a generalized commitment can be made to form commodity agreements, particularly agreements based on a specific market intervention mechanism such as a buffer stock. We believe that each commodity has its own unique characteristics of production, transport, storability, marketing, and consumption, and thus that commodity problems can only be dealt with on a case by case basis.

We will also not support the concept of a Common Fund for buffer stocks, particularly as a new independent international institution which would play an activist role in attempting to form agreements for individual commodities.

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While we generally believe buffer stocks to be a price stabilization technique that is preferable to alternative market intervention devices such as export controls, which may build rigidities into the market, the applicability of buffer stocks must be determined only on a case by case basis. We have carefully reviewed the ten commodities which UNCTAD has proposed as the core of its Integrated Program and we are skeptical of the viability or utility of buffer stocks as a stabilizing tool for most of those products.

We also believe that the appropriate method and sources of financing to support the mechanisms of a commodity agreement must vary with the circumstances of each commodity. These methods might include such techniques as commercial borrowing, direct contributions by participants, export taxes, or loans from existing international institutions. If there is sufficient consensus among major producers and consumers of a given commodity that an agreement is necessary, and agreement is also reached that a buffer stock is the appropriate technique to stabilize prices for that commodity, we are willing to support a variety of different avenues of financing the stock, but although we cannot support aspects of the "Integrated Program" nor the Common Fund, we do believe that a positive approach to commodity problems is needed. It's for this reason that over the past year and a half we have conducted an intense review of

U.S. commodity policy. We created an interagency Commodity Policy Coordinating Committee, reporting directly to the Economic Policy Board and the National Security Council, to undertake this task. Through this mechanism, the U.S. has reviewed the UNCTAD proposals and formulated our own comprehensive approach.

In this review, we have found that we could support a number of the objectives the UNCTAD program is intended to achieve. These would include a reduction in excessive fluctuations in prices and supplies; the expansion of efficient processing of primary commodities and diversification of productive capacity in developing countries; increased stability in developing countries' export earnings; and a lowering of trade barriers against processed and semiprocessed forms of raw materials.

We believe the best means to accomplish these goals, however, are different from the UNCTAD approach. It is our firm conviction that the market mechanism is on the whole the most efficient method of assuring that supply and demand of commodities are kept in balance in a dynamic world. Although markets do not always operate efficiently, the appropriate remedy is to strengthen their functioning, not intervene or further impede market operations.

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At UNCTAD IV the U.S. will stress its own proposals in the commodity field:

-- We believe that the most fundamental solution to problems of wide swings in export earnings as a result of changes in prices and demand for commodities is to be found in compensatory finance. The recent reform of the IMF compensatory finance facility, in line with U.S. recommendations at the Seventh Special Session, provides very substantial additional balance of payments support to those developing countries that experience fluctuations in their export earnings, while avoiding direct intervention in commodity markets. We have also proposed to broaden the proposed Trust Fund to include additional compensatory financing to developing countries that are particularly dependent on commodity exports, where there is a balance of payments need. A decision on this proposal depends on the creation of the Trust Fund and some experience with its operations.

-- Commodity problems should be analyzed on a case by case basis in forums composed of interested producers and consumers. Where specific problems are identified, we will examine proposed solutions and make suggestions of our own. Those proposed solutions may range from research and development measures to promote consumption and improve market distribution systems and production efficiency, to the creation of buffer stocks to stabilize prices and enhance supply security. In most cases, we believe that commodity problems will best be solved through strengthening the market mechanism, not by circumventing or thwarting it.

-- We support the creation of producer-consumer groups for all major traded commodities where these do not now exist. We will seriously study specific commodity problems in such forums in order to improve the operation of markets in those commodities. We are moving toward such a forum for copper and we are willing to look at others such as bauxite or iron ore.

-- We continue to be concerned that the investment climate in many developing countries may result in discouraging needed investment altogether or in forcing investment in less productive, but safer locations in developed countries. We have urged that the World Bank Group increase its role in raw materials investment by combining its resources and technical expertise with those of the private sector. We are also discussing the possibility of proposing the creation of a new investment institution which could be associated with the World Bank to promote such investment.

In this way, we believe the U.S. has a positive, comprehensive, and workable program to deal with commodity issues. We believe the solutions we propose meet the real needs of the developing countries. We hope that all participants in UNCTAD IV will maintain a constructive and realistic attitude in the commodity discussions, and that agreement will be reached on a realistic, viable program for further action in this field.

Development Issues:

Aside from commodity issues, the other major concern at UNCTAD IV will involve problems of developing country finance, particularly debt. Before discussing this issue in depth, however, I would like to make some observations on development issues in general, as debt is only one aspect of the larger question of how developing countries obtain the external resources they need for development purposes.

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Development is a process requiring the infusion of capital, technology, and management skills on a sustained and substantial scale. While we believe that the developing country itself is the main source for most of these resources and must therefore make the effort necessary to hold down present consumption in the interest of higher living standards in the future, international support is also indispensable.

At UNCTAD IV, the most sensitive issue related to the general question of aid flows is expected to be the demand by developing countries that the industrial countries increase their concessionary aid flows in order to achieve the so called UN Second Development Decade target of 0.7% of GNP. This compares with actual aid flows from industrial countries of 0.33% of GNP in 1974, the latest year for which such data are available.

The U.S. supports a substantial increase in such flows to the developing countries and has been increasing its own development assistance. We do not however, support the .7% target -- which is clearly unrealistic for the U.S., since it would require over $11 billion annually in bilateral aid, as compared with the $3.4 billion (0.25% of GNP) provided in 1974. A number of DAC countries have accepted the target in principle but only seven have committed themselves to achieve the target by 1980. Sweden actually achieved 0.7% in 1974 -- the first DAC country to do so.

Concessionary aid flows are important for development of poorer countries, but not as important for the other developing countries as export promotion and other types of capital flows. For this reason, the U.S. made a number of initiatives at the UN Seventh Special Session last fall in the areas of capital market access, transfer of technology, and direct investment.

Private capital markets are already a major source of development funds, either directly or through intermediaries. The World Bank and regional development banks borrow extensively to lend to developing countries. We have requests before Congress or will soon be making requests to expand the callable capital of several of these institutions. As you know, such capital serves to guarantee IFI borrowings in the private markets.

The more successful developing countries are the ones that rely heavily on borrowing in private capital markets. It is estimated that the developing countries borrowed roughly $10 billion from private sector sources in 1975, mainly in the form of commercial bank lending. The U.S. has, therefore:

-- Contributed actively to the work of the IMF/IBRD Development Committee to explore ways to improve access for developing countries.

-- Supported a major expansion of the resources of the IFC -- the World Bank affiliated investment broker with the widest experience in supporting private enterprise in developing countries.

-- Proposed creation of an International Investment Trust to mobilize portfolio capital for investment in local enterprises.

-- Reviewed our own conditions for LDC access to our capital markets and developed a technical assistance program within AID to facilitate LDC knowledge of and access to the U.S. capital market.

The other two areas of concern -- transfer of technology and private investment -- are closely related. Technology is vital to development, and international transfer of technology to the developing countries is necessary in view of the cost and skills required to develop it. Private investment is an important source of technology, as well as a source of managerial talent and capital.

Among the initiatives we have supported in these areas are:

- -- An International Industrialization Institute, to sponsor and conduct research on industrial technology.
- -- An International Center for the Exchange of Technological Information.
- -- Voluntary and non-binding guidelines for technology transfer to guide governments and enterprises in this area, including the element of restrictive business practices.
- -- A voluntary and non-binding code of conduct for multinational corporations to improve the understanding of all parties regarding their mutual obligations.

We believe that the U.S. is in a position to play a very forthcoming and constructive role at UNCTAD IV in these three areas vital to the development of developing countries -- capital market access, technology, and investment.

The Financing Difficulties of Developing Countries

Having briefly covered general development issues, including the various proposals the U.S. has made to deal with the development needs of the developing countries, let me turn to the finance question in greater detail, with particular attention to debt. UNCTAD IV comes at a period after the non-oil exporting developing countries have experienced two years of abnormally large balance of payments deficits as the result of increased oil prices, the accompanying recession in the industrial countries, and world wide inflation. Deficits on current account, which had averaged $9 billion annually in the early 1970's, jumped to $28 billion in 1974 and an estimated $35-37 billion in 1975. These increased deficits have been largely financed by borrowings which of course will increase debt service payments in future years.

Because of these circumstances, many of the developing countries have focused all their attention on debt; whereas we believe that the primary issue is really the balance of payments. In this regard, we believe that the balance of payments situation for the developing countries as a whole is beginning to improve. We project that the aggregate deficit of the non-oil developing countries will decline by perhaps $5 billion in 1976, and that as a result new external borrowing will also decline.

Projections of debt servicing prospects are difficult, particularly in view of the wide diversity of debt situations and the fact that the capacity of individual countries to respond to debt problems varies widely. It should be noted that a relatively small number of countries account for the bulk of the debt and, in particular, of the borrowings on commercial terms. Furthermore, the poorer developing countries most affected by recent economic events cannot resort to private market borrowings to offset the higher prices of oil and other imports and have to depend upon concessional capital. In view of low interest rates and grace periods, such capital has a limited impact on debt servicing, particularly in the short run.

Debt servicing is only one of the elements of the balance of payments problems, but of course any sustained deterioration in a country's balance of payments position makes debt service more difficult. It is encouraging, therefore, that improvement in the current account positions of developing countries is anticipated as the pace of recovery quickens in the industrial world and commodity exports and prices increase. Despite this, many countries see no way to finance their desired development programs without substantial further borrowings over the next several years.

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This situation has led the developing countries, with the strong backing of the UNCTAD Secretariat, to set forth a number of sweeping proposals to alleviate their internal debt situation. These proposals are based on the premise that debt rescheduling would provide fast-acting relief for their balance of payments situation and supplement what they consider to be inadequate flows of development assistance. The proposals include:

For public development credits:

-- Waiving debt service payments by the most-seriously-affected countries for the remainder of the decade; and

-- Converting such credits to grants for the least developed countries.

For private credits:

-- An international fund to refinance service payments over a period of 15-25 years at commercial rates of interest.

In addition:

-- A conference of major developed creditors and interested debtor countries to be convened in 1976 under UNCTAD auspices.

-- A shift in the forum and chairmanship for debt rescheduling from the traditional creditor club arrangements to the IMF.

The United States is deeply sympathetic with the balance of payments position of the non-oil developing countries and, together with other creditor countries, has taken a number of steps to make available funds supplemental to normal aid flows to meet the financial strain of the developing countries erected by the oil price increase and the onset of world-wide recession. The United States will continue its efforts in cooperation with other creditor nations to increase and direct aid flows to those countries in greatest need and to improve the access of developing countries to private capital markets. However, we cannot agree to proposals for generalized debt relief, debt moratorium, and new institutions for refinancing commercial debt and the like for a number of reasons:

-- The proposals assume there is a debt problem _per se_ for all non-oil developing countries; we believe that focusing on debt alone obscures the overall balance of payments situation, which for many countries is improving.

-- The proposals assume that all non-oil developing countries or groups of non-oil developing countries are encountering extreme problems in meeting their debt service payments; we believe that debt service problems are limited to very few countries.

-- The proposals assume that financing through debt rescheduling should be based on the amount of past debt or debt service payments incurred. We believe finance needs must be evaluated on a case by case basis, taking into account a country's present circumstances and future prospects.

-- The proposals assume that commercial credit can be rolled over for extended periods of time; we believe that commercial institutions cannot be relied upon to provide increasing amounts of private capital if the ultimate timing of repayment is continually subject to question.

-- They assume that proposals for debt relief can be undertaken without any adverse effects on developing country creditworthiness and new capital flows; we believe rescheduling adversely affects developing countries creditworthiness and new capital flows.

In short, we believe that adoption of these proposals could lead to a severe deterioration in international credit relationships. We strongly believe that these proposals are not in the best interest of the debtor countries because they will destroy their creditworthiness and the ability to borrow from public and private sources in the future.

With regard to institutional arrangements for debt rescheduling, the United States is willing to recommend that the IMF play a greater role analyzing technical issues related to rescheduling exercises than it has in the past. That would be in addition to its traditional task of negotiating standby agreements that give the creditors some assurance that the country requesting debt rescheduling will follow policies that will turn its economic situation around.

However, we firmly believe that actual negotiations to reschedule a country's external debts should remain in the creditor club context. A debt rescheduling is a very delicate process. Debtors want a lenient rescheduling; creditors wish to be repaid as soon as possible. To shift the forum and chair from the creditor club arrangement -- which has served both debtor and creditor countries well over the years through a series of extremely difficult debt rescheduling exercises -- to the IMF, would expose the IMF to the conflicting views of debtor and creditor countries and thereby threaten to undermine the basis of its neutrality which is of paramount importance to the continued success of the Fund.

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It could also lead to pressures to reschedule IMF drawings, thereby undermining the monetary character of the Fund.

We have recently appraised the nature and extent of the external debt situation of the developing countries, and have found the external debt situation of the great majority of non-oil developing countries to be manageable. The details of these findings were contained in our "Report on Developing Countries External Debt Relief Provided by the United States", submitted by Secretary Simon to this committee on January 30, 1976. Since the report was prepared, the economic situation in several of the countries has improved. Thus, for example, some countries, such as Bolivia, Peru and Uruguay, now appear in a more favorable light, due to the rise in economic activity of OECD countries and higher commodity and metal prices. Countries such as Chile and Zambia, which rely heavily on copper exports for foreign exchange earnings, now face a somewhat more manageable situation, as the price of copper has risen from 55 cents a pound in early January of this year to close to 70 cents. As for countries such as Brazil and Mexico, which the report noted have large private sector debts but also have productive and diversified economies, the anticipated strong pick-up in their exports to developed countries reinforces our earlier conclusion that they will be able to finance their projected deficits and avoid debt servicing difficulties in 1976.

As for the most seriously affected (MSA) countries, it is significant to note that two MSAs, India and Pakistan, account for over one-half of the debt service of all MSAs. It is our perception that the economies of both India and Pakistan are performing much better than most people realize.

For example, India is expected to attain a real growth rate on the order of 5 - 6 percent this year and next, and its trade deficit should narrow somewhat next year. India's international reserves have increased from $1.4 billion in December 1975 to over $2 billion in March. This amount is sufficient to cover about 5 months' imports which is quite good for a developing country. Pakistan's growth rate is also projected at about 5 percent, its reserves are sufficient to cover almost three months' imports, and Pakistan will continue to benefit through at least 1978 from the debt rescheduling arrangement of 1974.

As for the other MSAs, the picture is mixed. Some countries, such as Bangladesh, have contracted large amounts of external debt mainly from multilateral and bilateral institutions. Since most of these credits carry extremely low interest rates, the actual debt service payments falling due this year and next are relatively small.

To conclude, U.S. policy has been, and will continue to be, to extend credit on the explicit understanding that it will be repaid according to the schedule agreed upon

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by the borrower at the time the credit is authorized and signed. The U.S. does not consider general debt relief to be appropriate for providing official economic assistance to the developing countries.

Our policy on debt rescheduling is to evaluate the merits of each debt reorganization proposal on a case-by-case basis, predicated on the principle of basic adherence to scheduled terms of credit payment. Within this framework, our objective is to encourage countries to undertake appropriate corrective policies in order to minimize the incidence of debt rescheduling and relief operations.

Monetary Issues

In view of the comprehensive monetary reform package that was agreed at Jamaica, I would not anticipate extended debate on longstanding proposals by developing countries to restructure the monetary system or an effort to re-open a settled agreement. While some may feel that the reforms do not go far enough, I believe that most recognize that the package as a whole -- involving important amendments to the IMF Articles of Agreement, quota increases, and expansion of access to IMF resources -- achieves the desired balance and provides substantial benefits for all countries. Without attempting to comment in depth on all the complex provisions of the agreement, I would like to note the most significant elements.

-- The new more flexible exchange arrangements focus on achieving the underlying economic stability that is a prerequisite for true exchange rate stability. Countries are given wide latitude in choosing those particular exchange rate practices best suited to their own needs so long as they fulfill certain obligations calling for, among other things, the promotion of stable underlying economic conditions and non-manipulation of exchange rates to gain unfair competitive advantage. Past efforts to mandate stability by requiring maintenance of fixed rates provided only the appearance of stability and often required extensive controls and restrictions to sustain them. Such measures disrupted development efforts by impeding trade, limiting investment flows and forcing cut-backs in aid.

-- Concrete steps have been initiated to phase gold out of a central role in the monetary system. The IMF Articles will be amended to eliminate any important monetary role for gold in the Fund and to provide for the future disposition of IMF gold holdings. In addition, the IMF will begin disposal, under existing authority, of 50 million ounces of gold owned by the Fund (about one-third of its total holdings), 25 million ounces to be sold for the benefit of developing countries -- I already mentioned the

Trust Fund -- and 25 million ounces to be sold to IMF members in proportion to quotas. The developing countries will clearly obtain substantial benefits from these steps, including the major share of the benefits from the agreed Fund gold sales. I am aware of some concerns of developing countries that abolition of the official price might result in a strengthened role for gold and in increases in liquidity primarily for developed countries. I do not believe these concerns are warranted. The comprehensive actions being taken genuinely place gold on a one-way street out of the monetary system.

-- The SDR will be made a more usable asset under the amendments, thereby increasing its potential to become the principal reserve asset in the system, a long-sought objective of the developing countries. Proposals for an SDR-aid link were dropped from the monetary negotiations at an early stage of the Interim Committee discussions, and the U.S. will continue to oppose an SDR-aid link should the proposals resurface in UNCTAD. The link would be an inappropriate means of providing aid and is inconsistent with the monetary functions of the SDR.

-- In addition to amendments, IMF quotas will be increased by about one-third, thus ensuring that the Fund is in a position to meet members' future financing needs.

The quota share, and thus the voting share, of developing countries has also been increased, thereby enhancing their voice in IMF decision-making.

Monetary issues raised at UNCTAD IV may be introduced in the context of the effort to find international financing to meet the balance of payments problems of developing countries. Thus there may be efforts to use the IMF for this purpose.

The Fund is the sole international institution with responsibility for promoting the needed economic adjustments that represent the only lasting solution to a country's payments difficulties. The importance of IMF financing therefore transcends the actual amounts involved, crucial as they may often be, because it is closely linked to adoption of economic policies designed to correct the underlying cause of countries' problems.

The IMF has greatly expanded access to its resources to help meet the enlarged balance of payments financing needs of its members in the present period. In the past year, developing countries have borrowed nearly $2-1/2 billion from the IMF, nearly four times the peak annual drawings prior to the oil price rise. And, with agreement on acomprehensive monetary package in Jamaica in January the Fund's capacity to deal with members' payments problems has been strengthened importantly.

-- A Trust Fund managed by the IMF as trustee will be established and begin operations in the very near future to provide balance of payments support on concessional terms for the poorest countries. Resources will be obtained by utilizing part of the gold owned by the IMF, through market sales over a four year period. Thus an asset which has not been used in recent years will be mobilized to assist needy countries in meeting their current balance of payments difficulties. Other financial contributions to the Trust Fund will be welcomed.

-- A major liberalization of the IMF Compensatory Financing Facility has been implemented that will be expecially useful in dealing with payments problems in this period of recession-induced fall-off in export earnings. It is noteworthy that in the first quarter of this year, the liberalized facility has already provided nearly $500 million in loans, an amount that is more than 40 percent above the previous peak annual level of loans.

-- Access to the IMF's regular credit facilities has been temporarily expanded by 45 percent, pending implementation of the agreed increase in quotas.

-- The IMF Buffer Stock Facility has also been liberalized.

These measures represent a vigorous effort by the

IMF to help its members, developed and developing, to deal with their immediate financing problems. They also represent a reasoned response, and we do not feel it is desirable, indeed possible, for the IMF to attempt to do more. It is clear that the IMF cannot meet all the financing needs of the developing countries and that its design, as a monetary institution, is inappropriate to meeting development financing requirements. The resources available to the IMF are finite, and steps to increase access further could seriously impair the Fund's liquidity, to the detriment of developed and developing countries alike.

A major strength of the IMF, and the basis of its international prestige and support, is its unique monetary character. The private markets frequently rely on the Fund's "discipline" to ensure that countries experiencing balance of payments problems adopt the sound domestic policies that are the essential prerequisites for maintenance of credit-worthiness. The policy conditions applied by the IMF thus provide an important safeguard for private lenders, in that they know IMF involvement will entail the adoption of policies by borrowers that will strengthen their external positions and enable them to repay their loans. Should the market's perception.of this role for the IMF be weakened by an erosion of IMF conditionality, it is quite possible that a resulting reduction in private credit availability would more than offset any potential increase in IMF financing. This is one of the basic reasons why we cannot support a further allocation of SDR's according to the principle of an aid-SDR link. A further weakening of conditionality would seriously disrupt the flow of private credit to the developing countries, and make achievement of their development objectives even more difficult.

Trade

Although noncommodity trade issues will not be a central theme at UNCTAD IV, some developing countries may seek greater commitments from the developed countries on special and differential treatment in the Multilateral Trade Negotiations and for improvements on the various systems of tariff preferences now in existence.

The developing countries are impatient over progress in the MTN, and have argued that little progress has been made toward granting them the kind of special trade treatment suggested in the Tokyo Declaration of 1973, which launched the current negotiations in Geneva. They are particularly interested in being exempted from limitations on the use of export subsidies and in receiving special treatment or exemptions in safeguard actions, such as the recent U.S. escape clause actions on specialty steel and footwear.

They are interested in rapid action on the tropical products negotiations in Geneva.

We are sympathetic with interests of developing countries in securing additional benefits for their international trade, in increasing their foreign exchange earnings, diversifying their exports, and accelerating the growth of their trade. The MTN will provide great benefits to the developing countries. The tariff cutting formula we have introduced will help the LDCs by increasing their general access to the U.S. market, and by reducing the degree of tariff escalation on semi-processed and processed products. The U.S. has made a sound proposal in the tropical products negotiations, and we too hope for rapid progress. We do believe that some kind of special and differential treatment for developing countries will prove feasible in certain areas of the MTN, such as negotiation of general rules on subsidies and countervailing. However, we believe that the issue of special and differential treatment for developing countries can only be dealt with in the context of particular codes on other specific areas being negotiated, and cannot be moved at a faster pace than the discussions on these issues.

We will also stress at UNCTAD IV, as we have in the MTN, that the developing countries themselves can and must make contributions to the MTN, consistent with their levels of development. This issue of supply access is a case in point. Furthermore, we believe that special treatment for developing countries must be linked with a phase-out mechanism, so that as a developing country becomes more advanced and competitive on the world market, its special treatment will be phased out and it will begin to assume the same responsibilities as other developed members of the world trade community.

As for generalized systems of preferences, the developing countries would like to see these systems made a permanent part of the world trading system and considerably liberalized. We believe that as preferences are unilateral voluntary actions by the developed countries, they are not subject to negotiations, either in UNCTAD or at the MTN. We believe the new U.S. system is a good one, and as we gain experience with it we will examine possibilites of improving it. While we will certainly listen to the suggestions of others as to what improvements might be useful, actual decisions are strictly an internal U.S. government affair.

Conclusion

I hope that my testimony has made clear that the U.S. government has expended a great deal of effort in carefully analyzing the problems identified by UNCTAD and the solutions proposed by the Secretariat and by developing countries. It should be clear that we believe that today's world calls for cooperation among countries. In that regard we feel that we can agree with much of the articulation of the problems and long-range goals identified by UNCTAD and the developing countries. There are differences of opinion with respect to the solutions to these problems. We will not reject any proposed solutions out of hand, but explain why we do not believe certain approaches would be in the interest of the world. Further we have developed proposals of our own which we believe will accomplish the same objectives more effectively. It will be our task at Nairobi to lay these various proposals on the table and begin the process of arriving at a consensus on where to go next. If 1976 can be characterized as a year of dialogue, perhaps the work accomplished over the next months will make 1977 the year of consensus.

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ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SENATE FOREIGN RELATIONS COMMITTEE
APRIL 27, 1976 at 10:00 A.M.

I welcome this opportunity to appear before your Committee this morning in support of S. 3103, which would authorize a U.S. contribution of $50 million to the Asian Development Fund (ADF), the concessionary lending facility of the Asian Development Bank (ADB). It is contemplated that this amount, which has been included in the 1977 budget, would be the first installment of a three-year U.S. contribution to the ADF to be spread over fiscal years 1977-1979.

Before discussing the details of this legislation and the total replenishment proposal, I would like to address briefly the importance of U.S. participation in the international development banks and then provide some specific background material on the Asian Development Bank and Fund.

There are three international development banks of which the U.S. is a donor member. (Final passage is expected imminently of legislation authorizing the United States also to join the African Development Fund.) These banks are part of an international structure in which the developed and developing countries work together to solve problems. By cooperating with other developed countries in funding these institutions we improve the effectiveness of our own efforts.

From the U.S. national point of view, these banks encourage development along lines compatible with our

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own economy. They stress the role of market forces in the effective allocation of resources and the development of outward-looking trading economies. In working with the international development banks, developing countries are learning to administer large procurement programs effectively and honestly. These programs will result in increased procurement of goods and services in the United States and expanded future markets for our products, thus increasing employment in our country. Our participation in the international development banks will also provide more assured access to essential raw materials, and a better climate for U.S. private investment in the developing world.

Asian Development Bank

The Asian Development Bank, established in 1966, has a current membership of 42 countries which includes the developing nations of Asia, together with the developed countries of Europe, Asia and North America, including the United States. It makes hard loans on near market terms from its Ordinary Capital window and concessional loans from its Special Funds. It has developed, in a few short years, into a respected borrower in international financial markets, and an important provider of financial and technical assistance to the developing countries of the Asian region.

The Bank's ordinary capital lending, with interest rates now at 8.75 percent and terms of 15-25 years, is financed from its subscribed capital stock, the proceeds of borrowings (which are backed by the Bank's callable capital), the sale of participations in its loans, and profit derived from ordinary operations. The United States participated actively in the establishment of the Bank with an initial subscription to the Bank's capital stock of $200 million. In December 1974 the Congress authorized the United States to participate in a first replenishment of capital resources of the Bank in the amount of $361.8 million, to be subscribed in three annual installments of $120.6 million each. The United States subscribed to the first installment in FY 75, bringing U.S. contributions to capital stock to a level of $361.9 million or 11 percent of the total. The second installment of this subscription is included in the FY 76 Foreign Assistance and Related Programs Appropriation Bill. When this contribution is made the United States will have put in $482.5 million, comprising approximately 14 percent of total capital stock contributions to the Bank. The third and last installment has been requested for FY 77.

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The ADB has initiated discussions on a second ordinary capital replenishment, but the United States has not yet taken a position on the size or timing of such a replenishment, although it is clear that additional funds are needed relatively soon. From its establishment in 1966 through December 31, 1975, the Bank approved 150 loans from ordinary capital resources for projects in 15 member countries, totaling $1,925 million. The major portion of ordinary capital loans are made to South Korea, the Philippines, Malaysia, Thailand and Indonesia -- countries that have shown strong self-help efforts to achieve economic growth and are of particular importance to the United States.

Asian Development Fund

When the Bank was established it was recognized that it would have to provide financing on concessional terms to meet the needs of its poorest developing member countries. Initially, this was done through a Multi-Purpose Special Fund administered by the ADB. It was a collection of unscheduled bilateral contributions made by donor member countries -- each of whom put varying terms and stipulations on the use of its funds.

In 1973, the ADB's Board of Governors, with United States support, adopted a resolution creating a new multilateral special fund, the Asian Development Fund, to which all contributions would be made and used on the same terms and conditions. Subsequently, agreement was reached among the Bank's developed country members on an initial resource mobilization for the new ADF of $525 million for the three-year period ending December 31, 1975. In March 1972 the Congress authorized a U.S. contribution of $100 million and in December 1974 a further $50 million was authorized. Of this amount, $100 million was appropriated in FY 74 and FY 75, but only one-half of the remaining $50 million ($25 million) is in the FY 76 appropriations bill, as reported by the Conference Committee.

From its inception, through December 31, 1975 the ADF approved concessionary loans totaling $659 million. These loans went to the poorest South Asian and Pacific states with Bangladesh, Pakistan, Burma, and Sri Lanka as principal borrowers. As a matter of practice, India does not borrow from the Bank or Fund. Only Asian countries with 1972 per capita incomes of less than $300 are eligible for concessionary loans, which carry a service charge of 1 percent with maturities of 40 years, including a 10-year grace period on repayments.

To date the United States has contributed a total of $462 million to the ADB and ADF. This has generated contributions from other member countries to finance $2,584 million worth of projects in the developing countries of Asia -- or 5 times the U. S. investment.

Of total Bank and Fund lending 35 percent has been for public utility projects, 23 percent for agriculture and agro-industry, 22 percent for industry and development banks, 19 percent for transport and communication, and 1 percent for education. Bank and Fund loans serve the same developmental purposes; the only difference is in the terms, depending on the economic status of the borrowing country.

ADF Replenishment

As of December 31, 1975, the ADF had only $40.9 million remaining for new loan commitments in 1976, not including the U.S. FY 76 contribution. At this time the ADF has nearly exhausted its resources available for commitment.

Recognizing the depletion of ADF resources, multilateral replenishment negotiations were begun last year. During these negotiations the U.S. representative stated that he could give no indication of the amount or timing of a U.S. contribution, in part because the United States had not yet completed its contribution to the initial resource mobilization of the ADF, and consultations concerning U.S. participation in a replenishment had not yet been held with Congress. The U.S. representative did indicate that the U.S. continues to be a strong supporter of the ADB and would, in principle, expect to continue contributing to the ADF.

Understanding that the United States was unable to commit itself concerning the specific timing or amount of any U.S. contribution to the replenishment, the ADB Board of Governors, on December 3, 1975, adopted a resolution providing for the replenishment of the ADF resources, and authorizing the ADB to accept contributions to the replenishment from its developed member countries in amounts specified in the resolution, subject to possible later adjustment by the Board of Governors.

The resolution provides for an ADF replenishment in an amount not to exceed $830 million for the 1976-78 period. Despite possible modifications in the total figure, the ADF expects to raise resources sufficient to increase its 1976-78 commitment total substantially above the $456 million level of 1973-75, in order to increase its level of lending modestly in real terms despite the rapid worldwide inflation.

Most donor countries agreed to contributions equal to approximately 150 percent of their initial contributions. The Bank's resolution on the ADF permits members to suggest adjustments in their contribution levels. Last week the deadline for making such changes was extended to June 30. Canada has already indicated that it wishes to increase its contribution from $42.4 million to $76.4 million. The participation of Sweden and France is uncertain.

The Japanese have indicated they would provide one-third of the total contributions. Should the total be moderately less than the $830 million in the resolution we would hope Japan and other donors would not reduce the contribution amounts shown in Table I. However, for such reductions to be avoided the United States must show its firm commitment to the replenishment.

As no decision had yet been made on the total U.S. contribution to be requested for the ADF replenishment, the United States reserved its position on the $231 million proposed in the resolution for the U.S. share while commenting that such an amount seemed large. We formally abstained on the resolution. After reviewing carefully the financial needs of the Asian Development Bank and the burdensharing aspects of supporting a fund of major importance to the United States, the Administration believes that a three-year U.S. contribution in an amount substantially smaller than the Bank's suggested U.S. share of $231 million would be appropriate.

Pending final determination of the total three-year U.S. contribution level, we requested authorization of an initial U.S. contribution of $50 million for FY 77 which would represent the first installment of the replenishment. This amount represents the same level appropriated in FY 74 and FY 75 and requested in FY 76. Since contributions by other countries beyond the first year of the replenishment are contingent upon U.S. participation, a U.S. commitment, as provided in the proposed $50 million authorization, is essential for the successful implementation of the total ADF replenishment package. Authorization for the remaining two installments will be requested in the near future.

I urge your prompt consideration of this legislation given the time limitations for authorizations and appropriations imposed by the Budget Reform Act. A firm indication of a U.S. commitment to the Asian Development Fund is essential for the successful implementation of the replenishment. Asian countries will be contributing over $300 million to the replenishment and European donors have agreed to contribute nearly $200 million. However, the linchpin to this replenishment and the ADF itself is the United States.

The ADB -- now in existence nearly 10 years -- has developed into an important economic development institution for Asia. It brings special expertise and local knowledge to the development problems of the region. The Bank's growing impact on Asian economic progress is reflected in its recent activities. For example, it has substantially increased lending for agriculture in light of the world food crisis; it has given greater emphasis to the use of intermediate technology, thus encouraging cost effective project development; and it has mobilized supplementary sources of financing, including OPEC country resources.

By continuing our support for this institution, through this legislation on ADF replenishment, we will indicate to Asia and the world our determination to play a progressive and peaceful role in the Asian region, befitting our responsibilities and interests as a Pacific power.

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Table I

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Suggested Contributions to ADF Replenishment
Contained in Board of Governors' Resolution

Member	US $ Millions
Australia	41.6
Austria	6.9
Belgium	7.3
Canada	42.4 1/
Denmark	6.6
Finland	5.8
France	42.4 1/
Germany	53.1
Italy	30.8
Japan	272.6
Netherlands	12.9
New Zealand	9.2
Norway	6.1
Sweden	10.6 1/
Switzerland	8.3
United Kingdom	42.4
United States	231.0
Total	830.0

1/ Subsequent to the replenishment proposal Canada increased its proposed contribution to $76.4 million; participation by France and Sweden is uncertain.

Table II

Current Contributions to ADF/SF
(millions of dollars)

Country	Amount	Percent
Australia	$ 33.7	5.4
Belgium	6.9	1.1
Canada	35.9	5.7
Denmark	6.2	1.0
Finland	3.6	.6
Germany, Fed. Rep.	56.5	9.0
Italy	1.5	.2
Japan	314.8	50.1
Netherlands	17.2	2.7
New Zealand	5.1	.8
Norway	3.9	.6
Switzerland	7.6	1.2
United Kingdom	35.6	5.7
United States	100.0	15.9
Total	628.5	100.0
OC Set Aside	+57.4	
SF Net Income and other credits	6.0	
Total ADF/SF Resources	691.9	

Table III

Subscriptions to Asian Development Bank Ordinary Capital and Asian Development Fund U.S. and Other Donors

(in current U.S. dollars)

ADB-OC

	Original Resource Mobilization ($ millions)	Original Resource Mobilization (Percent)	Replenishment (as of Dec. 31, 1975) ($ millions)	Replenishment (as of Dec. 31, 1975) (Percent)
U.S.	241	19.9	362 1/	16.2
Other Donors	551	45.5	901	40.4
Borrowing Members	420	34.6	968	43.4
TOTAL	1212	100.0	2231	100.0

ADF

	Original Resource Mobilization ($ millions)	Original Resource Mobilization (Percent)
U.S.	150 2/	28.6
Other Donors	375	71.4
TOTAL	525 3/	100.0

1/ Amount authorized. The U.S. subscription to the replenishment as of December 31, 1975 is $121 million. A further $121 million is included in the FY 76 appropriations legislation. If appropriated this subscription will increase the U.S. share of ordinary capital to 14.5 percent, from the present level of 11.3 percent. The appropriation of the third $121 million will raise the U.S. share to 17.5 percent.

2/ A U.S. contribution of $150 million has been authorized of which $100 million has been contributed. Subsequently other countries have increased their contributions to the ADF to $486 million. So if the final $50 million of the U.S. contribution, of which $25 million is in the FY 76 appropriations legislation, is appropriated the U.S. share of the replenishment will drop to 23.6 percent.

3/ Excludes transfers of $57.4 million from Multi-Purpose Special Funds.

ASIAN DEVELOPMENT BANK
Subscriptions to Capital Stock and Voting Power
31 December 1975 (millions of dollars)

TABLE IV

MEMBERS REGIONAL	SUBSCRIBED CAPITAL	PERCENT OF CAPITAL	PERCENT OF VOTES
Afghanistan	$ 14,4	0.450	0.848
Australia	256.3	8,007	6.894
Bangladesh	45,2	1,413	1,618
Burma	24,1	0,754	1.091
Cambodia	10,6	0.330	0.751
China, Republic of	48,3	1,507	1,693
Fiji	3.0	0,094	0.563
Gilbert Islands	.2	0,006	0,492
Hong Kong	24.1	0,754	1.091
India	280.5	8,761	7,496
Indonesia	241.3	7,536	6.517
Japan	603.2	18,840	15,560
Korea, Republic of	223.2	6,971	6.065
Laos	1,3	0,040	0.519
Malaysia	120,6	3,768	3.502
Nepal	6,5	0,204	0.650
New Zealand	68,0	2,125	2.188
Pakistan	96,5	3,014	2.899
Papua New Guinea	4,2	0,130	0.592
Philippines	105.6	3.297	3.125
Singapore	15,1	0,471	0,865
Solomon Islands	.3	0,009	0.495
South Vietnam	36.1	1,130	1.392
Sri Lanka	25.7	0,803	1,130
Thailand	60.3	1,884	1.995
Tonga	.2	0,006	0,492
Western Samoa	.1	0,002	0,490
Total Regional	2,314.9	72,306	71.013

TABLE IV Cont'd

ASIAN DEVELOPMENT BANK
Subscriptions to Capital Stock and Voting Power
31 December 1975 (millions of dollars)

	SUBSCRIBED CAPITAL	PERCENT OF CAPITAL	PERCENT OF VOTES
NON-REGIONAL			
Austria	15.0	0.471	0.865
Belgium	15.0	0.471	0.865
Canada	75.4	2.355	2.372
Denmark	15.1	0.471	0.865
Finland	6.0	0.188	0.638
France	75.4	2.355	2.372
Germany, Fed. Rep. of	102.5	3.203	3.050
Italy	60.3	1.884	1.995
Netherlands	33.2	1.036	1.317
Norway	15.1	0.471	0.865
Sweden	6.0	0.188	0.638
Switzerland	15.1	0.471	0.865
United Kingdom	90.5	2.826	2.749
United States	361.9	11.304	9.531
Total Non-Regional	886.7	27.694	28.987
GRAND TOTAL	3,201.5	100.000	100.000

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Table V

Asian Development Banks
Summary of Loans by Country
December 31, 1975

(millions of dollars)

Country	Ordinary Capital	ADF/ Special Funds	Total	Percent
Afganistan	-	34.0	34.0	1.3
Bangladesh	11.4	125.4	136.8	5.3
Burma	6.6	60.2	66.8	2.6
China, Rep.	100.4	-	100.4	3.9
Fiji	6.7	-	6.7	0.3
Hong Kong	41.5	-	41.5	1.6
Indonesia	153.9	113.3	267.2	10.3
Khmer Rep.	-	1.7	1.7	0.1
Korea	433.6	3.7	437.3	16.9
Laos	-	11.7	11.7	0.5
Malaysia	248.5	3.3	251.8	9.7
Nepal	2.0	55.5	57.5	2.2
Pakistan	235.2	100.0	335.2	13.0
Papua New Guinea	-	14.3	14.3	0.6
Philippines	332.7	15.3	348.0	13.5
Singapore	101.4	3.0	104.4	4.0
Sri Lanka	14.1	56.7	70.8	2.7
Thailand	233.2	8.1	241.3	9.3
Tonga	-	1.3	1.3	0.1
Vietnam, Rep.	3.9	40.7	44.6	1.7
Western Samoa	-	10.6	10.6	0.4
Total	1,924.7	658.8	2,583.5	100.0

Table VI

ADB/ADF
Summary of Loans Approved By
Country and Sector as of
December 31, 1975

(millions of dollars)

	Outstanding Including Undisbursed	Repayments
Ordinary Capital	$ 1,924.7	$ 48.7
Special Funds/ADF	658.8	1.0

By Economic Sector:	Cumulative Percent	1975 Percent
Agriculture and Agro-Industry	22.8	37.2
Education	1.1	2.2
Industry and Development Banks	22.0	19.5
Public Utilities	35.1	28.7
Transport and Communication	19.0	12.4

By Country:	Cumulative	1975
Korea	16.9	15.4
Philippines	13.5	16.0
Pakistan	13.0	14.7
Indonesia	10.3	11.8
Malaysia	9.7	7.2
Thailand	9.3	11.8
Others	27.3	23.1

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BIOGRAPHICAL NOTES

EDWIN H. YEO, III
UNDER SECRETARY FOR MONETARY AFFAIRS

Edwin H. Yeo, III (pronounced Yoh), of Pittsburgh, Pa., signed the oath of office as Under Secretary of the Treasury for Monetary Affairs on August 5, 1975. Nominated to the third highest Treasury post by President Ford on July 22, his appointment was confirmed by the Senate on August 1.

Soon after becoming Under Secretary for Monetary Affairs, Mr. Yeo, as architect and negotiator of United States international monetary initiatives, charted a new course in U.S. negotiations for greater world economic and monetary stability.

As chief deputy to Secretary Simon on international monetary negotiations, Mr. Yeo announced that the U.S. delegation to the 30th annual World Bank-International Monetary Fund meetings September 1-5, 1975, would be open to proposals for "unbundling" the tightly bound package of issues obstructing agreement on general monetary reform.

The work of the Bank-Fund meetings was consolidated and further advanced in negotiations conducted by Mr. Yeo with financial authorities of the major industrial countries, preliminary to the Rambouillet summit meeting of November 1975, and the agreement concluded at that time by Secretary Simon.

Mr. Yeo represented Secretary Simon at the Paris meeting December 19, 1975 of the Group of Ten Finance Ministers and Central Bank Governors. The series of events led, in turn, to the Jamaica accord of January 1976 and the first general revision of international monetary arrangements since Bretton Woods in 1944.

The Under Secretary represents Treasury at the Deputies level in the G-10, which is concerned with the operation of the international monetary system, and is the U.S. Delegate to Working Party 3 of the Economic Policy Committee of the OECD, the group involved with the promotion of better international payments equilibrium.

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He also consults on a continuing basis with his counterparts in the Finance Ministries of other countries on matters relating to underlying economic and financial policies.

On the domestic side, as trustee of the Government's financing operations, Mr. Yeo innovated the Federal Funds Bill, and revived the priced note offering in an issue that was the first part of the February 1976 financing operation.

Additional flexibility in debt management was achieved subsequently in a redefining of the maximum time period for notes and proposals for new long bond authority, approved by the Congress in February 1976.

Mr. Yeo contributed to Treasury's drive for major reform in municipal financing with such proposals as the taxable bond option and disclosure legislation, while taking an active role in development of Federal policy toward New York City's financial problems.

Under Secretary Yeo is president of the Federal Financing Bank, chairman of the Committee on Foreign Investment in the U.S., a member of the Board of Directors of the Overseas Private Investment Corporation, a member of the Board of Governors of the American National Red Cross, and Treasury's representative on the National Security Council Intelligence Committee.

Before joining Treasury, he was vice chairman of both Pittsburgh National Bank and Pittsburgh National Corporation, and chairman of the Board of Pittsburgh National Discount Corporation. He was born in Youngstown, Ohio, May 23, 1934.

An economics major at the University of Maryland, Mr. Yeo completed a four-year course in less than three years for a bachelor degree in 1959. At that time he declined a National Defense Scholarship award for further study towards a doctorate, preferring an early business career. He was a member of the honor society at the University and maintained a 3.9 grade point average.

Prior to matriculating at the University, Mr. Yeo spent three years in the Marine Corps, serving in Korea, and put in several months as a salesman in Baltimore, earning money to supplement GI benefits for college.

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He went directly from college to banking as a management trainee in June, 1959 with Peoples First National Bank and Trust of Pittsburgh. In September that year, the bank, through merger, became the Pittsburgh National Bank.

Mr. Yeo was elected assistant secretary, then assistant cashier of Pittsburgh National in 1961. He was elected as vice president in 1964, senior vice president in 1968 and vice chairman in 1972.

In late 1963, under Mr. Yeo's direction, Pittsburgh National was one of the first banks in the country to start a regional Federal Funds market, which trades required reserve balances among banks on a one-day basis.

In mid-1960's, under his direction, the bank established a municipal bond department, distributing, underwriting and trading in high grade municipal bonds and short term tax exempt notes.

He started the bank in dealing in certificates of desposits of other major banks in 1972.

As a member of the Government and Federal Agencies Securities Committee, Mr. Yeo while at Pittsburgh National, served as advisor to the Treasury Department and to Secretaries George Shultz and William E. Simon.

He has written many papers and has been a speaker often on economics and money market matters at meetings of banking and industry groups in the United States and abroad.

Mr. Yeo has three teen-age children, Andrew, Douglas, and Claire. The family maintains a farm at Lowellville, Ohio, specializing in the breeding and raising of Charolais cattle.

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Contact: D. Cameron
Extension 2951
April 26, 1976

FOR IMMEDIATE RELEASE

ANTIDUMPING INVESTIGATION INITIATED ON
MULTI-METAL LITHOGRAPHIC PLATES FROM MEXICO

Assistant Secretary David R. Macdonald announced today the initiation of an antidumping investigation on imports of multi-metal lithographic plates from Mexico.

Notice of this action will be published in the Federal Register of April 27, 1976.

The Treasury Department's announcement followed a summary investigation conducted by the U.S. Customs Service after receipt of a petition alleging that dumping was occurring in the United States. The information received tends to indicate that the prices of the merchandise to unrelated U.S. purchasers are less than the prices of such or similar merchandise sold in the home market.

Mr. Macdonald further announced that, on April 22, 1976, the case had been referred to the U.S. International Trade Commission for a preliminary injury investigation. The Trade Act of 1974 provides for an I.T.C. preliminary investigation of injury at the initiation stage when there is substantial doubt that injury under the Act exists. If the I.T.C., within 30 days from the date of receipt of this referral, determines and advises the Secretaty that there is no reasonable indication that an industry in the United States is being or is likely to be injured, or is prevented from being established, Treasury's investigation would be terminated and no further proceedings would be conducted.

Imports of multi-metal lithographic plates from Mexico in 1975 were valued at approximately $200,000.

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FOR IMMEDIATE RELEASE April 26, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.6 billion of 13-week Treasury bills and for $3.5 billion of 26-week Treasury bills, both series to be issued on April 29, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 29, 1976			26-week bills maturing October 28, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.764	4.890%	5.02%	97.367 a/	5.208%	5.42%
Low	98.758	4.913%	5.04%	97.348	5.246%	5.46%
Average	98.759	4.909%	5.04%	97.356	5.230%	5.45%

a/ Excepting 1 tender of $15,000

Tenders at the low price for the 13-week bills were allotted 81%.
Tenders at the low price for the 26-week bills were allotted 67%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 47,390,000	$ 16,890,000	$ 71,680,000	$ 18,030,000
New York	4,513,025,000	2,337,655,000	4,928,855,000	3,093,405,000
Philadelphia	47,055,000	33,185,000	13,475,000	8,475,000
Cleveland	56,970,000	27,070,000	113,195,000	18,195,000
Richmond	61,495,000	21,395,000	100,315,000	28,175,000
Atlanta	28,540,000	19,440,000	33,605,000	25,105,000
Chicago	415,790,000	57,365,000	326,500,000	118,290,000
St. Louis	78,290,000	23,190,000	44,480,000	18,980,000
Minneapolis	45,170,000	13,420,000	57,875,000	32,835,000
Kansas City	40,365,000	23,065,000	23,970,000	15,940,000
Dallas	33,885,000	13,885,000	33,885,000	28,385,000
San Francisco	194,360,000	19,925,000	284,835,000	95,195,000
TOTALS	$5,562,335,000	$2,606,485,000 b/	$6,032,670,000	$3,501,010,000 c/

b/ Includes $ 330,875,000 noncompetitive tenders from the public.
c/ Includes $ 177,765,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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FOR IMMEDIATE RELEASE April 26, 1976

JERRY THOMAS
SWORN IN AS UNDER SECRETARY OF THE TREASURY

Jerry Thomas was sworn in as Under Secretary of the Treasury by Treasury Secretary William E. Simon today.

Mr. Thomas, 46, formerly was Chairman and President of First Marine Banks, Inc., a multi-bank holding company headquartered in Riviera Beach, Florida.

A former member of the Mid-West Stock Exchange and the Philadelphia-Baltimore-Washington Stock Exchange, Thomas also served as head of the Florida Securities Commission. He served in the Florida legislature for twelve years, concluding his legislative service as president and majority leader of the Florida Senate. In 1974, he was Florida's Republican nominee for governor.

The new Under Secretary succeeds Edward C. Schmults who resigned to accept an appointment as Deputy Counsel to the President.

A former Captain in the U.S. Marine Corps, Thomas is recipient of many civic and business awards including the U.S. Treasury Freedom Bond and Minuteman award. He received degrees from Palm Beach Junior College and Florida State University where he did post-graduate work in public administration. He received his master's degree from Florida Atlantic University.

Mr. Thomas is a native of West Palm Beach, Florida and has resided in Jupiter, Florida with his wife and five children.

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REMARKS OF WILLIAM M. GOLDSTEIN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE
FEDERAL TAX INSTITUTE OF NEW ENGLAND
April 24, 1976

I am most pleased to participate in this distinguished program with my former dean and estate planning professor. In Washington, trusts and estates are currently receiving more legislative attention than at any time in recent years. The Senate Finance Committee is considering House-passed changes in the taxation of accumulation trusts and foreign trusts. The Ways and Means Committee has approved, with amendments, Chairman Ullman's bill to tax transfers of securities to swap funds, including those organized as trusts.

Most importantly, both of the tax-writing Committees have taken up the matter of estate tax reform. At hearings before the Ways and Means Committee last month, the Administration proposed in detail major changes designed to reduce or eliminate the impact of the federal estate tax on smaller estates. Ways and Means is expected to report out a bill by June, and the Finance Committee may also act in this area in the mark-up sessions which will begin on Tuesday, April 27. In view of the importance of estate tax reform, I would like to devote my remarks primarily to that topic.

First, however, a brief review of developments with regard to the taxation of trusts seems in order. H.R. 10612 contains several provisions dealing with trusts. Except for the proposed grantor trust rule for foreign trusts, which would increase annual revenues by about $10 million, none of these provisions would have a revenue impact exceeding $5 million.

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With respect to accumulation trusts, the bill would simplify the method of computing the throwback rule for accumulation distributions. The bill also would repeal the capital gains throwback rule and provide instead a rule dealing more directly with the issue of bracket reduction through the transfer of appreciated assets into trusts; i.e., a special two-year holding period would be required.

With respect to foreign trusts, H.R. 10612 includes several provisions intended to prevent foreign trusts with U.S. beneficiaries from being used to accumulate income free of U.S. tax. Under the bill, U.S. grantors of foreign trusts with U.S. beneficiaries would be taxed currently on the income of these trusts under the grantor trust rules of present law. In all other cases, U.S. beneficiaries of foreign trusts would pay interest charges on U.S. taxes payable on any accumulation distributions when received. In addition, the excise tax on transfers of stocks and securities to foreign trusts and other foreign entities would be extended to transfers of all other types of property and would equal 35 percent of the excess of the value of such property over the sum of its basis and any gain recognized on the transfer.

As amended by Committee decision on April 7, 1976, H.R. 11920 would prevent the tax-free transfer of appreciated securities to so-called swap funds organized as partnerships and would also bar the tax free acquisition of non-diversified personal holding companies by regulated investment companies. In addition, the bill, which will be reported to the House next week, provides that gain or loss will be recognized by a person who transfers property to a trust which would be an investment company (within the meaning of section 351) if the trust were an incorporated entity. Inclusion of the definition of investment company in section 351 is intended to include as well the regulations thereunder which condition taxation upon diversification of investment holdings by the transferor. The bill also requires the recognition of gain or loss where appreciated property is transferred to a common trust fund (as defined in section 584) in exchange for an interest in such fund. Finally, the bill creates an exception from these rules in the case of transfers to a pooled income fund held for a charitable purpose as defined in Code section 642(c)(5). These rules are to apply to transfers to trusts on or after April 8, 1976.

The Treasury supports in principle all of the foregoing proposals dealing with the income taxation of trust beneficiaries and grantors.

Turning now to the question of estate tax reform, one cynic has noted that - perhaps due to Professor Casner's influence - people these days frequently seem more concerned with tax after death than life after death. Indeed, while the churches report some difficulties recruiting soul savers, Professor Casner and others provide us each year with a well-trained elite corps of estate tax savers.

Unlike most other areas of the tax law, the federal estate tax has been virtually untouched by Congress for about 30 years. The last major change was the adoption of the marital deduction in 1948. The estate tax rates and exemption have remained the same since 1942.

While estate tax law has stood still, the American economy has not. Over the past 30 years, real family wealth has increased dramatically and inflation has magnified this phenomenon. As a result, the estate tax gradually has been imposed on a larger and larger percentage of estates.

Through 1945, the percentage of estates filing estate tax returns never exceeded 1.2 percent. Since then, this percentage has more than doubled every ten years, rising to 11.2 percent in 1975. Similarly, the percentage of estates paying estate tax has risen from 1 percent in 1945 to almost 8 percent in 1975. If the rate of increase of the past 10 years continues over the next 10, by 1985 almost one out of every 4 estates will file a return, and one out of every 6 estates will be taxed.

As Secretary Simon told the Ways and Means Committee last month, "No longer does the /estate/ tax impact principally on the relatively larger estates. Rather the estate tax has shifted to a more broadly-based tax on the private capital accumulations of more moderate estates."

As the estate tax base has expanded, the nature of assets taxed has changed. Real estate, cash, and life insurance comprise a relatively large portion of the assets of smaller estates, while corporate stock represents a relatively small portion. The opposite is true of larger estates. For example, among estates filing returns in 1973, real estate represented almost one-third of the assets of gross estates of less than $100,000, but little more than one-tenth of the assets of estates of $1 million or more; in contrast, corporate stock represented only 14 percent of the assets of estates less than $100,000, but almost 50 percent of the million dollar estates. Real estate and cash, as a percentage of total assets taxed, have increased in recent years, while corporate stock has declined. As the estate tax becomes more broadly based, reaching relatively smaller and smaller estates, it becomes more of a tax on family homes, family cars, savings accounts, and life insurance - and less of a tax on bonds and corporate stock.

Whether one welcomes these changes in the estate tax depends on what one sees as the purpose of the tax. As George Shultz said when he was Secretary of the Treasury, "Most of the controversy involving estate and gift taxes turns on matters of personal philosophy. There is no one key to truth in this area, and even individuals of the same political persuasion feel differently and deeply." This Administration believes that the estate tax has the limited function of restraining undue accumulation of wealth within small family groups and that the tax should not be viewed as a device either to raise significant revenue or to achieve progressivity in the tax system.

In the past, taxes imposed at death have been motivated by both fiscal and social considerations. In their early days, death taxes were imposed primarily to raise revenue. For example, prior to 1916, the federal government used death taxes only as a supplemental source of revenue in times of extraordinary revenue need - mostly war. Then social attitudes began to change. Congress saw a need to curb the growing concentration of wealth among a relatively few families and the 1916 Act was aimed primarily at what were deemed unreasonable accumulations of wealth.

This is still the proper function of this tax. Accordingly, families which are just beginning to reap the benefits of hard work, saving, and investment, should not be penalized. A widow with little more than a home, modest savings, and life insurance proceeds, should not be subjected to a heavy federal estate tax. In other words, it is unfair to sit idly by and watch inflation make the estate tax into a broad-based tax.

As you know, the Administration has proposed several changes to reduce the impact of the estate tax on smaller estates. We would increase the present $60,000 estate tax exemption to $150,000 and simultaneously adjust the estate tax rates, remove the present 50 percent limitation on the marital deduction and provide very liberal payment provisions for estates which consist primarily of family farms and businesses. I will comment briefly on each of these proposals as well as some alternatives which have been urged by others.

First, the proposed increase in the exemption. Adjusting the $60,000 estate tax exemption for inflation which has occurred since 1942 would result in an exemption of $210,000. Since this step alone would result in a loss of approximately $2.3 billion in annual revenues, the Administration has proposed a somewhat lower exemption - $150,000, to be phased in over five years. If this exemption had been available to estates filing returns in 1973, the number of returns filed would have been cut by almost 70 percent. The political prospects of this proposal are encouraging.

To minimize the revenue loss, the Administration has also proposed that the lower bracket estate tax rates on the first $90,000 of taxable estate be eliminated. That is, the rate schedule would simply begin at 30 percent, rather than rising quite rapidly to 30 percent as under present law. Thus, if the exemption were raised to $150,000, most of those estates which would now be taxed at rates lower than 30 percent would be taxed, in effect, at zero percent. When fully effective, the Administration's proposed changes in the exemption and the rates together would cost (at 1977 levels of estate valuation) an estimated $1.16 billion.

In addition to completely exempting estates with an adjusted gross estate of less than $150,000 from tax, the Administration's proposal would somewhat reduce the tax burden on all estates up to $2 million (e.g., $12,500 on an adjusted gross estate of $1 million) and would somewhat increase the burden on larger estates (e.g., $14,100 on an adjusted gross estate of $5 million). These figures do not take into account the credit for state death taxes which would be decreased in all brackets by the Administration's proposal.

Several members of Congress have advocated using a credit against tax, rather than an increase in the exemption, to accomplish the result of relieving the burden on the smallest taxable estates without significantly altering the burden on larger estates. A credit of $35,700 would also free from tax an adjusted gross estate of $150,000 and would impose a lower burden than the Administration's proposal, on practically all estates. Of the estimated $202 million aggregate reduction in tax under the credit approach, as compared with increasing the exemption, all but $10 million results from the differing impact of the two types of changes on the credit for state death taxes, a subject which merits further consideration. In any event, it can be seen that the benefits of the distribution of relief under the Administration's proposal will certainly not, as has been changed, be more favorable to the large estates than would be a properly selected level of credit.

Another reason for using the increased exemption rather than the credit is that the cut-off level for filing returns would almost certainly have to be based upon the adjusted gross estate. That is, a taxpayer would have to determine the size of the adjusted gross estate before it could compute the tax to see if the tax was less than the credit.

Others have suggested reducing the rates on the smaller estates as opposed to either increasing the exemption or implementing a credit. The latter alternatives, however, have the advantage of reducing the costs of administering and collecting the estate tax since less returns will have to be filed, processed and audited.

The Administration's second major estate tax proposal is the unlimited marital deduction. As you know, under present law, an estate is entitled to a deduction up to 50 percent of the adjusted gross estate for qualifying gifts to a surviving spouse. The Administration believes that the principal adverse effect of this limitation is felt by widows whose husbands leave relatively small estates and that this situation warrants relief at this time. It is believed that a property transfer between a husband and wife is not the appropriate occasion for imposing tax upon such property since most couples, regardless of state law, feel that the property in question is in fact "theirs" rather than "his" or "hers." Adopting a rule which permits free interspousal transfers would recognize this practical reality.

As far back as 1968, the Treasury proposed an unlimited marital deduction and made the case therefor as follows:

> "Present rules with regard to interspousal transfers provide maximum benefits to extremely complex transfers and forms of ownership that bear little relationship to economic realities with respect to control and enjoyment of the property. The Federal Government has no real interest in whether the husband or the wife controls the passing of the property to the next generation; it need only be concerned that all of the property is subject to tax at the time it finally leaves the hands of the older generation and moves on to the younger generation."

The proposal of an unlimited estate tax marital deduction is also a relatively expensive proposition. The estimated revenue loss for fiscal 1978 is $703 million based upon 1977 levels of estate valuation. Such estimate would decrease each year, as the proposed increased exemption is phased-in, to a level of $596 million in 1981, again based on 1977 levels of estate valuation.

The Administration's third major estate tax proposal is designed to provide relief to the owners of family farms and businesses where such assets represent the major portion of relatively small taxable estates. Under present law, there is provision for the 10-year installment payment of tax at regular rates of interest in the case of qualifying estates regardless of the size of the asset which qualifies the estate for this benefit. Under the Administration's proposal, payment of the tax on the qualifying interest in real estate or corporate stock would be deferred for five years and it would then be payable over the next 20 years in installments together with interest at the rate of 4 percent. On an actuarial basis, this deferral and reduced interest rate, in combination, represent the equivalent of a 45 percent reduction in tax on the asset in question. The full benefit of these provisions would be available, however, only to qualifying assets valued at less than $300,000, would be phased out between $300,000 and $600,000 and would not apply at all to otherwise qualifying assets whose value exceeds $600,000.

The Administration has advanced this proposal because the types of estates which include family farms and businesses frequently have little, if any, significant liquid assets. Thus the pressure to pay Federal as well as state inheritance taxes frequently forces a premature sale of the farm or the sale, or merger into a larger company, of the business. Secretary Simon has stated that the enactment of these provisions, "would be a positive and essential step toward insuring the survival of small farms and businesses for future generations."

Several members of Congress have introduced bills which, in addition to providing for the deferral of estate tax payments in circumstances similar to those involved in the President's proposal, would create alternative means of valuing farm property for estate tax purposes. In essence, they would seek to establish an alternative valuation of the property if used as a farm where such valuation would be lower than the figure which would obtain under present techniques for determining "fair market value".

The Administration opposes these proposals for several reasons. First of all, they would appear to be unnecessary if the Administration's proposals with regard to the increased exemption, the unlimited marital deduction and the tax payment deferral described above are all adopted. Secondly, the proposed valuation techniques are uncertain at best and involve intricate definitional and administrative problems. For example, how long after the decedent's death must a farm be used as a farm to retain the benefit of the lower valuation? If the use changes within such period, would the higher tax then fall due and how would it be collected? Also, if no member of the family continues to reside on the family farm, would it still be eligible for the benefits of these valuation provisions? Finally, serious questions with regard to the valuation of other types of assets might arise if this proposal were adopted as a precedent. For example, should the value of a painting be reduced for estate tax purposes if the decedent were to require that it be kept in a vault for 50 years where no-one could look at it?

I hope that I have now sufficiently beaten this dead horse.

The estimated loss of revenue involved in the tax deferral proposal for family farms and businesses is quite modest. At 1977 levels of estate valuation, the proposal is estimated to cost only $2 million in fiscal 1977 and only $18 million in fiscal 1982.

Turning briefly to the subject of gift taxes, consistent with our proposal of the unlimited estate tax marital deduction, the Administration has recommended an unlimited marital deduction for life-time gifts. This proposal would cost an estimated $13 million in fiscal 1977 and $25 million in fiscal 1978 and thereafter, once again using 1977 gift tax valuation figures. The Administration has also urged the elimination of quarterly gift tax return filing unless and until gifts for the year total $100,000. The present requirement of quarterly returns unintentionally reduces the benefit of the marital deduction in certain cases and has proven to be more of an administrative burden than a device for raising revenue through more prompt collection of tax.

On the other hand, to date, the Administration has considered, but not recommended, increases in the gift tax annual exclusion and lifetime exemption to recognize the effect of inflation since 1942. Increases which would fully take into account the impact of inflation would be to $10,500 and $105,000, respectively. Increases which would parallel the proposed increase in the estate tax exemption to $150,000 would be to $7,500 and $75,000, respectively, and would cost an estimated $150 million and $185 million in the first year. The Administration believes that this matter can best be considered along with the general subject of the unification or integration of estate and gift taxes which, in our view, merits further study before recommending specific proposals.

Two other much-talked about proposals require brief mention at this time, although each could be the subject of a lengthy talk in its own right. These are the questions of generation skipping and the taxation of capital gains at death. The former subject is extraordinarily complex, is quite important and merits further study. Suggestions of so-called compromises which would allow one generation to be skipped are really not as simple as they sound. Consider, for example, the appropriate time for imposing a tax upon the transfers of property held in the various types of sprinkle trusts which your ingenious minds have created to date.

The Administration's views on the subject of capital gains at death are much more firmly established. Because of the revenue losses previously discussed from the increased exemption and the unlimited marital deduction, there has been considerable talk about finding a way to recoup some of this revenue within the general framework of the transfer of property at death. The three most common proposals are to tax capital gains as if the property had been sold on the date of death; to provide a carryover rather than a stepped-up basis to the heirs of the decedent; and to impose an "additional estate tax" on the untaxed appreciation in the estate.

The estimated revenue effect, at 1975 levels, of a capital gains tax on all appreciation on estates would be $2.4 billion; however, this revenue gain would fall to $1.3 billion if estates which do not file estate tax returns are excluded and the tax is not imposed on property transferred to a spouse. Various proposals to grandfather certain assets or give an alternative date for determining basis would also dramatically reduce the potential revenue gain. The adoption of a carryover basis rule is estimated to increase annual revenues by $600 million when fully effective. Finally, the additional estate tax would raise $1.6 billion per year at the flat rate of 10 percent and $850 million if a $150,000 minimum basis were allowed.

The Administration is opposed to all of these proposals since it believes that the proper level of taxation can best be established by adjustments to exemptions and rates which are now being reviewed by the Congress. The taxation of capital gains at death is particularly unfair due to its regressive aspects; i.e., applying a progressive income tax to capital gains at death places the most significant burden on the smaller estates since they receive the least benefit from the reduction in the estate tax attributable the income tax payment. The carryover basis concept is objectionable because of its administrative complexity, the basis adjustment for death taxes on appreciation, and the substantial burden which would be placed upon the heirs of the decedent to trace the adjusted basis of property back over several generations. If any steps are to be taken in this area, we favor the additional estate tax proposal of the American Bankers Association. This proposal is the least regressive and least complex of the three. Furthermore, it deals directly with the contention that death is an appropriate time to recognize the disparity of the income tax burden on the different ways of accumulating property during life.

As you have heard, touching briefly upon the currently active matters in this field makes for an unduly long speech. On the other hand, even in this rather staid field of the tax aspects of estate planning, these are exciting times for all of us. Professor Casner, as I well recall, concluded his course in estate planning by stating that even if we did not understand anything we heard during the year, we should at least know where to go to get the answers. I wish I could say the same with regard to future legislative developments in this field, but the situation on the Hill is far from clear. I think there will definitely be some action this year and if you will call me in a couple of months, I may have a few answers for you.

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Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

FOR RELEASE AT 4:00 P.M. April 27, 1976

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TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,200,000,000 , or thereabouts, to be issued May 6, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,600,000,000, or thereabouts, representing an additional amount of bills dated February 5, 1976, and to mature August 5, 1976 (CUSIP No. 912793 A30), originally issued in the amount of $3,803,690,000, the additional and original bills to be freely interchangeable.

182-day bills, for $3,600,000,000, or thereabouts, to be dated May 6, 1976, and to mature November 4, 1976 (CUSIP No. 912793 B8 8).

The bills will be issued for cash and in exchange for Treasury bills maturing May 6, 1976, outstanding in the amount of $6,412,825,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $2,463,650,000. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Monday, May 3, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on May 6, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing May 6, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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Contact: L.F. Potts
Extension 2951
April 28, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES FINAL DETERMINATION OF SALES AT LESS THAN FAIR VALUE WITH RESPECT TO ACRYLIC SHEET FROM JAPAN AND DISCONTINUANCE OF ACRYLIC SHEET INVESTIGATION WITH RESPECT TO MITSUBISHI RAYON CO., LTD.

Assistant Secretary of the Treasury David R. Macdonald announced today that acrylic sheet from Japan, except that produced and sold by Mitsubishi Rayon Co., Ltd., is being or is likely to be sold at less than fair value within the meaning of the Antidumping Act, 1921, as amended. Notice of the determination will be published in the Federal Register of April 29, 1976.

The case will now be referred to the U.S. International Trade Commission for a determination as to whether an American industry is being, or is likely to be, injured. In the event of an affirmative determination, dumping duties will be assessed on all entries of the subject merchandise from Japan which have not been appraised and on which dumping margins exist.

A "Withholding of Appraisement Notice," published in the Federal Register of January 22, 1976, stated that there was reasonable cause to believe or suspect that there were sales at less than fair value. Pursuant to that notice, interested persons were afforded the opportunity to present oral and written views prior to the final determination in this case.

With respect to the discontinuance for Mitsubishi, the Federal Register notice will state in part:

> After careful consideration it has been deemed appropriate to modify existing policy to discontinue the investigation with respect to any company, even if sales by other companies are made at margins of dumping which are more than minimal, when all or

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nearly all sales by such company to the U.S. during the period under consideration have been examined and the possible margins of dumping are minimal in relation to the volume of exports of the subject merchandise by such company. Under such circumstances, and consistent with existing policy where a discontinuance has applied on a country-wide basis, assurances of no future sales at less than fair value will be required, and such company, or companies, will be required to make such periodic reports as the Secretary deems appropriate.

Imports of the subject merchandise during calendar year 1975 were valued at roughly $2,000,000. Mitsubishi accounts for approximately 25-30 percent of exports to the U.S.

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INGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE April 28, 1976

ROBERT A. GERARD SWORN IN AS ASSISTANT SECRETARY

Robert A. Gerard, 31, took the oath of office today for the newly established Treasury post of Assistant Secretary of the Treasury for Capital Markets and Debt Management. He was sworn in by Secretary William E. Simon.

Mr. Gerard, a native of New York City, joined Treasury in December 1974 as the first Director of the Office of Capital Markets Policy. He was appointed Deputy Assistant Secretary for Financial Resources Policy in September 1975, and continued in that position until becoming Assistant Secretary.

Prior to joining Treasury, Mr. Gerard specialized in banking and securities law as an Associate with the Washington firm of Wilmer, Cutler & Pickering from 1970-74. In 1969 and 1970, he was Law Clerk to Judge Carl McGowan of the United States Court of Appeals for the District of Columbia Circuit.

He is a graduate, magna cum laude, of Columbia University Law School, 1969, and cum laude, of Harvard College, 1966, and a member of the Bar Association of the District of Columbia. At Columbia he was Notes & Comments Editor of the Law Review, and a Harland Fiske Stone Scholar.

Married to the former Elizabeth Coolidge Gallatin, the couple has two children, Celia Coolidge and Robert Gallatin, and reside in Washington, D.C.

As Assistant Secretary, Mr. Gerard is responsible for all domestic financial market matters and is principal advisor to the Secretary, Deputy Secretary, and Under Secretary for Monetary Affairs on debt management, federal financing, the financing of non-federal sectors of the economy, and general capital markets policy. He also oversees policy and control of Treasury operations in relation to the Federal Financing Bank, and is directly responsible for Treasury functions under the New York City Seasonal Financing Act of 1975.

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the Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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April 27, 1976

Statement by Treasury Secretary William E. Simon
concerning IMF work stoppage

The IMF staff is one of the highest paid group of workers in the history of international civil servants. Their demands for an even larger increase are ridiculous when I compare their salaries and fringe benefits with comparable organizations -- both domestic and international. When they name me "Beast of the Hour", I hope I get to pick the type of animal because I guarantee you it will be carnivorous.

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Note: Additional information on U.S. position regarding the IMF salary question can be obtained from Under Secretary for Monetary Affairs Ed Yeo, 964-5847 or Special Assistant to the Secretary Bill Rhatican, 964-5252.

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BACKGROUND INFORMATION
ON
IMF SALARY INCREASE REQUEST

1. The U. S. has recommended a salary increase of 5.8% in 1976.

2. IMF employees received salary increases of 19% in FY 1975.

3. 40% of IMF employees earn $30,000 per year (net). (Approximately $44-46,000 - when accounting for U. S. Federal taxes.)

4. U. S. accounts for approximately 22% of the $35 billion in the IMF. (Approximately 7-1/2 - 8 billion)

Department of the Treasury
Office of Public Affairs

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PARTIAL LIST OF IMF EMPLOYEE BENEFITS

1. Housing Loan -- Partial mortgage at favorable rate on 1st home for new employee

2. Home Leave - Every two years - transportation paid by IMF for employee and family

3. Medical Insurance - IMF pays two-thirds (May 1)

4. Subsidized Parking - Employee pays $25.00/month

5. Membership in Bretton Woods Recreation Association, Potomac, Maryland - Membership fee is nominal. Association property includes restaurant, golf course, Tennis courts.

Facility was built by IMF and paid for by IMF Funds.

6. "Point System" - When an IMF employee travels 200 days on official business, IMF will pay the spouse's transportation costs on one succeeding trip, after which employee begins accumulating points again.

7. Subsidized cafeteria

8. Education allowance for dependents of expatriate employees.

9. Fund pays all moving expenses to and from assignments.

10. Generous and fully indexed pensions system and lucrative severance arrangement in lieu of pension.

11: Before the 5.8% increase effective as of March 1, 1976, 39% of the total professional staff (773) made more than $30,000 yearly in <u>net</u> salaries and allowances.

12. More than 90 of the professional staff (12.7%) make more than the Secretary of the Treasury on a net basis.

Department of the Treasury
Office of Public Affairs.

he Department of the TREASURY NEWS
ASHINGTON, D.C. 20220 TELEPHONE 964-2041

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE April 28, 1976

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TREASURY ANNOUNCES MAY REFINANCING

The Treasury will raise $2.2 billion of new cash and refund $4.1 billion of securities maturing May 15, 1976, by issuing $2.0 billion of 2-year notes, $3.5 billion of 10-year notes, and $0.75 billion of 23-3/4-year bonds.

The $4.1 billion of maturing securities to be refunded in the general offering are those held by private investors. Government accounts and Federal Reserve Banks, for their own accounts, hold $1.4 billion of maturing securities that may be refunded by issuing additional amounts of the new securities. Additional amounts of the 2-year notes and the bonds may also be issued, for new cash only, to Federal Reserve Banks as agents for foreign and international monetary authorities.

The 2-year notes will be auctioned on Tuesday, May 4, 1976, with bidding on a yield basis. The interest rate will be set following the auction.

The 10-year notes will bear interest at the rate of 7-7/8%. They will be sold at par. Subscriptions will be received through Wednesday, May 5, 1976.

The 23-3/4-year bonds will bear interest at 7-7/8% and will be auctioned on Friday, May 7, 1976, by the price method.

Final payment for all of these securities will be required by Monday, May 17, 1976.

Further details about each of the new securities are given in separate press announcements and in the official offering circular.

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Department of the TREASURY NEWS
INGTON, D.C. 20220 TELEPHONE 964-2041

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For information on submitting tenders in the Washington, D. C. area: PHONE WO4-2604

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE April 28, 1976

TREASURY TO AUCTION $750 MILLION OF 23-3/4-YEAR BONDS

The Department of the Treasury will auction $750 million of 23-3/4-year bonds as one of three securities to be issued for the purpose of refunding debt maturing May 15 and raising new cash. Details of the other two securities are contained in separate announcements. Additional amounts of the bonds may be issued to Government accounts and Federal Reserve Banks for their own account in exchange for notes maturing May 15, 1976, and to Federal Reserve Banks as agents for foreign and international monetary authorities for new cash only.

The bonds now being offered will be an additional amount of 7-7/8% Treasury Bonds of 1995-2000 dated February 18, 1975, due February 15, 2000, callable at the option of the United States on any interest payment date on and after February 15, 1995 (CUSIP No. 912810 BS 6) with interest payable on February 15 and August 15. They will be issued in registered and bearer form in denominations of $1,000, $5,000, $10,000, $100,000 and $1,000,000, and they will be available for issue in book-entry form to designated bidders.

Tenders will be received up to 1:30 p.m., Eastern Daylight Saving time, Friday, May 7, 1976, at any Federal Reserve Bank or Branch and at the Bureau of the Public Debt, Washington, D. C. 20226; provided, however, that noncompetitive tenders will be considered timely received if they are mailed to any such agency under a postmark no later than Thursday, May 6, 1976. Tenders must be in the amount of $1,000 or a multiple thereof. Each tender must state the price offered, if a competitive tender, or the term "noncompetitive", if a noncompetitive tender. Fractions may not be used in tenders. The notation "TENDER FOR TREASURY BONDS" should be printed at the bottom of envelopes in which tenders are submitted.

Competitive tenders must be expressed on the basis of price, in two decimal places, e.g., 100.00. Tenders at a price less than 94.26 will not be accepted. Tenders at the highest prices, and noncompetitive tenders, will be accepted to the extent required to attain the amount offered. Successful competitive bidders will be required to pay for the bonds at the price they bid. Noncompetitive bidders will be required to pay the average price of all accepted competitive tenders; the price may be 100.00, or more or less than 100.00. BIDDERS SUBMITTING NONCOMPETITIVE TENDERS SHOULD REALIZE THAT IT IS POSSIBLE THAT THE AVERAGE PRICE MAY BE ABOVE PAR, IN WHICH CASE THEY WOULD HAVE TO PAY MORE THAN THE FACE VALUE FOR THE BONDS.

The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations noncompetitive tenders for $500,000 or less and all tenders from Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities, will be accepted in full at the average price of accepted competitive tenders.

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Commercial banks, which for this purpose are defined as banks accepting demand deposits, and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, may submit tenders for the account for customers, provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account.

Tenders will be received without deposit from commercial and other banks for their own account, Federally-insured savings and loan associations, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds, international organizations in which the United States holds membership, foreign central banks and foreign States, dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, Federal Reserve Banks, and Government accounts. Tenders from others must be accompanied by payment of 5 percent of the face amount of bonds applied for. However, bidders who submit checks in payment on tenders submitted directly to a Federal Reserve Bank or the Treasury may find it necessary to submit full payment for the bonds with their tenders in order to meet the time limits pertaining to checks as hereinafter set forth. Allotment notices will not be sent to bidders who submit noncompetitive tenders.

Payment for accepted tenders must be completed on or before Monday, May 17, 1976, and include accrued interest from February 15 to May 17, 1976, in the amount of $19.90385 per $1,000 of bonds allotted. Payment must be in cash, 6-1/2% Treasury Notes of Series B-1976 or 5-3/4% Treasury Notes of Series E-1976, which will be accepted at par, in other funds immediately available to the Treasury by the payment date or by check drawn to the order of the Federal Reserve Bank to which the tender is submitted, or the United States Treasury if the tender is submitted to it, which must be received at such Bank or at the Treasury no later than: (1) Wednesday, May 12, 1976, if the check is drawn on a bank in the Federal Reserve District of the Bank to which the check is submitted, or the Fifth Federal Reserve District in case of the Treasury, or (2) Monday, May 10, 1976, if the check is drawn on a bank in another district. Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at a Federal Reserve Bank. Where full payment is not completed on time, the allotment will be canceled and the deposit with the tender up to 5 percent of the amount of bonds allotted will be subject to forfeiture to the United States.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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For information on submitting tenders in the Washington, D. C. area: PHONE WO4-2604

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE April 28, 1976

TREASURY TO AUCTION $2.0 BILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $2.0 billion of 2-year notes as one of three securities to be issued for the purpose of refunding debt maturing May 15 and raising new cash. Details of the other two securities are contained in separate announcements. Additional amounts of the notes may be issued to Government accounts and Federal Reserve Banks for their own account in exchange for notes maturing May 15, 1976, and to Federal Reserve Banks as agents for foreign and international monetary authorities for new cash only.

The notes now being offered will be Treasury Notes of Series L-1978 dated May 17, 1976, due April 30, 1978(CUSIP No. 912827 FN 7) with interest payable on a semiannual basis on October 31, 1976, and thereafter on April 30 and October 31. The coupon rate will be determined after tenders are allotted. The notes will be issued in registered and bearer form in denominations of $5,000, $10,000, $100,000 and $1,000,000 and they will be available for issue in book-entry form to designated bidders.

Tenders will be received up to 1:30 p.m., Eastern Daylight Saving time, Tuesday, May 4, 1976, at any Federal Reserve Bank or Branch and at the Bureau of the Public Debt, Washington, D. C. 20226; provided, however, that noncompetitive tenders will be considered timely received if they are mailed to any such agency under a postmark no later than Monday, May 3. Tenders must be in the amount of $5,000 or a multiple thereof, and all tenders must state the yield desired, if a competitive tender, or the term "noncompetitive", if a noncompetitive tender. Fractions may not be used in tenders. The notation "TENDER FOR TREASURY NOTES" should be printed at the bottom of envelopes in which tenders are submitted.

Competitive tenders must be expressed in terms of annual yield in two decimal places, e.g., 7.11, and not in terms of a price. Tenders at the lowest yields, and noncompetitive tenders, will be accepted to the extent required to attain the amount offered. After a determination is made as to which tenders are accepted, a coupon rate will be determined at a 1/8 of one percent increment that translates into an average accepted price close to 100.000 and a lowest accepted price above 99.750. That rate of interest will be paid on all of the notes. Based on such interest rate, the price on each competitive tender allotted will be determined and each successful competitive bidder will pay the price corresponding to the yield bid. Price calculations will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final. Noncompetitive bidders will be required to pay the average price of accepted competitive tenders. / BIDDERS SUBMITTING NONCOMPETITIVE TENDERS SHOULD REALIZE THAT IT IS POSSIBLE THAT THE AVERAGE PRICE MAY BE ABOVE PAR, IN WHICH CASE THEY WOULD HAVE TO PAY MORE THAN THE FACE VALUE FOR THE NOTES.

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The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for $500,000 or less, and all tenders from Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities, will be accepted in full at the average price of accepted competitive tenders.

Commercial banks, which for this purpose are defined as banks accepting demand deposits, and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, may submit tenders for the account of customers, provided the names of the customers are set forth therein. Others will not be permitted to submit tenders except for their own account.

Tenders will be received without deposit from commercial and other banks for their own account, Federally-insured savings and loan associations, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds, international organizations in which the United States holds membership, foreign central banks and foreign States, dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, Federal Reserve Banks, and Government accounts. Tenders from others must be accompanied by payment of 5 percent of the face amount of notes applied for. However, bidders who submit checks in payment on tenders submitted directly to a Federal Reserve Bank or the Treasury may find it necessary to submit full payment with their tenders in order to meet the time limits pertaining to checks as hereinafter set forth. Allotment notices will not be sent to bidders who submit noncompetitive tenders.

Payment for accepted tenders must be completed on or before Monday, May 17, 1976. Payment must be in cash, 6-1/2% Treasury Notes of Series B-1976 or 5-3/4% Treasury Notes of Series E-1976, which will be accepted at par, in other funds immediately available to the Treasury by the payment date or by check drawn to the order of the Federal Reserve Bank to which the tender is submitted, or the United States Treasury if the tender is submitted to it, which must be received at such Bank or at the Treasury no later than: (1) Wednesday, May 12, 1976, if the check is drawn on a bank in the Federal Reserve District of the Bank to which the check is submitted or the Fifth Federal Reserve District in case of the Treasury, or (2) Monday, May 10, 1976, if the check is drawn on a bank in another district. Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at a Federal Reserve Bank. Where full payment is not completed on time, the allotment will be canceled and the deposit with the tender up to 5 percent of the amount of notes allotted will be subject to forfeiture to the United States.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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For information on submitting tenders in the Washington, D. C. area: PHONE WO4-2604

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE April 28, 1976

TREASURY TO OFFER $3.5 BILLION OF 10-YEAR NOTES

The Department of the Treasury will offer to sell $3.5 billion of 10-year notes as one of three securities to be issued for the purpose of refunding debt maturing May 15 and raising new cash. The amount of the offering may be increased by a reasonable amount to the extent that the total amount of subscriptions for $500,000 or less accompanied by 20% deposit so warrants. Details of the other two securities are contained in separate announcements. Additional amounts of the notes may be issued to Government accounts and Federal Reserve Banks for their own account.

The notes now being offered will be 7-7/8% Treasury Notes of Series A-1986 dated May 17, 1976, due May 15, 1986 (CUSIP No. 912827 FP 2). They will be sold at par. Interest will be payable on a semiannual basis on November 15, 1976, and thereafter on May 15 and November 15. The notes will be issued in registered and bearer form in denominations of $1,000, $5,000, $10,000, $100,000 and $1,000,000 and they will be available for issue in book-entry form to designated subscribers.

Subscriptions will be received through Wednesday, May 5, 1976, at any Federal Reserve Bank or Branch and at the Bureau of the Public Debt, Washington, D. C. 20226; provided, however, that subscriptions up to $500,000 accompanied by a 20% deposit will be considered timely received if they are mailed to any such agency under a postmark no later than Tuesday, May 4, 1976. Subscriptions must be in the amount of $1,000 or a multiple thereof. The notation "SUBSCRIPTION FOR TREASURY NOTES" should be printed at the bottom of envelopes in which subscriptions are submitted.

Commercial banks, which for this purpose are defined as banks accepting demand deposits, and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, may submit subscriptions for the account of customers, PROVIDED THE NAMES OF THE CUSTOMERS ARE SET FORTH THEREIN. Others will not be permitted to submit tenders except for their own account.

The Secretary of the Treasury expressly reserves the right to accept or reject any or all subscriptions, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, subscriptions for $500,000, or less, will be allotted in full provided that 20% of the face value of the securities for each subscriber is submitted as a deposit. Such deposits must be submitted to the Federal Reserve Bank or Branch, or to the Bureau of the Public Debt, with the subscription; this will apply even if the subscription is for the account of a commercial bank or securities dealer, or for one of their customers. Guarantees in lieu of deposits will not be accepted. Allotment notices will not be sent to subscribers making the 20% deposit.

Subscriptions not accompanied by the 20% deposit will be received subject to a percentage allotment irrespective of the size of the subscription. No allotment will be made of these subscriptions until and unless the subscriptions accompanied by 20% deposit pursuant to the preceding paragraph have been allotted in full. On such subscriptions a 5% deposit will be required from all subscribers except commercial and other banks for their own account, Federally-insured savings and loan associations, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds,

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international organizations in which the United States holds membership, foreign central banks and foreign States, dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, Federal Reserve Banks, and Government accounts. Commercial banks and securities dealers authorized to enter subscriptions for customers will be required to certify that they have received the 5% deposit from their customers or guarantee payment of the deposits.

Subscribers may submit subscriptions under each of the provisions of the two foregoing paragraphs, i.e., up to $500,000 with a 20% cash deposit and in any amount with a 5% deposit. Each of the two types of subscriptions will be treated as separate subscriptions.

Payment for accepted subscriptions must be completed on or before Monday, May 17, 1976. Payment must be in cash, 6-1/2% Treasury Notes of Series B-1976 or 5-3/4% Treasury Notes of Series E-1976, which will be accepted at par, in other funds immediately available to the Treasury by the payment date or by check drawn to the order of the Federal Reserve Bank to which the subscription is submitted, or the United States Treasury if the subscription is submitted to it, which must be received at such Bank or at the Treasury no later than: (1) Wednesday, May 12, 1976, if the check is drawn on a bank in the Federal Reserve District of the Bank to which the check is submitted, or the Fifth Federal Reserve District in case of the Treasury, or (2) Monday, May 10, 1976, if the check is drawn on a bank in another district. Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at a Federal Reserve Bank. Where full payment is not completed on time, the allotment will be canceled and the deposit with the subscription up to 5 percent of the amount of notes allotted will be subject to forfeiture to the United States.

Bearer notes will be delivered on May 17, 1976, except that if adequate stocks of the notes are not available on that date, the Department of the Treasury reserves the right to issue interim certificates on that date. The certificates would be bearer securities exchangeable at face value for 7-7/8% Treasury Notes of Series A-1986 when available.

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FOR RELEASE UPON DELIVERY

STATEMENT BY THE HONORABLE GERALD L. PARSKY
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FOREIGN COMMERCE AND TOURISM
SENATE COMMITTEE ON COMMERCE
MONDAY, MAY 3, 1976, 9:00 a.m.

Study of Foreign Portfolio Investment in the United States

Mr. Chairman and Members of the Subcommittee:

It is a pleasure for me to be here to present to you the findings of the Treasury Department's study of foreign portfolio investment in the United States. It is certainly fitting, Mr. Chairman, that the results of this study be presented to your subcommittee, for this represents the culmination of a process of consultation and cooperation between the Treasury and you and your staff that has extended over a period of more than two years -- beginning with your introduction of the Foreign Investment Study Act of 1974, which provided the authority for us to undertake the study.

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The idea for this study originated in 1973, at a time when concern was being expressed over the possible implications of the rise in investments here by European and Japanese interests. Later, the accumulations of funds by the oil-producing countries added to this concern and a number of bills were introduced in the Congress which would impose restrictions on investments from abroad.

The President has resisted these proposals and we have opposed new restrictions on foreign investment in the United States. We continue to believe that the operation of market forces will direct worldwide investment flows in the most productive way. Thus, we have sought to maintain our traditional policy of freedom for investments here by foreigners. At the same time, we did share the view of this Committee and others in Congress that adequate information on international investment should be available to all branches of government and to the public. Consequently, we strongly supported the Foreign Investment Study Act of 1974 which called upon the Commerce and Treasury Departments to undertake comprehensive overall studies of foreign direct and portfolio investments in the United States and to report their findings within 18 months. We did not view such legislation as in any way weakening our commitment to the free flow of investment capital. Rather, we saw it as a desire to ensure that the necessary facts were available so that sound policy could be developed.

As you are well aware, the Act was passed in October of 1974. Before that, however, in anticipation of its passage, the Treasury had begun laying the groundwork. First, we had to design a questionnaire form for business firms which would supply us with all the statistical data required. We then had to consult with representatives of the reporting community to assure that the information called for could be supplied at a reasonable cost and in time to allow us to assimilate it and analyse it within the time-frame of the Act. This process was completed in late 1974 and in January 1975 forms were mailed out to business firms.

For the research on some of the non-quantitative parts of the study -- why and by what means foreigners invest in the United States and the legal aspects involved -- we decided to contract for the services of a private research firm. After reviewing the numerous responses to our solicitation for bids, we awarded the contract to R. Shriver and Associates on the basis of its qualifications, work plan and price.

The collection, review and analysis of all the information we have gathered has been a substantial undertaking. We have received some 10,000 completed forms from business firms. In addition, Shriver and Associates has submitted to us reports on their interviews with over 100 persons in this country and abroad who are involved in foreign portfolio investment, and very extensive material on the purpose and effect of U.S. and foreign laws relating to foreign portfolio investment.

A completely thorough review and analysis of this wealth of information takes much longer than the few months which have passed since it became available to us and we will continue to review it for some time to come. However, the Congress, quite understandably, wanted a timely report on our findings which I am happy to submit at this time. Attached to my statement is a summary of our findings. Later this month we will print and distribute to the Congress and the public a more detailed report. I would now like to give you the highlights of our findings and our major conclusions and recommendations.

Highlights of the Treasury Study

The comprehensive benchmark survey which we undertook under the study shows that foreign portfolio investment in the United States was approximately $67 billion as of the end of 1974. This consisted of about $25 billion in stocks, $16 billion in corporate bonds and other private debt, and $26 billion in government bonds and notes.

The total derived from the benchmark survey was about $10 billion higher than our previous estimate; most of this difference, nearly $7 billion, was in the stock figure. This is not surprising since our previous estimate was based on a survey done for 1941 and both the composition and the value of this portfolio obviously could have changed substantially over a period of 33 years.

Special factors, not directly related to market forces, accounted for most of the foreign holdings of debt instruments in 1974. First, practically all of the holdings of U.S. Government securities were held by foreign official institutions, such as central banks, because of their policies of holding a major part of their international reserves in dollars. Secondly, nearly all of the recorded foreign holdings of U.S. corporate bonds are the result of the U.S. Government balance-of-payments programs in previous years when U.S. companies were encouraged to finance their overseas investments through Euro-bonds, even if they had to pay a higher interest rate than on borrowings in the United States.

When these special factors are taken into account, it becomes apparent that market-related foreign portfolio investment in this country is primarily in the form of corporate stocks.

This is seen more clearly if we examine the estimates of foreign portfolio holdings as of the end of 1975, which are based on the 1974 survey and our monthly data on foreign portfolio transactions plus estimates of the changes in market values of foreign-held securities. These estimates indicate that the total foreign portfolio as of end 1975 was $86 billion, of which $37 billion or 43 percent consisted of stocks. Since stocks play such a dominant role in foreign portfolio investment in this country, I think it is important to comment in a little more detail about these holdings.

The survey showed that virtually every country in the world held some U.S. stocks but the holdings were heavily concentrated in a few countries. Switzerland, the United Kingdom and Canada alone accounted for nearly 60 percent of the total and when the Netherlands and France are added, these five countries represented nearly 75 percent of total foreign holdings.

Slightly over half of the total was in the names of foreign banks, brokers, and nominees who were holding these securities in part on behalf of other persons. This was particularly true in the case of Switzerland where nearly

90 percent of the holdings were in this category, a considerable proportion of which represented holdings for beneficial owners in other countries.

The other categories of major holders were: individuals, holding $4.5 billion, about half of which was held by U.S. nationals residing overseas; institutional investors, such as investment trusts, with $3.7 billion; other private institutions, $2.5 billion; and foreign official institutions, $1 billion.

The distribution of these holdings by industry was fairly widely diversified and did not differ significantly from that of American investors. Foreign holdings of U.S. stocks were equal to about 5 percent of the value of all publicly traded stocks.

Through interviews with foreign portfolio managers here and abroad, we assessed the reasons for foreign portfolio investment activities in the United States. The principal motivations include:

1. Expectations of long-term capital gains .
2. The relative economic and political stability of the United States. Many European investors, for instance, see the United States as offering more profit potential and less risk of nationalization than other major countries

3. The large size and liquidity of U.S. capital markets. The lack of depth and liquidity associated with smaller capital markets elsewhere make it difficult to place large amounts of funds in a relatively short period of time.
4. Close regulation and organization of U.S. securities markets. This serves as a desirable safeguard.
5. Great range of investment choices.
6. Sales efforts of U.S. securities dealers.

and

7. Greater efficiency of U.S. markets.

In addition to seeking to determine the reasons behind investment activity, we also attempted to identify the processes and mechanisms through which investment is made in the United States. We found that foreign portfolio investors use the same investment channels as U.S. investors for the most part, i.e, the New York and American exchanges, the regional exchanges, and the over-the-counter market. Many of the major U.S. companies are also listed on foreign exchanges. Foreigners rely heavily on U.S. brokers and dealers for placing orders and obtaining information on U.S. securities.

The heterogeneous nature of the numerous foreign investors in U.S. securities makes it difficult to isolate the effects they have on our financial markets and on our economy. Nevertheless, it is true that any additional demand for securities in any segment of a capital market tends to raise prices and reduce yields on the type of securities demanded. Thus, foreign purchases of U.S. stocks and bonds have a tendency to reduce yields and therefore make raising of capital relatively easier for domestic borrowers. This in turn will tend to stimulate real investment and increase the output and productivity of the economy. We did find that foreign holdings of U.S. stocks are turned over somewhat more frequently than U.S. holdings. On the other hand, foreigners as a whole have been net purchasers of U.S. stocks in every year since 1959 except for the years 1964-1966, thus they have on balance tended to strengthen stock prices. Generally, our conclusion is that more participation in our markets tends to make them deeper and more efficient. Thus, foreign participation is beneficial.

The Treasury study also involved comprehensive research into the legal aspects of foreign portfolio investment. While the U.S. legal structure is generally viewed favorably by foreign investors, particularly our securities laws, some aspects are viewed as a deterrent to investments here. The U.S. withholding tax on dividends and interest payments and the fact that the U.S. estate tax is levied on the U.S. securities holdings of foreign investors are two illustrations of such negative factors.

OPEC Investments

Mr. Chairman, that provides you with the general outlines of our study. Since one of the major reasons for undertaking this study was the concern expressed by some over the potential of the oil-producing countries to acquire large amounts of assets in this country, before concluding, I would like to make some observations about these investors in particular.

In the early period of the large accumulations by the OPEC countries, almost all of their investments in the United States were in the form of short-term assets, such as Treasury bills and short-term bank C.D.'s. Being cautious and conservative investors it was natural for them to confine their investments to the safest and most liquid forms at the outset. This is one of the reasons why our benchmark survey, which was taken as of the end of 1974, shows relatively small holdings for these countries, \$2.4 billion, which was less than 4 percent of total foreign portfolio investment in this country.

In 1975 and early 1976, these countries shifted substantial amounts into longer-term assets, primarily Treasury and other Federal agency bonds and notes and corporate stocks; lesser, but not insignificant, amounts were also invested in long-term bank C.D.'s and corporate bonds. In 1975, OPEC countries made portfolio investments in the United States of about \$5.7 billion, and in January and February of this year they purchased another \$1 billion.

Looking ahead, we believe that the oil producing countries will place an increasing proportion of their investments in longer-term debt and equity instruments. Although investments will continue to be placed in the United States, we must recognize the fact that the rate of new investment by many of the oil producers outside their own countries will decline as they are able to absorb more internally.

With respect to the policies these countries are pursuing, enough time has now passed for us to have a clear picture of their approach to investment.

First, they are cautious and conservative investors. I have spoken to the managers of funds in most of the OPEC countries and in particular in those countries that are now accounting for the great bulk of the oil surpluses, namely Saudi Arabia, Kuwait and the United Arab Emirates. Although their internal development objectives differ, they all are following diversified investment objectives similar to any institutional investor.

Secondly, they are almost entirely portfolio investors and none of them have a desire to acquire and/or control major U.S. companies. The Saudi Arabian Government, for instance, has told me that they will not invest in more than 5 percent in any particular company, and recently indicated to us that they currently do not own more than 1 percent of any company. Further, a country like Kuwait has participated in our markets for years and has always been a most responsible investor.

These characteristics come through quite clearly both in the record of OPEC investments in the United States and in the numerous discussions which I have personally had with their leaders. I do not believe that these countries would consider investments here which would be against our national interest. I am also confident that they would consult with us before undertaking any significant direct investments. In sum, they have been and will continue to be good, sound investors; and I think we should continue to welcome their investments just as we do those of other countries.

Conclusions and Recommendations

Our final tasks under the Act were to study the adequacy of our information and reporting programs on foreign portfolio investment and to recommend means whereby this information can be kept current.

The benchmark survey which we have just completed gives us a comprehensive and detailed inventory of foreign portfolio investment as of the end of 1974. The magnitude and composition of this inventory will, of course, change as foreigners continue to buy and sell U.S. securities in the years after 1974. We will be able to update the major categories of this inventory reasonably accurately for some time to come by adding (or subtracting) our monthly data on transactions to the 1974 benchmark figures and applying estimated changes in the market values of foreign holdings.

The results of the survey suggest that there is some underreporting bias in these monthly data. This was not unexpected and the differences between the totals reported by the survey and those which had previously been estimated do not appear unduly large, in view of the long period of time that has elapsed since the previous benchmark in 1941 and the significance of the non-transaction factors affecting the investment position totals. It is noteworthy that the difference is substantially larger in the figures on equity holdings, where the valuation adjustment problem is greatest, than it is for holdings of debt instruments.

The survey results, therefore, do not appear to raise major questions about the current reporting system and we believe that the conceptual and institutional structure of this system is adequate. Nevertheless, it will be necessary to constantly monitor the reports and to maintain close communication with the reporting firms to ensure that there are no major gaps in our reporting network.

Although it might be desirable to undertake another benchmark survey at some time in the future, I think that this decision should be left for the future. The desirability of another survey can then be determined on the basis of how much the increased accuracy of the data would be worth as compared to the costs involved to both the Government and the private sector in undertaking a survey.

One important step toward improving our data gathering capability has already been taken by you, Mr. Chairman, in introducing the International Investment Survey Act of 1975, S.2839. Thus far, we have been relying on a patchwork of laws to collect data on foreign portfolio investment, laws which are either clearly lacking in some respects or ambiguous as to our authority to collect such data. S.2839 would give us broad and permanent authority to collect data on all forms of international investment and we again strongly support its passage with the amendments I proposed in my testimony of February 23, 1976.

My final observations go to the basic question which gave rise to this study over two years ago: Is the magnitude and nature of foreign investment in this country such that a change in our basic policy toward this investment should be made?

As you know, this country has traditionally had an "open door" policy toward foreign investment. We do not impose special barriers to such investment, except for a few long-standing and internationally recognized restrictions, nor do we offer special incentives for such investment. Furthermore, foreign investors are generally treated equally with domestic investors once they are established here, that is, they are accorded "national treatment." This policy is based on the premise that investment in this country from foreign sources is generally beneficial to our economy, just as is investment from domestic sources and, that the allocation of investment capital will be most productive if decisions on investment are left to the market place.

There is nothing in the findings of our study to indicate that this policy should be changed in any way. On the contrary, the study has reinforced our view that foreign investment is beneficial to our economy and that we should continue to welcome it. As long as our national security is protected, and as long as the company is willing to abide by our laws and compete in our market place, we should not object as to whether its owner is from the United States, or France, or Abu Dhabi.

The benefits of foreign investment are readily apparent when they are made directly in the form of new plants and equipment -- so called "bricks and mortar" investment. In the case of portfolio investments by foreigners, however, it is sometimes thought that we get nothing of substance, that only "paper transfers" are involved since foreigners are merely converting their holdings of liquid dollars into other forms of paper assets, such as stocks and bonds.

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This notion overlooks the fact that in the capital investment process there are many different kinds of investors and all of them play a vital role. Portfolio investors, domestic and foreign, broaden the market for U.S. securities, and thereby the opportunities for American firms to acquire the financing needed for new investments in "bricks and mortar." Even if foreigners never injected capital directly into U.S. firms by buying new security issues, their role would be no less beneficial since the market for new issues is directly dependent on a broad and lively secondary market.

The more participation we have in our capital market, the more efficient it is in serving the needs of our economy for investment capital. The participation of foreign investors serves this purpose, just as that of American investors does, and distinctions made on the basis of the nationality of investors have no economic rationale.

The American capital market is the largest and most efficient capital market in the world. Unrestricted access of foreigners to our market -- both as lenders and borrowers of portfolio capital -- is beneficial to this market. It is also beneficial to the interchange of goods, services and capital between nations, which is vital to the growth of the United States and the world economy.

Rather than contemplating new restrictions on foreign capital inflows, we should seek to assure that impediments to these healthy additions to our economy are minimized. The Administration's proposal to remove the withholding tax on dividend and interest payments to foreigners is an important step in this direction. We should continue to look for other measures we can take to assure that our capital market continues to grow as the world's major international financial center.

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STUDY OF FOREIGN PORTFOLIO INVESTMENT IN THE UNITED STATES

SUMMARY OF FINDINGS

U. S. Treasury Department
Office of the Secretary
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Introduction

This is a summary of the final report on the findings of a study of foreign portfolio investment in the United States that the Department of the Treasury has recently completed. This study was undertaken pursuant to the Foreign Investment Study Act of 1974 (Public Law 93-479) which authorized and directed the Secretaries of the Treasury and Commerce "to conduct a comprehensive, overall study of foreign direct and portfolio investments in the United States." In dividing this responsibility, the Act directed the Secretary of the Treasury to undertake that part relating to foreign portfolio investment while the Secretary of Commerce was to cover foreign direct investment. The Act called for interim reports on the findings of the two studies by October 1975 and final reports six months later.

The term "foreign portfolio investment" generally refers to foreign investments in U.S. securities that do not involve any significant influence on the management of the enterprise. The definition used for the purpose of this study covers investments in the United States in voting stocks involving less than 10 percent ownership by the foreign investor, in non-voting stocks, and in debt instruments with maturities of more than one year by persons residing in foreign countries (other than non-voting stock and debt owned by a "direct investor").

It should also be noted that the term "foreign" includes U.S. nationals residing abroad and excludes foreign nationals residing in the United States.

The idea for this study originated in 1973, at a time of increasing public concern over the possible effects on our economy of a rise during that year in investments here by European and Japanese interests. It received a further impetus the following year as the focus of this concern shifted to the oil-producing countries, who had begun to accumulate substantial amounts of investable surplus funds as a result of the increase in oil prices.

During the earlier phase of this concern, the Executive Branch undertook an overall review of U.S. policy toward foreign investment here. The conclusion of that review was that we should maintain our traditional "open door" approach to such investments, under which we (1) offer no special incentives to foreigners to invest in this country and, with a few exceptions, no special barriers, and (2) treat them equally with domestic investors once they are established here. It was also concluded, however, that we needed more information on foreign investment in this country.

Thus, the Executive Branch welcomed the bill which authorized this study of foreign investment in the United States when it was introduced in the Congress in December 1973. Officials of the Executive Branch testified in favor of the bill in both houses of Congress and their staffs worked closely with congressional staff members to refine it during the following months. In the fall, both the House and the Senate passed the bill by substantial majorities and on October 26, 1974, the President signed it into law.

Well before the Act was passed, the Treasury staff had already completed a substantial amount of groundwork on this study -- the first of this type to be done since 1941. A major part of the study was a statistical survey to collect data on foreign portfolio investment in this country. In this effort, first priority was given to determining exactly what data were needed and then designing forms and elaborating regulations that would facilitate its collection. Consultations were held with representatives of potential reporters to ensure that they could produce the required data at a reasonable cost to reporters and within the time frame set by the Act.

The final reporting forms and regulations were mailed to potential reporters in January 1975 with a deadline of March 1 for their completion and return. In total, more than 10,000 forms were completed and returned to the Treasury.

For some of the non-quantitative parts of the study -- relating mainly to the institutional and legal aspects of foreign portfolio investment in the United States -- the Treasury contracted for the services of a private consulting firm. In accordance with established legal procedures, the Treasury released a "request for proposals," soliciting bids from qualified firms. A number of firms responded to the request, and the contract was finally awarded to the firm of R. Shriver and Associates.

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The contractor's work plan involved two major tasks in regard to the institutional aspects of the subject:

-- A survey of the reasons for foreign portfolio investment activities in the United States.

-- Identification of the processes and mechanisms through which foreign portfolio investment is made in the United States, the financing methods used, and the effects of foreign portfolio investment on American financial markets.

The bulk of the contractor's effort consisted of interviews with more than 100 individuals in prominent financial institutions, both here and abroad, that are active in foreign portfolio investment in the United States. The institutions covered included investment banks, broker/dealers, stock exchanges, industry associations, bank trust departments, investment advisors, U.S. subsidiaries of foreign financial institutions, and insurance companies. The foreign countries in which interviews were conducted were: Canada, France, Hong Kong, Japan, the Netherlands, Switzerland, the United Kingdom, and West Germany.

The contractor's legal work was directed toward an analysis of the purpose and effects of U.S. laws and regulations that relate to foreign portfolio investment here. Information was obtained through study of the laws themselves and their legislative histories, discussions with officials of Federal and state government agencies, and interviews with representatives of the financial communities in the United States and selected foreign countries.

The Treasury's overall progress on the study through early October 1975, was reported in an Interim Report to the Congress, which was released on October 26. The past six months have been devoted to bringing our data collection and research efforts to an end, assimilating the results, and formulating our conclusions and recommendations. The remainder of this report is a summary of the findings of this study. The full report will be printed and made available to the Congress and the public in the near future.

The Benchmark Survey

The major undertaking of the Treasury study was a comprehensive benchmark survey of foreign portfolio investment in the United States as of the end of 1974. The Treasury Department has been collecting monthly and quarterly data on foreign portfolio investment in the United States for many years; however, this reporting program was not designed to yield the detailed data called for in the Foreign Investment Study Act. Furthermore, the continuing report series covers the flow of foreign portfolio capital into and out of the United States at transactions values; it does not show what the stock of this investment is, i.e., the total outstanding value of such investment at a given time.

The last complete survey of the outstanding amount of foreign portfolio investment in the United States was done by the Treasury Department for 1941. Working from this benchmark, the Department of Commerce has made annual estimates of the amounts outstanding by estimating changes in the market value of the investments held by foreigners and adjusting for recorded inflows or outflows in each year. Obviously, the use of such data over a period of more than 30 years can result in substantial differences between the estimated and actual amounts. Therefore, the first major task of the study was to undertake a new survey of the stock of foreign portfolio investment in the United States.

The data for the benchmark survey were collected from two sets of reporters. The first set was the "issuers" (i.e., of securities or long-term debt) themselves -- U.S. corporations, partnerships, investment companies, and other organizations and persons subject to the jurisdiction of the United States. These persons were required to provide, on the basis of their own records or those of their transfer agents, a detailed listing of direct foreign-resident ownership of each of their securities or their long-term debt disaggregated by country of residence and type of foreign-resident owner.

In many cases the name and address shown in the issuers' records are not those of the final beneficial owner, but rather those of a "nominee" holder of record, usually a broker or a bank, who holds the securities on behalf of the beneficial owner. If such a nominee is a U.S. person, he may hold these securities for foreign as well as domestic owners. A second set of report forms, therefore, had to be collected from U.S. holders of record who held U.S. securities for foreign accounts. These forms required information to be filed on the country of residence and type of holder for each of the securities held for foreign persons.

The results of this survey show that foreign portfolio investment as of December 31, 1974, was $67 billion. This compares with previous estimates published by the Commerce Department of $57 billion. The total consisted of five broad categories of investments as follows:

	($ billion)	(Previous estimate)
Stocks	24.7	(18.0)
Corporate bonds	8.0	(7.8)
Other private debt	8.3	(6.6)
U.S. Treasury bonds and notes	23.8	(22.0)
Other Federal, state and municipal debt	2.4	(2.6)
	67.1	(57.0)

Some $27.4 billion of the total represented the holdings of foreign official institutions, mainly central banks, monetary authorities, and international lending agencies. Of this amount, nearly $23 billion consisted of U.S. Treasury bonds and notes, more than half of the total U.S. debt held by foreigners. Most of these official holdings represented international reserves of the countries concerned, placed in the United States because of the unique position of the dollar as the world's chief reserve currency.

The volume of these official holdings is determined mainly by balance-of-payments factors, independently of the ability of U.S. financial markets to attract foreign capital through the operation of normal market forces. Only to a small extent, such as investments of official pension funds and some of the more recent investments of the Middle East oil-exporting countries, do official funds move primarily in response to market criteria.

Another important special factor affecting the survey totals was foreign holdings of U.S. corporate bonds and other long-term debt resulting from the U.S. Government capital control and restraint programs during the period from the mid-1960's to the early 1970's. Under these programs, U.S. firms were encouraged to go to foreign capital markets to raise the necessary funds to finance their direct investments abroad in lieu of moving funds from the United States to foreign countries. As a result, U.S. firms placed a large volume of both straight and convertible bonds abroad, so-called Euro-bond issues, and additionally raised funds through direct loans from foreign banks. When this was done by bond issues of U.S.-incorporated entities, such as finance affiliates incorporated in Delaware, foreign placements resulted in an increase of foreign portfolio holdings of U.S. bonds and other long-term debt.

It should also be noted that the reporting date of the benchmark survey fell in the early period of the large accumulations of funds by the oil-producing countries, before these countries had a full opportunity to allocate their holdings across a balanced and diversified portfolio. Consequently, the end-1974 holdings of these countries in the United States were heavily concentrated in short-term assets, which are not included in the survey. In 1975 and early 1976 the oil-producing countries moved substantial amounts of their U.S. holdings into longer-term assets.

Finally, it should be noted that the reporting date of the survey followed a period when the U.S. stock market was in a deep slump and the general lack of buyer interest in U.S. stocks was also applicable to foreigners. In 1975 and early 1976 there was a strong upsurge in foreign purchases of U.S. stocks, which, along with the sharp increase in the value of U.S. stocks held by foreigners as of end-1974, considerably increased foreign holdings of U.S. stocks, both in absolute terms and as a proportion of the total foreign portfolio of U.S. assets.

When all these factors are taken into account, it is seen that foreign interest in U.S. assets as market-related portfolio investments is primarily in the form of U.S. corporate stocks. Consequently, most of the data and analysis in this report are directed to these holdings.

Foreign Holdings of U.S. Stocks

The foreign holdings of U.S. stocks of about $25 billion as of end-1974 were widely diversified by U.S. industry but heavily concentrated by the recorded country of residence of the foreign holder. While virtually every country in the world was recorded as holding some U.S. stocks, three countries, Switzerland, the United Kingdom and Canada, accounted for 58 percent of the total and when the Netherlands and France are added these five countries alone accounted for 75 percent of the total.

These recorded country distributions are somewhat misleading, however, because of the so-called "nominee problem." Some holders of record of U.S. securities -- "nominees" -- hold these securities on behalf of other persons. Where these nominees were U.S. persons, subject to U.S. law, they were required to report the country of residence and the type of foreign persons on whose behalf they were holding securities as of end-1974. The existence of U.S. nominees, therefore, was not a significant problem in the collection of data for the survey. The existence of foreign nominees, however, who are not subject to U.S. law and the reporting requirements, did present a problem. Holdings by these foreign nominees disguise the true country of residence and the type of beneficial owners of U.S. securities to an unknown extent.

A further difficulty is that there is no way to determine how much of foreign-held U.S. securities are held by foreign nominees since the U.S. reporter often does not know whether the foreign holder indicated on his records is holding the securities for his own account or on behalf of some other person. In order to minimize this second difficulty, a category of foreign holders called "banks, brokers and nominees" was put in the questionnaire under the assumption that foreign banks and brokers who are holders of record of U.S. securities are, for the most part, holding these securities for other persons. The validity of this assumption varies from country to country, however, and it can only be said that the totals shown for "banks, brokers and nominees" are assumed to be the maximum amounts held by nominees in each foreign country.

This category of foreign holder accounted for $13.1 billion, or slightly more than half of total foreign holdings of U.S. stocks. In the case of Switzerland, 88 percent of total holdings was recorded in the names of banks, brokers, and nominees, and for France the comparable percentage was 68. For the other major holders of U.S. stocks, U.K., Canada and Netherlands, the proportions accounted for by this category were considerably less.

It should not be assumed, however, that the total for this category of foreign holders mostly represents holdings on behalf of persons residing in countries other than the countries of the nominees. Only in the case of Switzerland is it believed that the bulk of nominee holdings is for the account of persons in other countries, and even there a significant proportion is believed to be for the account of Swiss residents.

Of the $11.6 billion of foreign holdings of U.S. stocks held directly by types of holders who are presumed to have been the beneficial owners (that is, all holdings except those of "banks, brokers,and nominees") $4.5 billion was held by individuals, divided almost equally among U.S. nationals residing in foreign countries and foreign nationals. About $3.7 billion was held by institutional investors such as investment companies, insurance companies and pension funds. Various other private institutions accounted for $2.5 billion. Foreign official holdings at the end of 1974 amounted to a little less than $1 billion.

The distribution of foreign holdings of U.S. stocks by industry does not seem to differ much from that of American investors; evidence of this is found in the roughly similar industrial distribution of foreign holdings and the total value of stocks listed on the New York Stock Exchange.

There were 328 companies in which the total private portfolio ownership exceeded 10 percent of the stock outstanding; foreign portfolio investment in the voting stock of these companies amounted to $6.7 billion, and they consisted for the most part of large well-known firms whose stock is apparently very popular with foreign investors. An additional 536 companies fell in the five-to-ten percent range of foreign ownership, accounting for $6.6 billion of the portfolio investment in U.S. stocks; the remaining $10.7 billion was invested in 4,422 companies where the ownership was less than 5 percent.

Foreign holdings of U.S. stocks revealed by the survey are considerably higher than those previously published by the Department of Commerce, but not surprisingly so, considering the degree of estimation that necessarily enters into the Commerce Department estimates. One reason for the difference may well be the rather unexpectedly large holdings of stocks by U.S. citizens residing abroad. If these securities were in the main purchased by such citizens at the time they were U.S. residents, their acquisition would not have been reflected in the balance-of-payments statistics and therefore would not have been taken into account in the Commerce Department's estimates.

Foreign Holdings of U.S. Private Debt

U.S. private debt instruments held by foreigners as of end-1974 totaled $16.2 billion, of which $1.5 billion was held by foreign official institutions, including international institutions.

Foreign private holdings were about equally divided between corporate bonds and other forms of private long-term debt. As noted earlier, the bulk of foreign holdings of U.S. corporate bonds is the result of U.S. Government balance-of-payments measures to encourage the issue of Euro-bonds and thus is not truly indicative of foreign interest in U.S. corporate bonds as in the case of U.S. stocks. Nearly all foreign holdings of U.S. corporate bonds were accounted for by these Euro-issues.

Of the $7.3 billion of other forms of U.S. private debt held by private foreign holders, $6.1 billion represented notes and loans, and about one-half of the remaining forms of debt were accounted for by long-term bank certificates of deposit.

Foreign holdings of U.S. private debt were recorded as almost entirely in the hands of institutions, primarily banks, brokers and nominees, with individuals accounting for less than $1 billion. By geographic regions, the holdings were heavily concentrated in a few European countries and Canada. The United Kingdom was the largest holder of U.S. private debt with about 25 percent of the total.

When compared to the total amount of U.S. private marketable debt outstanding it is seen that foreign holdings were not a significant amount. Total foreign holdings of U.S. corporate bonds accounted for only about 3 percent of total U.S. corporate bonds outstanding as of December 31,1974.

Dividend and Interest Payments

The survey questionnaire required reporters to provide information on dividend and interest rates applying to their stock and debt issues outstanding. Information was also obtained on interest rates applying to government securities, and on other payments of income to owners or creditors of non-corporate business firms. Applying these payments to the shares and long-term debt held by foreign owners as of December 31, 1974, gives an annualized income to foreign portfolio investors of $4,621 million.

Heretofore, estimates of investment income payments in the balance of payments have been based on an assumed yield applied to estimated foreign portfolio investment. For the year 1974 these income payments were estimated at $3,779, about 18 percent less than the survey estimate.

Income payments derived from the survey indicated an overall yield of nearly 7 percent, about 6.4 percent on foreign holdings of stocks, and 7.2 percent on foreign holdings of long-term debt. By comparison, current balance of payments yields on total foreign portfolio investments equalled about 6.7 percent. It appears that the higher income amounts shown in the Treasury survey are not so much based on notably different yields applied to foreign-owned assets, but rather on the higher amount of foreign investment here established in the survey.

Table A

Summary of Foreign Portfolio Investment by Major Area
and Type of Investment
(In millions of dollars)

Area	Total	Equity	Debt
Total	67,098	24,671	42,427
Europe	45,326	17,562	27,764
Canada	8,338	3,580	4,758
Latin American Republics	971	618	353
Other Western Hemisphere	1,771	904	867
Middle East oil exporting countries	2,098	518	1,580
Other Asia	5,820	913	4,907
Africa	84	61	23
Other countries and unallocated	423	170	253
International organizations	2,271	348	1,923

Table B

Foreign Portfolio Investment in Stocks by Major Area and Type of Foreign Holder

(In millions of dollars)

Area	Grand total	Private holders						Official holders
		Total	Individuals residing abroad		Other foreign holders			
			U.S. nationals	Foreign nationals	Banks, brokers & nominees	Investment & insurance companies, etc.	Other business firms	
Total..............	24,671	23,677	2,245	2,249	13,076	3,653	2,454	994
Europe.................	17,562	17,453	1,541	1,027	11,023	2,294	1,570	109
Canada.................	3,580	3,564	225	680	1,386	880	393	16
Latin American Republics	618	618	161	195	13	108	142	*
Other Western Hemisphere	904	904	117	72	192	307	218	*
Middle East oil exporting countries.....	518	68	20	26	*	1	20	450
Other Asia..............	913	844	132	210	379	21	102	69
Africa..................	61	60	20	17	3	16	4	1
Other countries and unallocated............	170	169	30	25	84	27	5	1
International organizations	348	*	*	*	*	*	*	348

* Less than $0.5 million or 0.

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Table C

Foreign Portfolio Investment in Stocks by Major Industry and Type of Foreign Holder

(In millions of dollars)

Industries	Grand total	Private holders						Official holders
		Total	Individuals residing abroad		Other foreign holders			
			U.S. nationals	Foreign nationals	Banks, brokers & nominees	Investment & insurance companies, etc.	Other business firms	
Total	24,671	23,677	2,245	2,249	13,076	3,653	2,454	994
Agriculture, forestry, and fishing	23	23	2	7	8	2	4	*
Mining	2,284	2,231	139	178	1,234	389	290	53
Construction	262	249	18	23	152	45	11	13
Manufacturing	14,758	14,115	1,213	1,215	8,157	1,958	1,572	643
Transportation and public utilities	2,662	2,564	200	185	1,429	546	203	98
Trade	1,067	983	57	129	469	212	117	84
Finance, insurance, and real estate	3,301	3,203	595	440	1,490	441	237	98
Services	279	274	22	69	113	49	21	5
Federal Government	38	38	*	2	23	10	2	*
State & local governments	*	*	*	*	*	*	*	*

* Less than $0.5 million or 0.

Table D

Foreign Portfolio Investments in Long-Term Debt Obligations
by Major Area and Foreign Holder
(In millions of dollars)

Area	Grand total	Private holders						Official holders
		Total	Individuals residing abroad		Other foreign holders			
			U.S. nationals	Foreign nationals	Banks, brokers & nominees	Investment & insurance companies, etc.	Other business firms	
Total................	42,427	16,050	407	582	12,005	1,906	1,150	26,377
Europe..................	27,764	12,121	241	302	10,091	941	546	15,643
Canada..................	4,758	1,452	29	61	345	816	201	3,306
Latin American Republics..	353	280	46	94	88	9	43	73
Other Western Hemisphere..	867	866	27	12	655	81	91	1
Middle East oil exporting countries..........	1,580	161	7	2	149	1	1	1,419
Other Asia...............	4,907	924	43	25	607	23	226	3,983
Africa..................	23	16	7	3	5	*	*	7
Other countries and unallocated...............	253	231	8	82	65	34	41	22
International organizations	1,923	*	*	*	*	*	*	1,923

* Less than $0.5 million or 0.

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Table E

Foreign Portfolio Investment in Long-Term Debt Obligations
by Major Industry and Type of Holder
(In millions of dollars)

Industries	Grand total	Total	Private holders					Official holders
			Individuals residing abroad		Other foreign holders			
			U.S. nationals	Foreign nationals	Banks, brokers & nominees	Investment & insurance companies, etc.	Other business firms	
Total..................	42,427	16,050	407	582	12,005	1,906	1,150	26,377
Agriculture, forestry, and fishing................	14	12	*	*	9	2	2	3
Mining.....................	2,185	2,145	3	12	1,768	148	213	40
Construction..............	61	60	*	*	50	2	8	1
Manufacturing.............	8,132	7,969	20	234	6,495	506	713	165
Transportation and public utilities..............	2,506	2,045	42	18	1,459	453	75	470
Trade.....................	499	489	8	7	389	24	62	10
Finance, insurance, and real estate............	2,567	1,792	157	279	1,156	143	58	787
Services..................	209	207	2	3	197	1	4	2
Federal Government........	25,914	1,022	51	13	406	537	15	24,899
State & local government..	309	309	124	12	77	94	2	*

* Less than $0.5 million or 0.

Table F

Concentration of Foregin Portfolio Investments in Stocks,
Percentage of Ownership and Major Industry
(Amounts in millions of dollars)

Percent of concentration	Total	Mining	Manufac-turing	Transpor-tation, and public utilities	Finance insurance & real estate	Other indus-tries
Total:						
Number of companies......	5,286	177	2,114	444	1,598	953
Value of foreign-owned voting stock...........	23,995	2,280	14,610	2,690	2,818	1,596
0 under 2 percent:						
Number of companies......	3,303	67	1,169	300	1,214	553
Value of foreign-owned voting stock...........	2,023	106	667	446	516	288
2 under 4 percent:						
Number of companies......	871	33	437	76	169	156
Value of foreign-owned voting stock...........	6,651	237	4,466	1,154	525	269
4 under 6 percent:						
Number of companies......	425	29	216	29	73	78
Value of foreign-owned voting stock...........	4,744	681	2,960	195	440	468
6 under 8 percent:						
Number of companies......	240	20	100	17	50	53
Value of foreign-owned voting stock...........	2,949	504	1,675	107	429	234

Table F (cont.)

Percent of concentration	Total	Mining	Manufacturing	Transportation, and public utilities	Finance insurance & real estate	Other industries
8 under 10 percent:						
Number of companies......	119	9	54	4	26	26
Value of foreign-owned voting stock...........	902	241	364	10	256	31
10 percent and over:						
Number of companies......	328	19	138	18	66	87
Value of foreign-owned voting stock...........	6,726	513	4,478	778	652	305

Note: This table is based on total foreign holdings of voting stock only.

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Table G

Payment of Dividends by Major Area and Type of Holder
Based on Yearend 1974 Position
(In millions of dollars)

Area	Grand total	Private holders						Official holders
		Total	Individuals residing abroad		Other foreign persons			
			U.S. nationals	Foreign nationals	Banks, brokers & nominees	Investment & insurance companies etc.	Other business firms	
Total	1,579	1,523	107	182	764	350	120	56
Europe	1,019	999	55	48	632	184	79	20
Canada	394	394	12	110	104	148	20	1
Latin American Republics	35	35	14	10	1	4	5	*
Other Western Hemisphere	36	36	3	3	10	11	9	*
Middle East oil exporting countries .	22	4	1	1	*	*	1	18
Other Asia	42	38	11	7	14	2	5	4
Africa	11	11	8	2	*	1	*	*
Other countries and unallocated	8	8	3	1	3	1	*	*
International organizations...............	12	*	*	*	*	*	*	12

* Less than $0.5 million or 0.

Table H

Payment of Interest by Major Area and Type of Holder
Based on Yearend 1974 Position
(In millions of dollars)

		Private holders						
			Individuals residing abroad		Other foreign persons			
Area	Grand total	Total	U.S. nationals	Foreign nationals	Banks, brokers & nominees	Investment & insurance companies etc.	Other business firms	Official holders
Total	3,042	1,331	33	50	1,009	138	101	1,711
Europe	1,962	977	20	24	823	64	46	985
Canada	379	126	3	5	37	61	20	253
Latin American Republics	36	29	4	9	10	1	5	7
Other Western Hemisphere	84	84	2	1	66	6	9	*
Middle East oil exporting countries .	125	14	*	*	14	*	*	111
Other Asia	339	77	4	3	53	3	16	262
Africa	1	1	*	*	*	*	*	*
Other countries and unallocated	23	23	*	8	6	3	5	*
International organizations...............	93	*	*	*	*	*	*	93

* Less than $0.5 million or 0.

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Investments After 1974

A substantial amount of foreign portfolio investment in the United States was made in 1975 and early 1976, particularly in U.S. stocks. Net foreign purchases of U.S. stocks totaled $4.4 billion in 1975 and $0.8 billion in January and February of 1976.

The increasing interest of the oil-producing countries in U.S. equities was evident in these figures as those countries accounted for a third of the total inflow. Practically all of the remainder was accounted for by the same countries which have been the major purchasers of U.S. equities in the past, Canada and a few European countries. Germany emerged as a major purchaser of U.S. stocks for the first time in several years, accounting for $0.4 billion of the inflow in the fourteen-month period through February, 1976.

The total of $4.4 billion for 1975 was a record high but it was probably affected by the unusually small inflow in 1974 when market prices were declining and net foreign purchases of U.S. stocks were only $0.5 billion. When 1974 and 1975 are taken together it is seen that the total inflow for these two years was no greater than the total for 1972 and 1973.

The figures for 1974 and 1975 respectively follow the overall trend in buyer interest in the U.S. stock market, i.e., quite weak in 1974 and strongly recovering in 1975. Past experience indicates that foreigners generally follow overall trends in the U.S. stock market sometimes with a lag.

It should also be noted that purchases by European residents in 1974-1975 were considerably less than in 1972-1973. While the oil-producing countries are obviously an important new element in foreign demand for U.S. stocks, it remains to be seen whether purchases by these countries will continue to match their purchases of 1975 and early 1976, some of which probably represented one-time shifts from short-term to long-term investments in the United States.

The value of foreign holdings of U.S. stocks was also substantially increased by the sharp recovery in U.S. stock prices in 1975. The addition to the value of these holdings on account of price increases is estimated at $8.1 billion for 1975, which, along with the net inflow of $4.4 billion, raised the total of foreign investment in U.S. stocks to about $37 billion by the end of the year.

The relative lack of foreign interest in U.S. corporate bonds continued to be evident in 1975 and early 1976. Middle Eastern oil-producing countries purchased $1.4 billion of these instruments in 1975, but as in the case of their purchases of U.S. stocks, this may have been mostly a one-time shift in order to balance out the U.S. portfolios of these countries with more long-term assets. International institutions redeemed or sold off $1 billion of U.S. corporate bonds in 1975 and the net purchases of all other countries were about $0.2 billion.

As noted elsewhere in this report, foreign interest in U.S. corporate bonds has never been significant, except during the mid-sixties and early seventies when U.S. Government balance-of-payments programs caused U.S. companies to actively sell Euro-bonds at more attractive interest rates to foreigners. With the ending of these programs in early 1974, U.S. corporate bonds appear to be returning to their previous position as relatively unimportant in the U.S. portfolio of foreigners.

The dominance of U.S. stocks in this portfolio is seen in the estimates of the total amounts outstanding for foreign portfolio investment in the United States as of the end of 1975. These estimates are based on the 1974 survey and our monthly data on foreign portfolio transactions plus estimates of the changes in market values of foreign-held securities.

	$ billion	Percent
Stocks	37.2	43
Corporate bonds 1/	11.1	13
Other private debt	8.3	10
U.S. Treasury debt	29.4	34
TOTAL	86.0	100

1/ Includes issues of Federal agencies and state and municipal governments.

When account is taken of the special factors involved in foreign holdings of U.S. corporate bonds noted above and of the fact that U.S. Government bonds are mostly held by foreign official institutions for international reserve purposes, it is seen that U.S. stocks still have the predominant role in private foreign portfolio investments in this country.

Table I

Foreign Portfolio Investments in U.S. Stocks as of 12/31/74, and Calculated Values for 12/31/75
(In millions of dollars)

Area	Market value as of 12/31/74	Addition due to change in market value	Net 1/ foreign purchases of stocks	Estimated market value as of 12/31/75
Total	24,671	8,119	4,435	37,225
Europe	17,562	5,770	2,465	25,796
Canada	3,580	1,166	357	5,103
Latin American Republics .	618	199	9	825
Other Western Hemisphere .	904	288	-16	1,176
Middle East oil exporting countries	518	209	1,441	2,168
Other Asia	913	297	141	1,352
Africa	61	20	6	86
Other countries and unallocated	170	56	14	240
International organizations	348	114	18	480

1/ Adjusted to eliminate security transactions related to direct investments.

Table J

Foreign Portfolio Investments in Corporate Bonds as of 12/31/74
and Calculated Values for 12/31/75
(In millions of dollars)

Area	Value as of 12/31/74 1/	Addition due to change in market value 2/	Net foreign purchases	Estimated market value as of 12/31/75
Total	10,275	142	671	11,088
Europe	7,126	116	116	7,358
Canada	779	14	126	919
Latin American Republics ..	46	1	28	75
Other Western Hemisphere ..	227	4	3	234
Middle East oil exporting countries	745	6	1,427	2,179
Other Asia ....); Africa ....); Other countries and unallocated ....); International organizations)	1,351	1	-1,027	322

1/ Marketable securities are carried at market value; all other long-debt debt is carried at face or stated amounts.
2/ Adjustment is made only for marketable securities; other long-term debt is carried at face value.

Note: Data include transactions in issues of states and municipalities and of corporations and other agencies of the U.S. Government.

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Economic Factors Relating to Foreign Portfolio Investment in the United States

The second major task of the Treasury Department under the Study Act was to research the reasons for foreign portfolio investment in the United States and the processes, mechanisms and financing methods related thereto. The following findings in these areas are based primarily on interviews by a private research firm with bankers, brokers and others active in foreign portfolio investment in the United States and in selected foreign countries.

Why Foreigners Invest in U.S. Securities

Expectations for long-term capital growth. A large majority of foreign portfolio managers cited "long-term capital gains" as the major objective of investments in the United States. The term itself has undergone some changes in meaning over the past ten years. In the mid-sixties, for example, long-term capital growth referred to the strategy of buying stock in companies whose earnings were expected to grow and holding on to those stocks until this growth was reflected in the value of the stocks. More recently, foreign portfolio investors -- like those at home -- have come to realize that long-term capital gains positions could be eroded by failure to recognize in time abrupt changes occurring in the fundamental characteristics of the investee company, its industry, or even country. Consequently, it was reported, investment strategies have been altered to take short-term profits in particular securities when they occur, while nonetheless preserving the objective of long-term capital growth of funds. The fact that many foreign governments do not tax capital gains undoubtedly encourages such strategies. Some evidence of this view may be found in the fact that the turnover of foreign portfolios of U.S. stocks seems to be somewhat faster than the turnover of all stocks listed on the New York Stock Exchange.

Relative economic and political stability of the United States. Unlike their U.S. counterparts, international portfolio managers must first decide the "currency" (or country) in which to invest. This decision requires an assessment of international economic and monetary developments, as well as of relative political stability.

The United States is popular with foreign portfolio managers in large measure because of its relative political stability. Many European investors see the United States as more sympathetic to free enterprise and the profit motive than some other major countries, with less risk of nationalization of private enterprise.

There was also frequent expression of the view that the U.S. economy was less vulnerable to cyclical influences than some other countries. The question of exchange rate risk was frequently raised; while many respondents seemed to regard the present system of flexible rates as adding a new hazard, there was no evidence that the new system was deterring portfolio investment in the United States.

The size and liquidity of U.S. capital markets. The relatively small size of many foreign economies in relation to their stock of accumulated savings, and the fact that in many countries business investment is financed extensively by bank credit, closely held stock issues, and government funds, combine to limit domestic opportunities for portfolio investment. The lack of depth and liquidity associated with smaller capital markets abroad also makes it difficult to place large amounts of funds in a relatively short period of time. In short, there is a seasoned secondary market for securities in the U.S. markets that frequently does not exist elsewhere.

Organization and regulation of U.S. capital markets. Many foreign investors cited the regulation of the U.S. securities markets (mainly by the Securities and Exchange Commission) as a strong attraction to foreign investment. Other investors noted that the U.S. markets are better organized than many others; that is, the mechanisms for initiating and concluding a trade are more systematic, occur promptly, and specialists act to maintain orderly markets.

Great range of investment choices. Many foreign portfolio managers invest in the United States to participate in industries that simply do not exist locally, or in other foreign countries. Most high technology industries, such as computer, communications, and aerospace, are concentrated in the United States. Foreign investors are also attracted to the natural resources of the United States, such as oil, gas and timber.

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Finally, in some foreign countries, the choice of issues is limited because the local government is in charge of many sectors of economic activity; for instance, to invest in airlines, railroads or even utilities, it may be necessary to invest in the United States. The U.S. markets are also unique in offering a large variety of instruments such as warrants, options, rights, and convertible debentures.

Sales efforts of U.S. securities dealers. The U.S. securities industry makes a strong effort to sell U.S. securities abroad. Most large broker/dealers provide the same kinds of advice and services to their foreign clients as to their domestic accounts, and have established branch offices in major foreign cities to serve foreign clients (as well as to engage in underwriting of issues, notably Euro-issues, abroad).

Although many foreign investors reported having suffered losses in the late sixties and early seventies following the recommendations of salesmen for U.S. broker/dealers, they still continue to purchase securities through firms in which they have confidence. In effect, the "salesmen" are the analysts, economists and investment managers who combine to produce reliable recommendations.

In addition, U.S. corporate executives travel abroad regularly to address investor groups, to keep them informed of developments in their respective companies. Foreign investors are also "sold" U.S. securities by their own local brokers, particularly those who may have participated in foreign underwriting of U.S. issues.

The greater efficiency of U.S. markets. U.S. security markets are widely considered to be the most efficient in the world, in the sense that information is widely available and almost instantaneously reflected in the prices of stocks. This means that even inside information is no guarantee of consistent returns in excess of those earned by the market as a whole.

Some investors view the efficiency of U.S. markets as a reason for not investing in the United States; most, however, consider efficiency to be a positive factor. The former say they can make good profits only on markets where manipulation is common. The latter say that the full disclosure of accounting information required in the United States provides a broader knowledge of the companies in which to invest. By contrast, non-U.S. companies that are listed only on foreign markets often provide very limited information. The information that is provided is often poorly presented, incomplete and sometimes deliberately misleading.

Other Economic Factors

The outlook for the U.S. business cycle is obviously one consideration for potential foreign investors in the United States and they seem to be avid consumers of U.S. economic projections. However, the prevailing opinion among persons interviewed was that most foreign investors take a long view, that they are not trying to profit from short-term market swings.

Actual and anticipated exchange rate changes may alter at least the timing of portfolio investment, and countries subject to frequent or violent rate changes may lose even their longer term attractiveness to foreign investors. Some respondents expressed the view that flexible exchange rates may induce some investors to avoid exchange risk by investing locally. Some investors attempt to hedge against exchange fluctuations, but this is usually not practicable for relatively long periods of time, and besides may be costly enough to wipe out anticipated gains on the investment itself.

Relative interest rates among countries at any particular time, and current interest rates in the United States compared to those prevailing in the past or expected to prevail in the future, will obviously affect the timing, and perhaps the absolute volume, of private foreign investment in U.S. debt issues.

Changes in foreign exchange controls abroad obviously have a considerable effect on foreign portfolio investment in the United States. Most countries maintain *de jure*, if not always *de facto*, controls on outward capital movements; among the major countries, Canada, Switzerland, and Germany are outstanding exceptions.

Changes in the amount of real foreign capital available for outside investment, as indicated by balance-of-payments surpluses, will also affect portfolio investment in the United States. Variations among foreign countries in the share of world savings may also have an effect, since some countries (e.g. Canada), have a higher propensity than others for placing externally invested funds in the United States.

Foreign portfolio investors use the same investment channels, for the most part, as do U.S. portfolio managers. For equities, these channels are, in relative order of size, the New York and American Stock Exchanges, regional exchanges, the over-the-counter market and foreign exchanges which list U.S. securities.

Foreign investors use U.S. brokers, U.S. subsidiaries of foreign firms, and, when dealing on an overseas exchange, the stock exchange departments (or trading desks) of foreign banks. The point was made by some U.S. subsidiaries of foreign banks that, although they had originally been created to serve as a captive vehicle to reduce commission expenses for their parents, they had become independent brokerage firms competing with U.S. brokers for the same clients.

With the trend towards increasing independence by the formerly "captive" subsidiaries, more brokerage business is again being directed by foreign portfolio managers to U.S. brokers. The type of brokerage firm used is typically one which has good research facilities, will service overseas accounts well, and has execution expertise.

Some foreign portfolio managers will enter all orders to buy and sell listed securities to the New York Stock Exchange, while others use local exchanges. The number of U.S. securities listed on foreign exchanges varies, but will usually include the major U.S. corporations, as well as multinationals doing business in the host foreign country. In Switzerland, for example, a Swiss bank will often "sponsor" a U.S. company, and will then be responsible for maintaining a reasonable market in that company's stock.

In selecting brokers, foreign investors attach considerable importance to research capability and quality of investment ideas. Another important factor is the U.S. broker's ability to invite the foreign bank concerned into key underwritings.

To a greater extent than their U.S. counterparts, most foreign portfolio managers agree to place a certain volume of business with a U.S. broker in exchange for access to the firm's research capability. The complexity of these arrangements has caused most foreign institutional portfolio managers to use the services of a relatively small number of U.S. brokers.

Since almost all foreign investors are dependent on U.S. brokers for research and other information on U.S. companies, the foreign investors are not as commission conscious as their U.S. counterparts. While they expect a reduction from the fixed rates of pre-May 1, 1975, most indicated that they do not seek the lowest possible cost. Some foreign investors also expressed concern that the competitive commission structure would result in a significant reduction in the amount of investment research that U.S. brokers provide; their comments reflect their dependence upon U.S. brokers for such information.

In recent years Eurodollar bonds have been the most frequently used vehicle for foreign investment in U.S. bonds. The mechanism normally used is for the foreign bank to join the underwriting group, if possible, and then to sell to its own clients directly. Less frequently, the foreign portfolio manager will purchase these securities from U.S. or foreign underwriters of these issues.

Few foreign investors purchase domestically issued U.S. corporate debt obligations. However, some Canadian and U.K. insurance companies maintain a portfolio expert in the United States to facilitate participation in original underwritings.

With rare exceptions, foreign portfolio investment is not "financed" by borrowing, either in the United States or abroad. At the end of 1974, for instance, U.S. brokers reported only $200 million "due from foreigners," an amount that was actually exceeded by the $300 million due to foreigners. U.S. brokers, banks and other lenders are, of course, subject to Federal controls on margin requirements with respect to their foreign as well as their U.S. customers.

There are two apparent exceptions to this, which on closer examination prove not to be typical. First, British investors have from time to time engaged in what are called "loan fund" operations. These funds are explicitly set up to avoid the effects of U.K. exchange regulations, and involve the use of "back-to-back" loans to obtain the foreign currency necessary to purchase foreign assets, in effect by-passing the "investment dollar" pool with its attendant premium.

The second exception is that, from time to time, foreigners have placed the proceeds of U.S. borrowings in U.S. assets during the period between take-down of the proceeds and actual expenditure of funds. This has been particularly true of the largest borrowers -- international organizations and Canadian entities. Indeed, it was for some years U.S. policy to strongly encourage such actions.

Effects on U.S. Economy and Balance of Payments

As a general proposition, foreign portfolio investment is beneficial to the U.S. economy in the same way as other economic transactions between residents of the United States and foreign residents are beneficial to our economy. All economic transactions which are motivated by market forces are presumed to be beneficial to the economy as a whole, and transactions in U.S. securities between foreigners and U.S. residents are no different in this respect than any other kind of transaction between Americans or between Americans and foreigners.

Foreign portfolio investments in the United States are frequently termed as "inflows of foreign capital" and as such are sometimes viewed as additions to the U.S. pool of capital for investments. While foreign portfolio investment does benefit the capital investment process in the United States, it does not involve an inflow of capital in the real sense. The term "inflow" can also be misleading in the financial sense when applied to foreign portfolio investments since the process may involve nothing more than a change in the form of U.S. liabilities to foreigners.

To understand the process, it is useful to work through a typical foreign portfolio investment in the United States. When a foreigner buys a U.S. security he will usually buy it through a U.S. broker with dollars, which he will either have on deposit in a U.S. bank or acquire from some other foreigner (e.g., a bank) who has dollar deposits in the U.S. Thus far, the transaction is no different in its effect on the economy than a similar purchase by a U.S. resident, and the only effect on the U.S. international investment position -- our balance sheet vis-a-vis foreigners -- is an increase in our liabilities to one foreigner (the buyer of the security) and an equivalent decrease in our liabilities to another foreigner (the foreign bank). If the supplier of dollars (who may be the investor) does not replenish his inventory, the transaction is merely a "paper transfer" with no immediate effect on the balance of payments abroad. The effect of foreign transactions in U.S. securities in the aggregate on the capital investment process in the United States is significant, however.

Many different investors and intermediaries play important roles in the process of transmitting funds from savers to the ultimate users of capital, those who actually undertake the investments in "bricks and mortar." Portfolio investors are obviously a major source of capital for this purpose. Most portfolio investors do not, of course, inject capital directly into U.S. firms since the bulk of securities bought and sold are outstanding issues which are traded among portfolio investors. Nevertheless, the participation of investors in this secondary market helps to make the market for new issues. First, it supplies funds to those investors who may want to exchange their holdings of outstanding securities for new issues. Secondly, the knowledge that a new issue bought today can be later sold in a market which is broad and active enough to develop a good demand and fair price for the issue will make investors more inclined to invest in new issues.

Foreigners who participate in the U.S. capital market as portfolio investors serve these purposes in the same manner as U.S. portfolio investors. They add to the breadth and efficiency of the market and, to some extent, bring a new dimension to the market, i.e., proclivities for some kinds of issues which may not be common to U.S. investors.

From the standpoint of U.S. Government policy, the question of whether and to what extent foreign portfolio investment benefits the U.S. economy is meaningful only if we ask, as compared to what? That is, if Government measures were taken to either restrict or encourage foreign portfolio investment here, what would the effect be on the economy?

If restrictions were imposed on this investment the benefits noted above would be lost or diminished. The foreign-held funds which would otherwise have gone into long-term U.S. securities would be held instead in short-term dollar investments such as bank C.D.'s and Treasury bills or foreign investments and/or, as a result of a weaker dollar in international exchange markets, be spent for U.S. goods and services.

There is no presumption that the use of foreign funds for these purposes is any less (or more) beneficial to the U.S. economy than using them to acquire U.S. stocks and bonds, if they are the result of market forces. However, if special incentives or disincentives are given to guide these funds away from one use into other uses, the market test breaks down and there is no guide as to whether the funds are being allocated in the most economically efficient manner. In other words, there is no economic basis for judging that certain kinds of transactions with foreigners are "good" for the economy and that others are "bad", any more than for such judgments on particular kinds of domestic transactions.

Balance of Payments Effects

To the extent that foreign portfolio investment represents a demand for U.S. rather than foreign liabilities (as opposed to a demand for U.S. portfolio instruments rather than liquid dollar liabilities) it will tend to increase the value of the dollar in foreign exchange markets if exchange rates are reasonably free to fluctuate. If exchange rates are relatively fixed, portfolio investment is likely to be offset by official reserve movements. That is, foreign central banks either will lose official reserves (sell U.S. Government securities) or acquire fewer U.S. Government securities than they would have otherwise.

Under the present system of reasonably flexible exchange rates, the effect of a large and continuous flow of capital in one direction -- say large foreign purchases of U.S. securities over a considerable period of time -- would tend to affect trade and other current account items more quickly than under a system of fixed rates. This is because the resulting effect on exchange rates will change price relationships between U.S. and foreign goods, with an impact on both exports and imports. Even under flexible rates,

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however, the most immediate impact is likely to be on other capital items; changes in trade patterns require adjustments in production and distribution channels which cannot be instantaneously effected.

A shift in foreign portfolio preferences in favor of U.S. rather than foreign instruments would thus have complex effects both on other capital transactions and transactions on current account. In the very short run, such a shift might lead to a mild speculative flurry in favor of the dollar and a drawdown in foreign official reserves if foreign central banks maintain a policy of active intervention in support of exchange rate targets. In the longer-run, this shift would result in some increase in the quantity of real imports available to the United States at an exchange rate not influenced by intervention policy.

Foreign acquisition of U.S. securities does, of course, give rise to outflows of funds in the form of dividends and interest. These outflows are payments for "value received" (the U.S. use of foreign financial capital) and are thus strictly analogous to payments for the import of real goods and services. In this connection it should be remembered that foreign transactions in U.S. securities involve foreign payments to U.S. providers of financial services. It is estimated that in 1975 over $200 million of commissions were received by U.S. brokers from foreigners for transactions in U.S. stocks. An additional sum was paid for bond transactions.

In summary, under present institutional arrangements, flows of foreign portfolio capital do not affect the overall "surplus" or "deficit" in the balance of payments as in the pre-1973 period, but they can, and probably do, have a larger impact on other private international transactions, both in the capital and current accounts, than before.

International Investment Position

As noted earlier, foreign portfolio investment in the United States, in the first instance, affects only the composition of our international investment, not the overall creditor position of the United States. Our net international investment position can only be affected by movements of goods and services, in balance of payment terms, by current account surpluses or deficits. These investments can, however, indirectly affect the current account over time, but the effects are somewhat ambiguous.

Under fixed exchange rates, as already indicated, a movement of private capital in one direction was apt to be offset, at least in the short run, by movements of official capital in the opposite direction. Even under flexible rates, an autonomous movement of capital is apt to induce in the short run offsetting movements of other forms of capital, with no net effect on the overall investment position of the country. However, under flexible exchange rates, the possibility that sustained capital flow in one direction will affect the current account of the balance of payments in the opposite direction is, as just stated, more likely than under fixed rates. Thus, an inflow of foreign capital would now tend, more than formerly, to change the international investment position of the United States, that is, to increase foreign investment here relative to U.S. investment abroad.

Effects on Financial Markets

The effect of foreign portfolio investment on U.S. financial markets may be discussed in somewhat the same terms as the effects on the balance of payments. Any additional demand for securities in any segment of a capital market tends to raise prices and reduce yields on the type of securities demanded. Thus, foreign purchases of U.S. stocks and bonds have a tendency to reduce yields and therefore make raising of capital relatively easier for domestic borrowers. This in turn will tend to stimulate real investment and increase the output and productivity of the economy.

In fact, foreign portfolio capital inflows are relatively small in relation to total capital formation in the U.S. economy, which makes it difficult, if not impossible, to measure any such effects statistically. However, it seems quite likely that they have some impact on the structure of capital markets in the United States. Since foreign investors limit themselves mainly to securities of fairly wellknown corporations, the result is presumably to reduce the cost of capital to those sectors relying on those forms of financing. However, arbitrage among various sectors of the capital markets is probably sufficiently efficient to ensure that any increase in the flow of funds to one market sector will have a tendency to ease conditions in all sectors, although relatively more so in the sectors where the new funds are immediately injected.

Gross transactions of foreigners in U.S. stocks tend to be somewhat larger as a proportion of their total holdings of U.S. stocks than is the case with American investors. On the other hand, while foreign purchases have tended to move with the market -- rising in strong markets and declining in weak markets -- on the whole they have lagged behind U.S. investors in this respect. More importantly, foreigners as a whole have been net purchasers of U.S. stocks in every year since 1957, except for the years 1964-1966. Thus, foreigners have on balance tended to strengthen U.S. stock prices.

In this connection it should be noted that the figures on net foreign acquisitions of U.S. securities are the result of much larger gross purchases and gross sales. For example, net foreign acquisitions of U.S. stocks in 1974 of only $0.5 billion reflected gross purchases of $7.6 billion and gross sales of $7.1 billion, and in 1975 the net acquisitions of $4.4 billion reflected purchases of $15.0 billion and sales of $10.6 billion. Thus, foreigners' gross transactions in stocks in 1975 were equivalent in value to their total holdings as of the end of 1974. The impact of foreign participation in U.S. securities markets, therefore, is considerably larger than indicated by their total holdings or by their net purchases.

In any case, it is clear that foreigners add to the depth and resiliency of the market. If, in the same process, they may also add somewhat to its volatility, the latter effect may be regarded as a small cost for the larger benefits resulting from foreign participation.

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Effects of U.S. Laws

While there is very little in the way of U.S. legislation designed to affect the volume or type of foreign portfolio investments in the United States, these investments are affected by various laws drawn up for other purposes. In some cases these laws undoubtedly deter some foreigners from investing in the United States; in other cases, the law may be viewed as a positive factor. It is not possible, however, to judge objectively the extent of these effects; in this section we can only report on the likely effects of certain laws (i.e., to increase or decrease investment), as perceived by persons in the banking, legal and brokerage communities in the United States and abroad.

Tax Laws

Withholding tax: U.S. Federal tax law specifies that a foreign person (either a nonresident alien individual or a foreign corporation) will be taxed at a statutory withholding rate of 30 percent on his passive investment income other than capital gains. If the foreign person is a resident of a country that has a tax treaty with the United States, the tax on such passive investment income is normally lower, e.g., 15 percent on dividends, 0 percent on interest. Capital gains classified as passive investment income accruing to foreigners are not taxed by the United States.

The withholding tax is considered a substantial deterrent to foreign portfolio investors considering investments in income-oriented equities and debt issues. The U.S. banking and brokerage communities feel strongly that they are at a distinct competitive disadvantage in offering management and brokerage services in these areas. There has been so little foreign investor interest in this area that many brokers have discontinued sending investment information on fixed income securities to their foreign offices. Rumors of the United States terminating the withholding tax has stimulated inquiries as to U.S. brokerage capabilities on fixed income securities orders.

In the case of growth-oriented, low-yielding, equity issues, foreign investors view the withholding tax as a cost of doing business or as a sales tax item which must be paid in order to participate in the U.S. growth equity market.

The main objectives of investors in making commitments in growth equities are capital preservation and appreciation. Accordingly, the withholding tax reducing the investors' yield is an acceptable price to pay to achieve these objectives.

The lower treaty tax rates imposed on investment income of foreign investors of various treaty countries have encouraged foreign portfolio investment in the United States for two reasons. First, they generally mitigate the effect of the withholding tax on securities yields by reducing or, in some cases, eliminating the tax on various classes of income. In addition, the treaties frequently provide that the tax paid to the United States on dividends or interest can be offset as a credit against the tax payable by the foreign investor to his home country. Second, treaties providing for reduced withholding rates induce foreign investors of countries without treaties with the United States to form either personal holding companies or trusts in the foreign treaty jurisdiction in order to have their investments in the United States receive favorable withholding tax treatment. These entities are then afforded the benefit of treaty tax rates applicable to the jurisdictions in which they are operating.

On the other hand, treaties negotiated between the United States and other countries have provisions requiring both countries to exchange information necessary to carry out the tax law of each country and these provisions have deterred foreign investors who are sensitive to information on their financial assets being given to their home governments. Accordingly, these investors have either been deterred from investing in the United States entirely or have employed indirect devices or foreign institutions to make their investments in the United States, such as foreign trusts and personal holding companies, formed in tax haven jurisdictions. In certain cases, it is alleged that the fear of disclosure is so strong that foreign investors who are suspected of being residents of treaty countries claim to be residents of non-treaty countries, thus incurring a higher rate of tax, but avoiding disclosure to their home governments.

The effect of the withholding tax on foreign portfolio investment, as seen in the brokerage community, is the encouraging of speculation rather than sound investment analyses. The reduction of yields due to the withholding tax encourages the foreign investor who is exempt from capital gains taxes to look to short swing profits in both the equity and debt securities markets. The result is rapid turnover of foreign portfolios.

The banking community has observed that the foreign investor portfolios are deprived of full servicing in the American securities market due to the withholding tax. The portfolio manager is limited to certificates of deposit or foreign dollar securities to achieve the required yields on dollar securities for accounts for which income is a primary investment objective. Accordingly, the account is deprived of participating in U.S. Government and U.S. corporate debt issues to achieve its objectives.

The withholding tax collection burden imposed on U.S. institutions and foreign institutions in cases of treaty obligations is regarded as a deterrent in soliciting foreign portfolio accounts. Specifically, the cost of collection and payment of the tax is a factor in establishing fees for foreign accounts and acts as a deterrent in evaluating whether this line of business should be sought after by U.S. institutions. Similarly, foreign institutions which must act as collection agents for the United States under a treaty obligation in accounts where their foreign investor client is not entitled to the treaty rate applicable to the country where the financial institution is resident (e.g., Colombian client of a Swiss bank) are deterred by the cost of collection and recordkeeping from recommending more investment in U.S. securities.

Estate and Gift Tax

Federal tax law imposes an estate tax on a foreign investor's property situated or deemed to be situated in the United States. For estate tax purposes, United States corporate securities, no matter where the certificates are located, are deemed to be part of a nonresident alien's gross estate. Foreign corporate securities are, of course, excluded from a foreign investor's U.S. estate. The law provides for a $30,000 exemption and a 5 percent tax on the first $100,000 of an estate. The highest rate of tax is 25 percent applied to that part of an estate that exceeds $2,000,000.

Estate tax treaties modify the estate tax rules (e.g., for purposes of determining the status of certain kinds of securities and bank deposits). There is statutory authority for the President to impose a more burdensome estate tax on citizens of countries whose governments impose burdensome estate taxes on U.S. citizens who have property in those countries. Shares of a foreign personal holding company that is completely owned by foreign persons and which in turn holds U.S. securities are not subject to U.S. estate taxes.

The United States exempts gifts of intangible personal property by non resident aliens from the gift tax. Gifts of real estate and tangible personal property located within the United States are subject to the U.S. gift tax. These rules, however, may be modified by treaty.

Imposition of an estate tax on estates of nonresident aliens has deterred portfolio investors with $100,000 to $400,000 from investing directly in the United States by opening accounts with U.S. financial institutions. The U.S. institutions receive many inquiries from this size investor who are deterred from opening accounts once they learn of the existence of the U.S. estate tax and the U.S. institutions' obligation to act as statutory executor and comply with the payment of the tax. It is believed this type of capital is either deterred completely from investment in U.S. securities or is channeled to foreign intermediary institutions which do not comply with payment of the U.S. estate tax.

Large foreign portfolio investors tend to use personal holding companies to avoid the imposition of the U.S. estate tax. Under current law, the shares of such companies, if held by nonresident aliens, are exempt from the U.S. estate tax, thus the use of this indirect device merely increases the cost and administrative burden of investing in the United States. The personal holding companies are normally incorporated in tax haven jurisdictions. In some instances, large investors simply utilize foreign banking institutions to avoid payments of the estate tax. The capital is merely transferred from the decedent's account to a new account for the heirs without payment of the U.S. estate tax.

The attitude of many foreign investors is that the U.S. estate tax is a foolish tax and can be easily avoided.

Accordingly, there is a great deal of intentional non-compliance by placing funds in foreign banking institutions. In addition, there is a genuine lack of awareness of the tax and thus non-compliance for that reason.

It is generally felt by banks and brokers that the existence of the estate tax has encouraged tremendous amounts of capital to be placed offshore with foreign financial institutions rather than U.S. institutions which have the obligation to ensure that all estate taxes on foreign investors' accounts are paid, at least to the extent of the property in the account. Accordingly, U.S. financial institutions are at a competitive disadvantage with their foreign counterparts which have no legal liability to ensure compliance.

There is some concern among foreign investors that overly aggressive tax authorities will seek to tax the foreign investor's entire estate, although he is a non-resident alien subject to tax only on U.S. securities and osther property located within the United States. The fear stems from cases where the U.S. Government has alleged that U.S. citizens who have attempted to renounce their citizenship have failed to do so effectively and therefore are still, as citizens, subject to tax on their entire worldwide estate. However, irrational the fear is, it has encouraged investment through indirect means (foreign trusts, Swiss banks, etc.) to avoid the imposition of any tax.

The exemption from the gift tax of gifts of intangible property such as portfolio investments, apparently has not affected portfolio investment in the United States one way or the other. In most cases, foreign investors are not aware of our gift tax. There is general agreement that the present rules should be maintained in the interest of maintaining an unrestricted environment for foreign capital.

U.S. Securities Law

Remedies and protections provided to foreign investors under U.S. laws: The provisions of U.S. securities law requiring substantial disclosure of material information in U.S. registered public offerings and provisions against fraudulent practices in unregistered offerings are effective in inspiring confidence in the U.S. securities markets. The foreign investor has the overall feeling that our laws provide a more efficient, fairer market place for public offerings. In addition, the rules of fair practices imposed on the brokerage community, are very effective in encouraging foreign investors to take a positive view of the purchase of U.S. securities.

Availability of information: U.S. securities laws requiring issuers listed on major stock exchanges and many over-the-counter issuers to file public reports as to their financial condition are regarded as a real selling point for U.S. securities. Sophisticated foreign investors and large foreign institutional buyers of American securities are aware of these requirements and utilize such information in their investment decisions. The requirement for prompt disclosure of any important development which may affect the value of securities is also generally regarded positively. The entire trend of disclosure to shareholders through proxy solicitations, annual reports, etc., is effective in encouraging foreign investments in U.S. securities. Foreign investors have expressed a fear of investments in closely held corporations which are not subject to disclosure requirements. The concern is that abuses of private owners would not be discovered until after the investment is made.

Disclosure of ownership rules: U.S. securities law, Federal regulatory agencies, and state laws have requirements in various degrees as to disclosure of beneficial ownership of stockholders. These requirements are said to be a substantial deterrent to investment in the U.S. securities market because there is a great fear on the part of many foreign investors of having their names on reports filed with the U.S. Government since it could, they fear, lead to reporting to their home government, with unfortunate consequences for them.

There is also a difference in the foreign investor's regard for privacy, as opposed to that of the U.S. investor. Foreign investors regard their financial affairs as their own business and no one else's, including any government authority. The entire history of public reporting has been different abroad than in the United States. U.S. laws and attitudes on disclosure are believed to have led to substantial foreign capital being invested in the United States through indirect means. Specifically, large foreign investors use foreign personal holding companies, foreign trusts, and Swiss banks to channel their capital into the U.S. securities market and preserve their anonymity. U.S. financial institutions are thus deprived of managing large amounts of foreign capital.

Liabilities under U.S. securities law: Liability under U.S. securities law for insider trading, manipulative practices, violations of resale restrictions, fraud, etc., is generally not a deterrent to the pure foreign portfolio investor. The general feeling is that foreign portfolio investors regard these provisions of U.S. laws as positive factors in regulating our securities markets. There is some concern among foreign investors about innocent violations of U.S. securities law due to unawareness and complexity of U.S. laws. There is also some feeling that the criminal penalties outlined for violations deter some foreign investment. However, in general, foreign portfolio investors have accepted our laws with respect to liability and regard them as a positive factor in the overall regulation of the U.S. securities market.

Credit restrictions: There is general agreement in the financial community that U.S. securities law restricting credit for the purchase of securities is not a factor in limiting or encouraging foreign portfolio investment in the United States. The universal experience in the financial community is that foreign portfolio investors bring their unencumbered capital to the U.S. markets for investment. They do not require credit, at least not from U.S. sources, prior to entry into the U.S. securities market.

Bank secrecy law: The Currency and Foreign Transactions Reporting Act -- the "Bank Secrecy Act" -- provides for reporting and recordkeeping requirements on transactions in currency of more than $10,000 per single transaction effected through U.S. financial institutions. The Act requires the collection of data on the movement of money through domestic financial institutions and of currency and monetary instruments amounting to more than $5,000 in one transaction across the borders of the United States. Accordingly, transactions by foreign investors with or through U.S.

financial institutions may be subject to disclosure and reports of such transactions may be required under the provisions of Treasury regulations issued under the Act.

This law has projected a negative image of U.S. banking practice to the foreign investor. Foreign investors are warned by foreign money managers not to place deposits in foreign branches of U.S. banking institutions due to the risk of disclosure. They are also warned that securities with U.S. banks or brokers will be reported to the U.S. Government who, in turn, will -- if asked -- disclose such assets to the investors' home governments.

There is concern on the part of U.S. banking officials that they will violate foreign secrecy laws if they are compelled to disclose records maintained by foreign subsidiaries. Specifically, if the U.S. bank secrecy law is construed to require such disclosure, foreign affiliates of U.S. companies will be in danger of violating their host countries' secrecy laws. This apparent threat is of concern to foreign investors and clients doing business with foreign affiliates and has deterred business from them.

In the actual administration of the Act, there have been requests for information from foreign governments filed pursuant to the act. The decisions to disclose this information are within the discretion of the Treasury Department and, thus far, such requests have been denied. However, the mere possibility of disclosure to foreign governments has acted as a deterrent to foreign investment in the United States.

Other laws: Various U.S. laws limit the amount of foreign stockholdings in certain U.S. industries. However, the restrictions which are based on percentage limitations are in all cases well above the percentage of a U.S. company's stock which foreign portfolio investors are inclined to buy. Thus, these laws have not deterred foreign portfolio investment here.

Foreign portfolio investors believe the U.S. compares very favorably with other countries in regard to confiscation. Sophisticated foreign investors are well aware of the provision of the Trading with the Enemy Act but have concluded that the U.S. Government will not arbitrarily expropriate their property. Foreign investors believe that the United States has a system of economic due process which sets limits on what government power can do with regard to expropriation. There is a strong feeling among foreign investors that the United States is one of the last bastions of capitalism and that private property is sacred.

There is, however, concern among foreign investors who have experienced freezing of assets during the Second World War, e.g., German and Japanese investors. In addition, there is some concern among Arab investors due to the controversies arising out of the oil crisis.

As of the present time, the feeling in the financial community is that they can sell the United States to their clients as a safe haven from confiscation. Particularly in comparison to other jurisdictions where government intervention and control are more advanced, the United States is being viewed increasingly as a safe haven from political instability and property confiscation.

Adequacy of Information

The final tasks of the Treasury Department under the Study Act were to study the adequacy of our information and reporting programs on foreign portfolio investment and to recommend means by which this information can be kept current.

The information which we now have on foreign portfolio investment in the United States is of two kinds. One is a record of the transactions of foreigners in U.S. financial assets, which is collected, for the most part, on a monthly basis. The other is a record of the amount outstanding of foreign portfolio investment as of given dates, i.e., an inventory of foreign holdings of financial assets in this country.

The benchmark survey just completed for foreign holdings gives a comprehensive and detailed inventory of these holdings as of the end of 1974. For a limited time we will be able to update the major categories of this inventory reasonably accurately by adding (or subtracting) our monthly data on foreign portfolio investment into the 1974 benchmark figures and applying estimated changes in the market value of foreign holdings.

Our data on transactions give a breakdown of foreign purchases and sales of U.S. stocks, corporate and other non-Federal bonds, and U.S. Government securities. In addition, we collect monthly and quarterly data on outstanding amounts of long-term bank and non-bank liabilities to foreigners respectively. All these data series are broken down by the countries of residence of the foreign investors.

As time moves on, the 1974 composition of these holdings can be expected to change and the estimates of market values will gradually become less accurate. It might be desirable to undertake another benchmark survey at some time in the future, therefore. However, the 1974 benchmark survey along with our monthly reporting program will suffice to give us a reasonably accurate inventory of foreign portfolio investment in the United States for at least several years; thus the decision as to when another survey should be undertaken should be left for the future. The decision can then be made on the basis of how much the increased accuracy of the data would be worth as compared to the costs involved to both the Government and the private sector in undertaking a survey.

The results of the benchmark survey suggest that there is some underreporting bias in our reporting program for data on transactions, which was not unexpected. However, the differences between the totals reported by the survey and those which had previously been estimated do not appear unduly large, in view of the long period of time that has elapsed since the previous benchmark in 1941 and the significance of the non-transaction factors affecting the investment position totals. It is noteworthy that the difference is substantially larger in the figures on equity holdings, where the valuation adjustment problem is greatest, than it is for holdings of debt instruments. The survey results thus do not appear to raise major questions about the current reporting system.

While the conceptual and institutional structure of our reporting system appears to be adequate it will be necessary to constantly monitor the reports and to maintain close communication with the reporting firms to ensure that there are no major gaps in our reporting network. The benchmark survey results have given us some indications of avenues which can usefully be explored for this purpose.

Legislation recently introduced in the U.S. Senate will, if enacted, provide the Government with broader authority to collect information on foreign portfolio investment. Heretofore, the Treasury Department has been relying on a patchwork of laws to collect data on transactions, laws which are either clearly lacking in some respects or ambiguous as to the extent of their authority. The authority under which data for the benchmark survey were collected, the Foreign Investment Study Act, was temporary and has now expired.

The International Investment Survey Act of 1975 (S.2839) would provide clear and permanent authority to collect data on all forms of inward and outward investment and it has been supported by the Treasury Department with certain suggested amendments.

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FOR RELEASE UPON DELIVERY

STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
DEMOCRATIC RESEARCH ORGANIZATION
APRIL 30, 1976

Mr. Chairman and Distinguished Members of this Organization:

Your invitation to appear before you this morning is most welcome since I strongly support your organization's objective of seeking ways to bring about greater fiscal responsibility in the Federal budgeting process. Careful, thoughtful analysis should contribute to the development of realistic solutions to the serious problem of chronic budget deficits, and I look forward to working with you in this effort.

As you suggested, my remarks will be concerned with the implications of the growing portion of the Federal deficit being financed by the sale of Treasury securities to the public. However, I would first like to make a few observations about what I believe is the central issue of repeated budget deficits, namely the lack of control over spending. Such spending is not only rising rapidly but its growth shows signs of accelerating. Too often this year's outlays are viewed as the minimal starting point for next year's expenditures. In turn, next year's become the base for the year after thereby setting in motion a vicious spiral that threatens to outrun continuously our revenue base. Until the people stop demanding more "benefits" and more importantly until government stops promising greater and greater "favors," I feel that we are in a conundrum in trying to deal with this problem and all of its harmful effects on our economy. Indeed, I find the Congress' proposed outlays of $412-$413 billion for FY 1977 -- almost $18 billion over the President's proposals -- to be more of the same old excessive spending philosophy that brought about the budget problems in the first place.

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To put it bluntly, the Federal government's fiscal record is poor, if not an outright disgrace. Despite all the stated good intentions of fiscal responsibility and all of the impressive theories of balancing the budget either each year, or over the business cycle, or at so-called levels of "high employment," the record shows that we have woefully missed the mark and have thereby created serious economic distortions at a major cost to the economic well-being of the general public. The budget will have been in deficit 16 of the past 17 fiscal years (by the end of FY 1977) or 39 of the last 47 fiscal years, no matter what economic developments occur this year. The fact is that over this long time span the Federal government has failed to live up to its fiscal responsibility, and there is evidence that the record is getting worse, not better.

As seen in Table 1, Federal budget deficits relative to our GNP have been growing. From FY 1960-1965 they averaged 0.7 percent of GNP; from FY 1966-1971 they averaged 1.1 percent of GNP; and from FY 1972-1976 they have averaged 2.3 percent of GNP. The excess of spending over receipts is increasing faster than our economy, and it is no simple coincidence that the rate of inflation has also picked up over these same spans. From FY 1960-1965 the Consumer Price Index rose 1.4 percent per year; from FY 1966-1971 it rose 4.2 percent per year; and from FY 1972-1976 it will rise about 7.0 percent per year.

The key force behind this disappointing record has been the startling increase in government spending and the government's reluctance to raise taxes sufficiently to pay for the outlays. (Apparently our political biases prefer the "indirect tax" of inflation.) In FY 1962 government outlays crossed the $100 billion level for the first time in history. In FY 1977 they could easily be over $400 billion -- a quadrupling in just 15 years. Looked at from another perspective, from FY 1956 to FY 1965 government spending rose by 5.3 percent per year; from FY 1966 to FY 1975 it grew by 10.6 percent per year. From FY 1974 through FY 1976 -- just two fiscal years -- Federal spending will increase approximately 40 percent. We are now spending each year almost $2000 for every man, woman and child in our country. The primary factor behind our chronic budget deficits and our general inflation has been this virtually uncontrolled spending growth, especially in recent years. In turn, the inflation pressures have led to two recessions during the last decade.

The Department of Treasury is responsible for arranging the financing of these Federal deficits. Unfortunately, the

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massive size of Federal deficits is already creating some potentially serious problems for the management of the national debt. For example, in the ten year span ending with FY 1977, the Federal government will have borrowed almost one-half trillion dollars from U.S. financial markets to cover the cumulative Federal deficits of $267 billion and "net borrowings" of $229 billion to support an array of "off budget" programs. These are staggering sums.

The distribution of total, interest-bearing Treasury securities outstanding among various U.S. government accounts, such as the Social Security Trust Funds, the Federal Reserve System, and private investors is summarized in Table 2. Since the end of FY 1974 there has been a sharp change in the postwar trends of the ownership pattern. At that time the percent of Federal debt held by the U.S. government -- which had been growing over the postwar period -- peaked at 29.2 percent of the total. By February 1976 the U.S. Government's share had fallen to 23.6 percent. If Congress fails to take action on the Administration's initiative to increase the Social Security tax rate, this decline will likely persist if for no other reason than that the Social Security Trust Fund will decline steadily as current outlays continue to exceed payroll taxes and current investment income.

At the same time, the percent of government debt held by the Federal Reserve peaked at 17.0 percent at the end of FY 1974 (having slowly but steadily trended upward over the postwar years) and had fallen to 15.0 percent by February of this year. The absolute dollar amounts of securities held by the Federal Reserve have, of course, increased over these years in keeping with the growth in monetary reserves necessary to accommodate growth in the economy. But the proportion held by the Federal Reserve System has fallen because of the very sharp increase in the size of Federal deficits during Fiscal Years 1975 and 1976.

As a consequence of reduced Federal government and Federal Reserve System shares of outstanding government securities, the recent Federal budget deficits have had to be largely absorbed by private investors. The share of marketable debt held by the public rose from 34.8 percent (the postwar low) at the end of FY 1974 to 45.6 percent in February of this year. Of the $123 billion increase in outstanding debt since the end of FY 1974, about $110 billion, or almost 90 percent, had to be absorbed by the public. As long as large deficits continue, this trend will likely be sustained.

What are the economic implications of these trends? First let me point out one option that has not been used.

The proportion of marketable government securities held by the public need not rise if the monetary authorities absorb a large share of the net increase in government debt. In so doing they would monetize the debt with "high powered" money, namely bank reserves. The printing presses in effect would roll. We all know the likely repercussions of this approach -- rampant inflation. Fortunately, the monetary authorities have not adopted that tactic. Rather they have tried to manage the growth of bank reserves in a responsible manner by supporting the growth in real economic activity while avoiding attempts to accommodate fully the deficit which would rekindle high rates of inflation.

However, the debt management record in terms of inflation is not perfect because there are degrees of **liquidity when it** comes to deficit financing. Obviously total monetization of the debt by having the Federal Reserve System absorb the entire amount of deficit financing would have the most severe inflationary implications because money is the most liquid of assets. However, the sale of huge amounts of Treasury securities of short-term maturity also has inflationary consequences (although obviously not as severe as printing money). In some measure, spending decisions by households and businesses are influenced by the stock of financial assets readily convertible into currency and demand deposits, such as short-term Treasury securities. If rapid increases occur in the amounts of these securities in a period of rising or high economic activity, this will encourage current consumption at the expense of savings and investment. Obviously, this development would have adverse inflationary implications. Yet this is precisely what has been occurring over time. As indicated in the chart, the average maturity of the debt has slipped from over 5 years in 1966, to 4 years in 1969, to 3 years in 1974 and currently is around 2 years 4 months.

Because of such artificial restrictions as the 4-1/4 percent coupon ceiling on Treasury bonds, the maturity limitation on notes (recently increased from 7 to 10 years), together with the difficulty the market has in absorbing large amounts of long-term bonds, Treasury financing tends to be concentrated in the short- to intermediate-term area. Because of these constraints, it is difficult to sustain the maturity structure as existing obligations are constantly being refunded, let alone to place large net amounts of new securities with longer maturities.

What all of this suggests is that if there continues to be large Federal deficits, these deficits will need to be financed mostly from the public. Moreover, much of the net increase in debt will likely be relatively short-term in nature. In turn, this has serious implications for inflation, particularly as the economic advance gains momentum. There is no way to avoid this phenomenon as long as deficit financing remains large.

The implications of a continuation of these deficit trends are disconcerting as they are in direct conflict with the long-run needs of our society. If Federal deficits persist at huge levels year after year, this will inevitably deprive large areas of our private sector of needed funds for capital expansion, and we will eventually be faced with serious employment and inflation problems in my judgment. By forcing the private area to finance an ever increasing portion of these huge deficits we will inevitably crowd out some, if not many, private borrowers as the current economic expansion continues. Such a fiscal posture would deal a heavy blow to the capital needs of our society if we hope to employ our growing labor force (approximately 15-16 million net new entrants during the next decade), if we hope to meet our environmental and worker safety objectives, if we hope to achieve a greater degree of energy self-sufficiency by the 1980's, and if we hope to have adequate housing for our growing population. Continued massive deficits will inevitably frustrate the achievement of these goals by eroding the pool of savings and thereby leaving less funds available to the private sector than is needed to satisfy our clearly documented capital requirements ahead.

Capital formation is at the heart of improved productivity and ultimately is the source of improved living standards. It cannot be stressed often enough that only with improvements in our ability to produce goods and services does the true wealth of the Nation increase in the sense of being able to provide increased employment opportunities, economic growth and improvements in the standards of living enjoyed by Americans in a noninflationary enviromnent.

Yet if the Federal government continues to run large deficits as we approach full use of resources, these deficits will be at the expense of private-sector investment. It is essential that as the recovery progresses Federal deficits decline steadily and the budget comes into balance and indeed moves into surplus. Otherwise, investment will be insufficient, capacity constraints will be experienced, inflation will reignite and we will head for a third bout of boom-bust before the decade ends.

Conclusions

The responsibility of government in the area is clear. Sustained budget deficits are corrosive to our economic machinery and must be stopped. Not only do they create financing problems and misallocate resources, but they are a major cause of the inflation which has badly eroded the incomes and savings of our people. The deficits contribute to inflation:

-- first by being produced by too rapid a rise in spending which directly puts pressure on prices;

-- second by bringing about a large increase in liquid asset holdings of the public; and

-- third by depriving the private sector of needed funds which lowers the economy's future growth potential and heightens inflationary pressures.

The solution to the problem appears deceptively simple -- eliminate the deficit -- but how to actually accomplish this basic goal is another matter. The first step, of course, is that the rapid rise in Federal spending must be curbed. This is perhaps the single most important action that can be taken towards balancing the budget. Furthermore, greater flexibility in terms of debt maturity should be considered so that the deficits already in prospect do not automatically mean a flood of liquid or near liquid securities into public hands which will eventually only reinforce the inflationary pressures.

Your Committee has a proposal which would change the budgeting process and put some restraint on spending which is the primary source of this problem. I strongly applaud both the purpose and proper focus on spending of this proposal. When proposals of this sort have been tried at the State level, we know that in practice they are often circumvented. Of our 50 states, 45 have some type of requirement to balance their budgets each year, and yet there is always some accounting tricks or supplementals to get around the intended thrust of the law. Indeed, even New York City has for a long time had a requirement that its budget be in balance each year. Its current fiscal problems are hardly a testimony to laws which mandate budget balance.

Yet some new steps must be tried at the Federal level since our current procedures have not produced a very laudable record. I believe that the goals of responsible control over government spending and of budget balance are necessary conditions for a viable and ever growing economy. However, we should bear in mind that actual implementation of any such effort to control budget deficits cannot be effected in practice unless the people making such fiscal decisions will support both the letter and spirit of any such effort. We already have the means to balance the budget if we will just take the unpopular step of saying "no" to some of the spending requests. Until we accord this idea more than lip service, we will very likely find out that the practical implementation of such a goal can all too easily be subverted. What is really needed is prudent decision makers who have the ability to exercise restraint and who possess a good deal of common sense.

Thank you.

# # #

TABLE 1

UNIFIED FEDERAL BUDGET SURPLUS OR DEFICIT IN RELATION TO GNP
1954—1977

Fiscal Year	Budget Surplus (+) or Deficit (-) ($ billions)	Budget Surplus (+) or Deficit (-) as % of GNP: Annual	Budget Surplus (+) or Deficit (-) as % of GNP: Three-Year Moving Average (Centered)
1954	- 1.2	-0.3	-
1955	- 3.0	-0.8	- .0
1956	+ 4.1	1.0	0.3
1957	+ 3.2	0.7	0.3
1958	- 2.9	-0.7	-0.9
1959	-12.9	-2.7	-1.1
1960	+ 0.3	0.1	-1.1
1961	- 3.4	-0.7	-0.6
1962	- 7.1	-1.3	-0.9
1963	- 4.8	-0.8	-1.0
1964	- 5.9	-1.0	-0.7
1965	- 1.6	-0.2	-0.6
1966	- 3.8	-0.5	-0.6
1967	- 8.7	-1.1	-1.5
1968	-25.2	-3.0	-1.2
1969	+ 3.2	0.4	-1.0
1970	- 2.8	-0.3	-0.7
1971	-23.0	-2.3	-1.6
1972	-23.2	-2.1	-1.9
1973	-14.3	-1.2	-1.2
1974	- 3.5	-0.3	-1.5
1975	-43.6	-3.0	-2.7
1976e	-76.9	-4.8	-3.4
1977e	-44.6	-2.3	-

TABLE 2

OWNERSHIP OF INTEREST-BEARING PUBLIC DEBT SECURITIES

Fiscal year 1946 - II Quarter 1976 1/

($ millions)

						Held by Private Investors				
End of FY or Qtr	Total Interest Bearing (1)	Held by GA (2)	% of Total Interest Bearing (2÷1)	Held by Fed (3)	% of Total Interest Bearing (3÷1)	Total (4)	Marketable (5)	% of Total Interest Bearing (5÷1)	Non Marketable (6)	% of Total Interest Bearing (6÷1)
1946	268,111	29,121	10.9	23,783	8.9	215,206	159,064	59.3	56,143	20.9
1947	255,113	32,809	12.9	21,872	8.6	200,432	141,423	55.4	59,010	23.1
1948	250,063	35,761	14.3	21,366	8.5	192,936	133,567	53.4	59,369	23.7
1949	250,762	38,288	15.3	19,343	7.7	193,131	130,417	52.0	62,714	25.0
1950	255,209	37,830	14.8	18,331	7.2	199,048	131,629	51.6	67,419	26.4
1951	252,852	40,958	16.2	22,982	9.1	188,911	111,663	44.2	77,249	30.6
1952	256,863	44,335	17.3	22,906	8.9	189,623	115,185	44.8	74,437	29.0
1953	263,946	47,560	18.0	24,746	9.4	191,640	119,129	45.1	72,511	27.5
1954	268,910	49,340	18.3	25,037	9.3	194,533	121,771	45.3	72,762	27.1
1955	271,741	50,536	18.6	23,607	8.7	197,598	127,875	47.1	69,723	25.7
1956	269,883	53,470	19.8	23,758	8.8	192,655	126,304	46.8	66,351	24.6
1957	268,486	55,501	20.7	23,035	8.6	189,949	127,179	47.4	62,770	23.4
1958	274,698	55,842	20.3	25,438	9.3	193,418	134,593	49.0	58,825	21.4
1959	281,833	54,554	19.4	26,044	9.2	201,235	144,983	51.4	56,252	20.0
1960	283,241	53,081	18.7	26,523	9.4	203,639	151,268	53.4	52,371	18.5
1961	285,672	53,681	18.8	27,253	9.5	204,738	153,394	53.7	51,344	18.0
1962	294,442	54,251	18.4	29,663	10.1	210,528	159,179	54.1	51,349	17.4
1963	301,954	55,636	18.4	32,027	10.6	214,293	162,451	53.8	51,842	17.2
1964	307,357	58,593	19.1	34,794	11.3	213,971	161,819	52.6	52,152	17.0
1965	313,113	61,068	19.5	39,100	12.5	212,946	159,247	50.9	53,699	17.1
1966	315,431	64,316	20.4	42,169	13.4	208,946	154,909	49.1	54,037	17.1
1967	322,286	71,809	22.3	46,719	14.5	203,758	150,318	46.6	53,440	16.6
1968	344,401	76,138	22.1	52,230	15.2	216,032	159,668	46.4	56,363	16.4
1969	351,729	84,814	24.1	54,095	15.4	212,819	156,006	44.4	56,814	16.2

Fiscal year 1946 - II Quarter 1976 1/
($ millions)

End of FY or Qtr		Total Interest Bearing (1)	Held by GA (2)	% of Total Interest Bearing (2÷1)	Held by Fed (3)	% of Total Interest Bearing (3÷1)	Held by Private Investors: Total (4)	Marketable (5)	% of Total Interest Bearing (5÷1)	Non-Marketable (6)	% of Total Interest Bearing (6÷1)
1970	Sep	358,818	86,932	24.2	54,134	15.1	217,752	160,987	44.9	56,765	15.8
	Dec	366,221	89,042	24.3	57,154	15.6	220,026	162,415	44.4	57,610	15.7
	Mar	369,963	90,368	24.4	55,785	15.1	223,809	166,047	44.9	57,762	15.6
	Jun	369,026	95,170	24.0	57,714	14.6	216,142	157,911	39.9	58,231	14.7
1971	Sep	376,820	95,487	25.3	59,975	15.9	221,359	162,480	43.1	58,879	15.6
	Dec	387,252	97,093	25.1	62,142	16.0	228,017	168,480	43.5	59,537	15.4
	Mar	389,777	98,800	25.4	64,160	16.4	226,817	165,920	42.6	60,898	15.6
	Jun	396,289	102,888	26.0	65,518	16.5	227,883	161,863	40.8	66,020	16.7
1972	Sep	410,450	106,491	25.9	67,566	16.5	236,394	163,834	39.9	72,560	17.7
	Dec	422,308	106,045	25.1	70,218	16.6	246,046	173,376	41.0	72,670	17.2
	Mar	425,536	105,532	24.8	69,928	16.4	250,076	176,779	41.5	73,297	17.2
	Jun	425,360	111,460	26.2	71,356	16.8	242,545	165,978	39.0	76,566	18.0
1973	Sep	432,127	113,548	26.3	69,734	16.1	248,846	168,774	39.1	80,072	18.5
	Dec	447,298	116,897	26.1	69,906	15.6	260,459	180,244	40.3	80,251	17.9
	Mar	456,787	117,922	25.8	74,276	16.3	264,589	175,459	38.4	89,130	19.5
	Jun	456,353	123,385	27.0	75,022	16.4	257,947	167,869	36.8	90,078	19.7
1974	Sep	459,471	127,776	27.8	76,217	16.6	255,478	165,259	36.0	90,219	19.6
	Dec	467,827	129,641	27.2	78,516	16.8	259,670	170,747	36.5	88,923	19.0
	Mar	472,622	131,215	27.8	79,483	16.8	261,925	172,842	36.6	89,083	18.8
	Jun	473,238	138,206	29.2	80,485	17.0	254,548	164,862	34.8	89,686	19.0
1975	Sep	480,103	140,384	29.2	81,035	16.9	258,684	170,129	35.4	88,555	18.4
	Dec	491,561	141,207	28.7	80,500	16.4	269,854	181,000	36.8	88,853	18.1
	Mar	508,581	138,458	27.2	81,418	16.0	288,705	197,765	38.9	90,940	17.9
	Jun	532,122	145,283	27.3	84,749	15.9	302,090	210,386	39.5	91,704	17.2
1976	Sep	552,604	142,266	25.7	86,998	15.7	323,340	232,251	42.1	91,089	16.5
	Dec	575,657	139,343	24.2	87,934	15.3	348,380	255,865	44.4	92,515	16.1
	Feb	592,874	139,736	23.6	88,990	15.0	364,148	270,625	45.6	93,522	15.8

Office of the Secretary of the Treasury
Office of Debt Analysis

April 1, 197(

1/ Prior to 1960 the data are not classified according to the unified budget concept; consequently, some holdings currently classified under private investors were included under Government Accounts for that earlier period.

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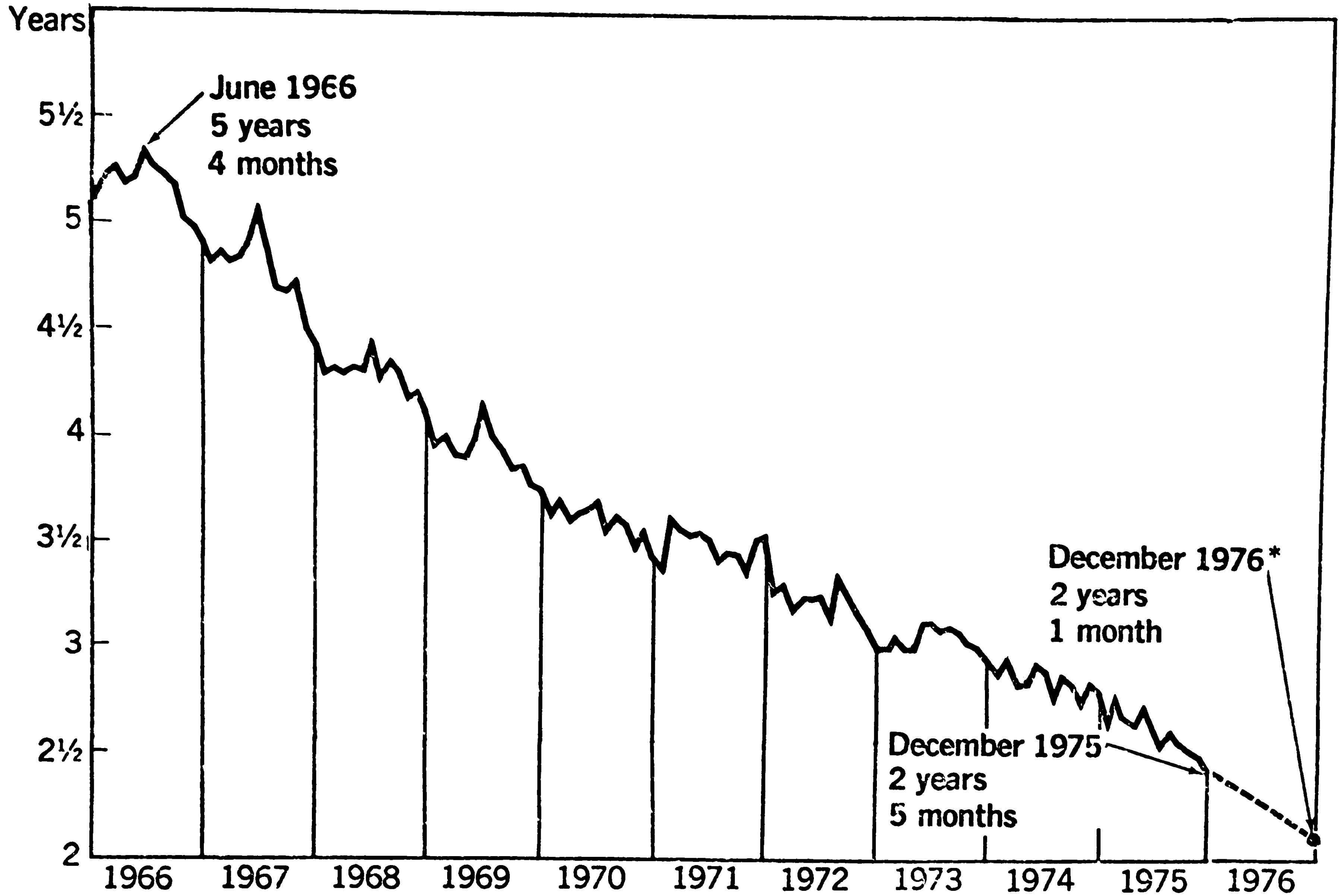
AVERAGE LENGTH OF THE MARKETABLE DEBT

Privately Held



*Estimated

Office of the Secretary of the Treasury
Office of Debt Analysis

January 26, 1976-23

Last month 5.78

Today 5.64

Low since
2/4/76 5.572

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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CORRECTED COPY

FOR IMMEDIATE RELEASE April 29, 1976

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,185 million of 52-week Treasury bills to be dated May 4, 1976, and to mature May 3, 1977, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS: (Excepting 2 tenders totaling $725,000)

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	94.338	5.600%	5.93%
Low -	94.265	5.672%	6.01%
Average -	94.292	5.645%	5.98%

Tenders at the low price were allotted 78%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted
Boston	$ 51,695,000	$ 46,695,000
New York	4,550,245,000	2,486,365,000
Philadelphia	2,890,000	2,890,000
Cleveland	64,335,000	54,335,000
Richmond	36,740,000	34,740,000
Atlanta	16,835,000	11,335,000
Chicago	414,655,000	323,655,000
St. Louis	31,445,000	15,445,000
Minneapolis	78,980,000	67,980,000
Kansas City	22,835,000	18,835,000
Dallas	19,030,000	18,030,000
San Francisco	230,065,000	105,065,000
TOTAL	$5,519,750,000	$3,185,370,000

The $3,185,370,000 of accepted tenders includes $ 95,320,000 of noncompetitive tenders from the public and $1,003,030,000 of tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities accepted at the average price.

An additional $150,000,000 of the bills will be issued to Federal Reserve Banks as agents of foreign and international monetary authorities for new cash.

WS-823

ederal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-964-2615

FOR IMMEDIATE RELEASE

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SUMMARY OF LENDING ACTIVITY

April 1 - April 15, 1976

Federal Financing Bank lending activity for the period April 1 through April 15, 1976 was announced by Roland H. Cook, Secretary:

The General Services Administration made the following borrowings from the Federal Financing Bank:

Date	Series	Amount	Maturity	Interest Rate
4/1	M	$ 830,850.00	7/31/03	8.172%
4/13	L	1,105,832.59	11/15/04	8.083%

On April 1, the United States Railway Association prepaid in full Note #1 in the amount of $3,435,096.

USRA made the following borrowings guaranteed by the Department of Transportation:

Date	Note	Amount	Maturity	Interest Rate
4/5	8	$ 6,500,000	4/30/79	7.318%
4/7	7	6,197,000	4/20/89	7.937%
4/12	8	7,525,000	4/30/79	7.066%
4/15	6	3,100,000	12/26/90	8.055%
4/15	8	17,133,000	4/30/79	6.927%
4/15	3	500,000	5/1/76	5.000%

The National Railroad Passenger Corporation (Amtrak) made the following drawings from the Bank against Note #7:

Date	Amount	Maturity	Interest Rate
4/2	$ 6,000,000	6/14/76	5.194%
4/14	10,000,000	6/14/76	5.000%

On April 6, Amtrak made a partial repayment of $38,000,000 on Note #6.

On April 14, $419,543.46 was advanced under a June 1, 1975 agreement with Amtrak and others to finance 25 GE diesel electric locomotives. The agreement provides for serial repayments with a final maturity of December 31, 1988.

WS-824

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The interest rate, set at the time of the agreement, is 7.92%. Amtrak borrowings are guaranteed by the Department of Transportation.

The Federal Financing Bank made the following loans to utility companies guaranteed by the Rural Electrification Administration:

Date	Borrower	Amount	Maturity	Quarterly Interest Rate
4/5	Cooperative Power Assoc.	$ 5,000,000	12/31/10	8.084%
4/7	Allied Telephone Co	313,463	12/31/10	8.009%
4/8	Tri-State Generaation & Transmission Assoc.	4,485,000	12/31/10	7.987%
4/9	Oglethorpe Electric Membership Corp.	117,060,000	12/31/10	7.995%
4/12	North West Telephone Co.	789,716	12/31/10	7.987%
4/13	Allied Telephone Co.	845,458	12/31/10	7.986%
4/14	Colorado-Ute Electric Assoc.	6,100,000	12/31/10	7.975%
4/14	Alabama Electric Coop., Inc.	5,282,000	12/31/10	7.975%
4/15	United Power Assoc.	3,000,000	12/31/10	7.952%

The following advances were made to borrowers guaranteed by the Department of Defense under the Foreign Military Sales Act:

Date	Borrower	Amount	Maturity	Interest Rate
4/5	Republic of Korea	$13,256,949.19	12/31/83	7.559%
4/7	Government of Argentina	2,374,226.34	4/30/83	7.459%
4/8	Government of China	508,435.89	12/31/82	7.349%

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Date	Borrower	Amount	Maturity	Interest Rate
4/9	Government of Guatemala	$ 1,333,745.88	12/31/82	7.374%
4/12	Government of Nicaragua	240,000.00	6/30/80	6.951%
4/13	Government of Argentina	697,128.33	4/30/83	7.303%
4/14	Kingdom of Jordan	1,880,800.00	6/30/85	7.406%
4/15	Government of China	5,680,019.97	1/2/84	7.253%

The FFB purchased the following Series D notes from the Department of Health, Education and Welfare:

Date	Amount	Maturity	Interest Rate
4/6	$ 519,000	7/1/2000	8.014%
4/9	3,925,000	7/1/2000	7.968%

The Department had previously acquired the notes which were issued by various public agencies under the Medical Facilities Loan Program. The notes purchased by the FFB are guaranteed by HEW.

On April 6, the Student Loan Marketing Association (SLMA) borrowed $10 million at an interest rate of 5.215% with a maturity of July 6, 1976.

On April 15, SLMA borrowed $10 million. The interest rate is 5.825%. The final maturity is April 12, 1977. Proceeds of the loan were used to repay a $10 million note maturing with the Bank. SLMA borrowings are guaranteed by the Department of Health, Education and Welfare.

The Tennessee Valley Authority borrowed $55 million on April 14. The note matures July 30, 1976 and bears interest at a rate of 5.020%.

The Federal Financing Bank loans outstanding on April 15, 1976 totalled $21.6 billion.

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NEWS

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CONTACT: GEORGE G. ROSS
202-964-5985

FOR IMMEDIATE RELEASE May 3, 1976

UNITED STATES AND UNITED KINGDOM AMENDED INCOME TAX TREATY

The United States Treasury Department today released the amended text of the new income tax treaty between the United States and the United Kingdom. The treaty, which was signed by both governments on December 31, 1975, has been submitted to the United Kingdom House of Commons for approval and will be sent to the United States Senate for its advice and consent to ratification. A copy of the amended text of the treaty is attached.

The provisions of the new treaty were outlined in Treasury Press Releases issued on November 4, 1975 and January 6, 1976. Those provisions of the original text which have been amended are paragraph (2) of Article 1 (Personal Scope), paragraph 1(j) of Article 3 (General Definitions), paragraph (3) of Article 8 (Shipping and Air Transport), paragraph 4 of Article 9 (Associated Enterprises) and Article 16 (Investment or Holding Companies).

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WS-825

CONVENTION

BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS

The Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland;

Desiring to conclude a new Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains;

Have agreed as follows:

ARTICLE 1

Personal scope

(1) Except as specifically provided herein, this Convention is applicable to persons who are residents of one or both of the Contracting States.

(2) A corporation which is both a resident of the United Kingdom within the meaning of paragraph (1)(*a*)(ii) of Article 4 (Fiscal residence), and a resident of the United States within the meaning of paragraph (1)(*b*)(ii) of Article 4 shall not be entitled to claim any relief or exemption from tax provided by this Convention except that such corporation may claim the benefits of Article 23 (Elimination of double taxation) with respect to the petroleum revenue tax referred to in paragraph (2)(*b*) of Article 2 (Taxes covered), of Article 24 (Non-discrimination) and of Article 28 (Entry into force).

(3) Notwithstanding any provision of this Convention except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Fiscal residence)) and its nationals as if this Convention had not come into effect.

(4) Nothing in paragraph (3) of this Article shall affect the application by a Contracting State of:

(*a*) Articles 9 (Associated enterprises), 23 (Elimination of double taxation), 24 (Non-discrimination), and 25 (Mutual agreement procedure); and

(*b*) Articles 19 (Government service), 20 (Teachers), 21 (Students and trainees) and 27 (Effect on diplomatic and consular officials and domestic laws), with respect to individuals who are neither nationals of, nor have immigrant status in, that State.

ARTICLE 2

Taxes covered

(1) This Convention shall apply to taxes on income imposed by each Contracting State and as hereinafter provided to taxes imposed by its political subdivisions or local authorities.

(2) The existing taxes to which this Convention shall apply are:

(*a*) in the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the tax on insurance premiums paid to foreign insurers; but (except as provided in paragraph (6) of Article 10 (Dividends)) excluding the accumulated earnings tax and the personal holding company tax. The foregoing taxes covered are hereinafter referred to as "United States tax";

(*b*) in the case of the United Kingdom, the income tax, the capital gains tax, the corporation tax and the petroleum revenue tax. The foregoing taxes covered are hereinafter referred to as "United Kingdom tax"; and

(*c*) for the purposes of paragraph (4) of Article 9 (Associated enterprises), taxes imposed on income by political subdivisions or local authorities of a Contracting State.

(3) This Convention shall also apply to any identical or substantially similar taxes which are imposed by a Contracting State or its political subdivisions or local authorities after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws.

(4) For the purpose of Article 24 (Non-discrimination), this Convention shall also apply to taxes of every kind and description imposed by each Contracting State, or by its political subdivisions or local authorities.

ARTICLE 3

General definitions

(1) In this Convention, unless the context otherwise requires:

(*a*) the term "corporation" means a United States corporation, a United Kingdom corporation, or any body corporate or other entity of a third State which is treated as a body corporate for tax purposes by both Contracting States;

(*b*) (i) the term "United States corporation" means a corporation (or any unincorporated entity treated as a corporation for United States tax purposes) which is created or organised under the laws of the United States or any State thereof or the District of Columbia; and

(ii) the term "United Kingdom corporation" means any body corporate or unincorporated association created or organised under the laws of the United Kingdom, but does not include a partnership, a local authority, or a local authority association;

(*c*) the term "person" includes an individual, a corporation, a partnership, an estate, a trust and any other body of persons;

(*d*) the term "enterprise of a Contracting State" means an industrial or commercial undertaking carried on by a resident of a Contracting State;

(*e*) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

(*f*) the term "competent authority" means:

(i) in the case of the United States, the Secretary of the Treasury or his delegate, and

(ii) in the case of the United Kingdom, the Commissioners of Inland Revenue or their authorised representative;

(*g*) (i) the term "United States" means the United States of America; and

(ii) when used in a geographical sense, the States thereof and the District of Columbia.

Such term also includes:

(*aa*) the territorial sea thereof, and

(*bb*) the seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the United States exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the Convention is being applied is connected with such exploration or exploitation;

(*h*) (i) the term "United Kingdom" means Great Britain and Northern Ireland, including any area outside the territorial sea of the United Kingdom which in accordance with international law has been or may hereafter be designated, under the laws of the United Kingdom concerning the Continental Shelf, as an area within which the rights of the United Kingdom with respect to the seabed and subsoil and their natural resources may be exercised;

(*i*) the term "Contracting State" means the United States or the United Kingdom, as the context requires;

(*j*) the term "third State" means any State or territory other than the United States or the United Kingdom and the term "enterprise of a third State" shall be construed accordingly;

(*k*) the term "nationals" means:

(i) in relation to the United Kingdom, all citizens of the United Kingdom and Colonies, British subjects under sections 2, 13(1) or 16 of the British Nationality Act 1948 , and British subjects by virtue of section 1 of the British Nationality Act 1965 , provided they are patrial within the meaning of the Immigration Act 1971 , so far as these provisions are in force on the date of entry into force of this Convention or have been modified only in minor respects so as not to affect their general character;

(ii) in relation to the United States, United States citizens.

(2) As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Article 25 (Mutual agreement procedure), have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

ARTICLE 4

Fiscal residence

(1) For the purpose of this Convention:

(*a*) the term "resident of the United Kingdom" means:

(i) any person, other than a corporation, resident in the United Kingdom for the purposes of United Kingdom tax; but in the case of a partnership, estate, or trust, only to the extent that the income derived by such partnership, estate, or trust is subject to United Kingdom tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a corporation whose business is managed and controlled in the United Kingdom;

(*b*) the term "resident of the United States" means:

(i) any person, other than a corporation, resident in the United States for the purposes of United States tax; but in the case of a partnership, estate, or trust, only to the extent that the income derived by such partnership, estate, or trust is subject to United States tax as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

(ii) a United States corporation.

(2) Where by reason of the provisions of paragraph (1) an individual is a resident of both Contracting States, then the individual's tax status shall be determined as follows:

(*a*) the individual shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him. If the individual has a permanent home available to him in both Contracting States or in neither of the Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closest (centre of vital interests);

(*b*) if the Contracting State in which the individual's centre of vital interests is located cannot be determined, he shall be deemed to be a resident of that Contracting State in which he has an habitual abode;

(*c*) if the individual has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national; and

(*d*) if the individual is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

(3) Where by reason of the provisions of paragraph (1) an estate or trust may be a resident of both Contracting States, the competent authorities of the Contracting States may settle the question of residence by mutual agreement.

(4) Where under any provision of this Convention income arising in one of the Contracting States is relieved from tax in that Contracting State and, under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income as is remitted to or received in the other Contracting State.

ARTICLE 5

Permanent establishment

(1) For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

(2) The term "permanent establishment" shall include especially:

(*a*) a branch;

(*b*) an office;

(*c*) a factory;

(*d*) a workshop;

(*e*) a mine, oil or gas well, quarry, or other place of extraction of natural resources; and

(*f*) a building or construction or installation project which exists for more than 12 months.

(3) Notwithstanding the provisions of the preceding paragraphs, the term "permanent establishment" shall be deemed not to include a fixed place of business used solely for one or more of the following activities:

(*a*) the storage, display, or delivery of goods or merchandise belonging to the enterprise;

(*b*) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display or delivery;

(*c*) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another person;

(*d*) the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

(*e*) the maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise; or

(*f*) a building or construction or installation project which does not exist for more than 12 months.

(4) A person acting in a Contracting State on behalf of an enterprise of the other Contracting State—other than an agent of an independent status to whom paragraph (5) applies—shall be deemed to be a permanent establishment of the enterprise in the first-mentioned State if such person has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless the contracts are confined to the activities described in paragraph (3) of this Article.

(5) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of independent status, where such persons are acting in the ordinary course of their business.

(6) The fact that a corporation which is a resident of a Contracting State controls or is controlled by a corporation which is a resident of the other Contracting State, or which carried on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either corporation a permanent establishment of the other.

ARTICLE 6

Income from immovable property (real property)

(1) Income from immovable property (real property), including income from agriculture or forestry, may be taxed in the Contracting State in which such property is situated.

(2) The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated. The term shall in any case include usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

(3) The provisions of paragraph (1) shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

ARTICLE 7

Business profits

(1) The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in that other State but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3), where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

(4) No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

(5) For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

(6) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

(7) For the purposes of this Convention, "business profits" includes, but is not limited to, income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting or from copyrights thereof. Such term also includes any other income effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State. Such term does not include the performance of personal services by an individual either as an employee or in an independent capacity.

ARTICLE 8

Shipping and air transport

(1) Notwithstanding the provisions of Article 7 (Business profits), profits of an enterprise of a Contracting State from the operation in international traffic of ships or aircraft registered under the laws of the Contracting State in which the person carrying on the enterprise is resident shall be taxable only in that State.

(2) For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include profits derived from the rental on a bareboat basis of ships or aircraft operated in international traffic if such rental income is incidental to other income described in paragraph (1).

(3) Notwithstanding the provisions of Article 7 (Business profits), profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise shall be taxable only in that State except where such containers are used for the transport of goods or merchandise solely between places within the other Contracting State.

(4) Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers owned and operated by the enterprise, the income from which is taxable only in that State, shall be taxable only in that State.

ARTICLE 9

Associated enterprises

(1) Where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly.

(2) Where any income, deductions, receipts or outgoings which have been taken into account in one Contracting State in computing the profits or losses of an enterprise are also taken into account in the other Contracting State in computing the profits or losses of a related enterprise in accordance with paragraph (1) of this Article, then the first-mentioned State shall make such adjustment as may be appropriate to the amount of tax charged on those profits in that State.

(3) If one Contracting State disagrees with the amount of any income, deductions, receipts or outgoings, taken into account in computing profits or losses in the other in accordance with paragraph (1), the two Contracting States shall endeavour to reach agreement in accordance with the procedure in Article 25 (Mutual agreement procedure).

(4) Except as specifically provided in this Article:

(*a*) where an enterprise doing business in one Contracting State:

(i) is a resident of the other Contracting State; or

(ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State; and

(*b*) where the enterprise which is a resident of the other Contracting State is a corporation, such corporation is neither:

(i) a controlled foreign corporation within the meaning of section 957 of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the general principle thereof); nor

(ii) created or organised under the laws of the first-mentioned State or of any third State or controlled, directly or indirectly, by a corporation which is a resident of any third State;

then, in determining the tax liability of the first-mentioned enterprise in the State in which it does business, or in a political subdivision or local authority of that State, such State, political subdivision or local authority shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State which is related to the enterprise of the other Contracting State, except that this prohibition shall not apply where the first-mentioned enterprise is a resident of the first-mentioned Contracting State, to the extent that it owns, directly or indirectly, the capital of the related enterprise.

(5) For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third person or persons (related to each other or acting together) control both.

Article 10
Dividends

(1) Dividends derived from a corporation which is a resident of a Contracting State by a resident of the other Contracting State may be taxed in the other Contracting State. However, such dividends may be taxed in the Contracting State of which the corporation paying the dividends is a resident, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed 15 per cent of the gross amount of the dividends.

(2) As long as an individual resident in the United Kingdom is entitled under United Kingdom law to a tax credit in respect of dividends paid by a corporation which is resident in the United Kingdom, paragraph (1) of this Article shall not apply. In these circumstances, dividends derived from a corporation which is a resident of a Contracting State by a resident of the other Contracting State may be taxed in the other Contracting State. However, such dividends may be taxed in the Contracting State of which the corporation paying the dividends is a resident, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed the tax provided in sub-paragraphs (*a*) and (*b*) below:

(*a*) In the case of dividends paid by a corporation which is a resident of the United Kingdom:

(i) to a United States corporation which either alone or together with one or more associated corporations controls, directly or indirectly, at least 10 per cent of the voting stock of the corporation which is a resident of the United Kingdom paying the dividend, the United States corporation shall be entitled to a payment from the United Kingdom of a tax credit equal to one-half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, subject to the deduction withheld from such payment and according to the laws of the United Kingdom of an amount not exceeding 5 per cent of the aggregate of the amount or value of the dividend and the amount of the tax credit paid to such corporation;

(ii) in all other cases, the resident of the United States to whom such dividend is paid shall be entitled to a payment from the United Kingdom of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received the dividend, subject to the deduction withheld from such payment and according to the laws of the United Kingdom of an amount not exceeding 15 per cent of the aggregate of the amount or value of the dividend and the amount of the tax credit paid to such resident;

(iii) the aggregate of the amount or value of the dividend and the amount of the tax credit referred to in sub-paragraphs (*a*) (i) and (ii) of this paragraph paid by the United Kingdom to the United States corporation or other resident (without reduction for the 5 or 15 per cent deduction, as the case may be, by the United Kingdom) shall be treated as a dividend for United States tax credit purposes.

(*b*) In the case of dividends paid by a United States corporation:

(i) to a corporation which is a resident of the United Kingdom and controls, directly or indirectly, at least 10 per cent of the voting stock of the

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United States corporation paying such dividend, the tax charged by the United States shall not exceed 5 per cent of the gross amount of the dividend;

(ii) in all other cases, the tax charged by the United States on payment of a dividend to a resident of the United Kingdom shall not exceed 15 per cent of the gross amount of the dividend.

For the purposes of this paragraph, two corporations shall be deemed to be associated if one controls directly or indirectly more than 50 per cent of the voting power in the other corporation, or a third corporation controls more than 50 per cent of the voting power in both of them.

(3) The term "dividends" for United Kingdom tax purposes includes any item which under the law of the United Kingdom is treated as a distribution and for United States tax purposes includes any item which under the law of the United States is treated as a distribution out of earnings and profits.

(4) Paragraphs (1) or (2), as the case may be, shall not apply if the person deriving the dividends, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Articles 7 (Business profits), 14 (Independent personal services), or 17 (Artistes and athletes), as the case may be, shall apply.

(5) Where a corporation which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the corporation, except insofar as such dividends are paid to a resident of that other State (and where that other State is the United States, to a national of the United States) or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base situated in that other State, even if the dividends paid consist wholly or partly of profits or income arising in that other State.

(6) A corporation which is a resident of the United Kingdom shall be exempt from United States tax on its accumulated or undistributed earnings, profits, income or surplus, if individuals (other than nationals of the United States) who are residents of the United Kingdom control, directly or indirectly, throughout the last half of the taxable year, more than 50 per cent of the entire voting power in such corporation.

(7) (*a*) If the beneficial owner of a dividend being a resident of a Contracting State owns 10 per cent or more of the class of shares of a corporation in respect of which the dividend is paid, then paragraph (1), or as the case may be paragraph (2), of this Article shall not apply to the dividend to the extent that it can have been paid only out of profits which the corporation paying the dividend earned or other income which it received in a period ending 12 months or more before the relevant date. For the purposes of this paragraph the term "relevant date" means the date on which the beneficial owner of the dividend became the owner of 10 per cent or more of the class of shares in question.

(*b*) Paragraphs (1) and (2) of this Article shall not apply if:

(i) the recipient of the dividend is exempt from tax thereon in the United States; and

(ii) the dividend is paid in such circumstances that, if the recipient were a resident of the United Kingdom exempt from United Kingdom tax, the exemption would be limited or removed.

Provided that this paragraph shall not apply if the beneficial owner of the dividend shows that the shares were acquired for *bona fide* commercial reasons and not primarily for the purposes of securing the benefit of this Article.

Article 11

Interest

(1) Interest derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States.

(2) Interest derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom.

(3) The term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and other debt claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises but subject to the provisions of paragraph (7) of this Article shall not include any income which is treated as a distribution under the provisions of Article 10 (Dividends). Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

(4) The provisions of paragraphs (1) and (2) shall not apply if the person deriving the interest, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Articles 7 (Business profits), 14 (Independent personal services), or 17 (Artistes and athletes), as the case may be, shall apply.

(5) Where, owing to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

(6) Whether or not a resident of a Contracting State derives profits or income from the other Contracting State, the other State may not impose any tax on the interest paid by that resident, except insofar as such interest is paid to a resident of that other State (and where that other State is the United States, to a national of the United States) or insofar as the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment or a fixed base of the person deriving interest situated in that other State.

(7) Any provision in the law of either Contracting State relating only to interest paid to a non-resident corporation shall not operate so as to require such interest paid to a resident of the other Contracting State to be treated as a distribution by the corporation paying such interest. The preceding sentence shall not apply to interest paid to a corporation of one Contracting State in which more than 50 per cent of the voting power is controlled, directly or indirectly, by a person or persons who are residents of the other Contracting State.

(8) The provisions of paragraph (2) of this Article shall not apply if the recipient of the interest is exempt from tax on such income in the United States and such recipient sells or makes a contract to sell the holding from which such interest is derived within three months of the date such recipient acquired such holding.

Article 12

Royalties

(1) Royalties derived and beneficially owned by a resident of the United Kingdom shall be exempt from tax by the United States.

(2) Royalties derived and beneficially owned by a resident of the United States shall be exempt from tax by the United Kingdom.

(3) The term "royalties" as used in this Article *(a)* means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting); any patent, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience; and *(b)* shall include gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; including the supply of assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of any such right or property.

(4) The provisions of paragraphs (1) and (2) of this Article shall not apply if the person deriving the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Articles 7 (Business profits), 14 (Independent personal services), or 17 (Artistes and athletes), as the case may be, shall apply.

(5) Where, owing to a special relationship between the payer and the person deriving the royalties or between both of them and some other person, the amount of the royalties paid exceeds for whatever reason the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13

Capital gains

Except as provided in Article 8 (Shipping and air transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

Article 14

Independent personal services

Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity may be taxed in that State. Such income may also be taxed in the other Contracting State if:

(a) the individual is present in that other State for a period or periods exceeding in the aggregate 183 days in the tax year concerned, but only so much thereof as is attributable to services performed in that State, or

(b) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities, but only so much thereof as is attributable to services performed in that State.

Article 15

Dependent personal services

(1) Subject to the provisions of Articles 18 (Pensions) and 19 (Government service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

(2) Notwithstanding the provisions of paragraph (1), remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(*a*) the recipient is present in that other State for a period not exceeding in the aggregate 183 days in the tax year concerned; and

(*b*) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other State; and

(*c*) the remuneration is not borne as such by a permanent establishment or a fixed base which the employer has in that other State.

(3) Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment as a member of the regular complement of a ship or aircraft in international traffic may be taxed by the Contracting State of which the employer operating the ship or aircraft is a resident.

ARTICLE 16

Investment or holding companies

(1) The provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention shall not apply to a corporation which is a resident of one of the Contracting States and which derives dividends, interest, or royalties arising within the other Contracting State if:

(*a*) (i) the tax imposed on the corporation by the first-mentioned Contracting State in respect of such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; or

(ii) the corporation is a resident of the United States and receives more than 80 per cent of its gross income from sources outside the United States as determined by and for the period prescribed in sections 861(*a*)(1)(B) and (*a*)(2)(A) of the United States Internal Revenue Code of 1954, as they may be amended from time to time in minor respects so as not to affect their general principle; and

(*b*) 25 per cent or more of the capital of such corporation is owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

(2) Nothing in this Article shall however prevent a claim under the provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) by a United States corporation where more than 75 per cent of the capital of that corporation is directly or indirectly owned:

(*a*) by a United States corporation which receives 20 per cent of more of its gross income from sources within the United States as determined by and for the period described in subparagraph (1)(*a*) (ii) of this Article; or

(*b*) by a corporation (other than a United States corporation) which by reference to the provisions of section 283 of the United Kingdom Income and Corporation Taxes Act 1970 (as it may be amended from time to time without changing the general principle thereof) would not fall to be treated as a close company; or

(*c*) by a corporation which is a resident of the United Kingdom and in which more than 50 per cent of the voting power is controlled, directly or indirectly, by individuals who are residents of the United Kingdom.

ARTICLE 17

Artistes and athletes

(1) Notwithstanding the provisions of Articles 14 (Independent personal services) and 15 (Dependent personal services), income derived by entertainers, such as theatre, motion picture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised, except where the amount of the gross receipts derived by an entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed 15,000 United States dollars or its equivalent in pounds sterling in the tax year concerned.

(2) Where income in respect of personal activities as such of an entertainer or athlete accrues not to that entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7 (Business profits), 14 (Independent personal services), and 15 (Dependent personal services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. For the purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue to another person if it is established that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions.

ARTICLE 18

Pensions

(1) Subject to the provisions of paragraph (2) of Article 19 (Government service), any pension in consideration of past employment and any annuity paid to an individual who is a resident of a Contracting State shall be taxed only in that State.

(2) Alimony paid to an individual who is a resident of one of the Contracting States by an individual who is a resident of the other Contracting State shall be exempt from tax in the other Contracting State.

(3) The term "annuity" means a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

ARTICLE 19

Government service

(1) (*a*) Remuneration, other than a pension, paid by a Contracting State to any individual in respect of services rendered to that State shall be taxable only in that State.

(*b*) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the recipient is a resident of that other Contracting State who:

(i) is a national of that State; or

(ii) did not become a resident of that State solely for the purpose of performing the services.

(2) (*a*) Any pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof shall be taxable only in that State.

(*b*) However, such pension shall be taxable only in the other Contracting State if the recipient is a national of and a resident of that State.

(3) The provisions of Articles 14 (Independent personal services), 15 (Dependent personal services), 17 (Artistes and athletes), and 18 (Pensions), as the case may be, shall apply to remuneration and pensions in respect of services rendered in connection with any business carried on by or on behalf of one of the Contracting States or a political subdivision or a local authority thereof.

ARTICLE 20

Teachers

(1) A professor or teacher who visits one of the Contracting States for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college or other recognized educational institution in that Contracting State and who was immediately before that visit a resident of the other Contracting State, shall be exempted from tax by the first-mentioned Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date he first visits that State for such purpose.

(2) The exemption provided in this Article may be applied by the Contracting State in which the teaching or research is performed to current payments to such professor

or teacher in anticipation of fulfilment of the requirements of paragraph (1) or by way of withholding and refund, but in either case exemption shall be conditional upon fulfilment of the requirements of paragraph (1).

(3) This Article shall only apply to income from research if such research is undertaken by the professor or teacher in the public interest and not primarily for the benefit of some other private person or persons.

ARTICLE 21

Students and trainees

Payments which a student or business apprentice who was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned Contracting State for the purpose of his full-time education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments are made to him from sources outside that State.

ARTICLE 22

Other income

(1) Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

(2) The provisions of paragraph (1) shall not apply if the person deriving the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Articles 7 (Business profits), 14 (Independent personal services), or 17 (Artistes and athletes), as the case may be, shall apply.

ARTICLE 23

Elimination of double taxation

(1) In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or national of the United States as a credit against the United States tax the appropriate amount of tax paid to the United Kingdom; and, in the case of a United States corporation owning at least 10 per cent of the voting stock of a corporation which is a resident of the United Kingdom from which it receives dividends in any taxable year, the United States shall allow credit for the appropriate amount of tax paid to the United Kingdom by that corporation with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to the United Kingdom, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. For the purposes of applying the United States credit in relation to tax paid to the United Kingdom:

(*a*) the taxes referred to in paragraphs (2) (*b*) and (3) of Article 2 (Taxes covered) shall be considered to be income taxes;

(*b*) the amount of 5 or 15 per cent, as the case may be, withheld under paragraph (2) (*a*) (i) or (ii) of Article 10 (Dividends) from the tax credit paid by the United Kingdom shall be treated as an income tax imposed on the recipient of the dividend; and

(*c*) that amount of tax credit referred to in paragraph (2) (*a*) (i) of Article 10 (Dividends) which is not paid to the United States corporation but to which an individual resident in the United Kingdom would have been entitled had he received the dividend shall be treated as an income tax imposed on the United Kingdom corporation paying the dividend.

(2) Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (as it may be amended from time to time without changing the general principle hereof):

(*a*) United States tax payable under the laws of the United States and in accordance with the present Convention, whether directly or by deduction, on profits or income from sources within the United States (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits or income by reference to which the United States tax is computed;

(*b*) in the case of a dividend paid by a United States corporation to a corporation which is resident in the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the United States corporation, the credit shall take into account (in addition to any United States tax creditable under (*a*)) the United States tax payable by the corporation in respect of the profits out of which such dividend is paid.

(3) For the purposes of the preceding paragraphs of this Article, income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise from sources within that other Contracting State, except that where the United States taxes on the basis of citizenship, the United Kingdom shall not be bound to give credit to a United States national who is resident in the United Kingdom on income from sources outside the United States as determined under the laws of the United Kingdom and the United States shall not be bound to give credit for United Kingdom tax on income received by such national from sources outside the United Kingdom, as determined under the laws of the United States.

(4) The provisions of this Article shall not affect the taxation by the United States of foreign oil and gas extraction income and foreign oil related income as provided in the Tax Reduction Act of 1975.

ARTICLE 24

Non-discrimination

(1) Individuals who are nationals of a Contracting State and who are residents of the other Contracting State shall not be subjected in that other State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.

(2) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

(3) Subject to the provisions of paragraph (4) of this Article, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, if reasonable in amount, be deductible for the purpose of determining the taxable profits of such enterprise under the same conditions as if they had been paid to a resident of the first-mentioned State. For the purposes of this paragraph, the term "other disbursements" shall include charges for amounts expended by such residents for the purposes of such enterprise, including a reasonable allocation of executive and general administrative expenses (except to the extent representing the expenses of a type of activity which is not for the benefit of such enterprise, but constitutes "stewardship" or "over-seeing" functions undertaken for such resident's own benefit as an investor in the enterprise), research and development in respect of which such enterprise has the benefits under a cost and risk sharing agreement and other expenses incurred by such resident for the benefit of a group of related enterprises including such enterprise.

(4) Paragraph (3) shall not apply to any interest, royalties, or other disbursements to which the provisions of Article 9 (Associated enterprises), paragraphs (5) and (7) of Article 11 (Interest) or paragraph (5) of Article 12 (Royalties) apply, or would apply but for the provisions of paragraph (2) of Article 1 (Personal scope).

(5) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

(6) Nothing contained in this Article shall be construed as obliging either Contracting State to grant to individuals not resident in that State any of the personal allowances and reliefs which are granted to individuals so resident.

ARTICLE 25

Mutual agreement procedure

(1) Where a resident or national of a Contracting State considers that the actions of one or both of the Contracting States result or will result in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of whch he is a resident or national.

(2) The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation not in accordance with the Convention. Where an agreement has been reached, a refund as appropriate shall be made to give effect to the agreement.

(3) The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may reach agreement on:

(*a*) the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

(*b*) the allocation of income, deductions, credits, or allowances between persons;

(*c*) the nature of particular items of income;

(*d*) the meaning of terms not otherwise defined in this Convention;

(*e*) the place where a particular item of income has its source.

(4) The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching agreement as contemplated by this Convention.

ARTICLE 26

Exchange of information and administrative assistance

(1) The competent authorities of the Contracting States shall exchange such information (being information available under the respective taxation laws of the Contracting States) as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret but may be disclosed to persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of taxes which are the subject of this Convention. No information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.

(2) Each of the Contracting States will endeavour to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by this Convention from taxation imposed by such other Contracting State does not enure to the benefit of persons not entitled thereto. The United Kingdom will be regarded as fulfilling this obligation by the continuation of its existing arrangements for ensuring that relief from taxation imposed by the laws of the United States does not enure to the benefits of persons not entitled thereto.

(3) Paragraph (2) of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own tax, or which would be contrary to its sovereignty, security or public policy. In determining the administrative measures to be carried out, each Contracting State may take into account the administrative measures and practices of the other Contracting State in recovering taxes on behalf of the first-mentioned Contracting State.

(4) The competent authorities of the Contracting States shall consult with each other for the purpose of co-operating and advising in respect of any action to be taken in implementing this Article.

ARTICLE 27

Effect on diplomatic and consular officials and domestic laws

(1) Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

(2) This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowances now or hereafter accorded by the laws of either Contracting State.

ARTICLE 28

Entry into force

(1) This Convention shall be ratified and the instruments of ratification shall be exchanged at Washington as soon as possible.

(2) This Convention shall enter into force immediately after the expiration of thirty days following the date on which the instruments of ratification are exchanged , and shall thereupon have effect:

(*a*) in the United Kingdom:

(i) in relation to any dividend to which sub-paragraph (2)(*a*)(ii) of Article 10 (Dividends) applies, in respect of income tax and payment of tax credit, for any year of assessment beginning on or after 6 April 1973. A dividend paid on or after 1 April 1973 and before 6 April 1973 shall be treated for tax credit purposes as paid on 6 April 1973;

(ii) in relation to sub-paragraph (2) (*a*)(i) of Article 10 (Dividends) and any other provision of this Convention, in respect of income tax and payment of tax credit and in respect of capital gains tax, for any year of assessment beginning on or after 6 April 1975;

(iii) in respect of corporation tax, for any financial year beginning on or after 1 April 1975; and

(iv) in respect of petroleum revenue tax, for any chargeable period beginning on or after 1 January 1975;

(*b*) in the United States:

(i) in respect of credits against United States tax allowed under paragraph (1) of Article 23 (Elimination of double taxation), for taxes paid to the United Kingdom on or after 1 April 1973;

(ii) in respect of tax withheld at the source, for amounts paid or credited on or after 1 January 1975; and

(iii) in respect of other taxes, for taxable years beginning on or after 1 January 1975.

(3) Subject to the provisions of paragraph (4) of this Article the Convention between the United Kingdom of Great Britain and Northern Ireland and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed at Washington on 16 April 1945 as amended by the Supplementary Protocol signed at Washington on 6 June 1946 , by the Supplementary Protocol signed at Washington on 25 May 1954 , by the Supplementary Protocol signed at Washington on 19 August 1957 , and by the Supplementary Protocol signed at London on 17 March 1966 , (hereinafter referred to as "the 1945 Convention"), shall cease to have effect in respect of taxes to which this Convention in accordance with the provisions of paragraph (2) of this Article applies.

(4) Where any provision of the 1945 Convention would have afforded any greater relief from tax any such provision as aforesaid shall continue to have effect:

(*a*) in the United Kingdom, for any year of assessment or financial year; and

(*b*) in the United States, for any taxable year beginning, in either case, before 1 January 1976.

(5) The 1945 Convention shall terminate on the last date on which it has effect in accordance with the foregoing provisions of this Article.

(6) This Convention shall not affect any Agreement in force extending the 1945 Convention in accordance with Article XXII thereof.

ARTICLE 29

Termination

(1) This Convention shall remain in force indefinitely but either of the Contracting States may, on or before 30 June in any year after the year 1980, give to the other Contracting State, through diplomatic channels notice of termination and, in such event, the present Convention shall cease to be effective:

(*a*) in respect of United States tax, for the taxable years beginning on or after 1 January in the year next following that in which such notice is given;

(*b*) (i) in respect of United Kingdom income tax and capital gains tax, for any year of assessment beginning on or after 6 April in the year next following that in which such notice is given;

(ii) in respect of United Kingdom corporation tax, for any financial year beginning on or after 1 April in the year next following that in which such notice is given;

(iii) in respect of United Kingdom petroleum revenue tax, for any chargeable period beginning on or after 1 January in the year next following that in which such notice is given.

(2) The termination of the present Convention shall not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting States.

In witness whereof the undersigned, duly authorised thereto by their respective Governments, have signed this Convention.

Done in duplicate at London this 31st day of December 1975.

For the Government of the United Kingdom of Great Britain and Northern Ireland:	For the Government of the United States of America:
GORONWY-ROBERTS OF CAERNARVON AND OGWEN.	RONALD I. SPIERS.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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REMARKS BY THE HONORABLE EDWIN H. YEO, III
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE MUNICIPAL FINANCE OFFICERS ASSOCIATION
AT THE SAN FRANCISCO-HILTON HOTEL
SAN FRANCISCO, CALIFORNIA
MONDAY, MAY 3, 1976

I SUSPECT I DON'T NEED TO TELL YOU THAT WE ARE AT A CRITICAL CROSSROADS IN DETERMINING THE FUTURE RELATIONSHIPS BETWEEN THE FEDERAL GOVERNMENT AND STATE AND LOCAL GOVERNMENTS. MANY TIMES OVER THE PAST YEAR YOU HAVE HEARD ME AND MY COLLEAGUES IN THE TREASURY DEPARTMENT WARN AGAINST THE DANGERS OF A FEDERAL TAKEOVER OF FISCAL AND FINANCIAL DECISION-MAKING AT THE STATE AND LOCAL LEVEL. THAT DANGER WAS -- AND CONTINUES TO BE -- VERY REAL. BUT IN THE CHOICES THIS NATION FACES, THERE ARE OTHER PATHS AS WELL. SOME ARE EVEN MORE DANGEROUS AND SOME, I AM PLEASED TO SAY, PROVIDE A BASIS FOR CONSIDERABLE OPTIMISM.

WHILE THE MATTER IS NOT YET SETTLED, THERE IS REASON TO BELIEVE THAT CONGRESS AND THE AMERICAN PEOPLE HAVE REJECTED THE FIRST PATH: A FEDERAL TAKEOVER OF THE DECISION-MAKING PROCESS. THIS REJECTION SEEMS APPARENT IN THE WAY IN WHICH THE NEW YORK CITY EPISODE WAS HANDLED AT THE FEDERAL LEVEL. BUT IN THE WAKE OF THE DECISIONS RELATING TO NEW YORK CITY AND IN LIGHT OF THE HARD CHOICES AND DIFFICULT TASKS REQUIRED IF NEW YORK CITY IS

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TO BE RESTORED TO FULL ECONOMIC HEALTH, A NEW AND TROUBLESOME ALTERNATIVE HAS DEVELOPED.

SIMPLY STATED THERE ARE THOSE WHO NOW CONTEND THAT THE WAY TO DEAL WITH THE FINANCING NEEDS OF STATE AND LOCAL GOVERNMENT IS TO PROVIDE THOSE GOVERNMENTS WITH DIRECT ACCESS TO THE FEDERAL TREASURY AND THE FEDERAL PRINTING PRESS.

BOTH IN THIS CONTEXT AND IN OTHERS I HAVE SPOKEN OF THE GRAVE THREAT TO OUR BASIC FREEDOMS PRESENTED BY REPOSING MORE AND MORE AUTHORITY OVER OUR INDIVIDUAL RIGHTS AND PRIVATE DECISIONS IN THE BUREAUCRACY EMPLOYED BY THE CENTRAL GOVERNMENT IN WASHINGTON, D.C. THE DANGERS INHERENT IN SUCH A SYSTEM ARE MAJOR, BUT THEY PALE IN COMPARISON TO THE DANGERS OF GOING ONE STEP FARTHER: TO THE DANGER OF ALLOWING THE BASIC FINANCIAL POLICIES OF THE CENTRAL GOVERNMENT TO BE DICTATED BY THE ACTIONS OF ISOLATED JURISDICTIONS THROUGHOUT THE COUNTRY.

IF THESE ALTERNATIVES SEEM GLOOMY TO YOU, YOU'RE RIGHT, THEY ARE GLOOMY. BUT THERE IS A THIRD ALTERNATIVE, ONE WHICH I AM PLEASED TO SAY THERE ARE SIGNS THAT THE AMERICAN PEOPLE ARE RECOGNIZING AND ADOPTING. THAT ALTERNATIVE, OF COURSE, IS FINANCING STATE AND LOCAL FUNCTIONS AT THE STATE AND LOCAL LEVEL AND CONFINING THE SCOPE OF STATE AND LOCAL FUNCTIONS TO

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THAT WHICH IS AFFORDABLE WITHIN THE JURISDICTION'S REVENUE BASE.

AFTER YEARS OF METEORIC GROWTH IN SPENDING BY THE STATE AND LOCAL SECTOR AND OF EVEN LARGER GROWTH IN THE PORTION OF STATE AND LOCAL EXPENDITURES FINANCED BY THE FEDERAL GOVERNMENT A CONTRARY TREND IS EMERGING. OUR PRELIMINARY SURVEY OF RECENT NATIONAL INCOME ACCOUNT DATA SUGGESTS THAT EXPENDITURE GROWTH AT THE STATE AND LOCAL LEVELS HAS MODERATED SIGNIFICANTLY AND THAT INCOME FROM LOCAL SOURCES IS HIGHER. IF THESE TRENDS CONTINUE, THE RIGHT COURSE -- FISCAL AND FINANCIAL AUTONOMY AT THE STATE AND LOCAL LEVEL -- MAY PROVE LESS DIFFICULT TO ADOPT. BUT WE CAN'T GET COMPLACENT. GIVEN OUR POLITICAL SYSTEM, THE PRESSURES IN THE OTHER DIRECTION WILL ALWAYS BE GREAT. IN MY REMARKS TODAY I WANT TO CONCENTRATE ON THE IMPLICATIONS OF YIELDING TO THOSE PRESSURES.

LET ME BEGIN MY ANALYSIS WITH A BRIEF DISCUSSION OF THE CATALYST FOR THIS PERIOD OF CHANGE. IT WAS A LITTLE MORE THAN A YEAR AGO THAT THE CAPITAL MARKETS CLOSED TO SECURITIES ISSUED BY NEW YORK CITY. AS WE ALL KNOW, NEW YORK CITY HAD BEEN RUNNING OPERATING DEFICITS FOR A DECADE AND A HALF. THROUGH FISCAL YEAR 1975, THESE DEFICITS TOTALLED OVER $4 BILLION, AND THIS YEAR'S OPERATING DEFICIT WILL ADD ANOTHER $1 BILLION TO THE TOTAL. IN ADDITION, SUBSTANTIAL AMOUNTS OF OPERATING EXPENDITURES WERE CAPITALIZED AND HIDDEN IN THE CAPITAL BUDGET.

NEW YORK CITY WAS ABLE TO RUN LARGE CONSECUTIVE DEFICITS AND HIDE OPERATING EXPENSES IN ITS CAPITAL PROGRAM BECAUSE INVESTORS WERE WILLING TO BUY THE CITY'S SECURITIES.

As long as the securities market remained receptive, New York City could finance its deficit spending. It sold a variety of debt instruments, TANs, RANs, BANs, and URNs. When its IOUs came due, the City printed and sold new batches. But a year ago, when the market closed, the City's elected officials finally had to face up to the necessity of cutting expenses and raising revenues until the two are balanced.

To his credit, Mayor Beame recognizes the need to balance the City's budget and has set forth a plan for achieving this goal by fiscal year 1978. But some others are still seeking some way of avoiding the necessity of cutting back expenditures to the point where they are congruent with the willingness and capacity of the taxpayers.

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For example, a recent magazine article defined the framework: "The City's ultimate survival depends on the U.S. Government. Without Federal assistance to stop the hemorrhaging, New York City will bleed to death... New York City has a critical need not merely for more money, but for Federal planning as well." The article then sets forth "an agenda" for Federal action, including takeovers of welfare and health care, subsidies to allow the City to "retain or lower" its subway fare and modernize its existing transit system, more public works and jobs and a Federal urban bank to "reduce the interest rates New York and other local governments must pay to meet their needs."

As this last idea on the "agenda" shows, it is just a short step from urging more Federal aid to New York City to urging a Federal takeover of large elements of the fiscal responsibilities of the State and local government sector. It is a step that influential parts of the press and individuals,

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INCLUDING SEVERAL PRESIDENTIAL HOPEFULS, HAVE TAKEN. LET ME GIVE YOU A FEW EXAMPLES OF SUCH THINKING.

-- FELIX ROHATYN, CHAIRMAN OF NEW YORK STATE'S MUNICIPAL ASSISTANCE CORPORATION: "A FEDERAL 'MARSHALL PLAN' FOR THE RECONSTRUCTION OF OUR OLDER CITIES WOULD BE BOTH STIMULATIVE AND, BY PROVIDING BOTH EMPLOYMENT AND PRODUCTION, ANTI-INFLATIONARY. ALTHOUGH POLITICALLY UNPOPULAR AT PRESENT IT IS MORALLY RIGHT."

-- CHAIRMAN HUBERT HUMPHREY OF THE JOINT ECONOMIC COMMITTEE ALSO HAS GIVEN HIS BLESSING TO A FEDERAL TAKEOVER. HE, TOO, BACKS A "MARSHALL PLAN FOR THE CITIES." AND HE HAS INTRODUCED LEGISLATION TO CREATE A NATIONAL DOMESTIC DEVELOPMENT BANK "TO PROVIDE AN ALTERNATIVE SOURCE OF CREDIT TO STATE AND LOCAL GOVERNMENTS FOR THE PURPOSE OF FINANCING PUBLIC AND QUASI-PUBLIC FACILITIES OF ALL TYPES." MANY OTHERS ON CAPITOL HILL HAVE OUTLINED SIMILAR PROPOSALS.

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A SIMILAR TACK WAS TAKEN DURING THE RECENT NEW YORK PRESIDENTIAL PRIMARY. AS REPORTED IN THE NEW YORK TIMES: "URGING HUNDREDS OF MILLIONS OF DOLLARS OF NEW AID FOR NEW YORK AND OTHER CITIES, THE THREE LEADING ASPIRANTS FOR THE DEMOCRATIC PRESIDENTIAL NOMINATION COURTED PRIMARY VOTES IN THE CITY YESTERDAY BY FACING A BATTERY OF DEMOCRATIC MAYORS WHO ACCOMMODATED THEM WITH EASY QUESTIONS SERVED AT BATTING-PRACTICE SPEED."

"THE QUESTIONS BY MAYOR BEAME AND NINE OTHER MAYORS ELICITED CALLS FOR WELFARE, HEALTH, EDUCATION, HOUSING AND ECONOMIC AID FOR THE CITIES..."

"ON THE FEDERAL PUBLIC WORKS BILL, VETOED EARLIER THIS YEAR BY PRESIDENT FORD, MR. JACKSON AND MR. UDALL CALLED FOR REVIVAL OF THE IDEA WHILE MR. CARTER TALKED IN TERMS OF FEDERAL MANPOWER AND CYCLICAL AID, AS WELL AS FEDERAL BOND GUARANTEES FOR PUBLIC PROJECTS."

FOR SOME, THESE PROPOSALS MAY HAVE A SUPERFICIAL APPEAL. BUT, I START FROM THE PREMISE, SOUNDLY GROUNDED IN BOTH FACT AND HISTORY, THAT THEY SIMPLY WON'T WORK. IF IMPLEMENTED, THEY WILL RAISE MORE QUESTIONS THAN THEY ANSWER, AND IMPOSE MORE COSTS THAN BENEFITS.

BEFORE TURNING TO THE DETAILS, LET'S SURVEY THE EXPERIENCE OF OTHER COUNTRIES.

POLITICAL AND SOCIAL INSTITUTIONS VARY FROM COUNTRY TO COUNTRY, BUT ADJUSTING FOR THE VAST DIFFERENCE BETWEEN THE UNITED STATES AND OTHER COUNTRIES, THE EXPERIENCE OF OTHERS IS OF RELEVANCE TO THE DEBATE IN THE UNITED STATES REGARDING THE PROPER ROLE OF THE FEDERAL GOVERNMENT. IN EVALUATING EXPERIENCE OF OTHERS, IT'S IMPORTANT TO DISTINGUISH BETWEEN CRITICISM OF THEIR ARRANGEMENTS, WHICH IS NOT INTENDED, AND STUDY OF THE ARRANGEMENTS AS THEY MIGHT APPLY TO OUR SITUATION.

IN ONE COUNTRY "TAX REFORM" HAS REMOVED MOST TAXING AUTHORITY FROM LOCAL GOVERNMENTS. THEIR RESIDUAL TAXING AUTHORITY TODAY ACCOUNTS FOR ONLY A VERY SMALL FRACTION OF THEIR REVENUES, AND THAT FRACTION IS DECLINING EVERY YEAR. THE BALANCE COMES FROM THE CENTRAL GOVERNMENT OR FROM BORROWING.

LOCAL BUDGETS WHICH ARE EXPECTED TO BE IN DEFICIT ARE REVIEWED BY A CENTRAL COMMITTEE FOR LOCAL FINANCE, AN INTER-MINISTERIAL COMMITTEE WHICH CONSISTS OF REPRESENTATIVES OF BOTH THE PUBLIC AND PRIVATE SECTORS. SUCH A COMMITTEE HAS POWER TO DISAPPROVE A LOCAL GOVERNMENT'S BUDGET, AND THEREBY TO PREVENT LOCAL DEFICITS, BUT IT IS ONLY THROUGH THIS COMMITTEE THAT THE CENTRAL GOVERNMENT HAS AN INPUT INTO THE LOCAL BUDGETARY PROCESS. BANKS WILL NOT EXTEND CREDIT TO LOCAL GOVERNMENTS UNLESS THEIR BUDGETS HAVE BEEN APPROVED BY THE COMMITTEE SINCE COMMITTEE APPROVAL OF A BUDGET DEFICIT IS, IN EFFECT, A GUARANTEE BY THE GOVERNMENT THAT A LOCAL

GOVERNMENT'S DEBT WILL BE REPAID.

LAST YEAR THE CENTRAL GOVERNMENT PAID OFF THE ENTIRE DEBT WHICH LOCAL GOVERNMENTS INCURRED IN 1971-1972. THIS YEAR IT IS EXPECTED THAT LOCAL DEBT ACCUMULATED IN 1973 WILL BE REPAID BY THE CENTRAL GOVERNMENT. A PRINCIPAL FUNCTION OF THE CENTRAL GOVERNMENT, HOWEVER, IS DIRECTLY TO FINANCE CURRENT DEFICITS; IN RECENT YEARS, 50% OF CURRENT LOCAL DEFICITS HAVE BEEN SO FINANCED, AND IN THE CASE OF CERTAIN CITIES, 100%. THE REMAINDER IS FINANCED BY BANK LOANS WHICH, ONCE AGAIN, IN EFFECT ARE GUARANTEED BY THE CENTRAL GOVERNMENT.

IN ANOTHER COUNTRY, LOCAL ENTITIES CANNOT PROVIDE SERVICES UNLESS THEY ARE EMPOWERED TO DO SO BY THEIR LEGISLATURE. THEY ARE SUBJECT TO STATUTORY REQUIREMENTS TO MAINTAIN SPECIFIED MINIMUM STANDARDS IN REGARD TO SOME SERVICES, AND MUCH OF THEIR TOTAL SPENDING IS MADE PURSUANT TO CENTRAL GOVERNMENT POLICIES.

THE BULK OF LOCAL REVENUES ARE PROVIDED BY THE CENTRAL GOVERNMENT. OF LAST YEAR'S TOTAL, 25% WAS RAISED BY PROPERTY TAXES, 14% CAME FROM PUBLIC HOUSING RENTS AND 54% FROM THE CENTRAL GOVERNMENT. THE REMAINING 7% CONSISTED OF LONG TERM BORROWINGS. SUCH BORROWING IS CHANNELED THROUGH A CENTRAL GOVERNMENT FACILITY. IT IS SUBJECT TO LIMITS AGREED TO BY THE CENTRAL AND LOCAL ENTITIES PRIOR TO THE INTRODUCTION OF THE BUDGET. LOCAL GOVERNMENTS CAN BORROW ON THEIR OWN AUTHORITY ONLY TO SMOOTH SEASONAL CASH FLOWS.

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THE PRINCIPAL METHOD WHICH THE CENTRAL GOVERNMENT USES TO PROVIDE FUNDS TO LOCAL GOVERNMENTS INVOLVES TIEING NON-EARMARKED GENERAL REVENUES FROM THE CENTRAL GOVERNMENT TO LOCAL PROPERTY TAXES. BECAUSE THE CENTRAL GOVERNMENT'S SUPPORT IS TIED BY FORMULA TO LOCAL PROPERTY TAX RATES, LOCAL GOVERNMENTS CAN INCREASE THE AMOUNTS THEY GET FROM THE CENTRAL GOVERNMENT BY INCREASING THEIR PROPERTY TAX RATES.

THIS SYSTEM IS AN INVITATION TO LOCAL GOVERNMENTS TO OVER-COMMIT BOTH LOCAL PROPERTY OWNERS AND THE CENTRAL GOVERNMENT. THIS HAPPENED LAST YEAR. BUT LOCAL PROPERTY OWNERS STRONGLY PROTESTED THE INCREASES IN PROPERTY TAX RATES. BEGINNING THIS YEAR, THE CENTRAL GOVERNMENT'S GRANTS WILL BE LIMITED IN ABSOLUTE AMOUNT. LOCAL GOVERNMENTS WILL ONLY BE GRANTED FUNDS SUFFICIENT TO COVER BUDGETED SERVICE LEVELS. THE GRANTS WILL BE EQUAL TO CURRENT COSTS PLUS ANTICIPATED INFLATION. ANY EXPENDITURES BEYOND WHAT THIS WILL COVER WILL REQUIRE INCREASES IN LOCAL PROPERTY TAXES. THERE ARE TO BE NO ADDITIONAL MATCHING OR SUPPLEMENTARY FUNDS FROM THE CENTRAL GOVERNMENT, EXCEPT IN CASES MANDATED BY NATIONAL LAW SUCH AS FAMILY ASSISTANCE.

THE EXPERIENCE OF SOME COUNTRIES DEMONSTRATES THAT CENTRAL GOVERNMENT CONTROL OVER LOCAL FINANCES MEANS DIRECT OR <u>DE FACTO</u> CONTROL OVER LOCAL BUDGETARY OPERATIONS AND LOCAL DECISION MAKING POWER. PERHAPS MORE IMPORTANTLY, BECUASE THE CONTROL PROCESS IS OFTEN IMPERFECT, IT HAS OFTEN LED TO INTOLERABLE INFLATIONARY PRESSURES.

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If applied in our own society, with more than 40,000 principal state and local government entities, how might these arrangements affect us? This is a question which must be addressed because the proposals of some directly or indirectly suggest the adoption of institutions and relationships used abroad.

Devices which explicitly tie Federal funds to state and local government programs alter individuals' choices on how much they wish to pay in taxes and what they want their tax dollars spent for. In terms of how much they pay in taxes they're presented with a Hobson's choice -- to "get" Federal funds they must provide revenues to fund "their" share of designated programs.

The preferences for paying for one program vis a vis another are of course altered by the funds tied to the preferred programs. They have been prioritized for us by Congress. It's true that these priorities are set by our own Democratic institution But that isn't the point. What matters is that the priorities are set once by Congress in a given climate of opinion and context of economic and social problems and once set are relatively immune from constant evaluation or resetting. It is in this sense that the citizen's right to decide to pay a given level of taxes and to support certain programs is twisted by a system of tied grants.

EVEN WORSE IS A SET OF ARRANGEMENTS WHICH ON AN AD HOC OR DELIBERATE BASIS PROVIDE FEDERAL FUNDING FOR DEFICITS RUN AT THE STATE OR LOCAL GOVERNMENT LEVEL. SUCH ARRANGEMENTS MAKE EVEN MORE REMOTE THE RELATIONSHIP BETWEEN THEIR COST, HIGHER TAXATION, AND THEIR BENEFIT -- THE PURPOSE FOR WHICH FUNDS WERE BEING SPENT. THE BENEFIT PRESUMABLY IS VISIBLE, AT THE STATE AND FOR LOCAL GOVERNMENT LEVEL. THE COST, HOWEVER, TAKES THE FORM OF SEEMINGLY SMALL INCREMENTS TO FEDERAL TAXATION. CONSTRAINTS ON STATE AND LOCAL GOVERNMENT SPENDING ARE SHARPLY REDUCED AS A RESULT OF THE TENUOUS TIE IN TERMS OF COSTS AND BENEFITS. DEFICITS ARE ENCOURAGED. IN FACT, WHAT POLITICIANS WOULD DO ANYTHING UNDER SUCH A SYSTEM BUT RUN DEFICITS?

PUT ANOTHER WAY, THIS TYPE OF ARRANGEMENT LENDS TO PROVIDE POSITIVE INCENTIVES FOR SUBSTANTIAL INCREASES IN THEIR RELATIVE LEVEL OF STATE AND LOCAL GOVERNMENT SPENDING, PAID FOR BY HIGHER LEVELS OF FEDERAL TAXATION OR ENLARGED DEFICITS AT THE FEDERAL LEVEL OR SOME COMBINATIONS OF THE TWO.

IF THE DEFICITS ARE PAID FOR BY HIGHER LEVELS OF TAXATION THE PENALTY IS ABSTRACT -- EVEN REMOTE TO SOME -- BUT NONETHELESS HIGH-- REDUCED INCENTIVES FOR ECONOMIC ACTIVITY ARE THE INEVITABLE RESULT OF ESCALATING TAX RATES. THE EVIDENCE ELSEWHERE IN THE WORLD THAT THIS IS SO HAS BECOME ELOQUENT.

A LIKELY METHOD OF FINANCING INVOLVES THE USE OF THE FEDERAL BORROWING POWER TO FINANCE OPERATING DEFICITS AT THE STATE AND

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LOCAL GOVERNMENT LEVEL. TO THE DEGREE THIS ROUTE IS TAKEN, A POSITION OF OUR SAVINGS FLOWS WOULD BE ABSORBED IN ORDER TO FINANCE THESE DEFICITS. THESE SAVINGS ARE THE SOURCE OF CAPITAL FORMATION.

ABSORPTION OF SAVINGS TO FINANCE STRUCTURAL DEFICITS, EVERYTHING ELSE BEING EQUAL, WOULD RESULT IN A SLOWER RATE OF CAPITAL FORMATION, LOWER RATES OF GAINS IN PRODUCTIVITY AND OF COURSE, ITS HANDMAIDEN: A REDUCED RATE OF IMPROVEMENT IN OUR REAL STANDARD OF LIVING.

NOT ONLY DOES THIS SAP OUR ABILITY TO GROW, BUT HEAVY FINANCING REQUIREMENTS STEMMING FROM STATE AND LOCAL GOVERNMENT SPENDING FOR WHICH THERE IS NO BRAKING SYSTEM WOULD TEND TO RAISE INTEREST RATES. THE SOLUTION THAT HAS BEEN USED IN OTHER COUNTRIES IS TO OFFSET THE ABSORPTION AND RELATED INTEREST RATE EFFECTS BY AT LEAST PARTIAL MONETIZATION OF THE FEDERAL GOVERNMENT'S DEFICITS; THAT IS, BY USING THE PRINTING PRESS.

UNDER SUCH CIRCUMSTANCES, MONETARY POLICY COULD BECOME A HOSTAGE TO THE EVER INCREASING DEMAND FROM STATE AND LOCAL GOVERNMENTS IF WE CHOSE EITHER ON AN AD HOC BASIS OR ON A DELIBERATE BASIS TO FINANCE VIA THE FEDERAL GOVERNMENT (DIRECTLY OR THROUGH THE USE OF GUARANTEES) THE DEFICITS OF STATES AND LOCAL GOVERNMENTS. IN THIS CASE, OUR CHANCES OF REGAINING ECONOMIC EQUILIBRIUM AND THE STABILITY THAT RESULTS FROM IT WOULD RECEDE TO THE POINT OF TOTAL OBSCURITY.

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In short, Federal financing of State and Local government services provokes an inevitable result: indefinitely large, uncontrollable Federal spending, or the transfer of local decision making authority to the Federal Government. From where I sit, I don't think this is the kind of society we want in this country. I don't think you do either.

Let me now turn to some specific examples.

FEDERALIZATION OF WELFARE

Consider federalization of welfare. This proposal is especially popular in New York. New York State argues that change is warranted because it now pays 50% of total welfare costs while, for example, Mississippi pays only 20%, the Federal Government paying the balance. On a superficial level, it would appear that federalization would help New York's hard pressed taxpayers, and do so without hurting its welfare recipients. And such would be the case if the Federal Government fully paid present welfare costs. But it would not be the case if total Federal welfare spending remained unchanged. In this event, Mississippi's taxpayers and its welfare recipients would be the likely winners and New York's, the losers. This is because New York's welfare clients now receive about $4 in Federal aid for every $1 that Mississippi's welfare clients get: $44.42 per recipient per month in New York versus $11.92 in Mississippi.

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Now let me ask the obvious question. If we federalize welfare or any other activities now financed at least partly by state and local governments, would Congress allow states and cities to decide the level of spending, as they now do?

In the case of welfare, the Federal Government currently absorbs stipulated percentages of whatever amount states decide to spend on welfare per recipient. As long as the percentage is significantly less than 100, state and local governments must act with restraint. But if the Federal Government absorbed 100% of what the states or local governments decided to spend per welfare recipient, the constraint would be removed. Politicians are not above competing for votes by a display of generosity, especially when their constituents do not have to pay the tab.

URBAN OR DEVELOPMENT BANK PROPOSALS

Proposals for an urban or national development bank fall in the same category as proposals for a Federal takeover of local government services. They are an unwarranted and destructive intrusion of Federal power. The purpose of these development banks is to allocate scarce financial resources at subsidized interest

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RATES. VIEWED FROM THE STANDPOINT OF THE MARKETPLACE, SUCH BORROWERS ARE BORROWING FOR LOW PRIORITY PURPOSES, AND ANY SUBSIDY OF SUCH BORROWING CAN ONLY COME AT THE EXPENSE OF OTHER MORE CREDIT WORTHY BORROWERS. THIS MEANS THAT THE EFFICIENT ALLOCATION OF CREDIT AND CAPITAL THROUGH OUR MARKETS WOULD BE DISTORTED.

INEVITABLY, SUCH A BANK WOULD FINANCE URBAN PROJECTS ON TERMS THAT PRIVATE LENDERS REJECTED. THERE ARE FEW THINGS ONE LEARNS MORE QUICKLY IN WASHINGTON THAN BUREAUCRATS SIMPLY CAN'T ALLOCATE RESOURCES MORE SOUNDLY THAN THE MARKET. ACCORDINGLY, AN URBAN OR DEVELOPMENT BANK WOULD TEND TO FINANCE "REJECT" PROJECTS LEADING INEXORABLY TO A PROLIFERATION OF SUCH PROJECTS AND THE CROWDING OUT OF OTHERWISE CREDIT WORTHY INVESTMENTS. LIKE IT OR NOT, WHEN WE SUBSIDIZE ONE BORROWER, WE MAKE IT JUST THAT MORE DIFFICULT FOR ANOTHER BORROWER TO OBTAIN FINANCING.

I HAVE ALREADY TOUCHED ON SOME OF THE COSTS AND RISKS PRESENTED BY THESE APPROACHES TO THE RELATIONSHIP BETWEEN THE FEDERAL GOVERNMENT AND STATE AND LOCAL GOVERNMENTS.

LET ME NOW SPEND A FEW MINUTES TOUCHING ON SOME OF THE SPECIFIC THINGS THAT CAN BE DONE TO ENSURE THAT WE ARE MOVING IN THE RIGHT DIRECTION. ON THE MOST NARROW LEVEL WE MUST FIRST CONCERN OURSELVES WITH RELIEVING THE EXISTING COST PRESSURES ON THE FINANCING OF LEGITIMATE STATE AND LOCAL PROJECTS. IN THAT REGARD I AGREE WITH YOUR ASSOCIATION'S POLICY REGARDING THE PROHIBITION OF INDUSTRIAL DEVELOPMENT

REVENUE BONDS, POLLUTION CONTROL BONDS, AND MORAL OBLIGATION BONDS FOR WHATEVER PURPOSES THEY MIGHT BE ISSUED. IT ALSO IS INAPPROPRIATE -- AND RISKY -- FOR MUNICIPAL ISSUERS TO ACT AS FINANCIAL INTERMEDIARIES, SELLING TAX EXEMPT SECURITIES -- IDRBS AND PCBS -- TO RAISE MONEY FOR ESSENTIALLY PRIVATE PURPOSES. THE PERFORMANCE OF THE MUNICIPAL MARKET HAS BEEN OUTSTANDING IN RECENT YEARS WHEN YOU CONSIDER HOW WE HAVE ALLOWED IT TO BECOME CROWDED WITH ISSUES THAT ARE AT MOST ONLY MARGINALLY "MUNICIPAL." DEAL WITH INFLATION AND RELIEVE CROWDING IN THE MARKET, AND MUNICIPAL ISSUERS WILL FIND THE EASE, RATES AND TERMS AT WHICH THEY CAN BORROW TO BE AS FAVORABLE AS THE PROPONENTS OF MASSIVE FEDERAL INTRUSION.

HAVING REJECTED THE SOLUTIONS OF OTHERS, LET ME SHARE MY OWN THOUGHTS WITH YOU. TO BE SURE, SOME STATES AND CITIES -- IN GENERAL, THE LARGE CITIES LOCATED IN THE NORTHEAST AND MIDWEST -- HAVE PROBLEMS. BUT THESE PROBLEMS, WHATEVER THE SOURCE, ARE NOT ATTRIBUTABLE TO A LACK OF FEDERAL CONCERN.

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For some, the conventional wisdom is that the Federal Government hasn't been doing enough for State and local governments. But let's look at the facts.

In 1950, Federal aid to the State and local government sector was $2.3 billion. Five years later, in 1955, it was $3.1 billion. In 1960, it was $6.5 billion. In 1965, it was $11.1 billion. By 1970, it had grown to $24.4 billion. Last year, it reached $54.2 billion. Of course, nearly every current dollar series exhibits strong upward trend especially in inflationary periods like 1965 to 1975. But Federal aid to State and local governments had grown faster than the gross national product; faster than Federal spending in general, and faster than the revenues State and local governments receive from all sources.

Measured against the GNP, Federal aid grew from less than 1% in 1950 and 1955, to 1.3% in 1960, 1.6% in 1965, 2.5% in 1970, and 3.6% last year. As a percent of total Federal spending, aid

TO STATES AND LOCAL GOVERNMENTS INCREASED FROM 5.6% IN 1950 TO 7.0% IN 1960, 11.9% IN 1970, AND 15.9% IN 1975. MEASURED AGAINST THE REVENUES OF THE STATE AND LOCAL GOVERNMENT SECTOR FROM ALL SOURCES, FEDERAL AID INCREASED FROM 10.8% IN 1950 TO 13.3% IN 1960, 18.1% IN 1970 AND 23.3% IN 1975. IN SHORT, WHETHER COMPARED TO GNP, TOTAL FEDERAL SPENDING OR STATE AND LOCAL GOVERNMENT REVENUES, FEDERAL AID HAS RISEN STEADILY SINCE THE 1950S AND RELATIVELY SHARPLY SINCE THE LATE 1960S.

CHANNELS OF FEDERAL AID

OF COURSE STATISTICS NEVER TELL THE WHOLE STORY. LARGE SUMS OF FEDERAL MONEY WERE PROVIDED FOR PURPOSES THAT DEFINITELY CONTRIBUTED TO THE GROWTH OF SUBURBS AT THE EXPENSE OF CITIES. THE FEDERAL HIGHWAY PROGRAMS ARE AN EXAMPLE OF THIS SITUATION. BUT HERE, TOO, THE STORY IS MORE COMPLICATED THAN THE STATISTICS WOULD SEEM TO INDICATE.

ROAD BUILDING CLEARLY PLAYED A ROLE IN THE MOVEMENT OF MIDDLE INCOME GROUPS FROM CITIES TO SUBURBS. BUT ITS IMPORTANCE IS EASY TO OVEREMPHASIZE. THE FEDERAL PROGRAM ACCOMMODATED, BUT DID NOT CAUSE, SUBURBAN GROWTH. ROADS ARE PAID FOR BY USER TAXES. OUR ROAD BUILDING PROGRAM LITERALLY COULD NOT HAVE COVERED THE GROUND IT DID IF IT HADN'T ACCOMMODATED SOME VERY NATURAL URGES. FOR EXAMPLE, THE URGE OF THE YOUNG PARENT TO HAVE A YARD FOR HIS CHILDREN, AND OF MOST PEOPLE TO SEPARATE THEMSELVES FROM THEIR NEIGHBORS (WHOEVER THEY ARE) AT LEAST A LITTLE BIT.

BY LEVYING AND COLLECTING TAXES TO BUILD ROADS AND THROUGH A NUMBER OF OTHER POLICIES, INCLUDING THOSE WHICH ENCOURAGE HOMEBUILDING AND HOME OWNERSHIP, THE FEDERAL GOVERNMENT HAS, WITH THE BEST OF INTENTIONS, ACCOMMODATED THE EROSION OF CITIES' TAX BASES AND THE CONCOMITANT EMERGENCE OF THEIR FISCAL AND FINANCIAL PROBLEMS. THIS MUST BE CONCEDED. BUT IT IS A PUZZLEMENT TO ME WHY THESE ESSENTIALLY ACCOMMODATIVE POLICIES ARE BLAMED FOR THE FINANCIAL PLIGHT OF CITIES WHEN OTHER

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FEDERAL POLICIES CAN BE CITED THAT INDUCED CITIES TO OVER-COMMIT THEMSELVES FISCALLY AND FINANCIALLY.

SPECIFICALLY, IN THE MID-1960S, WE STARTED A LARGE NUMBER OF NEW MATCHING GRANT-IN-AID PROGRAMS. UNHAPPILY, MATCHING GRANTS CAN IMPEL LOCAL EXPENDITURES WHICH ARE NOT CONSISTENT WITH LOCAL PRIORITIES. THEY INVITE STATE AND LOCAL GOVERNMENTS TO COMMIT SCARCE FINANCIAL RESOURCES TO PROJECTS AND ACTIVITIES THAT THEY WOULD OTHERWISE CHOOSE NOT TO FINANCE. STATES AND CITIES COMMIT THEIR OWN RESOURCES BECAUSE OF THE PROMISE OF MATCHING FEDERAL FUNDS.

MATCHING PROGRAMS OFTEN LOOK LIKE A BARGAIN AT FIRST, BUT AS NEW SPENDING PRIORITIES DEVELOP, THE MATCHING REQUIREMENT TURNS INTO AN ALBATROSS, FOREVER DRAINING RESOURCES INTO NON-ESSENTIAL ACTIVITIES. AT THE EXTREME, MATCHING PROGRAMS LURE CITIES INTO OVER-COMMITTING THEIR OWN FINANCIAL RESOURCES, LEADING TO THE INEVITABLE FINANCIAL CRISIS.

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A NEW SYSTEM FOR ROUTING FEDERAL AID TO STATES AND LOCAL GOVERNMENTS

IT IS TIME FOR THE FEDERAL GOVERNMENT TO CHANGE ITS PERSPECTIVE ON AID TO THE STATE AND LOCAL GOVERNMENT SECTOR. WE HAVE TO LET THE PEOPLE WHO GOVERN OUR STATES AND CITIES, THE MEN AND WOMEN DIRECTLY ACCOUNTABLE TO THE ELECTORATE, DECIDE, FREE FROM FEDERAL TEMPTATION AND REGULATION, THE SPECIFIC KINDS AND LEVELS OF SERVICES THEY WANT TO PROVIDE.

THE PRESIDENT'S PROPOSAL TO CONVERT LARGE ELEMENTS OF OUR MATCHING GRANT PROGRAMS INTO FUNCTIONAL OR "BLOCK" GRANTS SHOULD BE AN IMPORTANT STEP IN HELPING STATES AND CITIES AVOID FINANCIAL CRISIS.

BLOCK GRANTS WOULD PERMIT STATES AND CITIES TO USE FEDERAL AID AS THEY SEE FIT WITHIN FUNCTIONAL CATEGORIES SUCH AS EDUCATION. BECAUSE THEY ARE NOT TIED TO SPECIFIC PROJECTS AND ACITVITIES, BLOCK GRANTS WOULD GREATLY INCREASE FLEXIBILITY IN BUDGETING, REVIEWING AND MODIFYING EXPENDITURES. AND, FOR THOSE WHO FEAR THAT BLOCK GRANTS WOULD PROMOTE CORRUPTION AND OTHER ABUSES, LET ME POINT OUT THAT THEY NEED NOT BE MADE UNCONDITIONALLY. GRANT RENEWALS CAN BE MADE CONTINGENT ON MEETING MINIMUM STANDARDS OF PERFORMANCE AND PRACTICES.

FISCAL AND MONETARY POLICIES TO PREVENT INFLATION AND RECESSION

BLOCK GRANTS WILL NOT SOLVE ALL THE FINANCIAL PROBLEMS THAT THE STATE AND LOCAL GOVERNMENT SECTOR CURRENTLY IS EXPERIENCING. A LARGE PART OF THESE PROBLEMS CAN BE TRACED TO OUR ECONOMY'S RECURRING EPISODES OF INFLATION AND RECESSION.

THE FISCAL AND FINANCIAL PROBLEMS OF STATE AND LOCAL GOVERNMENTS HAVE BEEN EXACERBATED BY INFLATION AND RECESSION. INFLATION PUTS STATE AND LOCAL GOVERNMENTS IN A FINANCIAL SQUEEZE. PROPERTY TAXES GENERALLY LAG INFLATION, AND RESISTANCE TO INCREASED TAXES (PROPERTY AND OTHER) USUALLY MOUNTS IN INFLATION. IN ADDITION, THE PUBLIC DEMANDS MORE AND INCREASED SERVICES AND PUBLIC EMPLOYEES DEMAND HIGHER WAGES AND FRINGE BENEFITS. RECESSION EXACERBATES THAT SQUEEZE, PARTICULARLY

BY INCREASING WELFARE COSTS AND DECREASING INCOME AND SALES TAX REVENUES.

IT IS DIFFICULT TO SEE HOW STATE AND LOCAL GOVERNMENTS CAN AVOID FISCAL AND FINANCIAL CRISIS IN A WORLD CHARACTERIZED BY PERIODS OF INFLATION AND RECESSION OCCURRING IN TANDEM, SOMETIMES SO CLOSELY AS TO OVERLAP. IN TURN, NEITHER INFLATION NOR RECESSION, WHICH INEVITABLY FOLLOWS IN ITS WAKE, CAN BE AVOIDED UNLESS WE HOLD THE LINE ON FEDERAL SPENDING AND MAINTAIN STEADY MODERATE MONETARY GROWTH. BY FAR THE MOST IMPORTANT THING THE FEDERAL GOVERNMENT CAN DO TO EASE THE FINANCIAL PROBLEMS OF THE STATE AND LOCAL GOVERNMENT SECTOR IS TO PURSUE PRUDENT, MODERATE FISCAL AND MONETARY POLICIES. I AM CONFIDENT THAT WE IN THE ADMINISTRATION WILL DO OUR PART OF THE JOB. THE QUESTION IS WHETHER CONGRESS WILL DO ITS PART.

THE NECESSARY CONDITION: WHAT STATES AND CITIES MUST DO THEMSELVES

YOU HAVE ALL HEARD THE PHRASE: "NECESSARY AND SUFFICIENT." THAT TERMINOLOGY IS USEFULLY APPLIED TO THE FISCAL AND FINANCIAL PROBLEMS THAT AFFLICT CERTAIN STATES AND SEVERAL OR OUR LARGE CITIES. MISMANAGEMENT IS THE "NECESSARY" CONDITION, AND AS IN THE CASE OF NEW YORK CITY, IT CAN BE "SUFFICIENT" AS WELL. IN RECENT TESTIMONY BEFORE THE JOINT ECONOMIC COMMITTEE, I DESCRIBED HOW, IN THE LATE 1960S, THE CITY OF SEATTLE, WASHINGTON AVOIDED FINANCIAL CRISIS AND FISCAL DISASTER IN THE FACE OF SIGNIFICANT EROSION OF ITS JOB AND TAX BASES DUE TO CUTBACKS IN THE AEROSPACE INDUSTRY. IN ESSENCE, WHAT SEATTLE DID WAS TO BITE THE BUDGETARY BULLET. IT RAISED TAXES AND IT CUT SERVICES. THAT IS ALL IT TAKES. IT IS A LESSON NEW YORK CITY LEARNED THE HARD WAY, AND IS NOW PUTTING INTO EFFECT.

THERE IS, IN SHORT, NOTHING COMPLICATED ABOUT WHAT HAS TO BE DONE TO AVOID FINANCIAL CRISIS IN THE STATE AND LOCAL GOVERNMENT SECTOR. IN THE FINAL ANALYSIS, IT IS UP TO THOSE WHO ARE ELECTED

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TO GOVERN OUR STATES AND CITIES. THEY NEED ONLY ACT RESPONSIBLY AND PRUDENTLY. AT THE FEDERAL LEVEL, AS I SAID EARLIER, WE CAN HELP BY REASSESSING PROGRAMS IN THE AREA OF ASSISTANCE TO THE DISADVANTAGED, AND BY GIVING BLOCK SUMS IN PROVIDING AID FOR EDUCATION, ENVIRONMENTAL PROTECTION, MASS TRANSIT, AND OTHER LOCAL FUNCTIONS.

I SAID AT THE OUTSET THAT CERTAIN DEVELOPMENTS DO PROVIDE A BASIS FOR OPTIMISM. THERE IS MORE AND MORE EVIDENCE THAT THE ELECTORATE IS BEGINNING TO UNDERSTAND BOTH THE CHOICES THEMSELVES AND THE IMPLICATIONS OF THE VARIOUS ALTERNATIVES. MORE IMPORTANTLY THERE IS REASON TO BELIEVE THAT THE ELECTORATE IS UNWILLING TO ASSUME THE RISKS OF GREATER FEDERAL INVOLVEMENT IN STATE AND LOCAL AFFAIRS AND UNWILLING TO TOLERATE ACTIONS BY ELECTED OFFICIALS WHICH EXACERBATE THE POSSIBILITY THAT SUCH RISKS WILL BECOME REALITY.

IN SHORT, CITIZENS ARE BEGINNING TO PAY MORE AND MORE ATTENTION TO THE FISCAL AND FINANCIAL AFFAIRS OF THEIR STATE AND LOCAL GOVERNMENTS. THEY ARE BEGINNING TO DEMAND MORE FACTS AND BEGINNING TO QUESTION THE HITHERTO UNQUESTIONED NEED FOR MORE FRILLS, MORE MARGINAL ACTIVITIES, MORE DEFICIT SPENDING. IT IS INCUMBENT UPON PUBLIC OFFICIALS AT ALL LEVELS OF GOVERNMENT TO RECOGNIZE THIS KEY ATITUDINAL CHANGE. VIRTUALLY ALL THE PEOPLE IN THIS ROOM HAVE DEVOTED THEIR CAREERS IN PUBLIC LIFE TO FOSTERING THIS PHILOSOPHY OF GOVERNMENT. ACCORDINGLY, I AM SURE YOU SHARE WITH ME THE PLEASURE THAT WE MAY NOW HAVE THE OPPORTUNITY TO SEE THIS PHILOSOPHY BECOME REALITY.

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WASHINGTON, D.C. 20220 TELEPHONE 964-2041

ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
TO THE TRI-STATE HOSPITAL ASSEMBLY
CHICAGO, ILLINOIS, MAY 3, 1976

Thank you, Mr. Malasto.

It gives me great pleasure to be here today with a group that plays such an important role in delivering outstanding health care to thousands of citizens in Illinois, Indiana, Michigan and Wisconsin. In fact, if I felt any better about being here, one of you would probably diagnose my condition as hyperactive euphoria.

Actually, I feel pretty fit . . . except for this slight pain in the lower back. Perhaps one of the doctors in the audience could take a free look at it when my talk is over? Does that sound familiar? I experience the same phenomena in my own way in the government all the time. One interest group after another is always trudging into town to ask the Federal Government to spare just a few million dollars, or a few administrative officials, or a few ancillary regulations to ease their plight. If doctors treated every cocktail party complaint for free, soon they wouldn't have a practice. The converse is true of the government. If we assume that Big Government can play doctor to cure all our country's ills, soon we will have nothing left but Big Government -- and a bankrupt one at that.

There are many other parallels to be drawn between health care and government. Doctors and hospitals have come under increasing fire in recent years both to keep medical costs down and to maintain the high standards of the services they offer, in an inflationary economy. Health care costs have increased 14% in the last year alone. The public cries "too much!" to your costs and "not enough" to your services. It is something of a quandary.

The Federal Government finds itself in a very similar position. Rapidly increasing budget deficits spur more inflation, which the public denounces as "too much", but when we proceed cautiously to reduce that inflation, those who

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favor a pump priming quick fix for unemployment cry "not enough."

There will always be those who say we are not spending fast enough, or regulating enough, or governing enough, just as there are always some who will prefer quack remedies to sound professional care. But I know we are on the right course today as a people and as a government, if only we can hold to it.

I would agree certainly, that our economy has undergone some trials in the last few years. These have resulted in both serious unemployment and dangerous inflation. But, despite this, our country remains the world's greatest economic power. Even today, we are proving our basic strength by the speed and the security of our recovery from the recession as compared with other industrial nations around the world.

We still have a long way to go, but we are on the road to recovery. We adopted moderate, responsible policies. We resisted the demands of the special interests and big spenders. And it's working. Just consider the progress that we made during 1975:

-- 1975 opened with inflation raging at 13 percent; we have cut that rate to more than one-half.

-- During the spring of 1975, the unemployment rate reached nine percent; today it is down to 7.5 percent and the trend is clearly downward.

-- 2.6 million more people have found work and the total number of people employed today stands at a record high of more than 86 million.

-- Real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

-- Other signs point to an increasingly healthy economy -- personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects rising public confidence about the economy that contrasts sharply with the deep pessimism reported by the polltakers the middle of last year.

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Thus we made considerable headway in 1975, and we will make even more in 1976. But it's not good enough and this is certainly no time for complacency. The unemployment rate is still far higher than we can tolerate. And inflation is by no means completely under control. In fact, it remains the most dangerous enemy of real economic growth. And all of us -- especially those with a say in Federal spending -- must do everything we can to prevent another inflationary spiral. The ruinous inflation that crested in 1974 was the chief cause of the severe recession of 1975 and if we embark once again on excessive fiscal and monetary policies resulting in double-digit inflation, I guarantee you we will have an even worse recession than before. Let us hope that it will never be said that the pain and suffering of the 1974-75 recession were in vain because the government refused to face the economic facts of life.

But the problem is not confined to government alone. It may seem strange, and it is certainly ironic, but at a time when Americans are enjoying such great abundance and such great opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible. Somewhere along the line, there has been a dangerous breakdown in communications.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the dynamics of prosperity in a free society.

Today, when nearly everyone takes the fruits of the free enterprise system for granted -- the abundance, the opportunities, the freedom of choice, the unprecedented opportunities for learning, travel, and general upward mobility -- not everyone understands the basic economic facts of life that create all these benefits.

Small wonder then, that when economic difficulties like the recession hit, millions of otherwise reasonable people fall for the quack nostrums of politicians who are more interested in promising than performing, and for quick-fix government spending that may provide some short-term relief but only aggravates the long-term economic ills of inflation and stagnation in the private sector.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people.

What is at stake is not just the future of this or that industry. At stake is the survival of the private sector, and the individual liberties which have never long survived the collapse of a society's free enterprise system.

Unless we get the facts across today, the America of tomorrow -- of our children and grandchildren -- will be doomed to a system of economic and political bondage that is the very opposite of all that we hold dear.

The problem already exists, as I have had ample opportunity to observe, and it is getting worse, not better. It is a question of both policy and perception, for faulty perception of the economy makes faulty economic policy almost inevitable.

And I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times.

Part of it is a matter of image. Frequently, and especially to youthful idealists, those who support bigger government spending and more government domination of the private sector are perceived as concerned, socially progressive men and women who "care." In a nutshell, they are seen as the humane champions of the persecuted underdog.

On the other hand, those who warn that the government should not -- and cannot -- effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system are seen as either outdated theorists or a new generation of economic exploiters, indifferent to human suffering and only out to make a fast buck for themselves and their companies.

To make matters worse, surface appearances often tend to confirm this inaccurate impression. Advocates of big government are able to wax eloquent for hours about the ills they imagine they can cure by cranking out more currency and soaking up more credit through massive deficit spending. They have as many arguments as there are social, economic and political problems -- even though the spending they advocate as we have seen with the Great Society's War on Proverty, is often part of the problem rather than part of the solution.

Those of us who recognize the fallacy of the big government approach have only one argument. It's the right one, but, by dint of repetition, people are getting tired of hearing about it. For we constantly invoke the free enterprise system, too often without defining the freedoms and the opportunies that it, and it alone, provides. We chant a slogan, a label, without defining it in comprehensible, human terms.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean anything to those who do not understand what it really is and what makes it work. It's like trying to sensibly discuss the birds and the bees with someone who is unshakable in his belief that babies are delivered by the stork. People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition the average American shopping center would represent to nine-tenths of the earth's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and run agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions and feed not only our own people, but millions of others as well.

Too often they have been taught to scoff at the very profit and property motives which make our prosperity possible.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid, what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried.

They have not seen first-hand the political and social aftermath in societies where the government has destroyed free enterprise. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander Hamilton warned so long ago, "power over a man's substance amounts to power over his will."

And they have not experienced the economic stagnation and loss of initiative in free countries that have chosen the course of over-regulation and over-taxation that results in demoralization and even mass emigration of the vital middle class.

Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many new improvements. Whether we like it or not, it is an immutable law of human nature.

Unfortunately, like clear air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So we have reached the point where, although the free enterprise system works, and works better than any other economic system in effect anywhere in the world -- and although it feeds, clothes and houses more people more affluently than any other while serving as the underpinning of our free society -- it is somehow losing the war to an alien philosphy of government control and economic irresponsibility that has never worked but has somehow managed to preserve an aura of idealism and altruism that attracts many young idealists.

All of these misconceptions would be unimportant if they were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well being of our people, especially those who are impoverished or face disadvantages because of their sex or the color of their skin.

The central question is not who cares the most, but rather how we broaden prosperity and reduce human hardship without sacrificing our freedom or destroying the most successful economic system that man has ever known.

And I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and therefore our lives -- a road that we have been moving steadily down for several decades -- then our children will be robbed of their personal and economic freedoms. And, in the meantime, all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment. This is really what is at issue underneath the semantics and the misleading labels.

Let's look at a few facts about government spending. For most of our history, the Federal Budget stayed somewhere below the $100 billion mark -- usually way below it.

Then, in 1962, we finally hit $100 billion -- and that was only the beginning. Seven years later, the budget broke the $200 billion barrier and then, only four years after that, we hit the $300 billion mark. And now, in our bicentennial year, we have reached the point where the Federal Government is spending $1 billion a day.

The very size of such numbers makes them almost meaningless to the average American. But there are ways of getting the message across. For example: suppose that on the day Christ was born, a man had been given $1 billion on the condition that he or his heirs spent $1,000 every day, seven days a week. How long would that $1 billion last? Adding it up, I think you'll find that today, almost 2000 years later, the grandchildren would still not have spent the full billion dollars. In fact, the money would not run out until 2716, 740 years from now.

Yet our Federal government is spending $1 billion every single day, and going into debt another $1 billion every week.

And as the budget grows, the government comes to occupy a more and more dominant role within our society.

In 1930, government spending at all levels -- Federal, state and local -- amounted to about 10 percent of the Gross National Product. Today, because budgets have mushroomed, government accounts for nearly 40% of our entire national output, and if recent trends prevail, the government's share of the total economy will reach 60 percent before the end of this century.

For taxpayers, the burden of paying the government's bills has become so heavy that many are now in open rebellion. In the 1974 general elections, for example, voters across the country turned down some three quarters of all bond issues on the ballot. But we in the Federal government get around this public opposition by voting more federal spending without increasing taxes.

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The result has been a string of Federal Budget deficits that is unparalleled in our history. In 16 of the last 17 years, the budget has been in the red. And now, just when a balanced, healthy economic recovery has begun, the advocates of big spending would have us launch another round of reckless spending and runaway inflation.

It is up to us to stop them.

I wish that there were some way for television cameras to portray this story as vividly as they did the war in Vietnam or the race riots of earlier years. For, while the visual images are less dramatic, the problem is every bit as pressing and important.

But, as the great 19th century historian Thomas Carlyle once said, political economics is the "dismal science." On the surface, it seems nothing more than a pile of charts and a jumble of numbers so large as to be incomprehensible in everyday terms. To put it mildly, economics seldom makes "sexy" news stories. And yet the economy is the one thing that affects every other aspect of American life -- the food we eat, the quality of our education, our mobility, our freedom of choice in careers, services and merchandise, and our material and personal sense of pride and independence.

The smallest shock to the economy is felt in every limb of the body politic. And that is a big story, if only a gripping,graphic way of telling it could be found.

Consider the case of the Federal debt and its impact. As the debt climbs rapidly upwards, we have to pay higher and higher interest cost on it. In fiscal year 1976 we will spend $36 billion in interest payments alone -- in fiscal 1977 it will rise to $45 billion or $125 million per day.

That's twice what we spent in any single year on the war in Vietnam. It's almost half of our national defense budget. And it is money that could be better spent on needs such as public transportation, health care or any of a dozen worthy purposes.

This heavy borrowing by the government aggravates inflation and increases interest rates, creating strains in money and capital markets. This, in turn, affects everyone from the businessman interested in expanding his plant to create new jobs, to the young couple trying to buy their first home without paying an arm and a leg in mortage interest.

Reckless government spending is the basic cause of inflation, and inflation was the underlying cause of the worst recession our country has experienced in a generation -- a recession we are only now beginning to recover from.

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It was inflation that caused a loss of real income and the confidence of consumers, prompting the sharpest drop in consumer spending since World War II. And it was inflation that helped dry up the flow of savings into our thrift institutions, driving up interest rates and causing the housing industry to collapse.

So one of our prime concerns as we proceed with the economic recovery is to avoid another dose of the poison that brought the recession on in the first place -- rampant inflation fed by runaway federal spending.

But spending isn't the whole problem. There is also the matter of government control and regulation for, as government spending has grown by leaps and bounds, so too has federal red tape.

Did you realize that government agencies now exercise direct regulation over 10 percent of everything bought and sold in the United States and indirect regulation over almost every other sector of the private economy?

Did you know that it costs private industry -- and that means each one of us as consumers -- approximately $20 billion a year just to do the paper work demanded by Federal bureaucrats? Andjust to fill out the necessary forms the Amercan people must now spend over 130 million work hours a year.

Some of these regulations are, of course, necessary. But many of them are counter-productive, wasteful, or obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Let me conclude with these few observations:

As we enter our third century as a nation, I believe the time has come not to reappraise our dedication to a better life for all -- that dedication is clear -- but to reappraise what we can pay for and how we can do it. The current plight of New York City, the disease that afflicts many state controlled economies, and the overwhelming size of our own Federal deficits are all grave warnings to us. We can pay for what we now have and provide for the future only if our great capitalist economy does its job -- produces goods and services in a free market and makes a sufficeint profit.

I am sick and tired of apologizing for the free enterprise system. It has given this country the highest standard of living and the greatest prosperity ever known, and of most importance, has helped to give us the greatest freedom ever known to man.

And it will continue to do that unless it is crushed by the juggernaut of big Government. What we need are not fewer but more capitalists in the United States -- more people with a real and direct stake in the profits generated by a productive economy. We cannot continue to have more and more of our citizens involved only in receiving benefits from the government and fewer and fewer people responsible for paying for the benefits. We must broaden the base of those who work and narrow the base of those who are able but don't want to work.

President Ford urged that we strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our private enterprise system.

-- A balance that favors greater honesty and realism in dealing with the challenges of our time.

These are great goals -- goals worthy of the greatest nation on earth. We should not begin our Bicentennial year by retreating into the past, but by going forward into the future with a combination of patience, realistic hope, courage and common sense.

If we work together with common purpose and conviction -- with pride in ourselves and our nation -- the goals we share today can become the first achievements of our third century together.

President Ford has set a course which points us in the right direction and will permit us to get a grip on these problems, but it will take several years, not months, to bring this about. Unfortunately, the election is only a bit over six months away. There will be calls for "sweeping changes" and "broad new initiatives" which will really mean bigger spending, bigger deficits and ultimately bigger governmental control of the economy. We must persuade the American people that this course is wrong and that the other approach is much sounder in the long run.

The real choice is between government control or greater individual freedom. That is the true, crucial decision beneath the rhetoric and personalities of this election year. And the choice we make will affect not only our own future, but the future of our country itself as America embarks on its third century as the hope and inspiration of free people everywhere.

Thank you.

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FOR IMMEDIATE RELEASE

REMARKS OF THE HONORABLE ROBERT A. GERARD
ASSISTANT SECRETARY OF THE TREASURY
(CAPITAL MARKETS AND DEBT MANAGEMENT)
BEFORE THE NATIONAL VENTURE CAPITAL ASSOCIATION
WASHINGTON, D.C.
MONDAY, MAY 3, 1976, 1:30 P.M.

For the last year, one of my chief responsibilities at Treasury has been the New York financial situation. During this period, I witnessed many unusual events and heard many bizarre arguments. But the one that stands out in my mind today was the suggestion that the Federal Government had to bail out New York City, had to provide the funds to retire maturing notes and pay other debt service obligations because the markets couldn't tolerate a default. Of all the rhetoric which surfaced during this turbulent period, few arguments troubled me more: a system which begins to look to the government to prevent failure is a system which will soon be unable to foster -- indeed tolerate -- success.

Success, failure, risk, reward: these are the terms and concepts you work with every day; this is the terminology of capitalism. Take away failure, and you can't have success. Take away risk, and you can't have rewards. Take away success and reward, and society stagnates.

To those of you on the front lines of capitalism, these are hardly startling ideas. Unfortunately, however, there is nothing new about the bail-out concept either. There are many who would have the Government prevent failure in all endeavors, but they fail to note that the price of preventing failure is nothing less than the preclusion of success.

To put it bluntly, we risk no less than the loss of our pre-eminence among the economies of the world if we fail to continue to foster technological innovation. And, to be equally blunt, if we yield to the temptation to allocate resources by political fiat rather than through the marketplace, there won't be enough resources available to provide the level of reward essential in stimulating risk-taking and innovation.

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Let me be more specific. Technological and productive changes and the new untested ideas which generate these changes go hand in hand with a high level of risk. In this regard, one of the key factors which has made our economy so successful when compared to those of other older nations is that in America new ideas were matched with investors who were willing to bear the risk of possible failure. This was not the base in many countries where only a few institutions -- or just the state -- determined which investments would receive financing.

Part of the genius of America is that all investors have been allowed to choose among new ideas, and those willing to bear a high level of risk could make that investment in hope of obtaining a large return. Centralized investment or government-imposed incentives and barriers to different types of investments have not been a large part of the American success story, and can be linked to the erosion of other once healthy economies.

America and venture capital have brought forth new technologies and products which have changed the world a million times for the better. I don't have to name the giants of our economy that started with nothing but ideas and the seed money of risk oriented investors. And all of you know of many other companies as well which developed important new technologies which in turn led to more new ideas, new products and new growth in the American economy.

The key to real growth in the economy is increased productivity on the part of American enterprise. This increased productivity is the direct result of successful new technologies which have made American industry more competitive in world markets and have allowed scarce labor and capital in our country to be diverted to the most productive uses.

The simple fact is that new technology is vital to a country's economic growth. Not only because other countries continue to become more competitive, but because new technology will free labor and capital to move into other areas of the economy which need to be developed. New technology and new products financed through venture capital help make the economic pie larger. Government imposed barriers to capital investment or restrictions on the use of investment capital can only make the economic pie shrink.

It is Government intervention in the capital markets and unsound fiscal and monetary policies that distort and destroy needed capital investment in our economy. This group is well aware of what happens when government policies produce inflation or impose taxes which lower corporate earnings. When anticipated corporate earnings fall -- and the risk level of the investment remains the same -- then the price of equity falls and it becomes harder for a firm to raise needed new capital through equity issues. It is, of course, hardest of all for new untested firms with new ideas whose risk level is very high but whose anticipated earnings are discounted by the anticipation of more inflation. This is just what happened during the round of inflation and recession from which we are now recovering.

To begin with, inflation has eroded the real earnings of corporations. In periods of inflation, accounting for inventories and depreciation cause earnings to be substantially overstated. Moreover, income taxes are levied on fictitious levels of income, thereby resulting in a rise in the effective tax rate on real income. This overstatement and over-taxation of operating earnings caused by inflation hinders use of internally generated funds for investment. Inflation has also caused the deterioration of corporate balance sheets as well as the general financial condition of corporations, thereby inhibiting the ability of corporations to attract funds externally.

As a result of deterioration in real earnings, undistributed profits -- traditionally the prime source of capital for new investment in productive capacity -- have been inadequate. Availability of these funds reflects a healthy financial condition which enables corporations to attract additional investment funds in the capital markets. During the last decade, non-financial corporations dramatically increased the proportion of external funds in their financing operations. In 1955, external sources of funds accounted for 35 percent of capital financing. By 1975, the percentage had risen to 67 percent.

In resorting to external sources of financing to meet capital needs, corporations were forced to compete with the Government for the available supply of savings. In this contest, there were no winners, only losers. I am referring not only to the exorbitant interest rates some corporations had to pay on newly issued debt securities, but rather, more fundamentally, to the limited access of the majority of corporations to the long-term bond markets. Back in 1973, 92 percent of all capital raised in the corporate bond markets was on a long-term basis. By 1975, the percentage of long-term financing had dropped to 59 percent; the average maturity of newly issued corporate debt had fallen by more than five years.

Moreover, the severe inflation of this period effectively closed the equity new issues market. Equity stock prices fell as a result of deteriorating investor confidence in the ability of corporations to generate profits. Depressed stock prices caused the cost of equity financing to become prohibitive. Moreover, because of historically high interest rates on fixed income securities, investors were presented with attractive investment alternatives, thereby further deflating stock prices.

Investor disaffection for common stock investments has been evidenced by the diminishing number of shareholders in the country. According to a recent New York Stock Exchange survey, the number of shareholders declined 18 percent between 1970 and 1975. The decline in ownership of stocks corresponds with the decline in new equity issues. In the early 1970s, corporations raised about $13 billion per year in equity capital; in 1975, they raised only half that amount. Even at the blue chip level, permanent investment in America's growth was less and less attractive to Americans.

Why this painful contraction in the equities markets? It was clearly as a consequence of Government conduct.

The most important development in the capital markets has been the growth in Federal, state, and local government spending. As Government spending has expanded, the resources available to the private sector have been correspondingly reduced.

More important than the size of the budget is the fact that the Federal budget has shown only one surplus in the last 15 years. Since 1970, the Federal Government, through annual budget deficits ranging from $2.8 billion to $43.6 billion, has increased the cumulative deficit by $146.5 billion.

Because of these deficits, the Federal Government has had to borrow considerable amounts of funds. In 1970, Government borrowing accounted for 36 percent of the new issue dollar volume in the public markets; in fiscal year 1976, it is estimated that the Government will account for 72 percent of the new issue dollar volume.

And who buys this Government debt? It's either the Government itself, the Federal Reserve or the investing public. The proportion of outstanding Treasury debt held by the Federal Reserve System has fallen because of the very sharp increase in the size of Federal deficits during fiscal years 1975 and 1976.

If the Federal Reserve were to increase its share of the growing Federal debt, it would, in effect, monetize the debt with "high powered" money, namely bank reserves. The printing presses, in effect, would roll. We all know what this would mean -- rampant inflation. Fortunately the monetary authorities have not adopted that tactic.

As a consequence of more Government borrowing on the one hand and a lower rate of Government purchases of securities on the other, recent Federal borrowing needs have had to be largely financed by private investors. The share of marketable debt held by the public rose from 34.8 percent (the postwar low) at the end of FY 1974 to 45.6 percent in February of this year. Of the $123 billion increase in outstanding debt since the end of FY 1974, about $110 billion, or almost 90 percent, had to be absorbed by the public. As long as large deficits continue, this trend is likely to continue.

It is clear then, that if the Federal Government continues to run large deficits as we approach full use of resources, these deficits will be at the expense of private-sector investment. It is this private investment and capital formation that is at the heart of improved productivity and ultimately is the source of improved living standards. Thus, as the recovery progresses, it is essential that we reduce Federal deficits and that we bring the budget into balance.

Sensible fiscal and monetary policies will bring this about, but in order for these policies to continue it is important that public support for them remain strong. I am sure that this group in particular recognizes the importance of maintaining these sound policies in order to avoid a resurgance of inflation which again would endanger the equities markets.

Of course, there are means other than deficit spending by which the Government has acted to the detriment of our capital markets and of equity markets in particular. Tax policy is one of these areas. Tax policies which penalize earnings from investments act to hamper capital formation and investment. Tax policies which attempt to direct investment capital away from one type of investment in favor of another act to distort the market's allocation of capital toward its most productive uses and, in the end, can jeopardize the rate of our economic growth.

The Administration has proposed a comprehensive program of tax reforms to stimulate greater national savings and investment. This program includes the following measures:

-- Permanent personal and business income tax reductions coupled with corresponding reductions in the size of the Federal budget.

-- A plan to integrate corporate and personal income taxes and thereby eliminate the perverse effects of the current double tax on equity investments. This is the proposal Secretary Simon presented last July before the House Ways and Means Committee.

-- A tax incentive to encourage broadened stock ownership by low and middle income working Americans by allowing deferral of taxes on certain funds invested in common stocks.

-- A proposal to encourage capital formation and the efficient allocation of investment resources by the introduction of a sliding scale for the taxation of capital gains which will, in addition, alleviate the burden of taxation on inflationary gains.

The final means by which Government acts to distort the capital markets is through excessive regulation of these markets. Although securities market regulation developed at a time of great need and with the best of intentions, we must ask ourselves whether present levels of regulation hinder the smooth and efficient operation of the capital markets and especially the equity markets; that is, whether the costs justify whatever benefits may be derived. We in Treasury will continue to pay particular attention to these issues.

We have all learned some valuable lessons from the recent fall in our equities market. But the most important one is that Government policies clearly are the major factors in inhibiting our capital markets from assuring that capital resources are, first, available and, second, allocated for their most productive uses. Reliance on the Government for a "costless fix" or in some way to "correct" our capital markets through additional Federal intervention can only lead to less efficient and less effective operation of our markets.

In my view, the principal victims of Federal intervention have been the fledgling businesses -- the high risk enterprises -- which depend on venture capital for their growth. These businesses which develop much needed new technologies will be the first ones to suffer again from burdensome Government intervention and distortion of our capital markets. We cannot let this happen.

With this in mind, I believe that this group in particular and the corporate community in general should undertake efforts to rectify the misconceptions of the American public concerning the operation of the nation's economic system. Everywhere you turn, our national policies are imbued with the idea that somehow what restricts business and investment is good for the country. These policy decisions are based on misinformation and misunderstanding. The American public, which must be at the core of our policy-making process, needs to be informed that it takes capital, lots of capital, to develop new technologies and industries, and to expand production in existing industries. It is a responsibility of the corporate and financial communities as well as of those of us in Government, to educate the public and restore their confidence in the American private enterprise system.

# # #

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

FOR IMMEDIATE RELEASE 811

REMARKS BY THE HONORABLE JOHN M. PORGES
U.S. EXECUTIVE DIRECTOR, INTER-AMERICAN DEVELOPMENT BANK,
BEFORE THE TOWN HALL OF CALIFORNIA, TOWN
HALL WEST ECONOMICS SECTION, LOS ANGELES,
CALIFORNIA, HOLIDAY INN, MAY 5, 1976, 3 P.M. EDST

Economic Perspectives in Latin America and the Role of the Inter-American Development Bank

I am happy to be in Los Angeles today and very pleased to speak to members of Town Hall West. As United States Executive Director of the Inter-American Development Bank, I would like to talk about the work of the Bank and its contribution to the economic growth and the social development of Latin America. As citizens of this city and state, all of you are very much aware of important cultural and historical links between the United States and Latin America. You are also aware of the business and commercial links. With respect to this second point, I want to comment a little later on how we in the United States benefit from the work of the Inter-American Development Bank (IDB) both in terms of achieving our over-all foreign policy objectives and in the expansion of our exports and the creation of employment here at home.

Let me begin with a brief summary of the Bank's history and operations. As its name indicates, the Bank is an international lending institution. It provides long-term financing to accelerate the economic growth and development of its member countries. Some of this financing is provided on near market terms with interest rates of 8 per cent and maturities of 15 to 25 years. These are referred to as "ordinary capital" loans and are

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directed mainly toward projects which generate favorable financial rates of return. Other loans are provided on concessional terms -- with interest rates between 2 and 4 per cent per annum and with maturities of up to 40 years. These loans are called Special Fund Operations and are directed toward the least developed countries of the hemisphere and to the least-advantaged elements of the population in these countries for purposes such as potable water and rural health programs.

The Bank was founded in 1959. At the present time, its capital stock is owned by 24 Western Hemisphere countries, including the United States, Canada and 22 Latin American and Caribbean countries. Total subscribed ordinary capital is now \$5.9 billion. In addition, the Bank has mobilized concessional resources for the Special Operations to which I just referred amounting to more than \$4.5 billion.

Sometime this summer, these figures will increase to a total of \$17.2 billion. This will be done by an expansion of membership to include 11 European countries and Japan and an increase of the capital and concessional contributions of current members. These measures, by the way, have now been approved by both houses of the Congress. I expect that minor differences between House and Senate bills will be settled shortly in conference and that a final piece of legislation will be forwarded to the President soon.

For the governments of Latin America and the Caribbean, the IDB has been a primary source of official external development assistance. Last year, for example, the flow of development financing to Latin America amounted to nearly \$3.0 billion. Of this total, the IDB provided \$1.375 billion, or 47 per cent. So far as concessional lending is concerned, during the same period the IDB provided \$634 million, or nearly 80 per cent of this scarce and very useful financing.

In my own travels throughout the hemisphere, I have always been impressed by how aware local government officials are of the Bank's work. This awareness has been translated through extensive press coverage into public understanding -- especially in Latin America -- of the Bank's role and its impact on economic development in the hemisphere. I don't want to belabor you with statistics, but perhaps a few figures will give you a better idea of what this impact has been.

As of December 31 of last year, the Bank had made loans totalling more than \$8.0 billion. These loans were parts of projects which, in aggregate, were worth more than \$27.0 billion. In other words, through its lending operations the Bank has prompted its borrowers to mobilize \$19.0 billion of their own domestic or other resources. By working closely with borrowing governments we have tried to direct this money to key economic sectors where there can be a relatively rapid economic pay-off as well as to programs which have important long-term social benefits.

This flow of Bank capital assistance is impressive not only because of its own volume but also because of its catalytic effect in stimulating other investment flows. In this respect, I can cite our work in providing electric power generation and distribution facilities. As of December 31, 1975, we had loaned more than $1.75 billion for this purpose. We have also been very active with similar catalytic effect in potable water and road projects. Real development is not possible in the absence of infrastructure. By making loans for these purposes we have encouraged a parallel movement of private funds, both foreign and domestic, into areas where it would not have been possible before.

Another very important part of our loan portfolio is in the agriculture sector. On a cumulative basis the Bank has lent more than $1.6 billion to finance directly productive agricultural projects, mainly through relending programs. In addition, the Bank has lent considerable amounts for rural roads, rural electrification, water supply and other services which assist the farming communities. In 1975 alone, it is estimated that our lending program benefitted more than 1.6 million farmers. Between a quarter and a third of this lending was directed at small farmers, either singly or in cooperatives.

In Mexico and the Dominican Republic, ambitious projects for integrated rural development are now under way which promise to improve dramatically the situations of individuals who previously were physically isolated and unable to provide for themselves economically. Last year, the Bank also inaugurated a program of direct assistance to credit unions, cooperatives and their federations in Latin America. In this way, we hope to strengthen these institutions over the long term so they can more effectively reach the lower income groups throughout Latin America.

The Bank has been a leading and innovative lender in two other significant sectors as well. To date, we have lent $752 million to help finance potable water and sanitation projects. We were, in fact, the first to provide external financing for projects of this kind and pioneered in this area before other lending agencies. As a result, since 1960 the percentage of Latin America's urban population served by potable water connections has increased from 40 to 60 per cent. Over the same time period, the rural population with access to potable water jumped from 8 to 25 per cent.

We have also led the way in our loans for education. On a cumulative basis, these loans amount to more than $306 million. They have expanded or improved 690 learning centers, including 146 universities and 504 vocational and technical schools. Our emphasis on this sector is now shifting away from universitites toward technical and vocational schools. In my view, this is the correct approach because skilled manpower will be an increasingly key element as the process of economic growth continues in Latin America. In Brazil, especially in the Sao Paulo area, the training of skilled manpower has been absolutely vital to that country's impressive economic achievements.

Let me turn now to the subject of Latin America's current economic situation and prospects and what this means for future lending by the Bank.

In comparison with other parts of the developing world in Africa and Asia, Latin America's over-all level of economic development is relatively high. This reflects a great deal of progress achieved during the 1960's and 1970's. On a regional basis, per capita income is three times greater than it is in Africa and Asia. The process of industrialization is also farther advanced, with 25 per cent of regional GNP now originating in industry. Brazil is one of the great economic success stories and Mexico has been making impressive progress over a period of many years.

Other countries have not fared so well, however. Many are suffering from the effects of higher prices for petroleum and manufactured goods and their economic prospects have declined. Countries such as Paraguay, Bolivia, Guatemala, Honduras and Nicaragua are classified as least developed. They have low per capita incomes and show little progress or prospects for greater industrialization. Haiti is an extreme case of poverty with an estimated per capita income of $100 per year.

The Bank should be and is, in fact, paying greater attention to the problems of its least developed member countries. As a result of their improved position, the relatively more advanced countries such as Venezuela, Brazil, Mexico and Argentina are now making greatly increased contributions of freely usable funds to the Bank's resources. For the future, this process will continue and even accelerate. At the same time, we will see greater emphasis on lending to the poorest countries. Concurrently, the relatively more advanced countries will assume more and more of the donor country posturè. To illustrate this point, Venezuela no longer receives loans from the Bank. In addition, its contributions to the Bank are being made entirely in convertible currency and it has established a Special Trust Fund of one-half billion dollars administered by the IDB for lending to the poorer countries.

So far as sectoral emphasis is concerned, I have already mentioned the importance of agriculture and indicated that it constitutes a very significant part of our loan portfolio. Nevertheless, we have to further increase our concentration in this sector -- both in absolute and percentage terms. In addition, we have to become a greater force for change, both in production method and in pricing policy.

Currently, the Bank provides budgetary support for several international and national agricultural research institutes. These institutes serve as experimental stations and clearing houses for information on new seed varieties and better uses of fertilizers and pesticides. The contributions of these organizations have been very valuable. This year, the Bank is supporting several national institutes which modify and pass on where necessary to users in their own countries the results of work undertaken by the international institutes. What is now needed in the agricultural sector is a fuller mobilization of private capital expertise and the application of what we call agri-business method to food production problems throughout Latin America.

What is also needed is better planning and coordination among government agencies concerned with agriculture. In many instances, unwise pricing policies have frustrated individual farmers and discouraged needed investments. In Chile, for example, enactment of protectionist tariff measures promoted the establishment of assembly operations for consumer durable products. These operations flourished at the expense of agriculture and resulted finally in a situation in which Chile "manufactured" television sets and automobiles while increasing the amount of imported food. The economic irony is that this occurred in a country with unused arable farmland and unemployed farm labor. There are other examples which can be mentioned. The point is that at a time of food scarcity, such as today, agricultural production should not be penalized to promote an inefficient industrialization process.

Recently, the Inter-American Development Bank took the initiative to sponsor an international consultative group on agricultural production. Official designation of the organization is the Group for International Cooperation in Agricultural Development and Food Production in Latin America. Other agencies such as the World Bank, the United Nations Development Committee, and the Latin American countries are also participating. I hope this group can encourage more activity by private industry in the agri-business field in Latin America and change what I think are unwise pricing policies in some of the countries.

In my personal opinion, another matter of gravest concern to the future of Latin America is population growth. For the past decade the region has had the fastest rate of increase of any part of the developing world. Its population today is 300 million. By the year 2000, given present projections, this figure could reach 645 million. Of course, not all of the countries of Latin America have problems of population growth. Some, like Chile and Argentina have relatively low rates of 1.5 and 1.9 per cent per year. Other countries such as Mexico, Venezuela and El Salvador, have annual birth rates of up to 3.4 per cent. It is very clear that a solution needs to be found if the benefits of hard-earned economic growth are not to be lost to increased population demands. Some of the countries such as Mexico have already initiated programs to curb their population growth. Other countries with high annual birth rates need to do this also.

A component part of the population problem is the phenomenon of mass migration now going on from rural to urban areas. Rural areas in Latin America lack the job opportunities and services which one associates with city life, and consequently the attraction has been strong. In terms of population, Latin America has some of the world's leading cities. Greater Buenos Aires, with nearly 10 million people, contains close to 34 per cent of Argentina's total population. Rio de Janeiro by 1980 is expected to have more than 9 million people and the population of Sao Paulo, in southern Brazil, should exceed 12 million by the same date. Caracas, with 600,000 people in 1950, is expected to have more than 3 million by 1980. The economic and social systems of the developing countries are in most instances fragile and extremely vulnerable to the stresses of combined population growth and urban migration. Even in the relatively more advanced countries, jobs and services cannot be generated quickly enough to accomodate such large numbers of people. The results are the "favelas" of Rio de Janeiro and the "ranchos" of Caracas. For a least developed country such as El Salvador, the results can be worse.

The Bank has tried to help in the context of its lending for health purposes. For example, we have been increasing our emphasis on pre and post natal care and counseling. In the countryside, we have encouraged the construction of small clinics in an effort to reach larger numbers of the rural poor. Finally, by providing increased job opportunities and better services such as potable water and electricity, we have sought to create reasonable alternatives to city migration.

In summary, we can say that there have been notable economic successes in Latin America. The Bank, in the 16 years of its existence, has been very much a part of the success. At the same time, much remains to be done, especially in the "least developed" countries of the hemisphere. Increasing agricultural production and ameliorating the problem of population and urban migration are two large issues that have to be faced. With new funding coming from Europe and Japan and greater contributions from the

Latin Americans themselves, the Bank is better able to do its job. Nevertheless, there is a continuing need for a strong and effective U.S. participation in the Bank.

At the start of my remarks, I said that I wanted to comment on how the United States benefits from the work of the Inter-American Development Bank. These benefits are closely related to our over-all perceptions of U.S. interests in the region.

First, there is the benefit of access to the raw materials that are vital to the further expansion of our own domestic economy. Last year, for example, Latin America provided 24 per cent of our petroleum imports, 48 per cent of our copper imports, and 34 per cent of our iron ore imports. In addition, we obtained sizeable amounts of foodstuffs from Latin America, including 47 per cent of our sugar imports, 82 per cent of our bananas, 60 per cent of our cocoa and 40 per cent of our coffee. Bank infrastructure projects in many cases facilitate the production, processing and transportation of these products.

Secondly, there are the substantial benefits which we enjoy from trade and investment. The United States has had a traditional trade surplus with Latin America. In 1974, this surplus amounted to approximately $1.0 billion and when 1975 figures are available it is expected to exceed $3.0 billion. To the extent that we promote economic growth and development, we create additional effective demand for the goods and services which we produce. Over the life of the Bank, it is estimated that more than $1.0 billion in additional U.S. exports has been generated as a result of Bank loans. This translates into 36,500 man years of employment. The latest available data on U.S. direct investment indicate that 14 per cent or about $15.0 billion is in Latin America and that this investment earns $1.0 billion annually in investment income. As I indicated earlier, the loan operations of the IDB facilitate the flow of private investment and frequently promote parallel flows of capital.

Finally, there is the benefit to our basic national interest in helping to continue what has been a remarkably long period of general peace in this hemisphere. The Bank's lending operations are designed to promote economic growth and social development. It is these two factors, and the prospect for their improvement, which underlie the political stability necessary for peace in the hemisphere.

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13-wk		26-wk
4.909	Last week	5.230
4.981	To-day	5.339
4.957	High since 4/5/76	
	3/15/76	5.454

e Department of the TREASURY NEWS
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FOR IMMEDIATE RELEASE May 3, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.6 billion of 13-week Treasury bills and for $3.6 billion of 26-week Treasury bills, both series to be issued on May 6, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 5, 1976			26-week bills maturing November 4, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.769	4.870%	5.00%	97.321	5.299%	5.52%
Low	98.753	4.933%	5.06%	97.297	5.347%	5.57%
Average	98.756	4.921%	5.05%	97.301	5.339%	5.56%

Tenders at the low price for the 13-week bills were allotted 45%.
Tenders at the low price for the 26-week bills were allotted 84%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 41,165,000	$ 18,515,000	$ 14,230,000	$ 7,230,000
New York	4,622,975,000	2,208,290,000	6,439,105,000	3,014,030,000
Philadelphia	32,815,000	29,675,000	45,505,000	19,805,000
Cleveland	53,860,000	50,785,000	114,950,000	74,750,000
Richmond	23,260,000	20,840,000	77,750,000	30,250,000
Atlanta	35,345,000	25,490,000	37,715,000	28,465,000
Chicago	283,155,000	87,330,000	479,880,000	218,920,000
St. Louis	62,125,000	22,865,000	58,330,000	29,210,000
Minneapolis	28,505,000	7,505,000	51,355,000	10,915,000
Kansas City	50,175,000	44,055,000	23,765,000	18,565,000
Dallas	41,725,000	16,725,000	25,505,000	10,505,000
San Francisco	280,300,000	69,390,000	333,660,000	137,580,000
TOTALS	$5,555,405,000	$2,601,465,000 a/	$7,701,750,000	$3,600,225,000 b/

a/ Includes $ 348,560,000 noncompetitive tenders from the public.
b/ Includes $ 162,135,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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The Department of the TREASURY NEWS
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Contact: J.Davenport
Extension: 8585
May 4, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES FINAL DETERMINATION OF SALES AT LESS THAN FAIR VALUE WITH RESPECT TO HOLLOW OR CORED CERAMIC BRICK AND TILE, NOT INCLUDING REFRACTORY OR HEAT INSULATING ARTICLES, FROM CANADA

Assistant Secretary of the Treasury David R. Macdonald announced today that hollow or cored ceramic brick and tile, not including refractory or heat insulating articles, from Canada are being or are likely to be sold at less than fair value within the meaning of the Antidumping Act, 1921, as amended. Notice of the determination will be published in the Federal Register of May 5, 1976.

The case will now be referred to the U.S. International Trade Commission for a determination as to whether an American industry is being, or is likely to be, injured. In the event of an affirmative determination, dumping duties will be assessed on all entries of the subject merchandise from Canada which have not been appraised and on which dumping margins exist.

A "Withholding of Appraisement Notice", published in the Federal Register of January 28, 1976, stated that there was reasonable cause to believe or suspect that were sales at less than fair value. Pursuant to that notice, interested persons were afforded the opportunity to present oral and written views prior to the final determination in this case.

For the purpose of this determination, the term "hollow or cored ceramic brick and tile" means unglazed hollow ceramic brick, including bond beam units. Such brick ranges from approximately 25 to 40 percent void.

Imports of the subject merchandise from Canada during 1974 were valued at roughly $1.2 million. Two companies, Clayburn Industries, Ltd., Abbotsford, British Columbia, and I-XL Industries, Ltd., Medicine Hat, Alberta, accounted for virtually all of the imports from Canada during that year.

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FOR RELEASE AT 4:00 P.M. May 4, 1976

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,200,000,000 , or thereabouts, to be issued May 13, 1976, as follows:

91-day bills (to maturity date) in the amount of $ 2,600,000,000, or thereabouts, representing an additional amount of bills dated February 13, 1976, and to mature August 12, 1976 (CUSIP No. 912793 A4 8), originally issued in the amount of $3,901,620,000, the additional and original bills to be freely interchangeable.

183-day bills, for $3,600,000,000, or thereabouts, to be dated May 13, 1976, and to mature November 12, 1976 (CUSIP No. 912793 B9 6).

The bills will be issued for cash and in exchange for Treasury bills maturing May 13, 1976, outstanding in the amount of $6,404,090,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,234,590,000. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Monday, May 10, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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(OVER)

securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on May 13, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing May 13, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

Today 6.61

3/18/76
2-year 6.76

2/20/76
21-month 6.62

1/14/76
2-year 6.49

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FOR IMMEDIATE RELEASE May 4, 1976

RESULTS OF AUCTION OF 2-YEAR TREASURY NOTES

The Treasury has accepted $2.0 billion of $4.4 billion of tenders received from the public for the 2-year notes, Series L-1978, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	6.59% 1/
Highest yield	6.63%
Average yield	6.61%

The interest rate on the notes will be 6-1/2%. At the 6-1/2% rate, the above yields result in the following prices:

Low-yield price	99.837
High-yield price	99.765
Average-yield price	99.801

The $2.0 billion of accepted tenders includes 61% of the amount of notes bid for at the highest yield and $0.6 billion of noncompetitive tenders accepted at the average yield.

In addition, $0.5 billion of tenders were accepted at the average-yield price from Government Accounts and Federal Reserve Banks for their own account in exchange for notes maturing May 15, 1976, and from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash.

1/ Excepting 2 tenders totaling $25,000

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e Department of the TREASURY NEWS
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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
CENTRAL PIEDMONT INDUSTRIES
CHARLOTTE, NORTH CAROLINA, MAY 5, 1976

Chairman Andrews, Mayor Belk, Mrs. Hair, Members of the Central Piedmont Industries, Ladies and Gentlemen:

As always I'm delighted to be back in North Carolina, and, of course, especially pleased to be in the company of such a distinguished audience. There is a common bond that unites the people I have just acknowledged: all of them are blessed with a special genius that understands America. They know that the gifts of our past and the promise for our future both flow from an ever present spirit in America's heartland -- a spirit of vitality, self-reliance, individuality, and integrity. As I look around this room I can see living proof of that philosophy. For seated here this evening are many of the men and women whose leadership and commitment have brought a new sense of excitement to the Piedmont region, indeed to the entire state of North Carolina. I'm both aware of and interested in the efforts you are making here to promote private enterprise and improve relations between labor and management. Clearly, what you are creating here is a momentum that will result in an increasingly broad economic base, more jobs and a higher level of prosperity.

Unfortunately, in the town where I work, there lives a different breed of cat. Washington is just overflowing with politicians who are obsessed with our short-term problems and with the quest for instant formulas and overnight panaceas to solve them -- or at least give them a cosmetic covering. It is almost a cardinal sin in that city to look beyond November in an election year.

As a non-politician, I am going to commit that sin tonight and I ask your indulgence as we take a longer-term view of where we have been and where we are going as we confront our economic problems.

There is a strong irony in the fact that when the need for long-term vision about our economy has never been greater, we are being deluged with a series of suggestions of quick fixes for our economic ills. Those who call for these magic cures claim that we aren't spending enough, aren't pressing hard enough, aren't pushing enough panic buttons to solve our problems.

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Despite our steady economic gains, many of these critics say there is some basic flaw in our system and they bombard us with countless sleight-of-hand remedies: governmental control over economic planning -- guaranteed jobs for all at government expense -- a new round of wage and price controls -- and other so-called solutions.

Frankly, I believe that many of these critics suffer from what Mark Twain called "loyalty to petrified opinions." They fail to see that efforts to strengthen the public sector at the expense of the private sector is the problem, not the solution. They refuse to recognize that the same excessive governmental fiscal, monetary and regulatory policies they call for today have already led to abuse of our economy and helped trigger, first, a storm of inflation in the early 1970s and, second, the severe recession from which we are now recovering. And they fail to comprehend a gathering mood in this country against the further expansion of big government. They suffer from the economic variety of Potomac Fever -- the delusion that all economic cures must originate in Washington with the Federal government. As President Eisenhower once remarked, "there are a number of things wrong with Washington, and one of them is that everybody has been too long away from home."

But before we look at where we are going I'd like to take a moment to look at where we have been in the recent past -- and to itemize our recovery from the worst recession in more than a generation and the worst inflation in our peacetime history.

We adopted moderate, responsible policies. We resisted the demands of the special interests and big spenders. And it's working. Just consider the progress that we made during 1975:

-- 1975 opened with inflation raging at 13 percent; we have cut that rate to more than one-half.

-- During the spring of 1975, the unemployment rate reached nine percent; today it is down to 7.5 percent and the trend is clearly downward.

-- 2.6 million more people have found work and the total number of people employed today stands at a record high of more than 86 million.

-- Real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 7-1/2 percent during the first quarter of 1976.

-- Other signs point to an increasingly healthy economy -- personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects rising public confidence about the economy that contrasts sharply with the deep pessimism reported by the ~~polltakers~~ the middle of last year.

Thus we made considerable headway in 1975, and we will make even more in 1976. But it's not good enough and this is certainly no time for complacency. The unemployment rate is still far higher than we can tolerate. And inflation is by no means completely under control. In fact, it remains the most dangerous enemy of real economic growth. And all of us -- especially those with a say in Federal spending -- must do everything we can to prevent another inflationary spiral. The ruinous inflation that crested in 1974 was the chief cause of the severe recession of 1975 and if we embark once again on excessive fiscal and monetary policies resulting in double-digit inflation, I guarantee you we will have an even worse recession than before. Let us hope that it will never be said that the pain and suffering of the 1974-75 recession were in vain because the government refused to face the economic facts of life.

But the problem is not confined to government alone. It may seem strange, and it is certainly ironic, but at a time when Americans are enjoying such great abundance and such great opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible. Somewhere along the line, there has been a dangerous breakdown in communications.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the dynamics of prosperity in a free society.

Today, when nearly everyone takes the fruits of the free enterprise system for granted -- the abundance, the opportunities, the freedom of choice, the unprecedented opportunities for learning, travel, and general upward mobility -- not everyone understands the basic economic facts of life that create all these benefits.

Small wonder then, that when economic difficulties like the recession hit, millions of otherwise reasonable people fall for the quack nostrums of politicians who are more interested in promising than performing, and for quick-fix government spending that may provide some short-term relief but only aggravates the long-term economic ills of inflation and stagnation in the private sector.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people.

What is at stake is not just the future of this or that industry. At stake is the survival of the private sector, and the individual liberties which have never long survived the collapse of a society's free enterprise system.

Unless we get the facts across today, the America of tomorrow -- of our children and grandchildren -- will be doomed to a system of economic and political bondage that is the very opposite of all that we hold dear.

The problem already exists, as I have had ample opportunity to observe, and it is getting worse, not better. It is a question of both policy and perception, for faulty perception of the economy makes faulty economic policy almost inevitable.

And I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times.

Part of it is a matter of image. Frequently, and especially to youthful idealists, those who support bigger government spending and more government domination of the private sector are perceived as concerned, socially progressive men and women who "care." In a nutshell, they are seen as the humane champions of the persecuted underdog.

On the other hand, those who warn that the government should not -- and cannot -- effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system are seen as either outdated theorists or a new generation of economic exploiters, indifferent to human suffering and only out to make a fast buck for themselves and their companies.

To make matters worse, surface appearances often tend to confirm this inaccurate impression. Advocates of big government are able to wax eloquent for hours about the ills they imagine they can cure by cranking out more currency and soaking up more credit through massive deficit spending. They have as many arguments as there are social, economic and political problems -- even though the spending they advocate as we have seen with the Great Society's War on Proverty, is often part of the problem rather than part of the solution.

Those of us who recognize the fallacy of the big government approach have only one argument. It's the right one, but, by dint of repetition, people are getting tired of hearing about it. For we constantly invoke the free enterprise system, too often without defining the freedoms and the opportunies that it, and it alone, provides. We chant a slogan, a label, without defining it in comprehensible, human terms.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean anything to those who do not understand what it really is and what makes it work. It's like trying to sensibly discuss the birds and the bees with someone who is unshakable in his belief that babies are delivered by the stork. People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition the average American shopping center would represent to nine-tenths of the earth's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and run agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions and feed not only our own people, but millions of others as well.

Too often they have been taught to scoff at the very profit and property motives which make our prosperity possible.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid, what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried.

They have not seen first-hand the political and social aftermath in societies where the government has destroyed free enterprise. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander Hamilton warned so long ago, "power over a man's substance amounts to power over his will."

And they have not experienced the economic stagnation and loss of initiative in free countries that have chosen the course of over-regulation and over-taxation that results in demoralization and even mass emigration of the vital middle class.

Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many new improvements. Whether we like it or not, it is an immutable law of human nature.

Unfortunately, like clear air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So we have reached the point where, although the free enterprise system works, and works better than any other economic system in effect anywhere in the world -- and although it feeds, clothes and houses more people more affluently than any other while serving as the underpinning of our free society -- it is somehow losing the war to an alien philosphy of government control and economic irresponsibility that has never worked but has somehow managed to preserve an aura of idealism and altruism that attracts many young idealists.

All of these misconceptions would be unimportant if they were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well being of our people, especially those who are impoverished or face disadvantages because of their sex or the color of their skin.

The central question is not who cares the most, but rather how we broaden prosperity and reduce human hardship without sacrificing our freedom or destroying the most successful economic system that man has ever known.

And I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and therefore our lives -- a road that we have been moving steadily down for several decades -- then our children will be robbed of their personal and economic freedoms. And, in the meantime, all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment. This is really what is at issue underneath the semantics and the misleading labels.

Let's look at a few facts about government spending. For most of our history, the Federal Budget stayed somewhere below the $100 billion mark -- usually way below it.

Then, in 1962, we finally hit $100 billion -- and that was only the beginning. Seven years later, the budget broke the $200 billion barrier and then, only four years after that, we hit the $300 billion mark. And now, in our bicentennial year, we have reached the point where the Federal Government is spending $1 billion a day.

The very size of such numbers makes them almost meaningless to the average American. But there are ways of getting the message across. For example: suppose that on the day Christ was born, a man had been given $1 billion on the condition that he or his heirs spent $1,000 every day, seven days a week. How long would that $1 billion last? Adding it up, I think you'll find that today, almost 2000 years later, the grandchildren would still not have spent the full billion dollars. In fact, the money would not run out until 2716, 740 years from now.

Yet our Federal government is spending $1 billion every single day, and going into debt another $1 billion every week.

And as the budget grows, the government comes to occupy a more and more dominant role within our society.

In 1930, government spending at all levels -- Federal, state and local -- amounted to about 10 percent of the Gross National Product. Today, because budgets have mushroomed, government accounts for nearly 40% of our entire national output, and if recent trends prevail, the government's share of the total economy will reach 60 percent before the end of this century.

For taxpayers, the burden of paying the government's bills has become so heavy that many are now in open rebellion. In the 1974 general elections, for example, voters across the country turned down some three quarters of all bond issues on the ballot. But we in the Federal government get around this public opposition by voting more federal spending without increasing taxes.

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The result has been a string of Federal Budget deficits that is unparalleled in our history. In 16 of the last 17 years, the budget has been in the red. And now, just when a balanced, healthy economic recovery has begun, the advocates of big spending would have us launch another round of reckless spending and runaway inflation.

It is up to us to stop them.

I wish that there were some way for television cameras to portray this story as vividly as they did the war in Vietnam or the race riots of earlier years. For, while the visual images are less dramatic, the problem is every bit as pressing and important.

But, as the great 19th century historian Thomas Carlyle once said, political economics is the "dismal science." On the surface, it seems nothing more than a pile of charts and a jumble of numbers so large as to be incomprehensible in everyday terms. To put it mildly, economics seldom makes "sexy" news stories. And yet the economy is the one thing that affects every other aspect of American life -- the food we eat, the quality of our education, our mobility, our freedom of choice in careers, services and merchandise, and our material and personal sense of pride and independence.

The smallest shock to the economy is felt in every limb of the body politic. And that is a big story, if only a gripping,graphic way of telling it could be found.

Consider the case of the Federal debt and its impact. As the debt climbs rapidly upwards, we have to pay higher and higher interest cost on it. In fiscal year 1976 we will spend $36 billion in interest payments alone -- in fiscal 1977 it will rise to $45 billion or $125 million per day.

That's more than we spent in any single year on the war in Vietnam. It's almost half of our national defense budget. And it is money that could be better spent on needs such as public transportation, health care or any of a dozen worthy purposes.

This heavy borrowing by the government aggravates inflation and increases interest rates, creating strains in money and capital markets. This, in turn, affects everyone from the businessman interested in expanding his plant to create new jobs, to the young couple trying to buy their first home without paying an arm and a leg in mortage interest.

Reckless government spending is the basic cause of inflation, and inflation was the underlying cause of the worst recession our country has experienced in a generation -- a recession we are only now beginning to recover from.

It was inflation that caused a loss of real income and the confidence of consumers, prompting the sharpest drop in consumer spending since World War II. And it was inflation that helped dry up the flow of savings into our thrift institutions, driving up interest rates and causing the housing industry to collapse.

So one of our prime concerns as we proceed with the economic recovery is to avoid another dose of the poison that brought the recession on in the first place -- rampant inflation fed by run-away federal spending.

But spending isn't the whole problem. There is also the matter of government control and regulation for, as government spending has grown by leaps and bounds, so too has federal red tape.

Did you realize that government agencies now exercise direct regulation over 10 percent of everything bought and sold in the United States and indirect regulation over almost every other sector of the private economy?

Did you know that it costs private industry -- and that means each one of us as consumers -- approximately $20 billion a year just to do the paper work demanded by Federal bureaucrats? Andjust to fill out the necessary forms the Amercan people must now spend over 130 million work hours a year.

Some of these regulations are, of course, necessary. But many of them are counter-productive, wasteful, or obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Let me conclude with these few observations:

As we enter our third century as a nation, I believe the time has come not to reappraise our dedication to a better life for all -- that dedication is clear -- but to reappraise what we can pay for and how we can do it. The current plight of New York City, the disease that afflicts many state controlled economies, and the overwhelming size of our own Federal deficits are all grave warnings to us. We can pay for what we now have and provide for the future only if our great capitalist economy does its job -- produces goods and services in a free market and makes a sufficeint profit.

I am sick and tired of apologizing for the free enterprise system. It has given this country the highest standard of living and the greatest prosperity ever known, and of most importance, has helped to give us the greatest freedom ever known to man.

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And it will continue to do that unless it is crushed by the juggernaut of big Government. What we need are not fewer but more capitalists in the United States -- more people with a real and direct stake in the profits generated by a productive economy. We cannot continue to have more and more of our citizens involved only in receiving benefits from the government and fewer and fewer people responsible for paying for the benefits. We must broaden the base of those who work and narrow the base of those who are able but don't want to work.

President Ford urged that we strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our private enterprise system.

-- A balance that favors greater honesty and realism in dealing with the challenges of our time.

These are great goals -- goals worthy of the greatest nation on earth. We should not begin our Bicentennial year by retreating into the past, but by going forward into the future with a combination of patience, realistic hope, courage and common sense.

If we work together with common purpose and conviction -- with pride in ourselves and our nation -- the goals we share today can become the first achievements of our third century together.

President Ford has set a course which points us in the right direction and will permit us to get a grip on these problems, but it will take several years, not months, to bring this about. Unfortunately, the election is only a bit over six months away. There will be calls for "sweeping changes" and "broad new initiatives" which will really mean bigger spending, bigger deficits and ultimately bigger governmental control of the economy. We must persuade the American people that this course is wrong and that the other approach is much sounder in the long run.

The real choice is between government control or greater individual freedom. That is the true, crucial decision beneath the rhetoric and personalities of this election year. And the choice we make will affect not only our own future, but the future of our country itself as America embarks on its third century as the hope and inspiration of free people everywhere.

Thank you.

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federal financing bank NEWS
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SUMMARY OF LENDING ACTIVITY

April 16 - April 30, 1976

Federal Financing Bank lending activity for the period April 16 through April 30, 1976 was announced as follows by Roland H. Cook, Secretary:

The National Railroad Passenger Corporation (Amtrak) made the following drawings from the FFB against Note #6:

Date	Amount	Interest Rate
4/16	15,000,000	5.007%
4/28	10,000,000	5.093%
4/30	5,000,000	5.163%

The note matures June 29, 1976 and is guaranteed by the Department of Transportation.

The Bank made the following advances to borrowers guaranteed by the Department of Defense under the Foreign Military Sales Act:

Date	Borrower	Amount	Maturity	Interest Rate
4/19	Government of Israel	$ 21,816,848.68	6/10/85	7.379%
4/20	Government of Brazil	169,194.84	10/1/83	7.329%
4/22	Government of Greece	2,725,370.01	1/2/86	7.413%
4/22	Government of Greece	40,000,000.00	3/31/86	7.435%
4/22	Government of Brazil	17,974.86	3/15/83	7.199%

The Federal Financing Bank made the following loans to utility companies guaranteed by the Rural Electrification Administration:

Date	Borrower	Amount	Maturity	Interest Rate
4/19	United Telephone Company	$ 2,568,000	12/31/10	7.971%
4/20	South Mississippi Electric Power Assn.	6,495,000	4/24/78	6.591%
4/21	Ponderosa Telephone Company	115,000	12/31/10	7.975%
4/30	Southern Illinois Power Corporation	800,000	4/30/78	6.748%

Interest payments are made quarterly on the above REA loans.

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On April 21, the FFB purchased $1,360,000 of debentures from Small Business Investment Companies:

Company	Amount	Maturity	Interest Rate
Affiliated Investment Fund, Ltd.	$ 500,000	4/1/86	7.725%
Nelson Capital Corporation	250,000	4/1/86	7.725%
Venture Capital Corporation of New Mexico	610,000	4/1/86	7.725%

The debentures are guaranteed by the Small Business Administration.

On April 26, the United States Railway Association (USRA) borrowed $4.1 million from the FFB against Note #6. The rate matures December 26, 1990 and bears interest at a rate of 8.055%. USRA borrowings are guaranteed by the Department of Transportation.

On April 27, the Student Loan Marketing Association (SLMA) borrowed $20 million at an interest rate of 5.165%. The loan matures June 27, 1976. SLMA borrowings are guaranteed by the Department of Health, Education and Welfare.

On April 29, the Farmers Home Administration sold a $500 million CBO to the FFB. The final maturity of the loan is April 29, 1981. The interest rate is 7.646% on an annual basis.

The Tennessee Valley Authority borrowed $80 million on April 30. The loan matures July 30, 1976 and bears interest at a rate of 5.072%.

FFB loans outstanding on April 30, 1976 totalled $22.1 billion.

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The Department of the TREASURY NEWS
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FOR IMMEDIATE RELEASE

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May 4, 1976

TREASURY SECRETARY ANNOUNCES CONDITIONAL DISCONTINUANCE OF AUTOMOBILE DUMPING INVESTIGATION

Treasury Secretary William E. Simon announced today that the Treasury Department will conditionally discontinue its automobile dumping investigation against those foreign exporters who have been tentatively found to be selling into the United States at prices lower than their home country sales, so long as certain specialized assurances are received from such exporters concerning future prices to be charged on their products into the U.S. This action is being taken under a long-existing section of the anti-dumping regulations (19 CFR 153.15(a)(2)) which authorizes the discontinuance of investigations in appropriate circumstances.

"We believe that in this case," the Secretary said, "the procedures we are following more accurately reflect the competitive forces that the antidumping law was designed to preserve. We are therefore prepared to discontinue our investigation against those companies as to which dumping margins have been found, if certain assurances are received which will mitigate price differentials between home market and export sales in the future. One of the conditions of discontinuance will be careful monitoring of the U.S. sales of those companies as to which Treasury's investigation has been discontinued.

"The Treasury's tentative findings of 'dumping margins'", he continued, "indicate that all manufacturers investigated, other than Porsche, Rolls Royce, Toyota and Nissan, have been selling into the United States at prices below their equivalent home market prices. As the investigation has progressed, however, we have concluded that conditions in the auto industry require us to apply calculations and take corrective actions that are peculiar to these cases. In particular, we must take cognizance of the effect of fluctuating exchange rates upon automobile export prices to the U.S. Moreover, we feel that special consideration is necessary because of the incredibly high costs of anti-pollution equipment which is required on all autos sold in the U.S. These requirements can be viewed as discriminating against foreign manufacturers, with their shorter production runs for the U.S. market. Finally, as to Canadian models and parts, the fact that the Canadian and American auto industries have been integrated under the auspices of the Auto Agreement and that the autos produced in Canada are interchangeable with the U.S. product appears to make a withholding of appraisement and reference to the ITC inappropriate under present circumstances."

The automobile dumping investigation was commenced on August 11, 1975, based upon petitions filed by the United Auto Workers and Congressman John Dent of Pennsylvania.

Automobile imports from the eight countries investigated amounted to roughly $7.4 billion in 1975. Twenty-eight companies were investigated, as follows:

Belgium:	Volvo, Saab, General Motors
Canada:	Chrysler, General Motors, Ford, American Motors, Volvo
France:	Renault, Peugot
Italy:	Fiat, Alfa Romeo
Japan:	Nissan (Datsun), Toyota, Toyo Kogyo (Mazda), Fuji Heavy Industries (Subaru), Honda, Mitsubishi (Colt)
Sweden:	Volvo, Saab
United Kingdom:	British Leyland, Rolls Royce
West Germany:	Bayerische Motorenwerke (BMW), Volkswagen, Audi, Porsche, Daimler Benz (Mercedes), Ford

Under the Antidumping Act of 1921, as amended, the Secretary of the Treasury is required to issue a tentative determination of whether sales have been made at less than fair value within six months, nine months in complicated cases, from the date of initiation of the investigation. In the automobile case a Treasury decision must be made by May 11. Sales at less than fair value normally means selling a product at a price for export less than the home market price of the same merchandise.

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AUTOMOBILE ANTIDUMPING FACT SHEET

Initiation: Normally an antidumping investigation is initiated as a result of a petition submitted to the Treasury Department on behalf of the U.S. industry. Dumping as provided by the Antidumping Act of 1921, as amended, occurs when export prices to the United States are less than the home market prices of such or similar merchandise, (the difference being referred to as "dumping margins") and such sales injure a domestic industry. The Treasury Department determines whether these are dumping margins (sales at less than fair value), and the United States International Trade Commission determines whether there is injury.

The automobile investigation was initiated on the basis of petitions filed by the United Auto Workers and Congressman John Dent of Pennsylvania. The petitions respectively filed on July 8 and July 11, 1975 alleged dumping of automobiles by 28 companies from eight countries. A 30-day preliminary investigation was conducted by the Customs Service to determine whether there was adequate information to warrant initiation of a full-scale dumping investigation. Once the Secretary of the Treasury determined that a full-scale investigation should be initiated, an "Antidumping Proceeding Notice"was published in the Federal Register on August 11, 1975.

However, the Act provides that if during the preliminary investigation, the Secretary concludes that there is substantial doubt of injury, he will refer the case to the U.S. International Trade Commission for a preliminary injury determination. The Commission has 30 days to determine whether there is no reasonable indication of injury. Should the U.S. International Trade Commission make such a determination, Treasury's ongoing investigation would be terminated.

The automobile investigation was so referred, but the U.S. International Trade Commission did not determine that there was no reasonable indication of injury. Accordingly, the Treasury investigation was not terminated.

Full-Scale Investigation: Upon publication of the Antidumping Proceeding Notice, a full-scale investigation is conducted by the Customs Service both in the U.S. and abroad. This is termed the "Fair Value" investigation. The investigation encompassed autos imported in the period January 1-August 31, 1975. During this investigation, the Customs Service collected data from the foreign manufacturers concerning their pricing practices in both the home market and the United States. Normally, at least 60 percent of the dollar volume of a company's exports are examined. In the automobile case, information was gathered on 100 percent of the

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exports of each manufacturer.

Tentative Determination: Within six months, (nine months in complicated cases) after publication of a proceeding notice, Treasury must issue one of the following determinations:

1. tentative negative
2. tentative affirmative
3. tentative discontinuance

The automobile investigation was determined to be complicated, and the period for a tentative determination was extended to May 11, 1976.

Tentative Negative: A tentative negative determination is issued where there are no dumping margins, or where dumping margins are de minimis. Under the Antidumping Act, such a determination must be followed within three months by a final determination.

Tentative Affirmative: A tentative affirmative determination is made by issuing a notice of withholding of appraisement. The withholding of appraisement means that any merchandise imported on or after the date of publication of the withholding notice will not be appraised for assessment of duties until after the entire investigation has been concluded. If a finding of dumping results, duties are assessable retroactive to the date of withholding.

During the first three months of the six month withholding period, interested persons are given an opportunity to present views orally directly to Treasury officials at a Treasury Antidumping Conference. In such a case, a final determination is published by the end of the three month period, at which time, if the Secretary's final determination is affirmative, the case is referred to the International Trade Commission for a determination of injury to U.S. industry.

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<u>Tentative Discontinuance</u>: The <u>Secretary of the Treasury</u> may issue a <u>tentative discontinuance</u> when (1) the possible <u>margins of dumping are minimal</u> in relation to the volume of exports, price revisions have been made which eliminate any <u>possible sales at less than fair value</u>, and <u>assurances</u> have been received which eliminate any <u>likelihood of sales at less than fair value</u> in the future; <u>or</u> (2) <u>sales</u> to the U.S. have <u>terminated</u> and will not be resumed and <u>assurances</u> have been received to this effect; <u>or</u> (3) whenever <u>the Secretary</u> concludes that there are <u>other circumstances</u> on the basis of which it may <u>no longer be appropriate</u> to continue an <u>antidumping</u> investigation.

<u>Exclusion</u>: One or more <u>manufacturers</u> or <u>exporters</u> may be <u>excluded</u> either at the time of any <u>tentative</u> or <u>final determination</u> if 100 percent of its sales during the <u>Fair Value investigatory period</u> have been investigated and found not to have <u>dumping margins</u>. But the foreign manufacturer or exporter wishing to be <u>excluded</u> is under an obligation to come forward with its sales <u>information</u> to the <u>Customs Service</u> in order to be excluded, and it must submit such <u>information</u> in time for verification and analysis.

<u>Final Determination</u>: The <u>Secretary</u> must publish a <u>final determination</u> within three months after publication of the <u>tentative determination</u>. (1) If the <u>final determination</u> is <u>negative</u>, i.e., that there have been no sales at less than fair value, the case is closed. (2) If the final determination is affirmative, i.e., that there have been sales at less than fair value, the case is referred to the <u>International Trade Commission</u> for a determination whether there is <u>injury</u>, or <u>likelihood</u> of <u>injury</u> to, or <u>prevention</u> <u>of</u> <u>establishment</u> of, a U.S. industry. <u>The Commission</u> has three months after Treasury refers the case to make its <u>injury determination</u>. (3) If a <u>final discontinuance</u> is published, <u>the Secretary may monitor a company's</u> prices to ensure that the company abides by its assurances. After a period of time, usually two years, the investigation may be terminated, if appropriate.

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Dumping Finding: A dumping finding, which subjects imports to the assessment of additional duties if dumping margins persist, is ordinarily published within 30 days after an affirmative ITC injury determination. Publication of the finding is a routine administrative act which follows an affirmative injury determination.

Assessment of Duties: Any special dumping duties are assessed on an entry-by-entry basis, using current price comparisons rather than the comparisons made during the Fair Value investigation. The purpose of the Act is to remedy injurious price discrimination. Accordingly companies normally modify prices to eliminate less than fair value sales, rather than pay additional special dumping duties.

Other Issues: Several issues have arisen during the automobile investigation concerning the manner in which various adjustments in the calculations are made in order to assure that the comparison between autos sold in the home market and autos sold abroad is valid.

Pollution and Safety Equipment: A major adjustment, to the foreign manufacturers' detriment, has been made for the costs of required safety and pollution equipment on cars sold in the United States. This adjustment was made to allow comparison of "apples with apples." The Treasury Department in its administration of the Act consistently has made adjustments for differences in merchandise on the basis of the costs incurred in producing it, or in market value of such merchandise.

Exchange Rates: Another issue concerns the effect of fluctuating exchange rates on prices. As the value of the dollar declines in relation to the exporter's foreign currency, any "dumping margins" will increase, assuming no price change occurs. Exchange rate changes were not a significant factor in antidumping investigations prior to the Smithsonian Realignment in December 1971. At that time there was a realignment of major currencies and the relevancy to the Antidumping Act became recognized. At that time the approach taken by Treasury was to require that price adjustments be made to reflect new currency values. A press release was issued in March 1972 putting our major trading partners on notice that sales at less than fair value could result if prices were not adjusted after exchange rate changes. No time limits were given for adjustments, merely a statement that in an Exporter's Sales Price case (a case in which the U.S. importer is related to the foreign exporter, as in most automobile cases) in which margins were created by adjusted exchange rates all facts would be considered to determine whether a determination of sales at less than fair value was warranted. The following year in March 1973 another press release was issued, which provided that margins created solely as a result of exchange rate changes would be disregarded if prices were adjusted within a 45-day period. The essence of both of these Treasury positions was to the effect that where margins were created solely as a result of exchange rate realignments such margins would be disregarded for fair value purposes if prices were adjusted in a timely manner.

Since this period, however, the international monetary system has evolved into a system of floating exchange rates. Accordingly, Treasury has determined that for fair value investigations during periods of floating exchange rates some other method must be utilized which eliminates the effects of short-term variations on prices. It has been recognized that a business, particularly the automobile industry, cannot constantly change prices to reflect short-term variations in currency. A longer period reflecting fluctuations in exchange rates was therefore utilized to reflect the actual long-term effects on setting prices.

The Department of the TREASURY NEWS
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STATEMENT OF STANLEY L. SOMMERFIELD,
ACTING DIRECTOR, OFFICE OF FOREIGN
ASSETS CONTROL, U.S. TREASURY DEPARTMENT

before

THE SUBCOMMITTEE ON INTERNATIONAL RESOURCES,
FOOD, AND ENERGY

of the

HOUSE COMMITTEE ON INTERNATIONAL RELATIONS

on

MAY 6, 1976

Mr. Chairman and Members of the Subcommittee:

My name is Stanley L. Sommerfield. I am the Acting Director of the Office of Foreign Assets Control, Department of the Treasury.

Under the supervision of the Assistant Secretary of the Treasury for Enforcement, Operations and Tariff Affairs, my Office administers the Rhodesian Sanctions Regulations (31 CFR Part 530). These Regulations implement Executive Orders Nos. 11322 and 11419. The Orders were issued by the President to carry out U.S. obligations in connection with U.N. Security Council Resolutions 232 and 253. The Security Council Resolutions call on all U.N. members to impose economic sanctions on the illegal Rhodesian regime.

The Treasury Regulations prohibit, among other things, unlicensed remittances to Rhodesia; unlicensed imports of goods of Rhodesian origin; unlicensed expenditures of Rhodesian funds in the United States; and, other forms of economic relations between Americans and Rhodesia.

One of the purposes of the sanctions is to prevent Rhodesian accruals of foreign exchange from Americans. Accordingly, the Regulations prohibit all unlicensed transfers of funds from Americans to Rhodesia. Investments in Rhodesia are prohibited; sending funds to support the day to day activities of businesses in Rhodesia is prohibited; sending funds to friends and relatives there is prohibited, as are most other types of remittances.

There are, however, certain exceptions to the ban on remittances. The United Nations sanctions themselves contain an exception permitting remittances for pensions, and for medical, humanitarian or educational purposes, or for the provision of news material (SC Res. 253, paragraph 4). In order to have the most effective possible regulations, the Treasury's regulations contain a blanket prohibition against all unlicensed remittances for any purpose whatever. Then, the Regulations contain a general license permitting payments to Rhodesia for books, publications, and documentary or news films. (Section 530.510). A similar general license exists for expenditures by news gathering agencies such as the Associated Press or the television news agencies. In addition, specific licenses are issued on a case-by-case basis to church, missionary, and similar organizations to authorize the sending of funds for medical, humanitarian and educational purposes, as permitted by U.N. Resolution 253.

The dollar funds which accrue to Rhodesia from these authorized remittances are credited to Rhodesian bank accounts in the United States, and are usable for any purpose not illegal under other United States laws. They are used by Rhodesia to fund the Rhodesian Information Office in Washington.

Other expenditures which are licensed for Rhodesia are travel expenditures by American tourists. It is legal under American law for an American to travel to Rhodesia. Equally, the United Nations sanctions do not apply to travel by tourists in Rhodesia. Under these circumstances, it is Treasury policy to license tourists to expend funds for their hotels, meals, transportation and similar expenses in Rhodesia. The licenses specifically caution travelers that they may not import any gifts, souvenirs, or other Rhodesian goods. This ban on imports extends even to big game trophies shot by Americans while on hunting safaris in Rhodesia.

As I noted earlier, all of these remittances are permissible under the United Nations Resolutions. There exists, however, one other type of remittance which goes from Americans to Rhodesia, namely, remittances in payment of strategic goods imported under the "Byrd Amendment". Since its enactment in 1971, $130.8 million worth of strategic goods have been imported into the United States. A list of the commodities imported under that statute is appended, with the annual value thereof.

On April 6, 1976 the United Nations Security Council, as you know, passed a resolution calling for a ban by member nations on insurance of Rhodesian imports or exports, a ban on insurance of business undertakings in Rhodesia, and a ban on franchising Rhodesians to use trade names, trade marks, and registered designs.

The Treasury has always interpreted the 1968 Security Council Resolution as applying to insurance of Rhodesian imports and exports, and insurance of business activities in Rhodesia which are in any way related to import or export activities. Thus, the United States has banned this type of insurance since 1968, and we welcome the fact that other nations will now be expected to apply the same level of controls as the United States in this area of economic sanctions.

The other portion of the April 6 Security Council Resolution deals with franchises. The United States has not, since the 1968 Resolution, permitted any new franchise contracts to be entered into by Americans with Rhodesian firms. There were in existence in 1968, before the passage of Resolution 253, three franchise agreements related to Rhodesia. Of the three, one was cancelled in July 1974. We have written the other two firms instructing them to cancel their franchise agreements promptly, and we assume there will be no problem in securing full compliance.

In summary, Mr. Chairman, I think it fair to say that the United States has taken effective measures to carry out the United Nations mandatory sanctions since their inception and, with the exception of the imports of strategic goods under the "Byrd Amendment", we are in full compliance with all of the requirements of the sanctions program.

TABLE OF STRATEGIC COMMODITIES IMPORTED FROM SOUTHERN RHODESIA
BETWEEN JANUARY 24, 1972 and APRIL 30, 1976

COMMODITY	1972		1973		1974		1975		1976		TOTAL	
	Weight 1,000#	Value $1,000	Weight 1,000#	Value $1,000	Weight 1,000#	Value $1,000	Weight 1,000#	Value $1,000	Weight 1,000#	Value $1,000	Weight 1,000#	Value $1,000
Asbestos	360	88	31,310	817	2,809	865	4,767	2,364	1,680	594	40,926	4,728
Beryl Ore	54	8					87	1			141	9
Charge Chrome	2,239	253							4,207	1,322	6,446	1,575
Chrome Ore	184,724	2,823	141,043	17,008	160,790	3,116	223,392	3,819	45,813	1,084	755,762	27,850
Copper Cathodes			84	62							84	62
Ferrochrome High Carbon	34,933	2,866	100,017	8,812	56,164	5,177	159,009	20,550			350,122	37,405
Ferrochrome Low Carbon	7,224	1,339	11,873	2,568	12,125	3,044	8,697	5,182	5,519	2,783	45,438	14,916
Ferro Silicon	14,388	1,635	15,884	1,971	9,999	1,829			6,653	1,523	46,924	6,958
Nickel Cathodes	3,471	4,412	8,235	11,427	4,809	7,525	5,266	9,333	2,443	4,520	24,224	37,217
Tantalite Ore							9	31			9	31
Wolfram Ore							26	66			26	66
TOTAL	247,392	13,423	308,446	42,665	246,696	21,556	401,253	41,346	66,315	11,826	1,270,102	130,817

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FOR IMMEDIATE RELEASE May 5, 1976

SECRETARY SIMON TO VISIT LATIN AMERICA

Treasury Secretary William E. Simon will leave for Latin America on May 6 to hold high-level economic and trade discussions with Chile, Brazil and Mexico. He will return to Washington on May 16.

Secretary Simon will meet with President Geisel of Brazil and with President Pinochet of Chile.

Finance Minister Mario Henrique Simonsen will be the Secretary's host in Brazil. The two governments will be seeking ways of expanding trade and investment to the benefit of both countries. In Chile, Secretary Simon will conduct economic discussions with Finance Minister Jorge Cauas and other senior officials. He will also discuss the human rights issue with the Chilean government. In Mexico, the Secretary will attend the initial sessions of the Inter-American Development Bank meeting at Cancun. Simon serves as U.S. Governor of the Bank.

"This visit is part of our efforts to develop closer economic ties between the United States and the nations of Latin America," Simon said. "We believe that the United States must continue to exercise economic leadership and our efforts are aimed at helping the Latin American countries to help themselves. A major ingredient in this effort is the expansion of trade between nations."

The Secretary will be accompanied by Assistant to the President L. William Seidman, Assistant Treasury Secretary Gerald L. Parsky, and other senior U.S. officials.

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REMARKS BY THE HONORABLE GEORGE H. DIXON
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
CALIFORNIA MORTGAGE BANKERS ASSOCIATION
MONTEREY, CALIFORNIA
APRIL 22, 1976

Ladies and Gentlemen:

It is a great privilege to be here in the historic city of Monterey this morning to address such a distinguished audience.

As an Easterner by birth and, in recent years a Mid-westerner by choice, I have not had the opportunity to visit the West one-half as much as I would wish, so it is a genuine pleasure to be among you. Your sun-filled State is one of the most beautiful in our Union. It is also a very large component of our complex national economy. If California was a nation, its gross national product would rank among the top ten in the world. You lead the United States in output of goods and services, and in 1975, you generated over 125 billion dollars in personal income, one-ninth of our nation's total. Those of us at the Department of the Treasury -- and especially at the Internal Revenue Service -- feel very warmly about the great people of the State of California.

I'm sure that each one of you enjoyed as much as I David Heald's enthusiastic opening remarks on the "Sprit of '76." This is indeed a most appropriate theme as we seek in this Bicentennial year to recall, recover and regenerate the unrelenting drive of the men and women whose determination and courage -- whose "spirit" if you will -- gave birth to this great Nation of ours.

Throughout much of the past 200 years, the spectacular development of our nation has been propelled by an idea called "The American Dream." For the founding of America was not just a political event -- the breaking away of some unhappy colonies from what they saw as a shortsighted and selfish mother country -- it was also an act of political philosophy and faith. It was a promise, as Archibald MacLeish put it: A promise to the colonists, to their decendants, and to the world at large that people were capable of governing themselves, that they could live in both freedom and equality, and that given freedom and equality they would conduct their lives and affairs with a spirit of

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individual responsibility, self-reliance, and with reasonable tolerance of the needs and desires of their fellow countrymen.

Over the period of two centuries, steady and by and large unwavering faith and devotion to this simple promise vaulted a handful of insecure and only loosely affiliated New England colonies into the richest and most powerful nation of them all. For two hundred years, we enjoyed unparalleled prosperity and self-confidence, politically and economically, at home and abroad. Our people believed much of the time that we did in fact possess a "manifest destiny."

But then, in the span of only a few short years, some afflictions came along. Initially, we became involved in a prolonged, frustrating and ultimately unsuccessful land war in Asia that in the eyes of many cast doubts on the strength of our international position and caused deep domestic divisions across our land.

Then, just as we began to work out all of those great problems, our Government and people faced a damaging political scandal. Then our economy faltered. We became mired in the worst recession in forty years, and experienced double-digit inflation while too many of us lost our jobs.

As these things happened, each building on the other, we started to lose faith in the American system and in the dreams which it represents. With too much regularity the poll-takers presented empirical evidence of a collapse of confidence in all institutions -- Government, business, religion, the media, education, labor. Many people sensed this decline in public confidence long before the pollsters confirmed it. George Shultz, the former Secretary of the Treasury and now one of your distinguished citizens, summed up the problem pretty well: "We need moorings in our society," he pointed out, but in recent years "we let go of many old moorings before we had new ones to replace them."

If George Shultz is correct -- and I believe that he is -- it seems a worthwhile exercise in this Bicentennial year to attempt to seek out and comprehend the critical lessons of the past few years -- for if we can understand them and learn from them, they can provide a sturdy platform for a renewed set of values, a new set of moorings to serve us. This morning, may I share with you a few brief thoughts concerning one of the great and critical values of our time, that great mooring post -- our free economy -- and the lessons we've learned about the future of the free enterprise system in the United States.

The economic uneasiness of the past three years, inflation, recession, and unemployment may have a silver lining. It is that the American people, you and I, are wiser now about our economy than we were. As a nation, we have a deeper appreciation of fundamental economic concepts and a clearer understanding of the choices we face.

One area of increased understanding is with respect to the realistic limitations of our economy. During the 1960's, you will recall there was a popular belief -- many of us shared it -- eminent people wrote and talked about it, that we had outgrown the business cycle. The Government, it was thought, could simply fine-tune the economy, pulling or pushing on its controls to assure a continuous smooth, ever-upward ride. We would spend our way to a great society, fight a costly war in Asia, and solve many other problems -- all at the same time. Now once again we have learned that the economic cycle is still a powerful reality and that no Government can guarantee smooth sailing and instant happiness, or the entitlements that all of its citizens seek.

We also have a better grasp of the implications of ever-increasing Government spending and Government deficits. Economists agree that Government pump-priming during a slack period can assist economic revival. We now understand, perhaps better than before, that excessive Government stimulus, including the continuation of heavy deficit spending long after it is required, brings with it the risk of overheating, increased inflation and eventually an even more severe contraction in the economy.

Today all Government takes about 80 percent of the funds borrowed in the securities markets, leaving only 20 percent to the private sector, the part which still produces virtually all our goods and services and employs 83 percent of all workers. This massive Governmental presence has been one very important reason for the persistence of high interest rates and the strains we have seen in our financial markets. An even more serious result is that continuing deficits undermine our confidence in our ability to deal with inflation. As mortgage bankers, you are keenly aware of the profound impact that these increased Government borrowings and high interest rates can have on your businesses and the lives of your customers.

Today, we are in the midst of a healthy economic recovery which each day grows stronger, less fragile. To be sustainable the recovery must be broad-based; the credit system must be capable of providing sufficient funds to every sector of the economy -- particularly the ever-critical mortgage market. That is why it is essential that as its momentum builds, the Government plays a less dominant and demanding role in our financial markets.

In the last few years, there has also been a growing awareness of the need for much higher levels of capital investment. So far as I can tell there is now widespread agreement within the business community and even in Washington that in order to create millions of new jobs during the coming decade and to meet other economic goals such as self-sufficiency in energy, we must turn our economic system somewhat away from its heavy emphasis upon consumption and Government spending and toward a greater stress upon private savings and investment. Our presently estimated need for $4-1/2 trillion in new investment in the next decade is formidable by any standard, but it can be done if we remove the shackles that Government has imposed upon the free enterprise system.

Still another recent lesson we have learned is this: Washington does not hold or have the answers to all of our problems. Very often it isn't even asking the right questions. Indeed, Government itself -- in the form of Government spending, Government deficits, Government bureaucracy, and Government regulations -- lies at the core of many of our national problem. Most of us would agree that the Government must serve many beneficial purposes, but we have increasing doubts about its ability to accomplish everything it is attempting to do. In talking about the role of the United States in the world, Arnold Toynbee once said that "America is a large, friendly dog in a very small room. Every time it wags its tail, it knocks over a chair." Much the same can be said about the Federal Government within our economy; and it's time that we get it on a shorter leash.

There is another lesson of recent years that we may not have learned so well and I would like to explore it more deeply with you. It is a lesson that is central to our efforts and critical to our future. Unless we heed it, our struggle to preserve and strengthen the free enterprise system in America might fall short. The lesson is simply this: to restore faith in the American economic system -- the kind of faith that holds the system together -- we must not only make basic changes in the way that Government behaves, but the business community must also undertake a far reaching effort to improve its own house.

Though it is hard for me to grasp and to believe, it appears that our fellow citizens have almost as little faith in business today as they have in Government. You must know that according to the Louis Harris survey, confidence in business has slipped in the last decade from more than two-thirds of the population to less than one-fifth.

This lack of confidence could have a decisive impact on the future of the free enterprise system. History has shown us time and again that the public attitudes of today become the public statutes of tomorrow. Thus, it is entirely possible in coming years that we will see not less Government regulation of business -- as the Ford Administration strongly advocates -- but far more Government regulation. Another recent private poll established that three-quarters of the American people want greater regulation of business: .They want the Federal Government to "regulate major companies, industries and institutions to be sure that they do not take advantage of the public."

Given these circumstances, I would suggest that business leaders who care about the future of free enterprise -- and indeed, of freedom itself -- have an urgent responsibility to set about restoring public trust and confidence in the institutions they run. Many are surely trying.

In meeting this responsibility, businessmen must initiate a far more energetic program of basic public education in the economic as well as the political values of freedom. In the early 1960's, after he had served as Secretary of Commerce, Luther Hodges remarked: "If ignorance paid dividends, most Americans would make a fortune out of what they don't know about economics." I don't say this to be flippant, but rather to point out a fundamental weakness in this country today. Now, far from being a joke, the widespread lack of economic understanding in this nation could destroy our economy, our prosperity, and indeed, our freedom. For our economic freedom and our political freedom are indivisible -- one cannot ultimately survive without the other.

Those who practice free enterprise -- more than anyone else -- should share the responsibility for getting its success story across to the American people. Let us begin by teaching everyone the fundamentals of that "old time economic religion" -- about profits, capital investment, and productivity, and what they have meant to our unique economic system. Over the years, as we know, the United States has created the highest standard of living in the world, the average family income approached $13,000 in 1974; poverty has been sharply reduced, and jobs have been created for over 86 million people. But our task is far from complete. Over the next ten years, if we are to sustain our past accomplishments and our economic competitive strength around the world, it is estimated that we will have to create almost 20 million new jobs as contrasted to the 13 million of the past decade, and invest as much as a trillion dollars to meet our special energy needs. If we are to meet goals of this order of magnitude, the free enterprise ideals and principles that have guided this nation for 200 years will have to be maintained and openly encouraged.

President Ford has urged that we strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our free enterprise system;

-- A balance that favors greater liberty and self-reliance for individual Americans;

-- And a balance that favors greater honesty, genuineness and realism, in dealing with the challenges of our time.

These are great goals worthy of the greatest Nation on earth. We should begin our Bicentennial year by facing into the future with a shared sense of purpose, patience, realistic hope, courage, and common sense.

If we work together, with pride in ourselves and our Nation, the goals we set today can become the first great achievements of America's third century.

Thank you, ladies and gentlemen for the fun being with you today. And may the best of the spirit of Adam Smith be with you.

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Contact: Robert E. Harper
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FOR IMMEDIATE RELEASE MAY 11, 1976

TREASURY SECRETARY SIMON APPOINTS SANDSTROM OF STAUFFER AS VOLUNTEER KANSAS STATE CHAIRMAN FOR SAVINGS BONDS

Newly named Kansas State Chairman for U. S. Savings Bonds is Thad M. Sandstrom, Vice President/Broadcasting, Stauffer Publications, Inc., Topeka. He was appointed to that volunteer post by Secretary of the Treasury William E. Simon, effective April 14. He succeeds L. M. "Mike" Schwartz, President, Citizens State Bank, Paola, who received Treasury's "Award of Merit", highest recognition for volunteer service to the Bond Program, from August 1963 to November 1975.

He began his broadcasting career while a student at Washburn University, Topeka, in 1946, as announcer, salesman and promotion man. He served as General Manager of KSEK, Pittsburg, from 1949 through January 1957, becoming General Manager of WIBW Radio/Television in that year.

Sandstrom was elected to the Board of Directors of Stauffer Publications in 1964. Then, in 1969, he was named Vice President/Broadcasting. Stauffer operates in nine states -- Kansas, Missouri, Oklahoma, Iowa, Texas, Nebraska, Colorado, Michigan and South Dakota. He supervises 10 company broadcast properties, including WIBW-TV-AM-FM, Topeka; KGNC-AM-FM, Amarillo, Tex., and KRNT-KRNQ, Des Moines.

In May of 1975, Sandstrom was selected as "Kansas Broadcaster of the Year" by the Kansas Association of Broadcasters. He had been honored previously with the same title by the University of Kansas, in 1962, and by Kansas State University, in 1970.

He is a two-term Past President of the Kansas Association of Radio Broadcasters, 1960-62. On four different occasions, he testified before Congressional committees. He helped initiate Educational TV in Kansas, and has served four years as a Director of the TV Code Board. He is a four-year Director of the 44-man Board of the National Association of Broadcasters. Other industry activities include Chairman, CBS Radio Affiliates Association, and Vice President, Associated Press Broad-

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casters Association.

Sandstrom has served civic-interest responsibilities importantly as follow -- Past President, Pittsburg Chamber of Commerce, 1956, Greater Topeka Chamber of Commerce, 1967, and Kansas Council on Economic Education, 1964; Commissioner, Kansas Economic Development Commission, 1965-69; Chairman, Coordinating Council for Health Planning in Kansas, appointed by Governor Bennett; President, Better Business Bureau of Topeka; Director, Topeka United Fund, Kansas Council on Economic Education and Junior Achievement.

He conceived the idea for television of the "All-American Futurity", world's richest horse race, on Labor Day, at Ruidoso Downs, New Mexico, produced for annual telecast via a special coast-to-coast network of 180 stations. WIBW Radio is originating station for the Kansas City Royals 56-station network, the only station not located in a major-league city to own the rights to major-league radio broadcasts.

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FOR IMMEDIATE RELEASE May 7, 1976

RESULTS OF OFFERING OF 7-7/8 PERCENT, 10-YEAR TREASURY NOTES

Preliminary figures indicate that approximately 41,000 subscriptions totalling $8.9 billion were received from the public for the offering of $3.5 billion of 7-7/8 percent, 10-year Treasury Notes of Series A-1986.

Due to the substantial response to the offering, the Secretary of the Treasury has exercised his authority to increase the size of the amount of the offering to accommodate all subscriptions accompanied by a 20 percent deposit and a 15 percent allotment on those subscriptions not accompanied by a 20 percent deposit.

Subscriptions for $500,000 or less accompanied by a deposit of 20 percent of the face value of the notes applied for totalled $3.9 billion and will be allotted in full. Subscriptions not accompanied by the 20 percent deposit totaled $5 billion and will be allotted 15 percent.

Approximately $4.7 billion of the notes will be issued to the public. In addition, $0.5 billion of the notes will be allotted to Government accounts and Federal Reserve Banks for their own account.

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FOR IMMEDIATE RELEASE May 7, 1976

TREASURY CLARIFIES POSITION
ON BANK SPONSORED MEMBERSHIP IN BUSINESS CLUBS
WITH MEMBERSHIP NOT OPEN TO WOMEN OR MINORITIES

Today the Treasury Department announced the clarification of its position on the equal employment opportunity enforcement of banks who sponsor employees in business or service clubs whose membership is not open to women or minorities.

Warren F. Brecht, Assistant Secretary (Administration) and Director of Treasury's Equal Opportunity Program, acknowledged the recent opinion of the Solicitor, Department of Labor, which was made at Treasury's request. The Labor Department opinion suggests that such discriminatory practices are detrimental to women and minorities by denying them the same developmental opportunities as their white male counterparts.

In clarifying Treasury's position, Mr. Brecht stated:

"We recognize that the Treasury Department is but one of 16 federal agencies delegated authority by the Labor Department to carry out the enforcement of Executive Order 11246. We realize that banks cannot control the admission standards and policies of the business or service clubs used in entertaining customers or business associates.

"At the same time, Treasury is aware that it is important for the career advancement of women and minority bank officers that they have the opportunity to entertain business contacts at a suitable facility. We are conscious of the importance that when banks sponsor membership in such business or service clubs, such opportunities should be made available to all bank employees of comparable rank without regard to sex, race, religion, or national origin. Yet, we recognize that changes in long-established membership policies are not brought about by attention to just one industry.

"Accordingly, the Secretary of the Treasury has concluded that this issue should be reviewed thoroughly to determine the most effective way of assuring compliance with the Labor

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Department regulations. He further asked that the entire question be addressed not only within Treasury, but with the Labor Department and other responsible agencies, to assure a coordinated approach. We have already begun discussions with the Labor Department. We are advised that Labor is preparing to issue a government-wide policy statement for guidance to all compliance agencies."

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Contact: H.C. Shelley
Extension 2951
May 7, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES REVOCATION OF DUMPING FINDING ON PRIMARY LEAD METAL FROM AUSTRALIA AND CANADA

Assistant Secretary of the Treasury David R. Macdonald announced today a "Notice of Determination to Revoke Dumping Finding," with respect to primary lead metal from Australia and Canada. Notice of this action will appear in the Federal Register of Friday, May 7, 1976.

On February 4, 1975, a petition was received by the Treasury Department requesting revocation of the finding. Since the request for revocation was based primarily upon considerations involving the injury aspect of the antidumping proceedings, the petition was referred to the U.S. International Trade Commission for such review of its injury determination as the Commission deemed appropriate.

On April 21, 1976, the U.S. International Trade Commission advised the Secretary of the Treasury that, "if the finding of dumping were revoked, an industry in the United States would not be or would not be likely to be injured by reason of the importation of primary lead metal from Australia and Canada sold, or likely to be sold, at less than fair value within the meaning of the Antidumping Act, 1921, as amended." Accordingly the Treasury is revoking the finding of dumping. As of April 27, 1976, the date the International Trade Commission's determination was published in the Federal Register, special dumping duties will no longer be assessed on this merchandise from Canada and Australia.

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FOR RELEASE UPON ARRIVAL May 7, 1976

Treasury Secretary William E. Simon made the following statement upon his arrival in Santiago, Chile today.

"I am happy to have this opportunity to visit Chile even though my stay will be a brief one. I am looking forward to the discussions I will be having today with President Pinochet, Finance Minister Cauas and other Chilean Ministers. I expect these talks will be frank and productive, as we seek to develop a common understanding that will enable the United States to develop closer economic relations with Chile.

"The government of Chile has been taking firm economic steps to restore stability and economic growth to the country. The results of these policies and programs are clearly laying the foundation for viable economic development. By removing most of its price, foreign trade and other economic controls, the government has demonstrated its desire for greater economic freedom. As a result, and despite of the massive oil price increase and the deepest global recession the industrial countries have had for 40 years, Chile has been able to double its non-copper exports, increase its agricultural production and resume payment of its foreign debt.

"Nevertheless, we must all recognize that there is an inextricable relationship between our economic freedoms and our personal and social freedoms. One without the other is not sustainable. The important recent economic developments that have taken place in Chile, and our desire to support them, will be handicapped if there is not a clearer understanding of how the Chilean government is ensuring that human rights are respected. The Chilean government has stated that it is committed to ensure the protection of human rights and has been developing practical measures to accomplish this. We will be discussing the concrete results that have been taking place.

"I would like to thank Finance Minister Cauas for his invitation to visit your beautiful country. We welcome this opportunity to discuss with him and his colleagues these very important issues."

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FOR RELEASE: IMMEDIATE May 7, 1976

Washington, D.C. -- A ruling disallowing a foreign tax credit for a share of oil production retained by the Indonesian Government under a production sharing contract with a United States taxpayer was today announced by the Internal Revenue Service.

This ruling will not be applied, however, to amounts claimed as taxes paid or accrued to Indonesia, for taxable years beginning before June 30, 1976, under production sharing contracts entered into before April 8, 1976.

The IRS had announced on April 8, 1976, in News Release IR-1591, that it has taken the position that the share of production retained by the foreign government is in substance a royalty in its entirety, and is not eligible for the foreign tax credit. In addition, the IRS said that no deduction would be allowed for foreign income taxes. The IRS announcement also said that a ruling would be published on this topic.

Revenue Ruling 76-215, attached, will also appear in Internal Revenue Bulletin 1976-23, dated June 7, 1976.

XXX

Attachment

26 CFR 1.901-1: Allowance of credit for taxes.
(Also Sections 164, 903; 1.164-1, 1.903-1.)

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Rev. Rul. 76-215

Advice has been requested whether any portion of, or any amount attributable to, a share of oil production received by an Indonesian Government entity under the circumstances described below is an "income tax" creditable under section 901(b) or section 903 of the Internal Revenue Code of 1954 or deductible under section 164(a)(3).

P is a domestic corporation engaged, with its affiliated companies, in the production, transportation, refining, and marketing of petroleum and petroleum products in the United States and abroad. S is a wholly owned United States subsidiary of P that joins with P in the filing of a Federal income tax return on a consolidated basis. Under the Law of 1971 Regarding State Oil and Natural Gas Mining Enterprises ("Pertamina Law"), all oil located in Indonesia is the property of the Indonesian Government. Pertamina, an Indonesian legal entity, wholly owned by the Government of Indonesia, was formed with the exclusive right to explore, develop, mine, and market Indonesian oil and gas.

Under Article 12 of the Pertamina Law, Pertamina may enter into production sharing contracts with non-government parties for the purpose of performing any of the above functions, provided such contracts conform with government regulations and are approved by the Indonesian President.

S presently holds several production sharing contracts that apply to different geographical regions within the jurisdiction of the Government of Indonesia. S entered into one such contract, a 30 year production sharing contract ("Contract"), with Pertamina in January 1975. The Contract is terminable by Pertamina only if S commits a major breach of the Contract and conclusive evidence of that breach is proved by arbitration or final court decision.

Under the Contract, S is required to: (1) invest in each of the first 6 years of the Contract in exploration operations alone, a minimum amount averaging over 1,000x dollars; (2) pay Pertamina a signature bonus of 1,250x dollars on the signing of the Contract; (3) make various charitable contributions; and (4) pay Pertamina certain production bonuses when production reaches a certain level. In addition, S must pay for all equipment used in its Indonesian operations and all expenses incurred in exploration, development, extraction, production, transportation, and marketing.

(MORE)

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To recover the foregoing expenditures S must look solely to the extraction of oil or gas and the income therefrom. Specifically, S may recover such costs in barrels of oil prior to the division of oil between S and Pertamina, but such recovery may not exceed an amount equal to 40 percent of the value of all barrels of oil produced and saved from the Contract area during the year. With respect to the recovery of costs allowed under the Contract, S may not include as recoverable costs the signature bonus, the production bonuses, and interest on money borrowed for petroleum operations.

S may carry forward and recoup the costs recoverable to the extent such costs, together with the recoverable costs incurred during the subsequent taxable year, do not exceed 40 percent of the value of all barrels of oil produced and saved from the Contract area during that year.

Pertamina and S divide the production that remains after recovery of S's allowable operating costs. The Contract provides that S is "entitled to take and receive" 30 percent of the remaining production and Pertamina is entitled to the other 70 percent of such production. Pertamina is required by Article 14(1)(b) of the Pertamina Law, however, to deposit 60 percent of remaining production in the Indonesian Treasury. Thus, after recovery of operating costs, S receives 30 percent of remaining production and Pertamina and the Indonesian Treasury receive 10 percent and 60 percent, respectively.

The Contract recites that S remains subject to and Pertamina must discharge the following Indonesian taxes of S: all Indonesian income taxes such as the corporate income taxes imposed by the Corporation Tax Ordinance of 1925, as modified ("Corporation Tax"), and income taxes based on income and profits including all dividend, withholding, and other taxes imposed on the distribution of S's income or profits; the transfer tax; certain import and export duties; and exactions in respect of property, capital, net worth, operations, remittances, or transactions including any tax or levy on or in connection with operations performed thereunder by S, its contractors, or subcontractors. In Rev. Rul. 69-388, 1969-2 C.B. 154, it was stated that the Corporation Tax is an income tax.

Under Article 15 of the Pertamina Law the receipt by the Indonesian Treasury of its share of production represents payment of, and relieves Pertamina and S from liability for, all of the foregoing taxes.

The Contract recites that S's annual income for Indonesian tax purposes is: (1) the total "sums" received from disposing of 30 percent of the oil produced from the Contract area during the year after the deduction (recovery) of S's allowable operating costs; plus (2) an amount equal to what S's Corporation Tax would be thereon.

The income under one production sharing contract is computed separately from the income under other production sharing contracts held by S. Thus, a loss under one contract may not be offset against income earned under other contracts.

S acquires title to its share of production at the point of export. S has primary responsibility for marketing the share of production of Pertamina and the Indonesian Government (hereinafter collectively referred to as "the Government"). However, both S and the Government are entitled to take and receive their respective portions of the oil in kind.

Section 901(b) of the Code authorizes qualifying United States taxpayers to claim a foreign tax credit for the amount of any income tax paid or accrued during the taxable year to any foreign country or to any possession of the United States. Section 1.901-2(b) of the Income Tax Regulations provides, in part, that the term foreign country includes any foreign state or political subdivision thereof.

Section 164(a)(3) of the Code provides, in part, that foreign income taxes are allowed as a deduction for the taxable year in which paid or accrued.

Section 903 of the Code provides, in part, that the term "income taxes" as used in section 901 and section 164(a)(3) shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country.

If a payment is in fact made to a foreign government by a taxpayer or on the taxpayer's behalf, then before that payment can be deducted or credited under the above sections, it must first be established that such payment is a tax. If it is in fact a tax, it must then be determined whether such tax qualifies as either an income tax or a tax in lieu of an income tax.

(MORE)

Principles developed under Federal law, not state or foreign interpretations or designations, determine whether an arrangement falls within the meaning of the word "tax" as used in a Federal statute. With respect to section 131 of the Revenue Act of 1928, the predecessor to section 901 of the Code, the Supreme Court of the United States stated in Biddle v. Commissioner, 302 U.S. 573 (1938), 1938-1 C.B. 309 that:

> . . . there is nothing in its language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characteristics and classifications of tax legislation.

The same principle was held applicable to section 164 of the Code in Aaron Dubitzky, 60 T.C. 29 (1973).

In addition, nothing in the legislative history of section 903 of the Code indicates that the word tax as used therein should be measured by different criteria than the word tax under section 901. See S. Rep. No. 1631, 77th Cong., 2nd Sess. 131 (1942).

Under Federal law amounts paid to a government or its agency for the privilege of using or purchasing the government's property or as payment for a special privilege cannot generally qualify as taxes. See, for example Sands v. Manistee River Improvement Co., 123 U.S. 288 (1887); Aaron Dubitzky; Benjamin Mahler, 8 P.H. BTA Mem. 795 (1939), aff'd (on this issue) 119 F. 2d 869 (2d Cir. 1941), and Rev. Rul. 61-152, 1961-2 C.B. 42, which defined tax under section 164 of the Code to exclude a ". . . payment for some special privilege granted or service rendered. . ." by a government. A royalty received by a government would fall within such exclusion.

A mineral royalty is essentially a fixed percentage of production or payment: (1) based on production (whether in cash or in kind), or a share of net profits from production, received by a person with a right to the minerals in place; (2) for permitting another to extract and take those minerals; and (3) payable only from the minerals produced or the proceeds derived from the disposition of those minerals. See Burton Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946), 1946-1 C.B. 237; Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946), 1946-1 C.B. 69; Cox v. United States, 497 F.2d 348 (4th Cir. 1974); Logan Coal & Timber Ass'n v. Helvering, 122 F.2d 848 (3rd Cir. 1941); and United States Steel Corp. v. United States, 270 F. Supp. 253 (S.D.N.Y. 1967).

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The Contract provides but one source of revenue for the Government and that source is the Government's retained share of production. The Government has legal title to all oil located in Indonesia, and must look solely to a percentage of production for compensation for the exhaustion of oil deposits.

Before gross production is divided between the Government and S, S is entitled to recover its annual operating costs (including pre-production costs). However, S may not recover its signature and production bonuses or the interest paid on borrowed money used for petroleum operations. In addition, S may not recover its annual operating costs in excess of 40 percent of the value of all barrels of oil produced and saved from the Contract area during the year.

Without these prohibitions and limitations, S's costs, including interest and bonuses paid, could, in some years, equal the value of all the oil produced and saved from the Contract area during the year. leaving nothing to compensate the Government for the taking of its property. Thus, the effect of the 40 percent limitation and the other prohibitions is to assure that the Government will retain a fixed percentage of oil produced in any year regardless of whether S has any net gain from such production. Such an assured share of production retained by the mineral owner is characteristic of a royalty and not of a tax within the United States concept of the terms.

In addition, the fact that the Government retains separately computed amounts under each production sharing contract assures that the Government will retain its share of production without regard to whether S operates, in Indonesia at a gain or loss. This is consistent with the view that the Government's share of production constitutes a royalty.

Furthermore, the fact that the Government is assured a share of production regardless of whether S realizes income also supports the conclusion that such share of production represents a royalty rather than payment of an income tax. For example, if S did not dispose of its share of production for a particular year, S would realize no income subject to Indonesian tax because, under the Contract, its income is defined as: (1) the amount realized from the disposition of its share of oil produced from the Contract area during the year after the deduction of its allowable operating costs; plus (2) an amount equal to its Corporation Tax thereon. Yet, the Government's share of production would remain the same. This is characteristic of a royalty.

Under the principles discussed above the Government's share of production is a royalty and is, therefore, excluded from S's income. With respect to United States principles of taxation, the terms royalty and tax are mutually exclusive. Because the Government's share of production is a royalty, no portion of such production may be characterized as a tax.

Because all oil located in Indonesia is the property of the Government, and because S's Contract provides in substance for a division of the oil within the Contract area between S and the Government, the Government is merely retaining a share of the oil it already owns. A tax cannot be considered to have been paid by S or on S's behalf to Indonesia from Indonesia's share of production, because Indonesia's share of production was always the property of Indonesia and was not acquired from S. In summary, no tax was paid under the Contract.

Accordingly, no part of the Government's share of production is a tax, and, therefore, no credit may be taken by S under section 901(b) or section 903 of the Code and no deduction may be taken by S under section 164(a)(3).

Pursuant to the authority contained in section 7805(b) of the Code, the instant Revenue Ruling shall not be applied to amounts claimed as taxes paid or accrued to Indonesia, for taxable years beginning before June 30, 1976, under production sharing contracts entered into before April 8, 1976.

Rev. Rul. 69-388 holds that tax paid pursuant to a contract executed under Indonesian Law No. 1 of January 10, 1967, is a tax in lieu of an income tax under section 903 of the Code and is a creditable tax for purposes of the foreign tax credit. To the extent such Revenue Ruling implies that all contracts executed under the authority of Indonesian Law No. 1, of January 10, 1967, result in the imposition of foreign taxes creditable under section 901 and section 903, Rev. Rul. 69-388 is modified to remove that implication.

PARENT BANKS PLEASE CONFIRM TOTAL AMOUNT OF ALLOTMENT SHOWN BELOW FOR THE TREASURY BOND OF 1995-2000 FOR ENTIRE DISTRICT TO HINTGEN, USING CODE WORD SILVER.

DISTRICT	ACCEPTED
BOSTON	$ 8,743,000
NEW YORK	649,878,000
PHILADELPHIA	2,258,000
CLEVELAND	13,582,000
RICHMOND.	20,411,000
ATLANTA	18,083,000
CHICAGO	7,817,000
ST. LOUIS	11,905,000
MINNEAPOLIS	98,000
KANSAS CITY	2,525,000
DALLAS	454,000
SAN FRANCISCO	14,224,000
PUBLIC DEBT	85,000
TOTAL	$750,063,000.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE May 7, 1976

RESULTS OF AUCTION OF 23-3/4 YEAR TREASURY BONDS
AND SUMMARY RESULTS OF MAY REFINANCING

The Treasury has accepted $0.8 billion of the $1.5 billion of tenders received from the public for the 23-3/4 year 7-7/8% bonds auctioned today. The range of accepted competitive bids was as follows:

	Price	Approximate Yield: To First Callable Date	Approximate Yield: To Maturity
High	97.50 1/	8.13%	8.11%
Low	96.36	8.26%	8.22%
Average	96.73	8.22%	8.19%

The $0.8 billion of accepted tenders includes 19% of the amount of bonds bid for at the low price, and $20 million of noncompetitive tenders accepted at the average price.

In addition, $0.1 billion of tenders were accepted at the average price for Government accounts and Federal Reserve Banks.

1/ Excepting 8 tenders totaling $1,001,000

SUMMARY RESULTS OF MAY REFINANCING

Through the sale of the three issues offered in the May refinancing the Treasury raised approximately $3.6 billion of new money and refunded $5.5 billion of securities maturing May 15, 1976. The following table summarizes the results:

	New Issues: 6-1/2% Notes 4/30/78	New Issues: 7-7/8% Notes 5/15/86	New Issues: 7-7/8% Bonds 2/15/95-2000	New Issues: Nonmarketable Special Issues	New Issues: Total	Maturing Securities Held	Net New Money Raised
Public	$2.0	$4.7	$0.8	$ -	$7.5	$4.1	$3.4
Government Accounts and Federal Reserve Banks	0.3	0.5	0.1	0.5	1.4	1.4	-
Foreign Accounts for Cash	0.2	-	-	-	0.2	-	0.2
TOTAL	$2.5	$5.2	$0.9	$0.5	$9.1	$5.5	$3.6

WS-845

Department of the TREASURY NEWS
INGTON, D.C. 20220 TELEPHONE 964-2041

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MEMORANDUM FOR CORRESPONDENTS: May 7, 1976

On Monday, May 3, 1976, Senators Edward M. Kennedy and Floyd K. Haskell released a Library of Congress study on the DISC provisions of the Internal Revenue Code. Attached, for your information, is a letter from Treasury Assistant Secretary Charles M. Walker to Senator Russell B. Long, Chairman of the Senate Finance Committee, transmitting a Treasury Department memorandum contrasting the approaches used by the Congressional Research Service and the Treasury.

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WS-846

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

Dear Mr. Chairman:

On Monday, May 3, 1976, there appeared in the Congressional Record, at S.6323, a joint statement of Senators Kennedy and Haskell releasing a Library of Congress study of the DISC provisions of the Internal Revenue Code. I am deeply concerned with this statement because it accuses the Treasury Department of a "grossly misleading presentation of the economic data on DISC" in its 1974 Annual Report, and impugns the credibility of the Treasury and its professional staff. These accusations have no basis in fact, and do not serve the cause of rational public debate.

The 1974 Annual Report clearly and accurately presents the data which will make possible a rational debate on the merits of the DISC provisions. The major purpose of the Report is to provide data which will enable readers to make their own determinations concerning the merits of DISC. Most of the Report presents statistical tables and background explanation.

Chapter 5 of the Report represents an attempt by the Treasury Department to analyze the impact of DISC on exports and employment. This analysis was made in response to inquiries from members of the Senate and the House. Chapter 5 contains a clear statement that the estimates must be viewed with extreme caution. The statistical procedures are spelled out in the text and tables, and Chapter 5 emphasizes that other statistical methods and assumptions might produce different estimates.

The Congressional Research Service of the Library of Congress has relied on the statistics, the analysis, and the qualifications of the Treasury Report in preparing its own study. The Congressional Research Service employed different methods and assumptions to estimate the impact of DISC on exports. It is therefore not surprising that the Congressional Research Service reached different results than the Treasury. What is surprising is the

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unsupported assertion of the Congressional Research Service that the Treasury estimates "cannot be viewed as a measure of the impact of the DISC provision on the total value of U.S. exports." Even more surprising is the Congressional Research Service's embrace of an estimating approach which, in the Service's own words, depends on "extremely uncertain" parameters.

There is enclosed for your information a Treasury staff memorandum contrasting the approaches used by the Congressional Research Service and the Treasury. The Congressional Research Service analysis relies on the price elasticities approach which, depending upon the assumptions made, can produce a range of estimates of the DISC effect on exports of between zero and $8.5 billion. This range is so large that the estimates can serve little useful purpose in a public debate over DISC. Moreover, as the memorandum points out, the price elasticities approach analyzes the DISC export effect solely in terms of an effect on prices. DISC was never intended to operate by lowering prices. There is no quantitative evidence that DISC has affected export prices. The purpose of DISC is to focus the attention of U.S. firms on exports and to provide a tax deferred source of capital for use in the export business.

The Treasury analysis of the export effect of DISC is based on a careful comparison of the actual export experience of firms with DISCs and firms without DISCs. This approach suggests that DISC stimulated U.S. exports by about $4.6 billion in DISC year 1974, subject to the qualifications stressed in Chapter 5 of the <u>Report</u>. The Congressional Research Service has challenged certain statistical procedures used by the Treasury. While reasonable analysts might differ on some of the procedures, the Treasury believes that its methods are defensible for the reasons explained in the enclosed memorandum.

I believe that a careful reading of the enclosed memorandum will further demonstrate that the repeal or reduction of DISC benefits would adversely affect exports and export-related jobs.

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I am sending a similar letter to Senator Curtis, with copies to Senators Kennedy and Haskell.

Sincerely yours,

Charles M. Walker

Charles M. Walker
Assistant Secretary

The Honorable
Russell B. Long
Chairman,
United States Senate
Washington, D. C. 20510

nclosure

U.S. Treasury Department
Office of International Tax Affairs
May 7, 1976

THE TREASURY REPORT AND THE LIBRARY OF CONGRESS STUDY OF DISC

Senators Kennedy and Haskell recently released a Library of Congress study of DISC.[1/] In their accompanying press release, the Senators accuse the Treasury's 1974 Annual Report[2/] of containing a "grossly misleading presentation of the economic data on DISC". In other ways, the Senators impugn the credibility of the Treasury and its professional staff. These accusations have no basis in fact, and do not serve the cause of rational public debate. The Treasury Department believes that its Report clearly and accurately sets forth the data. The Treasury further believes that its analysis of the export effect of DISC, which was carefully qualified in the Report, is based on a sounder approach than that adopted by the Library of Congress.

When DISC was enacted in 1971, Congress directed the Treasury to prepare an annual report on its operation and

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1/ Library of Congress, Congressional Research Service, The Domestic International Sales Corporation (DISC) Provision and Its Effect on Exports and Unemployment: A Background Report, May 3, 1976.

2/ Department of the Treasury, The Operation and Effect of the Domestic International Sales Corporation Legislation: 1974 Annual Report, April 1976.

effect. In fulfilling this request, the Treasury has prepared three annual reports. The Treasury has devoted more effort to these annual reports than to any other evaluation of a special purpose tax measure. The 1974 Annual Report is a carefully prepared study which represents months of statisticial tabulation and analysis. The Report is authored by experienced international tax economists and lawyers, and it is reviewed throughout the Administration before submission to Congress.

The major purpose of the 1974 Annual Report is to provide data which will enable readers to make their own determinations concerning the merits of DISC. Most of the Report presents statistical tables and background explanation.

Chapter 5 of the Report represents an attempt by the Treasury Department to analyze the impact of DISC on exports and employment. This analysis was made in response to inquiries from members of the Senate and House. Chapter 5 begins by clearly stating the difficulties with estimating the impact of DISC on exports, and carefully sets forth the methodology used so that others may verify or challenge the estimates. Chapter 5 contains a clear statement that the estimates must be viewed with extreme caution. The statistical procedures are spelled out in the text and tables, and Chapter 5 emphasizes that other statistical methods and assumptions might produce different estimates.

The Congressional Research Service of the Library of Congress relied on the statistics, the analysis, and the qualifications of the Treasury Report in preparing its own study. However, the Congressional Research Service employed different methods and assumptions to estimate the impact of DISC on exports. It is not surpising that the Congressional Research Service reached different results than the Treasury. What is surprising is the unsupported assertion of the Congressional Research Service that the Treasury estimates "cannot be viewed as a measure of the impact of the DISC provision on the total value of U.S. exports." Even more surprising is the Congressional Research Service's embrace of an estimating approach which, in the Service's own words, depends on "extremely uncertain" parameters.

The approaches used by the Congressional Research Service and the Treasury may be usefully contrasted.

Congressional Research Service Study

The Congressional Research Service adopts the price

-- Some firms, with full order books, may give priority to export sales.

-- Some firms may use the income accumulated in a DISC both to build U.S. plants for the production of export goods and to extend credit to foreign buyers of U.S. merchandise.

The Congressional Research Service ignores all these possible avenues and proceeds to make a number of implicit and explicit assumptions concerning the workings of the price mechanism in export markets. The Congressional Research Service assumptions result in estimates of the DISC impact on U.S. exports in DISC year 1974 1/ ranging from a "worst case" figure of zero to a "best case" figure of $1.35 billion. The "best case" figure supposedly represents the highest reasonable estimate of the DISC impact within the framework of the elasticities approach. However, the Congressional Research Service "best case" figure of $1.35 billion depends on assumptions about which reasonable analysts could easily differ. It is therefore useful to examine the three most important assumptions embedded in this figure.

1/ DISC year 1974 covers tax returns filed for taxable periods ending between July 1, 1973 and June 30, 1974.

1. Price elasticity. The Congressional Research Service approach begins with estimates of the elasticity of foreign demand for U.S. exports. The elasticity of foreign demand is theoretically calculated as the percentage increase in quantity of U.S. exports demanded divided by the percentage decrease in U.S. export prices. Using the elasticities approach, the estimated DISC effect on exports increases more than proportionately with the size of the elasticity.

An extensive literature has developed on econometric methods for making elasticity estimates, and the variety of estimates is only exceeded by the number of scholars making them. In commenting on empirical estimates of demand elasticities, Professors Caves and Jones, the authors of a well-known textbook on international economics, have this say:

> In proceeding from the theoretical elasticities to real-world measurements, the economist runs into many difficulties, which we can only hint at ... How can the influence of changes in the terms of trade be filtered out when imports are affected by many disturbances, such as changes in employment levels and tariff rates? How does one allow for the varying periods of time people require to adjust their plans and purchases when the relative price of imports changes? Because of these and other problems, economists are reluctant to bet heavily on the predictive accuracy of the elasticities they have estimated. 1/

1/ Richard E. Caves and Ronald W. Jones, World Trade and Payments: An Introduction, 1973, pp. 46-47.

Despite these difficulties, the Congressional Research Service did no original research on the appropriate elasticity value, and instead considered only two "widely quoted" elasticity estimates, a low value of 1.51 and a high value of 2.85. The Congressional Research Service seems unaware that elasticity estimates as high as 5 are also "widely quoted."1/ If the Congressional Research Service had assumed a high elasticity value of 5, it would have obtained a DISC export effect more than twice as large as its "best case" figure of $1.35 billion.

2. Price "passthrough". The Congressional Research Service makes various assumptions about the "passthrough" of DISC tax deferral into lower export prices. Under the elasticities approach, the estimated effect of DISC on exports is directly proportional to the extent of "passthrough". While there is no evidence that DISC has led to a reduction of export prices, the Congressional Research Service states that the maximum "passthrough" figure is 1.7 percent. This figure erroneously understates the maximum "passthrough". Consistent with earning the same after-tax rate of return, U.S. firms could in fact "passthrough" an export price reduction as large as

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1/ Caves and Jones, op. cit., p. 47; United States Senate, Committee on the Budget, DISC: An Evaluation of the Costs and Benefits, November, 1975, p. 210.

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3.3 percent.[1/] If the Congressional Research Service had instead used a 3.3 percent "passthrough" figure, its "best case" estimate of the DISC export effect would have been almost twice as large as the cited $1.35 billion figure.

3. Export base. The Congressional Research Service implicitly assumes that the price "passthrough" will only affect foreign demand for the exports of firms with taxable DISC income. This may not be the case. If all U.S. exports of a certain product type are sold at the same price, it would then be reasonable to assume that the "passthrough" price reduction would lead to an increase in foreign demand for all U.S. exports. Since DISC exports were only about 60 percent of total U.S. exports, the Congressional Research Service assumption as to the appropriate export base significantly understates a "best case" estimate of the possible impact of DISC on U.S. exports.

The large downward biases inherent in the Congressional Research Service "best case" parameters dramatically reduce the "best case" export estimate. Using reasonable "best case" parameters within the framework of its approach, the Congressional Research Service should have reached a "best case"

1/ United States Senate, Committee on the Budget, DISC: An Evaluation of the Costs and Benefits, November, 1975; p. 238.

estimate of the DISC effect of $8.5 billion rather than $1.35 billion for DISC year 1974. The $8.5 billion "best case" figure would be calculated as follows:

	Billions of dollars
Actual total exports in DISC year 1974	$73.2
Estimated total U.S. exports in DISC year 1974 without DISC 1/	64.7
Estimated "best case" DISC effect	$ 8.5

In short, proper application of the Congressional Research Service methodology would lead to estimates of the 1974 DISC year impact ranging between zero in the "worst case" and $8.5 billion in the "best case". Treasury

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1/ The "best case" calculation using the price elasticity approach is as follows:

Actual total exports in DISC year 1974 =

$$\left[\begin{array}{l}\text{Estimated total U.S. exports in}\\ \text{DISC year 1974 without DISC}\end{array}\right] \times \left[\text{One plus} \begin{pmatrix}\text{high elasticity}\\ \text{value minus one}\end{pmatrix} \times \begin{pmatrix}\text{maximum price}\\ \text{"passthrough"}\end{pmatrix}\right]$$

or

$$\$73.2 \text{ billion} = \left[\$64.7 \text{ billion}\right] \times \left[1 + (5-1)(.033)\right]$$

questions the validity of the price elasticities approach for analyzing DISC. Equally important, the Treasury doubts that the Congressional Research Service "worst case" — "best case" approach, which does no more than suggest a range of estimates between zero and $8.5 billion, significantly contributes to the public debate on DISC.

Treasury 1974 Annual Report

In contrast to the Congressional Research Service approach, the Treasury's Report is based on a careful comparison of the actual export experience of firms with DISCs and firms without DISCs. The Treasury approach suggests that DISC stimulated U.S. exports by about $4.6 billion in DISC year 1974. This figure is subject to the qualifications stressed in Chapter 5 of the Report.

The Treasury approach requires close examination of the data and careful procedures. Judgments must be made in carrying out the approach and reasonable analysts could differ on certain statistical questions. The procedures and adjustments adopted are thoroughly spelled out in the text and tables of the Report.

The Congressional Research Service particularly criticized the Treasury Report treatment of product groups in which non-DISC exports apparently grew faster than DISC exports. In these cases, the Treasury Report assumed that the incremental DISC effect was zero, a procedure noted in the relevant tables. The Treasury's procedure was based on careful consideration of timing adjustments, possible reporting errors, and product comparability in the particular groups.

The Congressional Research Service instead favors a mechanical procedure which would lead to a "negative DISC effect" for these product groups. Under the Congressional Research Service procedure, the "negative incremental DISC effect" in DISC year 1973 would be $67 million for grains and soybeans, $691 million for transportation equipment, and $73 million for two other product groups. In DISC year 1974, the "negative incremental DISC effect" would be $51 million for two product groups. Making these adjustments, and corresponding adjustments for year-to-year growth, the Congressional Research Service arrives at a DISC export effect of $3.5 billion for DISC year 1974, by comparison with the Treasury estimate of $4.6 billion.

Appropriate treatment of the apparent "negative DISC effect" is a matter on which reasonable analysts might differ. The Congressional Research Service argues that, theoretically, DISC could lead to a fall in the value of exports, and that these special circumstances must account for the more rapid growth of non-DISC exports. This line of reasoning is subject to question on at least two grounds: first, it ignores the fact that the special circumstances under which DISC could cause a fall in DISC exports relative to non-DISC exports are very unlikely to occur; and second, it ignores the special problems of timing adjustments, possible reporting errors, and product comparability which largely account for the more rapid apparent growth of non-DISC exports. These considerations underlie the Treasury procedure of disregarding a mechanically computed "negative DISC effect" for grains and soybeans, transportation equipment, and other products groups.

Exports of grains and soybeans were growing rapidly and abruptly in 1972 and 1973, with the result that minor timing differences between DISC exports and non-DISC exports could badly distort the comparison. Although careful timing adjustments were made in the Report, the Treasury assumed that the more rapid apparent growth of non-DISC exports in DISC year 1973 reflected, not a DISC effect, but undetected timing differences. 1/

In the case of transportation equipment exports, reporting problems were suspected for certain large returns, but these problems could not be checked in time for the 1974 Annual Report. In addition, the two major components of the product group -- motor vehicles and aircraft -- experienced

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1/ No other product group was nearly as sensitive to timing adjustments.

very different export growth patterns in 1972 and 1973, and these differences in turn can distort the aggregate estimate.

After publication of the Report, further investigation revealed a reporting problem that alters the mechanically calculated estimate for the 1973 DISC effect from a negative figure of $691 million for transportation equipment to a negative figure of $212 million. If, in addition, transportation equipment exports are disaggregated into three groups -- motor vehicles and equipment, aircraft and parts, and other transportation equipment -- the estimated 1973 DISC effect becomes a positive figure of about $180 million for the whole group. In short, the Treasury's original assumption of a zero DISC effect for the transportation equipment group in DISC year 1973 is more reasonable than the negative figure of $691 million mechanically computed by the Congressional Research Service.

Impact of DISC on the U.S. Economy

The Treasury approach indicates that DISC stimulated U.S. exports by about $4.6 billion in DISC year 1974. A very rough extrapolation to calendar year 1976 suggests that the DISC effect may now be $9 billion at an annual rate. Contrary to some claims, these estimates indicate that the repeal or reduction of DISC benefits would adversely affect exports.

While attention has been focused on the export and employment effect of DISC, it should not be forgotten that DISC also works to offset two kinds of distortions present in our trading relations with foreign countries.

Our tariff system reduces U.S. imports of many products and protects domestic industries which compete with these imports. Indirectly, tariff protection also depresses the level of U.S. exports, and penalizes domestic industries which produce export goods. Tariff protection thereby deprives American producers and American consumers of the benefits of full participation in world markets. The DISC works to offset this distortion by increasing U.S. exports.

Secondly, DISC reduces the artificial pressure which the U.S. corporate tax system places on firms to export capital and produce abroad. Without DISC, the high U.S. corporate tax rate would provide an even stronger incentive for U.S. firms to manufacture abroad for the purpose of supplying foreign markets. This artificial tax incentive erodes domestic capital formation. In an limited way, DISC serves as a corrective adjustment, at the border, for our 48 percent corporate income tax.

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FOR IMMEDIATE RELEASE 894

STATEMENT OF WILLIAM M. GOLDSTEIN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
ON H.R. 13500
BEFORE THE WAYS AND MEANS COMMITTEE
MAY 12, 1976, 10:00 a.m.

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss H.R. 13500, which is a bill designed to prescribe the extent to which certain public charities may engage in so-called "lobbying" activities.

BACKGROUND

For some forty years the Internal Revenue Code has granted tax exemption to charitable organizations "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation". This language has created much difficulty for us, as administrators of this provision, as well as for charitable organizations.

First, questions were raised with respect to the definition of the phrase "carrying on propaganda, or otherwise attempting, to influence legislation."

Second, we had to define the term "no substantial part."

As to the phrase "carrying on propaganda, or otherwise attempting to influence legislation," we have interpreted it so as to permit non-partisan research and study of matters that may become the subject of legislation, and the publication of those studies. We have also interpreted it as permitting lobbying with respect to legislation directly affecting the functions and tax-exempt status of charitable organizations. We have interpreted it as permitting attempts to influence administrative decisions as to the application of legislation, and to influence the exercise by administrative officials of discretion given to them by legislation. We have interpreted it to permit litigation in the courts to construe legislation that has been enacted or to construe the provisions of constitutions.

However, we have not been able to extend our interpretation to permit attempts to persuade legislative bodies as to the enactment of legislation, and especially not to permit so-called "grass roots" lobbying to persuade the public to bring influence to bear upon members of legislative bodies to affect their vote. Those activities appear to us to be clearly limited by the Code.

In order to give effect to the term "no substantial part" we have adopted broad rules which essentially exclude from the category of charitable organizations those organizations which seek an activist role in legislative affairs. Such organizations have been required to obtain tax exemption as social welfare organizations under section 501 (c)(4) of the Code, thereby depriving their supporters of the benefits of income tax deductions for contributions.

However, we recognize that our standards may also have precluded non-activist charitable organizations from engaging in legislative activities, even to a nominal extent. That is because of the uncertainty involved in determining in advance whether lobbying activities will exceed permissible levels. Whether an organization's legislative activities are substantial often depends not only upon a measurement of dollars expended to promote the enactment of legislation but also upon the frequency and intensity of the lobbying efforts made, upon the use of non-cash resources such as, for example, the employment of volunteers, and so on.

The penalty for miscalculation is severe; it is outright loss of exemption under section 501(c)(3). Unlike the case of private foundations, the Code does not impose penalty taxes on public charities which engage in excessive lobbying as an intermediate sanction. Thus, even one isolated violation of the rules could disqualify a charity.

ANALYSIS OF THE BILL

H.R. 13500 is designed to provide certainty in the application of the lobbying rules to charities. The bill provides an election for charitable organizations who wish to come under its rules. Churches and their auxiliary organizations and private foundations may not elect.

The new standards measure the substantiability of lobbying activities solely by dollar expenditures. Dollar limits are imposed on a sliding scale which allows proportionately less expenditures for larger organizations than for smaller ones.

The permitted expenditure levels for direct lobbying are 20 percent of the first $500,000 of the organization's total expenditures; 15 percent of the second $500,000; 10 percent of the third $500,000, and 5 percent of any additional expenditures. In addition, there is an overall limit on expenditures of $1,000,000. Furthermore, within the permitted expenditure level, no more than one-quarter of expenditures is permitted for "grass roots" lobbying.

These provisions are so designed that small excessive expenditures in any one year will not result in loss of exemption. Thus, if over any period of four consecutive years the organization does not exceed the permitted amount by more than 50 percent, it will remain exempt. However, the organization will be required to pay a tax of 25 percent on the excess amount.

The bill seeks to spell out with specificity what activities are subject to spending ceilings and what activities are not. The bill also provides rules to prevent avoidance of these limitations. It contains special provisions for dealing with affiliated groups of charities as well as for restrictions on cross-overs from section 501(c)(3) status to section 501(c)(4) status in order to avoid the imposition of penalty taxes.

Finally, the bill provides that these rules should apply for a period of ten years--from 1977 to 1986--so that Congress can evaluate the merits of the new standards after seeing them in operation over a reasonable period of time.

TREASURY POSITION

H.R. 13500 is a product of a number of attempts to reach a compromise among representatives of conflicting interests. It has been designed to provide certainty and predictability to the administration of the lobbying provisions of section 501(c)(3). It provides clear quantitative measures of permissible lobbying activities. It defines with some precision which activities constitute lobbying and which do not. Finally, it enlarges the scope of activities in which charitable organizations can engage.

This last feature of the bill may work a substantive change in the present law fabric of section 501(c)(3). Organizations which under present Treasury regulations are deemed to be "action" organizations and, hence, cannot satisfy the section 501(c)(3) lobbying standards, may now be able to qualify as charities described in section 501(c)(3) and 170(c) and engage in lobbying both at the legislative and the "grass roots" levels.

This liberalization of the lobbying rules, it has been argued, is supportable by the proposition that, where broad issues of social and governmental policies are involved, both business and nonbusiness interests should confront each other before legislative bodies on an equal basis. In this confrontation, tax policy should assume a neutral stance.

Under section 162(e) of the Code, enacted in 1962, business taxpayers are permitted to deduct expenses of appearances before legislative committees, or communications to committees, to individual members of legislative bodies, or to members of business organizations. Thus, business interests can be promoted with tax deductible dollars while so-called "public" interests may not be.

However, it should be noted that business expenses may be deducted only when incurred with respect to legislation that is "of direct interest to the taxpayer" or to "an organization of which [the taxpayer] is a member." Furthermore, they cannot be incurred for "grass roots" lobbying. Under this bill, however, charities are free to lobby on any subject and they may engage in "grass roots" lobbying, subject only to certain dollar limitations.

While it may be argued that this legislation tilts the balance in favor of nonbusiness interests, we believe that, in the aggregate, the changes made by H.R. 13500 are desirable and should be enacted. If, after the ten-year testing period, Congress feels that the balance between business and nonbusiness interests needs to be redressed, it may do so simply by allowing this provision to lapse.

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CONCLUSION

In conclusion, the present law with respect to lobbying by public charities is unsatisfactory. It often deprives legislatures of the views of organizations having substantial expertise and, at times, results in the presentation of only one side of a dispute. H.R. 13500 promotes the balance in the presentation of conflicting views and eases the burdens of administration of section 501(c)(3). For those reasons, Treasury supports enactment of the bill.

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FOR IMMEDIATE RELEASE
FRIDAY, MAY 7, 1976

STATEMENT OF THE SECRETARY OF THE TREASURY
WILLIAM E. SIMON ON HIS VISIT TO CHILE MAY 7, 1976

The discussions I have had today with Finance Minister Cauas and other Chilean ministers have been both informative and promising. In our meetings, we discussed a wide range of economic and financial subjects of interest to our two countries. I was impressed by the resolve of the Chilean Government to take forceful steps to reduce its balance of payments deficits, control domestic inflation and accelerate the rate of growth of the economy. These constitute an impressive list of challenges, but I feel that the Chilean Government has adopted economic policies, such as the removal of most price, exchange and other economic controls, which should greatly enhance the prospects for stability and economic growth. There are already positive signs of improvement. There has been a significant increase in non-copper exports, and a substantial increase in agricultural production. Further, the government has emphasized its desire to meet its responsibilities to its creditors, and this year Chile anticipates repaying over 500 million dollars of foreign debts. These economic developments are most promising, and the United States wants to support these efforts to correct the economic imbalances of the past.

However, increasing restraint is being felt in the United States because of the human rights issue. In order for the United States-Chilean economic and financial relationships to grow and in order for other countries also to support Chile's economic programs, the United States believes that greater understanding has to be reached about what the Chilean Government is doing to ensure that human rights are respected. In our meetings, the Chilean Government described the steps it has taken to ensure the rights of individuals and to prevent abuses and emphasized its firm commitment to these principles.

In this regard, I am pleased to note that in the past few days a number of individuals have been released from prison and given exit decrees. I have attached to my statement a list of the names of these people. In addition, the

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government informed me that it will be announcing shortly amendments to Chile's Constitution and additional measures that will provide further guarantees against human rights violations.

The Government of Chile has agreed to:

1. The Government of Chile will meet shortly with the working group of the United Nations Commission on Human Rights to establish rules of procedure so that a review of the measures underway to ensure human rights can take place in Chile. The desire to have all American countries view what is taking place in Chile was the basis for the government's invitation to the General Assembly of the Organization of American States.

2. The Government of Chile will continue to process the release of persons under the parole program and under other programs, shortly announcing the release of a number of such persons; and, in the future, the momentum of this program will increase.

3. The Government of Chile has and will continue to vigorously prosecute those officials who inflicted abuses on the persons detained in Chile. It informed me of the prosecution and sentencing of a number of such persons.

I think these steps offer significant promise and I have encouraged the government to accelerate the release of individuals and the adoption of necessary legal reforms.

With this in mind, the United States is prepared to work closely with Chile in the months ahead. We are prepared to assist Chile in its efforts to establish economic stability and promote economic prosperity but we can only do so within the framework of a system that ensures personal and political freedom. The elimination of public concern in the United States and elsewhere that will result from this process will pave the way for a dynamic joint effort to move Chile's economic development programs to a new level of achievement.

As this process evolves, we will look toward ways of increasing public and private help. In particular, we will look toward a major program of encouraging United States private investment in Chile through activation of our OPIC investment insurance program, promotion in the United States of the investment opportunities in Chile and through an agreement to avoid double taxation in order to provide the security and stability investors require.

The potential for joint cooperation between our two countries is substantial and I personally intend to make sure that every avenue is fully explored and every effort made to ensure that these opportunities are not neglected. I intend to continue the dialogue we have opened, for I firmly believe that the adoption of giving stronger constitutional guarantees and the release of persons still under detention for political reasons will ensure the development of strong economic ties between the United States and Chile, in support of Chile's development aspirations and for the benefit of both countries.

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Political Prisoners Released by the Chilean Government

Vera Moreno, Rento

Villalobos, David

Canquil Vargas, Bernando

Valanzuela Gonzalez, Mario

Vargas Gudinez, Miguel

Santos Fuentes, Esteban

Orellana Jimenez, Hector

Castillo Montenegro, Rafael

Rivas Velazquez, Juan

Angle Olivares, Norindo

Morales Saavendra, Luis

Leal Solis, Carlos

Gilbero Araya, Segundo

Ulloa Uribe, Conrado

Hernandez Hernandez, Ernesto

Altamirano Lemuy, Ariel

Lizama Alvarez, Juan

Santander Cepeda, Jorge

Jeria Rios, Pablo

Herrera Cid, Carlos

Bernales Olivares, Heriberto

Sanches Martinez, Raul

Biott Vidal, Hernan

Espinoza Donoso, Floridor

(more)

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Garcia Zegarra, Octavio

Ramirez Martinez, Luis

Noriega Ordonez, Cosme

Sanchee Bustos, Alfredo

Villarroel Decerra, Luis

Ibacache Lagos, Jaime

Mela Rossel, Guillermo

Maldonado Maldonado, Tadeo

Lobos Umanzor, Rene

Goncales Parades, Jorge

Maturana Banados, Leonardo

Matta Palet, Jose

Abarca Cisternas, Sergio

Torres Jrojas, Juan

Pena Carreno, Miguel

Donoso Villarroel, Eduardo

Sanhueza Andrade, K Luis

Sepulveda, Andres

Ramirez, Pedro Felipe

Vuskovic, Sergio

Palma, Anibal

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FOR IMMEDIATE RELEASE May 10, 1976

TREASURY CLARIFIES 7-7/8 PERCENT BOND RESULTS

The Treasury clarified today that it has sold $750 million of the 7-7/8 percent bonds of 2/15/95-2000 to the public rather than $800 million as reported in some news stories.

The figure used in the news reports was a misinterpretation of the May 7 Treasury press release.

13-wk		26-wk
4.921	last week	5.339
5,072	To-day	5.426
5.258	High since 3/1/76	
	3/15/76	5.459

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FOR IMMEDIATE RELEASE May 10, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.6 billion of 13-week Treasury bills and for $3.6 billion of 26-week Treasury bills, both series to be issued on May 13, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 12, 1976			26-week bills maturing November 12, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.720 a/	5.064%	5.20%	97.259 b/	5.392%	5.62%
Low	98.715	5.084%	5.22%	97.240	5.430%	5.66%
Average	98.718	5.072%	5.21%	97.242	5.426%	5.66%

a/ Excepting 1 tender of $540,000
b/ Excepting 1 tender of $10,000
Tenders at the low price for the 13-week bills were allotted 4%.
Tenders at the low price for the 26-week bills were allotted 7%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 58,270,000	$ 20,085,000	$ 28,490,000	$ 9,490,000
New York	4,905,335,000	2,383,515,000	5,378,490,000	3,336,825,000
Philadelphia	20,735,000	17,620,000	45,265,000	10,865,000
Cleveland	75,595,000	23,370,000	88,445,000	16,870,000
Richmond	28,155,000	15,655,000	98,120,000	12,620,000
Atlanta	30,885,000	26,010,000	11,180,000	10,180,000
Chicago	238,510,000	33,065,000	469,475,000	28,075,000
St. Louis	46,475,000	20,910,000	64,115,000	31,185,000
Minneapolis	23,550,000	11,550,000	55,690,000	5,040,000
Kansas City	39,625,000	22,330,000	21,420,000	16,320,000
Dallas	38,430,000	13,430,000	22,310,000	12,310,000
San Francisco	231,595,000	13,645,000	235,265,000	111,165,000
TOTALS	$5,737,160,000	$2,601,185,000 c/	$6,518,265,000	$3,600,945,000 d/

c/ Includes $322,970,000 noncompetitive tenders from the public.
d/ Includes $174,955,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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THE DEPARTMENT OF THE TREASURY 1789

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JOINT COMMUNIQUE
OF MARIO HENRIQUE SIMONSEN, MINISTER OF FINANCE OF BRAZIL
AND WILLIAM E. SIMON, SECRETARY OF THE TREASURY
OF THE UNITED STATES
MAY 11, 1976

The Secretary of the Treasury, William E. Simon, concluded today his visit to Brasilia. During his visit, the Secretary met with President Geisel, Finance Minister Simonsen and with Ministers Silveira, Velloso, Paulinelli, Ueki and with the Secretary General for Trade and Commerce, Belotti. Secretary Simon's discussions with Brazilian leaders covered a broad range of economic topics of major interest to the two governments and were marked by a spirit of cordiality.

At the conclusion of their meetings in Brasilia, the Secretary and Minister Simonsen announced a number of specific results which are a practical demonstration of the close ties between the U.S. and Brazil and open significant opportunities for future collaborative efforts of major benefit to the two countries.

Secretary Simon and Minister Simonsen agreed that a resolution of key bilateral trade issues would provide major impetus to an expansion of trade and investment between the U.S. and Brazil and deepen the relationship between them. They agreed, therefore, that this goal should be given their personal and priority attention. After a series of meetings they reached agreement on a number of important measures in achievement of this important goal.

Minister Simonsen announced his Government's intention to adjust export incentives in order to avoid barriers to the increase of Brazilian exports.

With respect to footwear, Minister Simonsen welcomed the recent decision taken by the President of the United States not to increase import barriers on footwear from Brazil. The Minister confirmed that no more export incentives on footwear are being provided than there were in 1974 and that the noted adjustments in the export incentives of Brazil assure that the utilization of tax credits is no higher than in 1973. Secretary Simon welcomed these developments and agreed that the present countervailing duties on footwear would not be reevaluated until the last quarter of next year.

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Minister Simonsen indicated that the Brazilian Government would also adjust its tax credit program on exports of leather handbags. Secretary Simon indicated that this action would enable the United States to waive countervailing duties imposed on imports of leather handbags from Brazil and agreed to take such action effective July 1, 1976.

Minister Simonsen expressed his concern to Secretary Simon over the possibility of trade restrictions against Brazilian exports to the United States because of tax credits granted by the Brazilian Government on exports of soybean oil. He agreed with Secretary Simon on the importance of avoiding such action.

Toward this objective, Minister Simonsen informed Secretary Simon of the Brazilian Government's decision to adjust export incentives on soybean oil exports. As a result of this action, Secretary Simon indicated he did not believe that a complaint by U.S. producers would be filed under Section 301 of the Trade Act and that the issue has been satisfactorily resolved.

Recognizing the importance to relations between the U.S. and Brazil of avoiding disagreements over incentives and countervailing policy, Minister Simonsen and Secretary Simon agreed to consult fully on incentive-countervail issues. As for any U.S. investigations of countervailing complaints concerning Brazilian exports Secretary Simon indicated that the U.S. will consult with the Brazilian Government on all aspects of any such cases.

The Minister and the Secretary also agreed that both Governments should discuss marketing and ways to promote demand and usage of soybeans, soybean meal and soybean oil.

Minister Simonsen and Secretary Simon agreed that the above measures represent a major contribution toward the development of a sound and dynamic trading relationship between the United States and Brazil. They agreed that a hospitable climate for investment and capital flows was also of great importance. In this connection, the Secretary and the Minister agreed on the importance of a treaty between the two countries to avoid double taxation, and agreed that their tax experts should meet in the near future to discuss the provisions that might be incorporated in such a tax treaty.

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Secretary Simon discussed with the Brazilian Ministers Brazil's development plans and prospects, and in particular, capital projects under consideration in Brazil which could be facilitated by U.S. investment. Secretary Simon expressed his belief that U.S. investment in Brazil, which now exceeds over $3 billion, will continue to grow and make a significant contribution to Brazil's development efforts. He agreed to bring key Brazilian projects to the attention of the private sector in the United States.

Secretary Simon noted that the sharp increases in oil prices has shifted the pattern of the world's surplus investment funds. He expressed his belief that this shift has created important opportunities for countries such as Brazil, as it seeks capital to develop a viable rapidly growing industrial/agricultural economy. Secretary Simon and Minister Simonsen agreed on the importance of close collaboration to maximize these opportunities. They agreed to work together to facilitate tripartite investments, joining U.S. and Brazilian enterprises in partnership with the oil-producing countries for productive investments in Brazil, for the benefit of each of the parties. The Secretary and the Minister agreed that the opportunities for bilateral and tripartite investment in Brazil were extensive.

Minister Simonsen explained to Secretary Simon the programs and policies Brazil has undertaken to consolidate its economic accomplishments and to attain internal and external equilibrium for the long-term. The Minister expressed his concern about the existing deficit for Brazil in the trade balance with the United States, and his desire that trade equilibrium be achieved through the increase of Brazilian exports to the U.S. market. Secretary Simon expressed his view that Brazil's economic prospects remained highly favorable. Secretary Simon felt that Brazilian economic policies should be effective in achieving greater price stability and equilibrium in Brazil's balance of payments position, and that these efforts merited the confidence of foreign investors and lending institutions.

During their meetings, Secretary Simon and Minister Simonsen also exchanged views on conditions prevailing in the major foreign exchange markets of the world and on other topics of current interest in the international monetary area. They also discussed the policies and prospects of the international financial institutions.

Secretary Simon and Minister Simonsen agreed on the importance of continuing the dialogue between them on issues of major significance in the economic and financial area.

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Within the framework of the memorandum of understanding signed in Brasilia February 21, 1976, and to underscore the importance of continued consultations and to provide a more formal mechanism in which these discussions can take place, the Ministers agreed to establish and co-chair a consultative group on trade, investment, and financial issues within the area of responsibility of the Department of Treasury and of the Ministry of Finance. The Ministers will designate Co-Executive Secretaries for support of the Consultative Group.

In concluding his visit to Brasilia, Secretary Simon indicated to Minister Simonsen that in his view the measures that he and Minister Simonsen had agreed upon during his visit represented a significant development in the overall relationship between the two countries, heralding the prospect for broader and more intensive ties between the United States and Brazil that would prove of substantial benefit to the two countries. Secretary Simon expressed his government's determination to build on the impressive framework of the current relationship between the U.S. and Brazil and to add to the accomplishments which had resulted from his visit and the visit of Secretary Kissinger earlier this year. Minister Simonsen agreed that the economic relationship between the United States and Brazil had been enhanced as a result of Secretary Simon's visit and expressed his conviction that the measures they have announced today will be of major benefit to both countries.

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FOR RELEASE UPON DELIVERY
May 12, 1976

STATEMENT OF JOHN A. BUSHNELL
ACTING ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE HOUSE SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE
MAY 12, 1976 at 9:30 A.M.

I welcome this opportunity to appear before your Committee this morning in support of S. 3103, which would authorize a U.S. contribution of $50 million to the Asian Development Fund (ADF), the concessionary lending facility of the Asian Development Bank (ADB). It is contemplated that this amount, which has been included in the 1977 budget, would be the first installment of a three-year U.S. contribution to the ADF to be spread over fiscal years 1977-1979.

Before discussing the details of this legislation and the total replenishment proposal, I would like to address briefly the importance of U.S. participation in the international development banks and then provide some specific background material on the Asian Development Bank and Fund.

There are three international development banks of which the U.S. is a donor member. (Final passage is expected imminently of legislation authorizing the United States also to join the African Development Fund.) These banks are part of an international structure in which the developed and developing countries work together to solve problems. By cooperating with other developed countries in funding these institutions we improve the effectiveness of our own efforts.

From the U.S. national point of view, these banks encourage development along lines compatible with our own economy. They stress the role of market forces in the effective allocation of resources and the development of outward-looking trading economies. In working with the international development banks, developing countries are learning to administer large procurement programs effectively and honestly. These programs will result in increased procurement of goods and services in the United States and expanded future markets for our products, thus increasing employment in our country. Our participation in the international development banks will also provide more assured access to essential raw materials, and a better climate for U.S. private investment in the developing world.

Asian Development Bank

The Asian Development Bank, established in 1966, has a current membership of 42 countries which includes the developing nations of Asia, together with the developed countries of Europe, Asia and North America, including the United States. It makes hard loans on near market terms from its Ordinary Capital window and concessional loans from its Special Funds. It has developed, in a few short years, into a respected borrower in international financial markets, and an important provider of financial and technical assistance to the developing countries of the Asian region.

The Bank's ordinary capital lending, with interest rates now at 8.75 percent and terms of 15-25 years, is financed from its subscribed capital stock, the proceeds of borrowings (which are backed by the Bank's callable capital), the sale of participations in its loans, and profit derived from ordinary operations. The United States participated actively in the establishment of the Bank with an initial subscription to the Bank's capital stock of $200 million. In December 1974 the Congress authorized the United States to participate in a first replenishment of capital resources of the Bank in the amount of $361.8 million, to be subscribed in three annual installments of $120.6 million each. The United States subscribed to the first installment in FY 75, bringing U.S. contributions to capital stock to a level of $361.9 million or 11 percent of the total. The second installment of this subscription is included in the FY 76 Foreign Assistance and Related Programs Appropriation Bill. When this contribution is made the United States will have put in $482.5 million, comprising approximately 14 percent of total capital stock contributions to the Bank. The third and last installment has been requested for FY 77.

The ADB has initiated discussions on a second ordinary capital replenishment, but the United States has not yet taken a position on the size or timing of such a replenishment, although it is clear that additional funds are needed relatively soon. From its establishment in 1966 through December 31, 1975, the Bank approved 150 loans from ordinary capital resources for projects in 15 member countries, totaling $1,925 million. The major portion of ordinary capital loans are made to South Korea, the Philippines, Malaysia, Thailand and Indonesia -- countries that have shown strong self-help efforts to achieve economic growth and are of particular importance to the United States.

Asian Development Fund

When the Bank was established it was recognized that it would have to provide financing on concessional terms to meet the needs of its poorest developing member countries. Initially, this was done through a Multi-Purpose Special Fund administered by the ADB. It was a collection of unscheduled bilateral contributions made by donor member countries -- each of whom put varying terms and stipulations on the use of its funds.

In 1973, the ADB's Board of Governors, with United States support, adopted a resolution creating a new multilateral special fund, the Asian Development Fund, to which all contributions would be made and used on the same terms and conditions. Subsequently, agreement was reached among the Bank's developed country members on an initial resource mobilization for the new ADF of $525 million for the three-year period ending December 31, 1975. In March 1972 the Congress authorized a U.S. contribution of $100 million and in December 1974 a further $50 million was authorized. Of this amount, $100 million was appropriated in FY 74 and FY 75, but only one-half of the remaining $50 million ($25 million) is in the FY 76 appropriations bill, as reported by the Conference Committee.

From its inception, through December 31, 1975 the ADF approved concessionary loans totaling $659 million. These loans went to the poorest South Asian and Pacific states with Bangladesh, Pakistan, Burma, and Sri Lanka as principal borrowers. As a matter of practice, India does not borrow from the Bank or Fund. Only Asian countries with 1972 per capita incomes of less than $300 are eligible for concessionary loans, which carry a service charge of 1 percent with maturities of 40 years, including a 10-year grace period on repayments.

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To date the United States has contributed a total of $462 million to the ADB and ADF. This has generated contributions from other member countries to finance $2,584 million worth of projects in the developing countries of Asia -- or 5 times the U. S. investment.

Of total Bank and Fund lending 35 percent has been for public utility projects, 23 percent for agriculture and agro-industry, 22 percent for industry and development banks, 19 percent for transport and communication, and 1 percent for education. Bank and Fund loans serve the same developmental purposes; the only difference is in the terms, depending on the economic status of the borrowing country.

ADF Replenishment

As of December 31, 1975, the ADF had only $40.9 million remaining for new loan commitments in 1976, not including the U.S. FY 76 contribution. At this time the ADF has nearly exhausted its resources available for commitment.

Recognizing the depletion of ADF resources, multilateral replenishment negotiations were begun last year. During these negotiations the U.S. representative stated that he could give no indication of the amount or timing of a U.S. contribution, in part because the United States had not yet completed its contribution to the initial resource mobilization of the ADF, and consultations concerning U.S. participation in a replenishment had not yet been held with Congress. The U.S. representative did indicate that the U.S. continues to be a strong supporter of the ADB and would, in principle, expect to continue contributing to the ADF.

Understanding that the United States was unable to commit itself concerning the specific timing or amount of any U.S. contribution to the replenishment, the ADB Board of Governors, on December 3, 1975, adopted a resolution providing for the replenishment of the ADF resources, and authorizing the ADB to accept contributions to the replenishment from its developed member countries in amounts specified in the resolution, subject to possible later adjustment by the Board of Governors.

The resolution provides for an ADF replenishment in an amount not to exceed $830 million for the 1976-78 period. Despite possible modifications in the total figure, the ADF expects to raise resources sufficient to increase its 1976-78 commitment total substantially above the $456 million level of 1973-75, in order to increase its level of lending modestly in real terms despite the rapid worldwide inflation.

Most donor countries agreed to contributions equal to approximately 150 percent of their initial contributions. The Bank's resolution on the ADF permits members to suggest adjustments in their contribution levels. Last month the deadline for making such changes was extended to June 30. Canada has already indicated that it wishes to increase its contribution from $42.4 million to $76.4 million. The participation of Sweden and France is uncertain.

The Japanese have indicated they would provide one-third of the total contributions. Should the total be moderately less than the $830 million in the resolution we would hope Japan and other donors would not reduce the contribution amounts shown in Table I. However, for such reductions to be avoided the United States must show its firm commitment to the replenishment.

As no decision had yet been made on the total U.S. contribution to be requested for the ADF replenishment, the United States reserved its position on the $231 million proposed in the resolution for the U.S. share while commenting that such an amount seemed large. We formally abstained on the resolution. After reviewing carefully the financial needs of the Asian Development Bank and the burdensharing aspects of supporting a fund of major importance to the United States, the Administration believes that a three-year U.S. contribution in an amount substantially smaller than the Bank's suggested U.S. share of $231 million would be appropriate.

Pending final determination of the total three-year U.S. contribution level, we requested authorization of an initial U.S. contribution of $50 million for FY 77 which would represent the first installment of the replenishment. Authorizing legislation for this $50 million passed the Senate on May 6. This amount represents the same level appropriated in FY 74 and FY 75 and requested in FY 76. Since contributions by other countries beyond the first year of the replenishment are contingent upon U.S. participation, a U.S. commitment, as provided in the proposed $50 million authorization, is essential for the successful implementation of the total ADF replenishment package. Authorization for the remaining two installments will be requested in the near future.

I urge your prompt consideration of this legislation given the time limitations for authorizations and appropriations imposed by the Budget Reform Act. A firm indication of a U.S. commitment to the Asian Development Fund is essential for the successful implementation of the replenishment. Asian countries will be contributing over $300 million to the replenishment and European donors have agreed to contribute nearly $200 million. However, the linchpin to this replenishment and the ADF itself is the United States.

The ADB -- now in existence nearly 10 years -- has developed into an important economic development institution for Asia. It brings special expertise and local knowledge to the development problems of the region. The Bank's growing impact on Asian economic progress is reflected in its recent activities. For example, it has substantially increased lending for agriculture in light of the world food crisis; it has given greater emphasis to the use of intermediate technology, thus encouraging cost effective project development; and it has mobilized supplementary sources of financing, including OPEC country resources.

By continuing our support for this institution, through this legislation on ADF replenishment, we will indicate to Asia and the world our determination to play a progressive and peaceful role in the Asian region, befitting our responsibilities and interests as a Pacific power.

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Suggested Contributions to ADF Replenishment
Contained in Board of Governors' Resolution

Member	US $ Millions
Australia	41.6
Austria	6.9
Belgium	7.3
Canada	42.4 1/
Denmark	6.6
Finland	5.8
France	42.4 1/
Germany	53.1
Italy	30.8
Japan	272.6
Netherlands	12.9
New Zealand	9.2
Norway	6.1
Sweden	10.6 1/
Switzerland	8.3
United Kingdom	42.4
United States	231.0
Total	830.0

1/ Subsequent to the replenishment proposal Canada increased its proposed contribution to $76.4 million; participation by France and Sweden is uncertain.

Table II

Current Contributions to ADF/SF
(millions of dollars)

Country	Amount	Percent
Australia	$ 33.7	5.4
Belgium	6.9	1.1
Canada	35.9	5.7
Denmark	6.2	1.0
Finland	3.6	.6
Germany, Fed. Rep.	56.5	9.0
Italy	1.5	.2
Japan	314.8	50.1
Netherlands	17.2	2.7
New Zealand	5.1	.8
Norway	3.9	.6
Switzerland	7.6	1.2
United Kingdom	35.6	5.7
United States	100.0	15.9
Total	628.5	100.0
OC Set Aside	+57.4	
SF Net Income and other credits	6.0	
Total ADF/SF Resources	691.9	

Table III

Subscriptions to
Asian Development Bank Ordinary Capital and Asian Development Fund
U.S. and Other Donors

(in current U.S. dollars)

ADB-OC

	Original Resource Mobilization ($ millions)	(Percent)	Replenishment (as of Dec. 31, 1975) ($ millions)	(Percent)
U.S.	241	19.9	362 1/	16.2
Other Donors	551	45.5	901	40.4
Borrowing Members	420	34.6	968	43.4
TOTAL	1212	100.0	2231	100.0

ADF

	Original Resource Mobilization ($ millions)	(Percent)
U.S.	150 2/	28.6
Other Donors	375	71.4
TOTAL	525 3/	100.0

1/ Amount authorized. The U.S. subscription to the replenishment as of December 31, 1975 is $121 million. A further $121 million is included in the FY 76 appropriations legislation. If appropriated this subscription will increase the U.S. share of ordinary capital to 14.5 percent, from the present level of 11.3 percent. The appropriation of the third $121 million will raise the U.S. share to 17.5 percent.

2/ A U.S. contribution of $150 million has been authorized of which $100 million has been contributed. Subsequently other countries have increased their contributions to the ADF to $486 million. So if the final $50 million of the U.S. contribution, of which $25 million is in the FY 76 appropriations legislation, is appropriated the U.S. share of the replenishment will drop to 23.6 percent.

3/ Excludes transfers of $57.4 million from Multi-Purpose Special Funds.

ASIAN DEVELOPMENT BANK
Subscriptions to Capital Stock and Voting Power
31 December 1975 (millions of dollars)

TABLE IV

MEMBERS REGIONAL	SUBSCRIBED CAPITAL	PERCENT OF CAPITAL	PERCENT OF VOTES
Afghanistan	$ 14,4	0,450	0.848
Australia	256,3	8,007	6.894
Bangladesh	45,2	1,413	1,618
Burma	24,1	0,754	1.091
Cambodia	10,6	0.330	0.751
China, Republic of	48,3	1,507	1.693
Fiji	3,0	0,094	0.563
Gilbert Islands	,2	0,006	0,492
Hong Kong	24.1	0,754	1,091
India	280.5	8,761	7,496
Indonesia	241.3	7,536	6.517
Japan	603,2	18,840	15,560
Korea, Republic of	223,2	6,971	6.065
Laos	1,3	0,040	0.519
Malaysia	120,6	3,768	3,502
Nepal	6,5	0,204	0.650
New Zealand	68,0	2,125	2.188
Pakistan	96,5	3,014	2.899
Papua New Guinea	4,2	0,130	0.592
Philippines	105.6	3.297	3.125
Singapore	15,1	0,471	0,865
Solomon Islands	,3	0,009	0.495
South Vietnam	36,1	1,130	1.392
Sri Lanka	25,7	0,803	1,130
Thailand	60,3	1,884	1,995
Tonga	,2	0,006	0,492
Western Samoa	,I	0,002	0,490
Total Regional	2,314.9	72,306	71.013

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TABLE IV Cont'd

ASIAN DEVELOPMENT BANK
Subscriptions to Capital Stock and Voting Power
31 December 1975 (millions of dollars)

	SUBSCRIBED CAPITAL	PERCENT OF CAPITAL	PERCENT OF VOTES
NON-REGIONAL			
Austria	15.0	0.471	0.865
Belgium	15.0	0.471	0.865
Canada	75.4	2.355	2.372
Denmark	15.1	0.471	0.865
Finland	6.0	0.188	0.638
France	75.4	2.355	2.372
Germany, Fed. Rep. of	102.5	3.203	3.050
Italy	60.3	1.884	1.995
Netherlands	33.2	1.036	1.317
Norway	15.1	0.471	0.865
Sweden	6.0	0.188	0.638
Switzerland	15.1	0.471	0.865
United Kingdom	90.5	2.826	2.749
United States	361.9	11.304	9.531
Total Non-Regional	886.7	27.694	28.987
GRAND TOTAL	3,201.5	100.000	100.000

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Asian Development Banks
Summary of Loans by Country
December 31, 1975

(millions of dollars)

Country	Ordinary Capital	ADF/ Special Funds	Total	Percent
Afganistan	-	34.0	34.0	1.3
Bangladesh	11.4	125.4	136.8	5.3
Burma	6.6	60.2	66.8	2.6
China, Rep.	100.4	-	100.4	3.9
Fiji	6.7	-	6.7	0.3
Hong Kong	41.5	-	41.5	1.6
Indonesia	153.9	113.3	267.2	10.3
Khmer Rep.	-	1.7	1.7	0.1
Korea	433.6	3.7	437.3	16.9
Laos	-	11.7	11.7	0.5
Malaysia	248.5	3.3	251.8	9.7
Nepal	2.0	55.5	57.5	2.2
Pakistan	235.2	100.0	335.2	13.0
Papua New Guinea	-	14.3	14.3	0.6
Philippines	332.7	15.3	348.0	13.5
Singapore	101.4	3.0	104.4	4.0
Sri Lanka	14.1	56.7	70.8	2.7
Thailand	233.2	8.1	241.3	9.3
Tonga	-	1.3	1.3	0.1
Vietnam, Rep.	3.9	40.7	44.6	1.7
Western Samoa	-	10.6	10.6	0.4
Total	1,924.7	658.8	2,583.5	100.0

Table VI

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ADB/ADF
Summary of Loans Approved By Country and Sector as of December 31, 1975

(millions of dollars)

	Outstanding Including Undisbursed	Repayments
Ordinary Capital	$ 1,924.7	$ 48.7
Special Funds/ADF	658.8	1.0

By Economic Sector:	Cumulative Percent	1975 Percent
Agriculture and Agro-Industry	22.8	37.2
Education	1.1	2.2
Industry and Development Banks	22.0	19.5
Public Utilities	35.1	28.7
Transport and Communication	19.0	12.4

By Country:	Cumulative	1975
Korea	16.9	15.4
Philippines	13.5	16.0
Pakistan	13.0	14.7
Indonesia	10.3	11.8
Malaysia	9.7	7.2
Thailand	9.3	11.8
Others	27.3	23.1

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 4:00 P.M. May 11, 1976

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,000,000,000 , or thereabouts, to be issued May 20, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,500,000,000, or thereabouts, representing an additional amount of bills dated February 19, 1976, and to mature August 19, 1976 (CUSIP No. 912793 A5 5), originally issued in the amount of $3,603,990,000, the additional and original bills to be freely interchangeable.

182-day bills, for $3,500,000,000, or thereabouts, to be dated May 20, 1976, and to mature November 18, 1976 (CUSIP No. 912793 C2 0).

The bills will be issued for cash and in exchange for Treasury bills maturing May 20, 1976, outstanding in the amount of $6,210,140,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,016,015,000. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Monday, May 17, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on May 20, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing May 20, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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Department of the TREASURY NEWS
INGTON, D.C. 20220 TELEPHONE 964-2041

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Contact: D. Cameron
Extension 8257
May 12, 1975

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES PRELIMINARY
AFFIRMATIVE COUNTERVAILING DUTY DETERMINATION ON
VITAMIN K FROM SPAIN

Assistant Secretary of the Treasury David R. Macdonald announced today the issuance of a preliminary determination that bounties or grants are being paid or bestowed on imports of Vitamin K from Spain within the meaning of the Countervailing Duty Law (19 U.S.C. 1303). A notice to this effect will be published in the Federal Register of May 13, 1976.

Interested parties will be given an opportunity to submit written views before the Commissioner of Customs in time to be received no later than 30 days from the date of publication of this notice. As required under the Countervailing Duty Law, a final determination will be issued in the Federal Register by no later than November 10, 1976.

Treasury's preliminary affirmative determination indicates that bounties or grants are being paid or bestowed within the meaning of the statute in the form of an overrebate of indirect taxes under the Desgravacion Fiscal and preferential financing. If a final affirmative determination is made, the Countervailing Duty Law requires the Secretary of the Treasury to assess an additional duty on merchandise benefiting from such bounties or grants.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
BRAZIL-U.S. CHAMBER OF COMMERCE
SAO PAULO, BRAZIL
WEDNESDAY, MAY 12, 1976

I am delighted to have an opportunity to address this distinguished group and to share with you some of my thoughts about the future of U.S.-Brazilian economic relations. Our two nations now have an unprecedented opportunity to accomplish much together. Brazil has assumed a new role in world affairs, building on the country's great history and even greater promise. I have come to Brazil to offer my country's commitment to strengthen economic ties with Brazil and I believe that during the last two days my good friend Mario Simonsen and I have given added meaning, strength and permanence to our relationship.

The recent record of Brazilian economic development represents a model which has attracted worldwide admiration. Rapid growth rates have been achieved by adherence to market-oriented economic policies, a recognition of the importance of the private sector in development plans, and increased participation in the world economy through expanded trade and the creation of a favorable climate for foreign investment. At the same time, the rate of inflation was reduced from nearly 100 percent annually in 1964 to 15 percent by 1973. Much of the credit for this successful attack on inflation can be attributed to the sound fiscal policies pursued by the Brazilian government, which succeeded in converting previously large annual budgetary deficits into modest surpluses. Even though there has been an increase since 1973, clearly Brazil has adopted the proper policies that are designed to reduce the rate of inflation and work toward structural equilibrium in its balance of payments.

Most oil-consuming nations are now going through a painful transition during which they must adjust to the adverse impact of sharp increases in the price of imported petroleum. Brazil was especially hard-hit by the higher costs of oil due to its relatively large dependence on external oil sources. The effects of the resulting four-fold increase in annual oil

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import costs to a total of $3.0 billion made the task of Brazil's policy makers much more difficult. Reconciling the desire for continued rapid expansion of the domestic economy with the need to establish better balance in the external sector has not been easy. The recent policy measures recommended by Mario Simonsen and taken by the Brazilian government demonstrate determination to take the tough steps necessary in order to achieve greater price stability and balance of payment adjustment. I believe that these measures as they are implemented will merit the continued confidence of foreign investors and lending institutions in the soundness of Brazil's development policies.

Most importantly, Brazil's long-term economic prospects should be highly favorable. The United States will continue to do its part to cooperate in Brazil's progress toward becoming a major world industrial power. However, the means of providing support for Brazilian development efforts have undergone a changed emphasis, reflecting Brazil's recent transformation from a nation still in the early stages of development to a country on the threshhold of advanced country status. From the end of World War II until the late 1960s, the chief instrument of U.S. cooperation in Brazilian development was our bilateral assistance program. Over the past 30 years this aid amounted to about $3 billion making the program in Brazil one of our largest anywhere in the world.

Our aid provided concessional foreign exchange resources to overcome particular hurdles in the development process in Brazil, including the creation of a sound financial infrastructure. By laying this groundwork in cooperation with thousands of Brazilian technicians and policy officials our aid program in some measure helped prepare the way for the impressive growth Brazil achieved in the late 1960s and the early 1970s. That growth has now been an on-going process for nearly a decade. During that short time Brazil has created entire new export industries running the gamut from soybeans to sophisticated capital and transport equipment. Per capita annual income has tripled to nearly $900. The road system and electric power networks have been extended throughout Brazil. Industrialization and organization have proceeded to the point where Brazil now experiences some of the same social and economic challenges of industrialization experienced by countries where industrialization commenced earlier.

It is these challenges that have brought forth a changed emphasis in U.S.-Brazilian cooperation. In effect, the rapid evolution in Brazil's development prospects has signaled the attainment of our aid-related objectives. Brazil has now reached the stage of development in which it has outgrown dependence on concessional development aid. The large flows of aid we had annually directed to Brazil are now needed more urgently by poorer countries where the level of economic development is far lower than Brazil's. We have also supported assistance to Brazil from the international financial institutions such as the World Bank and the Inter-American Development Bank. Loans to Brazil from these two institutions have totaled $4.5 billion. Further, the United States Export-Import Bank has provided more financing for projects in Brazil than in any other country. Currently Ex-Im Bank has $2.4 billion of commitments outstanding. We will continue such support. However, where exactly should we focus our attention in order to achieve the maximum favorable impact from our cooperative efforts? Our two countries will find new avenues of bilateral cooperation where joint benefit and mutual strength guide our choices.

After reviewing the number of impressive economic and social targets established in Brazil's second development plan, I propose that the new era in our bilateral relationship ought to take as a starting point the issue of how the resources and technology of the U.S. can be utilized most effectively to promote the achievement of Brazil's development objectives. Clearly, enormous financial resources will be required (more than $100 billion, I understand, just between now and 1980). Much of this undoubtedly will come out of domestic savings, but the external sector through expanded trade and greater investment also has a role to play. In both of these areas the U.S. offers Brazil unique opportunities.

First, the U.S. is Brazil's largest and most dynamic market. Brazilian exports to the U.S. increased at the rate of 30 percent annually over the 1970-74 period, reaching $1.7 billion in the latter year. The U.S. share of total 1974 Brazilian exports was about 21 percent. Although agricultural commodities still comprise the largest category of our imports from Brazil, the U.S. has also been one of Brazil's best markets for manufactured exports. In 1974, 29 percent of Brazil's exports to the U.S. were manufactured goods, up from only 7 percent in 1968. Nor should the growing diversification in U.S. imports of agricultural commodities from Brazil be overlooked. In 1968 coffee represented two-thirds of the proceeds from this category, compared to only 13 percent in 1974. Other Brazilian exports to the U.S. which have rapidly expanded include chemicals, iron ore and transport equipment. There was a slight decline in Brazilian exports to the United States last year, in large part due to the U.S. recession.

As our recovery accelerates, we expect Brazilian exports to the United States to resume their upward trend. Although I know both the U.S. and Brazilian government share the same basic philosophy of a free and open world trading and investment order, there are sometimes differences on particular trade issues.

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Recently there has been a great deal of discussion here about the current future direction of U.S. trade policy towards Brazil and the world. There have been charges that the U.S. is drifting towards a policy of protectionism.

Let me assure you that this is not the case. As cause for their concern, critics have cited the recent determinations of the International Trade Commission in favor of import relief for a few specific U.S. industries and, in particular, the increased number of countervailing and antidumping investigations by the United States. As to countervailing duties and antidumping investigatons, let me state first of all that these proceedings are authorized by international agreement; that is to say by the General Agreement on Tariffs and Trade. Industries in all countries have the right to be free from injurious international dumping of marginal or excess production. They also have the right not to be required to compete against government-subsidized imports. Our antidumping and countervailing duty laws are designed to implement those rights. Complaints of unreasonable or unjustified trade practices under Section 301 of the Trade Act of 1974 are designed principally to remedy artificial trade distortions and barriers in connection with our exports to third countries.

On a more practical level, I believe that equitable administration of laws pertaining to unfair trade practices actually assist the United States and other countries in reducing generalized barriers to trade. Unless we in the Administration can convince Congress and domestic interests that the U.S. intends to provide remedies against unfair trade practices, it will be impossible to develop the necessary support for generalized trade liberalization. In other words, we see no inconsistency between free trade and fair trade and the assurance of the latter is what enables us to progress in achieving the former. Believe me, it is hard to convince Congress that we should cut tariffs across the board if we just stand by while those same imports benefit from government subsidies. Moreover, we do not believe that artificial export subsidies are in Brazil's best interests.

First, they distort market forces and interfere with the allocation of capital where it will be most productive. Second, they are an expensive use of scarce government resources, because even when not countervailed they transfer resources from Brazil to its trading partner.

Finally, they have the effect of unilaterally negating another country's tariff rate and therefore tempt that country to raise its tariff rate or to seek other protection through quotas or other non-tariff trade barriers. The most effective way to ensure that trade between countries such as ours can flourish is through agreement in the multilateral trade negotiations on fair practices in the subsidy in countervailing duty areas. We have put forward positive proposals and I can assure you that we will make every effort to achieve such an agreement.

As I said, the United States remains committed to a free and open world trading and investment order. That means that we are committed to keeping American markets open to Brazil's exports. We believe that this is the most useful step we can take toward meeting Brazil's development needs. In this regard President Ford's recent decision not to impose special barriers to imports of footwear was a strong reaffirmation of our policy of liberal market access to Brazilian exports. I believe that Brazil's export prospects in the U.S. will be brighter than ever now that the U.S. economy is entering its second year of a vigorous, healthy and balanced expansion.

The performance of the U.S. economy during the first quarter of '76 was especially encouraging. The real output of goods and services increased at an annual rate of 7.5 percent significant progress in reducing inflation has continued, and employment has risen rapidly. This continued expansion has stimulated new orders for inventories and capital goods which in turn increases the demand for imports. The latest import figures show that the demand for foreign goods has already accelerated. We expect the U.S. current account position will shift by more than $15 billion from '75 to '76, reflecting this resurgence in U.S. imports. This bodes well for a country like Brazil whose competitiveness in U.S. markets is already well known.

The second major source of U.S.-Brazilian cooperation is in the area of U.S. private investment. U.S. investors account for over one-third of total foreign investment in Brazil, by far the largest sum of any country. Total U.S. direct investment in Brazil quadrupled in the eight-year period from '66 to '74. In fact Brazil is now the seventh largest recipient of U.S. investment among all countries in the world. In terms of complimentary technology, U.S. capital has provided Brazil with significant support for its most technologically sophisticated industries. These figures, however, do not provide the complete story about the role of U.S. investment in Brazil's development. U.S.firms in Brazile provide significant employment opportunities and have substantial export capacity. These important factors underline the mutually advantageous character of American private investment in Brazil and they suggest how increased U.S. investment can be expected to strengthen Brazilian effort to meet specific employment and strengthen balance of payments needs. U,S. financial institutions have also shown the support and confidence in the soundness of Brazil's future development and have provided substantial financial resources.

To me this is not surprising. It is but one more example of how the pursuit of sound economic policies will attract U.S. investors eager to channel large-scale outside resources into the local development efforts, when there is solid economic progress, security and a favorable rate of return. They realize that a well-managed economy represents the best possible place for the investment of their capital.

For the future, American capital and technology can make major contributions to the advancement of all these sectors. During the last two days Mario Simonsen and the other economic ministers described to me an impressive program for the industrial and agricultural development of Brazil. They outline to me their plans to achieve self-sufficiency in a broad range of industries such as pulp paper, fertilizers, steel products and petrochemicals. They also described the prospects for development of the country's natural resources, especially through a substantial increase in hydroelectric capacity and oil production.

I am bringing back to the United States a number of projects in these areas and will be alerting the U.S. private sector about these significant opportunities. Let us hope that leaders in the developing countries can learn the very important lesson from the Brazilian experience that what is needed to speed up the pace of economic development around the world is less rhetoric that focuses solely on what governments might do to increase foreign aid. The United States is committed to help the developing countries to help themselves. However, the only permanent solution to the problem is to adopt domestic economic policies that will allow the creative and productive forces of the private sector to expand freely. Policy makers in every country should be devoting far greater attention than at present to the implementation of long-delayed internal reforms such as disciplined fiscal budgeting, maintenance of market-oriented interest and exchange rates, adoption of more suitable monetary policies and greater emphasis on facilitating the private sector's contribution to development. The objective should be to create afriendly climate that will attract investments rather than a hostile environment dominated by excessive taxation, nationalization or cartelization.

Brazil has enjoyed an enviable record of dynamic development for a number of years. As a nation with a rapidly developing economy, it offers one of the most outstanding examples of what an economy when unfettered by excessive governmental interference is able to accomplish in a short time. We believe that only a free and open economy can mobilize the creative energies of an entire nation and galvanize a people for the upward struggle for achievement of a better standard of human existence.

We in the United States want to join with Brazil as it seeks economic prosperity for its people. The purpose of my visit was to expand the horizons of economic cooperation between our two countries. Yesterday we announced significant steps toward this goal by removing impediments to expansion of Brazilian exports, by eliminating barriers to trade, by agreeing on steps to facilitate increased U.S. investment in Brazil and by establishing a mechanism of regular consultation between our finance ministries. Progress is never automatic, but as President Geisel said to me, let us walk down the path of the future together. All great achievements begin as dreams. With realism and the will to work together we can transform our dreams into plans and those plans into practical realities -- for our two countries and for all mankind.

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Contact: L.F.Potts
Extension 2951
May 13, 1976

FOR IMMEDIATE RELEASE

ANTIDUMPING INVESTIGATION INITIATED ON
MONOSODIUM GLUTAMATE FROM KOREA

Assistant Secretary David R. Macdonald announced today the initiation of an antidumping investigation on imports of monosodium glutamate from Korea.

Notice of this action will be published in the Federal Register of May 14, 1976.

The Treasury Department's announcement followed a summary investigation conducted by the U.S. Customs Service after receipt of a petition alleging that dumping was occurring in the United States. The information received tends to indicate that the prices of the merchandise to unrelated U.S. purchasers are less than the prices of such or similar merchandise sold in the home market.

Mr. Macdonald further announced that on May 11, 1976, the case had been referred to the U.S. International Trade Commission for a preliminary injury investigation. The Trade Act of 1974 provides for an I.T.C. preliminary investigation of injury at the initiation stage when there is substantial doubt that injury under the Act exists. If the I.T.C., within 30 days from the date of receipt of this referral, determines and advises the Secretary that there is no reasonable indication that an industry in the United States is being or is likely to be injured, or is prevented from being established, Treasury's investigation would be terminated and no further proceedings would be conducted.

Imports of the subject merchandise from Korea during calendar year 1975 were valued at roughly $830,000.

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WS-855

Department of the TREASURY NEWS
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Contact: D. Cameron
Extension 2951
May 13, 1976

FOR IMMEDIATE RELEASE

ANTIDUMPING INVESTIGATION INITIATED ON
PRESSURE SENSITIVE TAPE FROM ITALY

The Treasury Department announced today the initiation of an antidumping investigation on imports of pressure sensitive tape from Italy.

Notice of this action will be published in the Federal Register of May 14, 1976.

The Treasury Department's announcement followed a summary investigation conducted by the U.S. Customs Service after receipt of a petition alleging that dumping was occurring in the United States. The information received tends to indicate that the prices of the merchandise to unrelated U.S. purchasers are less than the prices of such or similar merchandise sold in the home market.

Imports of pressure sensitive tape from Italy in 1975 were valued at approximately $2.5 million.

* * *

WS-856

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 4:00 P.M. May 13, 1976

TREASURY ANNOUNCES SALE OF 2-YEAR NOTES AND 52-WEEK BILLS

The Department of the Treasury announced today that it will sell to the public $2.25 billion of two-year notes to mature May 31, 1978. The notes will be sold at a yield auction on Wednesday, May 19, for settlement Tuesday, June 1. Monday, May 31, is a Federal holiday. The proceeds will be used to retire $1.5 billion of maturing notes held by the public and to raise $750 million new cash.

The Treasury indicated that it expects to offer, on or about May 18, $2.9 billion of 52-week bills maturing May 31, 1977. The proceeds will be used to retire $2.4 billion of 52-week bills maturing June 1, 1976, and to raise $500 million new cash.

The Treasury also said that it would announce its plans with respect to a possible note issue in the four-year intermediate maturity area sufficiently prior to the two-year note auction on May 19, so that the market would be fully informed of these plans prior to the auction.

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less, and all tenders from Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities, will be accepted in full at the average price of accepted competitive tenders.

Commercial banks, which for this purpose are defined as banks accepting demand deposits, and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, may submit tenders for the account of customers, provided the names of the customers are set forth therein. Others will not be permitted to submit tenders except for their own account.

Tenders will be received without deposit from commercial and other banks for their own account, Federally-insured savings and loan associations, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds, international organizations in which the United States holds membership, foreign central banks and foreign States, dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, Federal Reserve Banks, and Government accounts. Tenders from others must be accompanied by payment of 5 percent of the face amount of notes applied for. However, bidders who submit checks in payment on tenders submitted directly to a Federal Reserve Bank or the Treasury may find it necessary to submit full payment with their tenders in order to meet the time limits pertaining to checks as hereinafter set forth. Allotment notices will not be sent to bidders who submit noncompetitive tenders.

Payment for accepted tenders must be completed on or before Tuesday, June 1, 1976. Payment must be in cash, 6% Treasury Notes of Series M-1976, which will be accepted at par, in other funds immediately available to the Treasury by the payment date or by check drawn to the order of the Federal Reserve Bank to which the tender is submitted, or the United States Treasury if the tender is submitted to it, which must be received at such Bank or at the Treasury no later than: (1) Wednesday, May 26, 1976, if the check is drawn on a bank in the Federal Reserve District of the Bank to which the check is submitted, or the Fifth Federal Reserve District in case of the Treasury, or (2) Monday, May 24, 1976, if the check is drawn on a bank in another district. Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at a Federal Reserve Bank. Where full payment is not completed on time, the allotment will be canceled and the deposit with the tender up to 5 percent of the amount of notes allotted will be subject to forfeiture to the United States.

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For information on submitting tenders in the Washington, D. C. area: PHONE WO4-260'

FOR RELEASE AT 4:00 P.M. May 13, 1976

TREASURY TO AUCTION $2.25 BILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $2.25 billion of 2-year notes to refund $1.5 billion of notes held by the public maturing May 31, 1976, and to raise $750 million of new cash. Additional amounts of the notes may be issued to Government Accounts and Federal Reserve Banks for their own account in exchange for $0.1 billion of maturing notes held by them, and to Federal Reserve Banks as agents of foreign and international monetary authorities for new cash only.

The notes now being offered will be Treasury Notes of Series M-1978 dated June 1, 1976, due May 31, 1978 (CUSIP No. 912827 FQ 0) with interest payable on a semiannual basis on November 30, 1976, May 31, 1977, November 30, 1977, and May 31, 1978. The coupon rate will be determined after tenders are allotted. The notes will be issued in registered and bearer form in denominations of $5,000, $10,000, $100,000 and $1,000,000, and they will be available for issue in book-entry form to designated bidders. Payment for the notes may not be made through tax and loan accounts.

Tenders will be received up to 1:30 p.m., Eastern Daylight Saving time, Wednesda May 19, 1976, at any Federal Reserve Bank or Branch and at the Bureau of the Public Debt, Washington, D. C. 20226; provided, however, that noncompetitive tenders will be considered timely received if they are mailed to any such agency under a postmark no later than May 18. Tenders must be in the amount of $5,000 or a multiple thereof, and all tenders must state the yield desired, if a competitive tender, or the term "noncompetitive", if a noncompetitive tender. Fractions may not be used in tenders. The notation "TENDER FOR TREASURY NOTES" should be printed at the bottom of envelopes in which tenders are submitted.

Competitive tenders must be expressed in terms of annual yield in two decimal places, e.g., 7.11, and not in terms of a price. Tenders at the lowest yields, and noncompetitive tenders, will be accepted to the extent required to attain the amount offered. After a determination is made as to which tenders are accepted, a coupon rate will be determined at a 1/8 of one percent increment that translates into an average accepted price close to 100.000 and a lowest accepted price above 99.750. That rate of interest will be paid on all of the notes. Based on such interest rate, the price on each competitive tender allotted will be determined and each successful competitive bidder will pay the price corresponding to the yield bid. Price calculations will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final. Noncompetitive bidders will be required to pay the average price of accepted tenders. BIDDERS SUBMITTING NONCOMPETITIVE TENDERS SHOULD REALIZE THAT IT IS POSSIBLE THAT THE AVERAGE PRICE MAY BE ABOVE PAR, IN WHICH CASE THEY WOULD HAVE TO PAY MORE THAN THE FACE VALUE FOR THE NOTES.

The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for $500,000 or

(OVER)

Department of the TREASURY NEWS
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FOR IMMEDIATE RELEASE

REMARKS BY THE HONORABLE GEORGE H. DIXON
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE BOARD OF DIRECTORS
MARINE NATIONAL EXCHANGE BANK
MILWAUKEE, WISCONSIN
MAY 12, 1976

Ladies and Gentlemen:

It is a privilege to be here on the shores of Lake Michigan this evening to address such a distinguished audience. Having spent the last eight years as one of your Minnesota neighbors, and having spent some happy weekends in your state, I've developed a great appreciation for the beautiful scenery and warm and friendly people of the State of Wisconsin, which makes me all the more delighted to be here.

As Jack Geilfuss noted in his gracious introduction, I've been a member of the Treasury team for a relatively short period of time. If this were last year, I'd probably be sitting in a group similar to this, listening to some Washington bureaucrat and recalling the wisdom of Will Rogers, who used to say: "I don't tell jokes--I just watch the Government and report the facts."

Now that I'm no longer just watching the Government, the wisdom of Will Rogers seems much less compelling. It's really quite remarkable what a couple of months in Washington will do to one's perspective and to change one's expectations.

And it's also quite remarkable what a short stint at the Treasury Department will do for one's appreciation of the complexities and capabilities of our economic system. As you know, the last three years have been a time of economic anxiety for all of us. We've experienced the worst inflation in our peacetime history and the worst recession in more than a generation. Too many of our fellow citizens have been out of work. And for the first time since our rise to preeminent industrial power, our system has become seriously vulnerable to the political pressures of foreign nations through embargo actions of the OPEC cartel.

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But if there has been a silver lining in this experience--and I think there has--it lies in the fact that in the last year, through a clearer understanding that there's a lot we don't understand, and at least the beginning of the application of fundamental economic concepts, we've made significant progress in getting the economy moving ahead again. Over the past nine months, total national production has risen at an annual rate of eight percent and there exists at present plenty of evidence that the momentum will continue for some time.

The rebound of the industrial sector of our economy has been even stronger. From its lowest point in April, 1975, the output of factories, mines and power plants has increased at an annual rate of eleven percent. As business activity rose, employment across the nation increased by 2-1/2 million to bring the total employed to the highest levels in our history, to 87.4 billion people, 1.1 million more than the pre-recession high (in July, 1974) of 86.3 million.

The recovery we've experienced during the last year provides, I believe, solid grounds for encouragement. It came earlier, had an impact sooner, and remained stronger than many forecasters predicted. Its pattern has matched the pace of previous cyclical upturns, and there is every reason to believe that expansion will continue throughout 1976 and 1977, if reasonably good decisions are made and implemented. The situation is so generally positive that I can't help but be reminded of one of Murphy's Laws, the Law of Random Perversity: "If everything appears to be going well, you've obviously overlooked something."

I believe it was Winston Churchill who once advised that "short words are best, and simple words when short are best of all." In keeping with the Prime Minister's sage advice, I would like to share with you this evening some brief, simple thoughts concerning a process which is essential to our hopes for a genuinely durable economic recovery and continued economic prosperity--the proper and effective coordination of fiscal and monetary policy.

Economic events of the past decade have demonstrated clearly that this nation needs a highly responsible fiscal policy. It must also have an equally responsible monetary policy. (I realize that the terms "fiscal policy" and "monetary policy" may leave you glassy-eyed, and I can't help but be reminded of the old adage about the lawyer or perhaps the Government bureaucrat who will go a thousand miles to give a speech he won't walk across the street to hear.) But just think of fiscal policy as the attempt to manage Government income and expenditures and monetary policy as the attempt to influence expansion of the money supply and the levels of interest rates. They are interrelated, and unless we manage each of these policies well, and unless they are properly linked together, we can get into trouble again with inflation, unemployment, and unsatisfactory economic output.

In recent years we've come to appreciate once again the linkages which exist between fiscal policy and monetary policy. There is a clear tie between Government spending and the levels of interest rates. As Government expenditures increase, budget deficits--which must be financed--usually occur. The Government borrows in our financial markets to meet these deficits, and the increased demand it causes tends to drive interest rates upward. Since a good deal of this financing is carried on through the banking system, it also has the effect of increasing the money supply unless countervailing measures are taken by the Federal Reserve. A renewed appreciation of the links that exist between fiscal and monetary policy, and an understanding of the need to consider these links in policy-making decisions, is essential to our goal of lasting economic stability.

During the 1960's, you will recall, there was a popular belief--many of us shared it--that we had outgrown the business cycle: The Government, it was thought, could through its fiscal policies simply fine-tune the economy, pulling or pushing on its controls to assure a continually smooth, upward ride. Central to this process was the use by the Government of deficit financing. Enough about economics has been stuck under our noses for most of us to know that under traditional Keynesian theory, deficit financing is intended to be used as a tool to stimulate the economy in sharp recessionary periods. But in recent times that purpose has generally been lost from view, as deficit financing has been used for a multitude of other purposes--to fight a costly war in Asia, to finance social and welfare programs, and to create a Government that at all levels has become too overbearing.

We have been guilty of trying to cram four pounds of commitments into a three-pound bag.

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It's taken time, but now, once again, we seem to be getting the message--the message that the philosophy of "everything for everyone" has produced, by default, a fiscal policy which is not a design, but a consequence, a policy which has been a root cause of inflation. And as we once again come to realize the need for moderation in our fiscal policies, I'm reminded of the story of Archie and Mehitabel who one day were talking about a new tune when Archie asked: "Is it original?" To which Mehitabel replied: "It was once, and it may be again."

Moderate fiscal policies are once again gaining strong support from many sectors of our economic and political communities. But this "new economic tune" (which is really a very old one) won't prove lasting unless we avoid the excesses which have so clearly marked our recent fiscal practices.

In sixteen out of the last seventeen years, our Federal Government has spent more than it has taken in--and in the last few years a great deal more. We not only have had deficits in periods of economic boom, but even larger deficits in periods when there has been less than full utilization of our resources.

Over the past decade, the Federal Government has borrowed nearly one-third of a trillion dollars in our capital markets. Our national debt continues to climb at a rate of more than $1 billion a week, and in the last ten years the interest on the debt has more than tripled--to almost $38 billion this year. In Fiscal Year 1977, it will climb to $45 billion. As these annual interest payments grow, our flexibility in the use of fiscal policy is substantially constrained.

So the task now before us is to reduce our deficits by holding or cutting our spending rate, by trying to wind down the cost of Government, and by trying to avoid costly new programs.

And there is a further danger in running and financing huge budget deficits. During the last three years the Treasury has witnessed a 33 percent decline in the average maturity of its publicly-held debt. The average maturity is now something like two years and five months. This over-reliance on short-term financing, and the resulting

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lack of balance in our overall debt structure, creates an enormous pool of near-cash investment, and exposes this nation to some risks.

-- One risk is that short-term financing opens up the possibility of higher Federal borrowing costs which, as you've probably guessed, are ultimately borne by you--the American taxpayer.

-- Another is that it soaks up a lot of money which might otherwise go to meet the financing needs of small and medium-sized businesses.

-- Finally, it is an inflation threat--simply because of its potential for converting some of that pool of near-cash to cash and inserting it into the spending stream.

In an attempt to diminish these problems and in order to promote a debt management policy which is consistent with monetary policy and long-term economic and financial stabilization goals, the Treasury requested and Congress recently approved an extension in the maximum maturity of Treasury notes from the present seven years to ten years, and an increase of $2 billion in the amount of long-term debt exempted from current 4-1/4 percent rate ceilings. We at Treasury believe these new debt management tools will allow us to begin the critical process of halting the decline in the average maturities of public debt, of reducing liquidity and hence the danger of inflation in our economic system, and of restoring the crucial element of stability to our capital markets.

But because of the linkages I mentioned earlier, sound fiscal and debt management policies will not remain so for long in the absence of a reasonable and effective monetary policy. And as we look back over the economic record of the past year, it is reasonable to conclude that the "steady as she goes" monetary policy which the Federal Reserve Board seems to be pursuing has played a crucial role in the relatively quick and stable recovery. Most of you will recall that about a year ago, when the Fed announced that it would pursue very moderate levels of money growth, concern was expressed by many economists, as well as by some members of Congress, that such growth rates would prove inadequate to finance strong economic expansion. Interest rates would move up sharply, they argued, as the demand for money and credit rose with increased aggregate spending--and shortages of money and credit would soon choke off the recovery.

The Federal Reserve Board did not share this pessimistic view. From a careful reading of history, the Fed knew that the turnover of money tends to rise rapidly in the early stages of an economic upswing. It also suspected that changes in financial practices might of themselves be acting strongly to reduce the amount of money needed to support economic expansion. And despite the often vocal criticism directed toward its moderate monetary practices, the Board never lost sight of the danger that excessive expansion of money and credit could reignite the fires of inflation and set the stage for another recession sometime out ahead.

The prudent monetary policy pursued by the Federal Reserve over the past year has probably helped to increase national confidence and foster conditions in financial markets that contributed to our recovery. But we've now reached a most delicate period in our pursuit of economic stability. As recovery progresses, we must recognize the need to hold to a course of monetary policy that will promote further economic expansion, and once more bring to our nation satisfactory levels of production and employment. We must also recognize that monetary policy needs to be consistent with an eventual return to stability in the general price level.

With these dual goals in mind, Federal Reserve Chairman Arthur Burns announced last week the ranges adopted by the Federal Open Market Committee for monetary growth in the coming year. The growth rates are slightly narrower than those previously predicted, but this narrowing does not constitute, in my judgment, and as some argue, a marked change in monetary growth policies. Rather, it seems to reflect the experience of the past year, when a very modest rise in the money stock proved sufficient to finance a solid economic recovery with declining interest rates. The change also reflects the recognition by the Fed that the economy is clearly building momentum, and that monetary policy is subject to a pronounced "lag" between the time the Fed decides to modify monetary growth rates and the time the change is felt in the marketplace. The Fed is wisely putting a little cinch in the saddle now, timed to take effect when the economy reaches a later state of expansion, when the need for restraint, possibly to prevent overheating, will be more apparent.

It's clear that the economic troubles of the past three years and the strong economic rebound of the past twelve months have taught us a critical economic lesson well worth remembering. Simply stated the lesson is this: To achieve

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economic stability in the United States, we must adopt moderate fiscal and monetary policies, which take proper cognizance of the changes in the day-to-day economic marketplace, but which at all times attempt to remain consonant with one another in seeking to achieve our long-range economic goals. If this lesson is put into practice, we should have a better chance of looking forward to continued expansion in production and employemnt. Consumer spending, which began to strengthen early in 1975, has recently gained even stronger momentum. Retail sales have been moving up strongly in recent months, and in March and April averaged 14.9 percent higher than a year ago. Consumers have greater confidence--they are spending a larger fraction of their current incomes.

We have made progress. Things are better, and with some luck and by heeding the lessons we've learned, we'll continue on an upward path. This is not to say we've cured all our economic problems; indeed, we never do that. Unemployment is still too high. Productivity has been lagging. The expansion of industrial plant and equipment has been proceeding at too slow a pace. The home building industry and other branches of construction are still depressed. And independence in the energy area is still a distant goal.

But over the past year or so, we as a nation have begun to face up more squarely to our challenging economic problems and to deal with them more constructively. There now exists a willingness to strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our free enterprise system;

-- a balance that favors greater liberty and self-reliance for individual Americans; and

-- a balance that favors greater honesty, realism and genuineness in dealing with the challenges of our time.

These are great goals--goals worthy of the greatest nation on earth. We should go through our Bicentennial Year by going forward into the future with a shared sense of purpose, patience, realistic hope, courage and common sense.

If we work together, with pride in ourselves and our nation, the goals we set today can become the first great achievements of America's third century.

In closing, I am reminded of a story Mark Twain used to tell: "I once heard a preacher who was powerful good. I decided to give him every cent I had with me. But he kept at it too long. Ten minutes later I decided to keep the bills and just give him my loose change. Another ten minutes and I was darned if I was going to give him anything at all. Then, when he finally stopped, and the plate came around, I extracted two dollars out of sheer spite."

So that I won't tempt any of you fine people to charge me for too long a sermon, I'll conclude by thanking you for your patience, for the opportunity to be with you this evening, and with the proposition that the best of the spirit of Adam Smith be always with you.

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The Department of the TREASURY NEWS
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FOR RELEASE ON DELIVERY

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STATEMENT BY JOHN M. NIEHUSS
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR ENERGY POLICY
BEFORE THE
HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
SUBCOMMITTEE ON ENERGY & POWER
WASHINGTON, D. C.
MONDAY, MAY 17, 1976, AT 10:00 A.M.

Financing an Alaskan Natural Gas Transportation System

Mr. Chairman and Members of the Committee:

I am pleased to testify before you today concerning the proposed Alaskan natural gas transportation systems. I will concentrate my remarks on the feasibility of financing such large projects in the private capital markets.

At the outset, it should be noted that the Treasury Department believes that it is possible to arrange a financing without Federal financial assistance. Although the size and nature of the project make private financing a difficult task, we are convinced that with the proper regulatory actions and participation by the various parties benefiting directly from the project, a private financing could be accomplished.

Federal financial assistance should not be used as a substitute for proper regulatory action as this would result in inefficiencies and unnecessary increases in the already excessive role of the Federal Government in our economy. The needed actions involve steps which would require the major beneficiaries of the project to pay the cost and bear the risk, on an equitable basis, of delivering Alaskan gas. The decisions required to bring this about will not be easy but are needed if a gas transportation system is to be financed in the most efficient and, in the long run, least costly way.

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As you are aware, for the Interior Department's December 1975 Report to Congress on Alaskan Natural Gas Transportation Systems, the Treasury Department prepared a section dealing with "Financing Problems and Issues." I am submitting for the record a copy of that section.

In my testimony today, I would like to highlight a few of the major conclusions we reached in this analysis and, in particular, point out areas where we feel proper regulatory actions will facilitate a private financing of the project. After discussing the overall capacity of the capital markets to handle a project of this size, I would like to outline the major financial risks perceived by potential investors in the project and point out the ways such risks can be handled if appropriate regulatory actions are taken. Finally, I will consider the general question of Federal financial assistance.

Capacity of the Capital Markets to Finance Such a Large Project.

The Interior Department has estimated that construction costs for a 2.5 billion cubic feet per day (BCFD) gas flow range from $9 to $11 billion for the Alaska-LNG System and from $10 to $12 billion for the Alaska-Canada System, depending on such variables as interest on debt during construction and cost overrun contingencies as well as estimates for inflation. If financed by private capital, this project would be the largest single project so financed. By comparison, the cost of the Trans Alaska oil pipeline is now estimated to be in excess of $7 billion--excluding field development costs and the tanker fleet.

Despite the unprecedented size of this project, we believe that the U.S. capital markets have the capacity to finance this gas transportation system and that private capital markets, including the international markets, will finance it if it is shown to be a viable and creditworthy project.

Nature of the Financial Risks

The sponsors of both projects propose to finance them through what is commonly called "project financing." This type of financing involves creation of a separate project entity which issues securities structured so that the debt service and equity returns are provided by the revenues generated by the project. The preliminary financing plans involve capitalization of 25 percent equity and 75 percent debt.

Before they will provide funds to either of the proposed projects, both equity and debt investors must be satisfied that the project is creditworthy and that the level and certainty of their expected return on investment is adequate to compensate them for the risks they assume. The bulk of the equity will be provided by the project sponsors, and the debt will be sought mainly from financial institutions.

Although debt investors generally assume some amount of risk in return for higher interest rates, the large amounts of capital required for this project probably cannot be raised if there is any substantial perceived risk to the timely repayment of principal and interest. Thus, a prerequisite to financing this project is to establish that payment of debt service could be expected regardless of what other events occur. The two major financial risks faced by investors are (1) the risk of non-completion of the project and (2) the risk that, once completed, revenues will be insufficient to cover all project costs --including debt service. Non-completion could result from unforeseen construction difficulties, excessive cost overruns that make the project uneconomic, environmental suits, and other legal or political difficulties. Insufficient revenues could result from (a) the failure of regulatory agencies to allow tariffs which recover the full project costs, or (b) interruption of gas flow due to natural disaster, mechanical failure, or other force majeure events.

The Non-Completion Risk

In the event of non-completion, the fundamental concept of project financing (i.e., service of debt through project revenues) is frustrated and, in the absence of other protection, the lender loses his investment. Therefore, before committing funds to an Alaskan gas transportation system, lenders will seek (a) assurances that there are adequate funds to finance completion and (b) protection in the event of non-completion for reasons other than lack of funds.

The first non-completion risk of major concern to investors involves large cost overruns which could result from such things as delays in the construction schedule or errors in engineering estimates. In addition, construction delays would add to debt-interest costs.

The second major non-completion risk of concern to potential lenders is the fact that their debt might not be repaid if the project never goes into operation to generate the revenues they are looking to as the primary source of their debt service. As in the case of cost overruns, investors must have adequate assurances that their debt will be repaid in the event of non-completion before they will advance funds to the project.

Thus, the key question is who will finance cost overruns and bear the other risks of non-completion of the project? At this point in time, the question remains unanswered. If a private financing is to be arranged, these risks must be borne by one or more of the various parties standing to benefit directly from the project, including:

-- Equity investors

-- Other gas pipeline and distribution companies receiving gas

-- Gas consumers receiving gas

-- Owners of Alaskan gas reserves or

-- State of Alaska

We believe that these potential project beneficiaries collectively have the capacity to provide lenders the necessary assurances against non-completion risks. The financing capabilities of these main project beneficiaries are discussed at some length in our contribution to the Interior Department Report. I refer you to that report for our detailed analysis, but I would like to summarize for you briefly our analysis of the various categories of beneficiaries.

Equity Investors. As discussed in the Interior Report, it appears that, considering both internally generated cash flow and external financing possibilities, the current group of project sponsors could provide the requisite equity capital--although this would clearly be a large undertaking for a group of companies of this size, and some problems could arise for particular companies.

However, the lenders will also be looking to the project sponsors to provide part of any cost overrun financing that might be required or possibly assist in repaying debt in the event of non-completion. While such commitments do not require the immediate generation of cash, they do result in a contingent liability of an indeterminate and conceivably quite large amount. As they themselves have indicated, the

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current sponsors apparently do not have the capacity to assume fully the risk of repayment of the project's debt.

Gas Pipeline and Utility Companies. There are a number of interstate gas pipeline and distribution companies, other than El Paso and those in the Arctic Gas group, who could be considered as potential project sponsors. For example, the ten largest of these other interstate gas pipeline companies (in terms of natural gas sales) had a combined internal net cash flow of about $1.5 billion in fiscal year 1974. Were the 1974 cash flow levels to continue, the combined internal cash flow of these companies over a six-year period would be around $9.0 billion. Thus, they could make a substantial contribution toward financing and bearing the cost overrun and non-completion risks of this project.

Owners of Alaskan Gas. Another potential source of financing would be the owners of the gas reserves. They recognize that without a transportation system the large proven gas reserves and potential future gas discoveries are virtually worthless. However, it must be recognized that any decision by the producers to help finance the project would have to take into account other competing demands for funds, the rates of return on alternative projects and the fact that they are already committed to provide substantial additional amounts of capital in order to produce North Slope oil and gas. One action which could affect the willingness and ability of these companies to participate in the financing would be the deregulation of wellhead price for Alaskan gas.

Gas Consumers. A third additional source of financing is gas consumers. The large benefits that are expected to accrue to consumers of Alaskan gas would appear to justify the adoption of regulatory procedures which would involve them more directly in financing and bearing the risks of this project. With respect to the cost overrun and non-completion risks, a surcharge on current gas consumption might be used to help finance cost overruns and/or repay project debt in the case of non-completion.

Very large amounts of capital could be raised in this way. One form of surcharge would be a direct add-on to the current utility bill which would be used to finance cost overruns. Another, somewhat more indirect, form would be the inclusion of work in progress in the rate base so that consumers would pay the interest charges on project debt and return on equity investment while the project is under construction. A consumer surcharge mechanism, in effect, increases the current cost of gas to consumers but reduces

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future costs to a level lower than would prevail if consumers did not help finance the project. This reduction in future costs comes about because the amount of debt service (i.e. principal and interest payments) that would have to be recovered through transportation tariff charges would be reduced.

State of Alaska. The State of Alaska is another potential source of financing. Alaska would receive significant benefits if production of Alaskan gas were assured by the building of a transportation system since it would receive a 12 1/2 percent royalty and approximately a 4 percent production tax. Thus, the State of Alaska, as a direct beneficiary of a transportation system for gas, might decide to finance a portion of the pipeline or help finance cost overruns or guarantee a portion of the debt to insure its repayment in the event of non-completion.

Other. Other potential project beneficiaries who might bear some of the cost overrun and non-completion risks include (1) large industrial gas customers who could provide substantial amounts of capital through advance payments in exchange for an assured supply of gas and (2) the financial institutions providing debt capital who might be willing to commit to finance some level of cost overruns.

As this summary indicates, there are direct beneficiaries of the project who together have the capacity to finance substantial cost overruns or repay the project's debt in the case of non-completion.

The Risk of Insufficient Project Revenues

Even if the various project beneficiaries were able to provide adequate assurances to the prospective lenders with respect to non-completion risks, the difficult question of who would bear the risks of inadequate project revenues would remain. With projects of this size and complexity, even a low risk of interruption or diminution of revenues is of concern to lenders. As in the case of non-completion, if a private financing is to be arranged, this risk must be borne by the various parties standing to benefit directly from the project.

There are two major ways of satisfying the lender's need to have some mechanism to insure debt repayment in the unlikely event of a long-term service interruption. First, the lender might be satisfied by a clearly creditworthy party, or parties, agreeing to guarantee repayments of the project's debt. In many projects, this type of guarantee is provided by the project sponsors. However, in the present case, the proposed projects are so large that the current group of gas pipeline and utility sponsors have indicated that they do not have sufficient aggregate credit to satisfy the lenders. Therefore, if a private financing is to be achieved, it may be necessary to strengthen the combined credit of the sponsoring group by adding new members (for example, additional gas pipelines and utilities, and/or the State of Alaska and/or the gas producers). As noted earlier, this could also assist in covering the risks of project overruns or non-completion.

Second, users of the project's output or service might enter into what are called "all events full cost of service contracts." Under such a contract, the purchaser is obligated to pay a minimum amount sufficient to service the project's debt and cover certain other project costs even if he does not receive output from the project. In short, he pays regardless of what other events may occur. Thus, lenders might be satisfied with an "all events full cost of service contract" which would require gas shippers to pay the full cost of operating the transportation system (including debt service), regardless of whether gas was flowing or not. In theory, this type of tariff would assure lenders that, once the project is completed, revenues would always be adequate to cover the project's expenses. Under such a contract, the costs could be passed on to the local gas utilities, who in turn, assuming approval by relevant State regulatory authorities, would pass on the cost to gas consumers.

Such a tariff would be essentially an insurance program underwritten by consumers to cover whatever risks commercial insurance companies will not underwrite at reasonable costs. By accepting these risks, consumers would not only assist in arranging a private financing, but would also benefit from lower gas transportation charges from two sources. First, the insurance premiums associated with an unconventional commercial insurance program would be avoided. Second, the debt interest costs would be lower, reflecting the increased creditworthiness of the project.

Thus, an all events full cost of service tariff could provide substantial assurances to lenders with regard to the adequacy of revenues to repay the project's debt. If, in addition, there were a wide distribution of Alaskan gas, this could minimize any contingent price increase which consumers might face under such a tariff were there to be a service interruption. Taken together, a clearly enforceable all events full cost of service tariff and a wide distribution of Alaskan gas do offer one way of handling the risk of insufficient project revenues.

Nevertheless, it should be clearly recognized that an all events full cost of service tariff implies that gas consumers would bear much of the project's post-completion risks, including force majeure service interruptions or even costs resulting from management error. Whether it is reasonable to ask certain gas consumers to bear this level of risk must be judged in relation to the benefits those gas consumers could expect to receive, and whether such risk bearing is required in order to get the project financed. Apparently, the gas consumers receiving Alaskan gas could expect to receive substantial economic benefits. Under the present system of regulated wellhead natural gas prices, gas consumers are in a favored position and could receive the bulk of the net economic benefits made available by a gas transportation system.

From the standpoint of arranging private financing, an all events full cost of service tariff could be needed. Nevertheless, it would be premature to rule out the possibility that the level of risk which gas consumers would bear under an all events tariff could be reduced by adopting something less than the full cost of service feature. This might be accomplished by carefully defining in the tariff which categories of costs are allowed to be passed on in all events. Through specially designed tariff formulas, we believe the risks associated with an Alaskan gas transportation system can be equitably shared between project sponsors and consumers.

In any event, such a tariff would have to be approved by the Federal Power Commission--a decision that has not yet been made. If approval does occur, it may be necessary to consider ways of assuring both the gas pipeline and gas distribution companies and the lenders who are relying on this tariff that the tariff will be maintained and enforced over the life of the project.

Feasibility of a Private Financing

On the basis of this analysis, we believe that the various private parties standing to benefit directly have the capacity to finance the project and bear its risks. Since the project seems to be economic on current price/cost estimates, there is sufficient incentive for these parties to arrange a private financing provided the needed regulatory actions are taken, including steps to involve gas consumers in sharing the risk of the project. Certainly the extent of involvement of gas pipeline and distribution companies, as well as the extent of participation of the owners of the reserves, will be important. However, the regulatory conditions under which the project will operate will be critical to determining whether the project will be financed privately.

Government Financial Assistance

Whether a totally private financing is achievable will remain a matter of speculation until one of the projects is selected and its sponsors are able to determine further the capabilities and intentions of the potential financial participants and to determine the regulatory conditions under which the project would be constructed and operated. Accordingly, it would be premature to consider legislation providing Federal financial assistance to the project.

Despite this, if it is eventually determined that some form of Federal financial assistance to the project is both necessary and desirable, then the following important considerations should be kept in mind. First, any Federal financial assistance granted should be kept to the absolute minimum needed. Federal assistance should supplement and facilitate the maximum feasible amount of private financing for the project; it should not substitute for available private financing or for appropriate regulatory actions.

Second, any legislation providing such assistance should give the administrator of this assistance adequate flexibility to tailor the form of financial assistance to the needs of the project. At this time, we, of course, do not know which of the particular financial risks of this project may prove insurmountable without Federal assistance. It would, therefore, seem desirable to defer legislation until the problems of the project are sufficiently well understood to allow identification of why the private market cannot respond. However, possible forms of such assistance would include Federal guarantees of the project's debt against certain specific risks such as non-completion of the project or long-term service interruptions, Federal insurance against the service interruption risk, or the financing of cost overruns above some determined level. The exact type, amount, and terms of any Federal assistance would have to be worked out through detailed negotiations with the project's sponsors.

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<u>Third</u>, it is important to minimize the impact on our capital markets and on the management of the Federal debt of any Federal financial assistance program. Any type of Federal financial assistance resulting in the undertaking of investments that would not otherwise have been made leads to some redirection of resources in our capital markets. Such incentives increase the demand for capital while having little or no effect on the overall supply of capital and thus tend to cause interest rates to rise. Accordingly, we believe it is essential that the Secretary of the Treasury have the authority to approve the timing, terms, and conditions of any Federal guaranteed securities that might be issued.

<u>Conclusion</u>

In conclusion, I would like to stress again our belief that <u>if appropriate regulatory and administrative actions are taken</u>, Federal financial assistance to an Alaskan gas transportation system will not be necessary and, therefore, would urge that no such Federal assistance be provided at this time. Instead, we would recommend that one or more of the following actions be taken:

1. Prompt selection of a specific gas transportation system;

2. Grant of all necessary governmental authorizations including timely resolution of all environmental and legal questions regarding the project;

3. Approval of all events tariffs, which permit shippers to pass on a substantial portion of the costs, if not the full costs, of the project to the ultimate consumer coupled with strong assurances that they will be maintained in effect and enforced over the life of the project;

4. Approval of a mechanism (such as inclusion of work in progress in the rate base) by which the principal and interest payments on some part, if not all, of the debt funds used during construction could be passed on to gas consumers even in the remote contingency of non-completion of the project;

5. Approval of a consumer surcharge mechanism which would provide funds to help finance the project;

6. Decontrol of natural gas prices or setting the wellhead price of Alaskan gas at a level high enough to attract the financial participation in the project of the owners of the gas.

These actions would clarify the present regulatory and administrative uncertainties and would provide equitable means whereby the private beneficiaries of the project can assist in financing and sharing of the risks without the unnecessary and undesirable financial involvement of the Federal Government. In our view, there are great long-run dangers if we continue to substitute government financial assistance for difficult regulatory decisions which equitably apportion the costs and risks of large energy projects. This project affords us an opportunity to show that, through innovative governmental action, we can create the conditions necessary for the private capital markets to finance this project.

That concludes my prepared testimony and I would be happy to answer any questions you may have at this time.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE May 17, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.5 billion of 13-week Treasury bills and for $3.5 billion of 26-week Treasury bills, both series to be issued on May 20, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 19, 1976			26-week bills maturing November 18, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.683	5.210%	5.35%	97.122 a/	5.693%	5.94%
Low	98.667	5.273%	5.42%	97.094	5.748%	6.00%
Average	98.673	5.250%	5.39%	97.105	5.726%	5.98%

a/ Excepting 1 tender of $70,000

Tenders at the low price for the 13-week bills were allotted 90%.
Tenders at the low price for the 26-week bills were allotted 3%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 42,510,000	$ 27,510,000	$ 41,470,000	$ 22,330,000
New York	3,752,280,000	2,046,605,000	5,357,950,000	2,936,740,000
Philadelphia	48,750,000	48,750,000	106,435,000	71,435,000
Cleveland	32,835,000	32,835,000	153,880,000	114,480,000
Richmond	38,455,000	28,455,000	46,985,000	35,285,000
Atlanta	34,630,000	32,330,000	15,520,000	13,020,000
Chicago	283,515,000	56,515,000	354,905,000	99,205,000
St. Louis	45,050,000	33,050,000	36,415,000	19,415,000
Minneapolis	27,295,000	12,295,000	72,315,000	27,915,000
Kansas City	93,250,000	91,050,000	33,410,000	24,625,000
Dallas	38,600,000	21,600,000	14,630,000	12,630,000
San Francisco	185,110,000	69,110,000	272,225,000	123,945,000
TOTALS	$4,622,280,000	$2,500,105,000 b/	$6,506,140,000	$3,501,025,000 c/

b/ Includes $ 371,870,000 noncompetitive tenders from the public.
c/ Includes $ 169,500,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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This Wk. 5.250%

Last Wk. 5.072%

Highest since

3-1-76 5.258%

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This Wk. 5.726%

Last Wk. 5.426%

Highest since

12-15-75 5.914%

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FOR IMMEDIATE RELEASE May 18, 1976

INCOME TAX TREATY NEGOTIATIONS

The Treasury Department today announced the countries with which it is engaged in income tax treaty negotiations, released the text of its current "model" income tax treaty, and invited comments.

The Treasury Department has a general policy of announcing initial income tax treaty negotiations with particular countries, and giving an opportunity for comment. However, often negotiations are scheduled on short notice, making notice impractical, and often negotiations extend over a period of several years, so that earlier comments no longer reflect current problems. In order to give better guidance and in order to obtain comments from interested persons, the Treasury Department today announced that negotiations are currently in process (or contemplated in the near future) with the following countries:

Australia	Jamaica
Bangladesh	Malta
Botswana	Morocco
Brazil	Netherlands
Canada	Singapore
Costa Rica	Spain
Denmark	Tunisia
India	Yugoslavia
Iran	Zambia

The Treasury Department would welcome amendments to previous comments, or new or supplemental comments concerning negotiations with those countries. Comments should be sent in writing to Charles M. Walker, Assistant Secretary of the Treasury, U.S. Treasury Department, Washington, D.C. 20220. In addition, the Treasury Department always welcomes comments with respect to the advisability of entering into or revising income tax treaties with any country.

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The Treasury Department also made available today the text of its current "model" income tax treaty. The Treasury Department is currently suggesting this model as a starting point for negotiations. The model conforms closely to the revised draft treaty now being developed by the Organization for Economic Cooperation and Development. Any comments on this model may also be sent to Charles M. Walker.

The Treasury Department also announced today that negotiations are virtually completed with the following countries:

Indonesia	Republic of China (Taiwan)
Kenya	South Korea
Philippines	

Income tax treaties with Cyprus, Egypt, Israel, and the United Kingdom were signed on April 19, 1974, October 28, 1975, November 20, 1975, and December 31, 1975, respectively. The treaties with Egypt and Israel have been submitted to the Senate for approval.

The announcement appeared in the Federal Register of May 18, 1976.

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MODEL OF MAY 18, 1976

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The Government of the United States of America and the Government of , desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, have agreed as follows:

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Article 1

PERSONAL SCOPE

1. Except as otherwise provided in this Convention, this Convention shall apply to persons who are residents of one or both of the Contracting States.

2. Notwithstanding any provision of this Convention except paragraph 3 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Fiscal Domicile)) and in the case of the United States its citizens (including a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss) as if this Convention had not come into effect.

3. The provisions of paragraph 2 shall not affect:

a) the benefits conferred by a Contracting State under paragraphs 1 b) and 4 of Article 18 (Pensions, etc.), Articles 23 (Elimination of Double Taxation), 24 (Nondiscrimination), and 25 (Mutual Agreement Procedure); and

b) the benefits conferred by a Contracting State under Articles 19 (Government Service), 20 (Students and Trainees) and 27 (Effect of Convention on Diplomatic and Consular Officials, Domestic Laws, and other Treaties), upon individuals who are neither citizens of, nor have immigrant status in, that State.

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of each Contracting State.

2. The existing taxes to which this Convention shall apply are:

   a) In the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations, but excluding the accumulated earnings tax and the personal holding company tax.

   b) In the case of ________, ______________________

   ____.

3. The Convention shall apply also to any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes which have been made in their respective taxation laws and shall notify each other of any official published material concerning the application of this Convention, including explanations, regulations, rulings, or judicial decisions.

4. For the purpose of Article 24 (Nondiscrimination), this Convention shall also apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. For the purpose of Article 26 (Exchange of Information and Administrative Assistance), this Convention shall also apply to taxes of every kind imposed by a Contracting State.

Article 3

GENERAL DEFINITIONS

1. In this Convention, unless the context otherwise requires:

   a) The term "person" includes an individual, a partnership, a company, an estate, a trust, and any other body of persons;

   b) The term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

   c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

   d) The term "nationals" means:

      A) in relation to ____________, ____________

      ____

      ____

      B) in relation to the United States, United States citizens.

   e) The term "international traffic" means any transport by a ship or aircraft, except where such transport is solely between places in the other Contracting State.

f) The term "competent authority" means:

1) In the case of the United States, the Secretary of the Treasury or his delegate, and

2) In the case of ,

____.

g) 1) The term "United States" means the United States of America; and

2) When used in a geographical sense, the term "United States" means the states thereof and the District of Columbia. Such term also includes:

A) The territorial sea thereof and

B) The seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which the United States exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the Convention is being applied is connected with such exploration or exploitation.

h) 1) The term means ________________ and

2) When used in a geographical sense, the term includes:

A) The territorial sea thereof, and

B) The seabed and subsoil of the submarine areas adjacent to the coast thereof, but beyond the territorial sea, over which   exercises sovereign rights, in accordance with international law, for the purpose of exploration for and exploitation of the natural resources of such areas, but only to the extent that the person, property, or activity to which the Convention is being applied is connected with such exploration or exploitation.

2. As regards the application of this Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires and subject to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

Article 4

FISCAL DOMICILE

1. For purposes of this Convention, the term "resident of a Contracting State" means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature; provided, however, that:

a) this term does not include any person who is liable to tax in that Contracting State in respect only of income from sources therein or capital situated in that State; and

b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax as the income of a resident of the Contracting State, either in its hands or in the hands of its partners or beneficiaries.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then the individual's tax status shall be determined as follows:

a) The individual shall be deemed to be a resident of the Contracting State in which the individual has a permanent home available to him. If the individual has a permanent home available to him in both Contracting States or in neither Contracting State, the individual shall be deemed to be a resident of the Contracting State with which the individual's personal and economic relations are closer (center of vital interests);

b) If the Contracting State in which the individual's center of vital interests is located cannot be determined, the individual shall be deemed to be a resident of that Contracting State in which the individual has an habitual abode;

c) If the individual has an habitual abode in both Contracting States or in neither of them, the individual shall be deemed to be a resident of the Contracting State of which the individual is a national; and

d) If the individual is a national of both Contracting States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created or organized under the laws of a Contracting State or a political subdivision thereof, it shall be treated as a resident of that State.

4. Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavor to settle the question and to determine the mode of application of the Convention to such person.

5. For purposes of this Convention, an individual who is a national of a Contracting State shall also be deemed to be a resident of that State if (a) the individual is an employee of that State or an instrumentality thereof in the other Contracting State or in a third State; (b) the individual is engaged in the performance of governmental functions for the first-mentioned State; and (c) the individual is subjected in the first-mentioned State to the same obligations in respect of taxes on income as are residents of the first-mentioned State. The spouse and minor children residing with the employee and subject to the requirements of (c) above shall also be deemed to be residents of the first-mentioned State.

6. Where under any provision of this Convention income arising in one of the Contracting States is relieved from tax in that Contracting State and, under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income as is remitted to or received in the other Contracting State during the year such income accrues.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" shall include especially:

a) a branch;

b) an office;

c) a factory;

d) a workshop; and

e) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, shall constitute a permanent establishment only if it lasts more than 24 months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display, or delivery or goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on for the enterprise any other activity if it has a preparatory or auxiliary character.

f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e) of this paragraph.

5. Notwithstanding the provisions of paragraphs 1 and 2, if a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises in a Contracting State, an authority to conclude contracts in the name of such enterprise, that enterprise shall be deemed to have a permanent establishment in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised at a fixed place of business, would not make this fixed place of business a permanent establishment by virtue of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6

INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

1. Income derived by a resident of a Contracting State from immovable property (real property) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of professional services.

5. A resident of a Contracting State who is subject to tax in the other Contracting State on income from immovable property situated in the other Contracting State may elect for any taxable year to compute the tax

on such income on a net basis as if such income were attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authorities of the two Contracting States, pursuant to a request by the taxpayer made to the competent authority of the Contracting State in which the taxpayer is a resident, agree to terminate the election.

Article 7

BUSINESS PROFITS

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in that other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment and with any related person within the meaning of paragraph 3 of Article 9 (Associated Enterprises).

3. In the determination of the business profits of a permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative

expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of the preceding paragraphs, the business profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where business profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of this Convention, "business profits" means income derived from any trade or business whether carried on by an individual, company or any other person, or group of persons, including the rental of tangible personal (movable) property, or the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting.

Article 8

SHIPPING AND AIR TRANSPORT

1. Profits of an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that State.

2. For purposes of this Article, profits from the operation of ships or aircraft in international traffic include profits derived from the rental on a full or bareboat basis of ships or aircraft operated in international traffic if such rental profits are incidental to other profits described in paragraph 1.

3. Profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise in international traffic shall be taxable only in that State.

Article 9

ASSOCIATED ENTERPRISES

1. Where a person subject to the taxing jurisdiction of a Contracting State and any other person are related and conditions are made or imposed between such persons in their commercial or financial relations which differ from those which would be made between independent persons, then any income, deductions, credits, or allowances which would but for those conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person.

2. Where a redetermination has been made by one Contracting State with respect to a person in accordance with paragraph 1, the other Contracting State shall, to the extent it agrees that such redetermination reflects arrangements or conditions which would be made between independent persons, make the corresponding adjustments with respect to persons who are related to such person and are subject to the taxing jurisdiction of that other State, notwithstanding any time limits or similar legal barriers in the national law of that other State. To the extent that other State disagrees with such redetermination, the two Contracting States shall endeavor to reach agreement in accordance with the mutual agreement procedure in Article 25 (Mutual Agreement Procedure).

3. For purposes of this Convention, a person is related to another person if either person directly or indirectly controls the other, or if any third person or third persons (related to each other or acting together) control both.

Article 10

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the law of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 percent of the gross amount of the dividends if the beneficial owner is a company which owns, directly or indirectly, 10 percent of the voting stock of the company paying the dividends;

b) in all other cases, 15 percent of the gross amount of the dividends.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the taxation law of the State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the dividends, being a resident of a Contracting State, carries on

business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Where a company is a resident of a Contracting State, the other Contracting State may not impose any tax on the dividends paid by the company, except insofar as

a) such dividends are paid to a resident of that other State,

b) the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, or

c) for the three-year period ending with the close of the company's taxable year preceding the declaration of the dividend (or for such part of that period as such company has been in existence, or for the first taxable year if the dividend is declared in that year), at least 50 percent of such company's gross income from all sources was included in the computation of profits attributable to a permanent establishment which such company had in that other State.

Where subparagraph c) applies and subparagraphs a) and b) do not apply, any such tax shall be subject to the limitations of paragraph 2.

Article 11

INTEREST

1. Interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "interest" as used in this Convention means income from debt claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums or prizes attaching to bonds or debentures.

3. The provisions of paragraph 1 shall not apply if the person deriving the interest, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment or a

fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then the said interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

5. Where, owing to a special relationship between the payer and the person deriving the interest or between both of them and some other person, the amount of the interest paid, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the person deriving the interest in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

6. Whether or not a resident of a Contracting State derives profits or income from the other Contracting State, the other State may not impose any tax on the interest paid by that resident, except insofar as such interest is paid to a resident of that other State or insofar as the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment or a fixed base of the person deriving interest situated in that other State.

Article 12

ROYALTIES

1. Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting); any patent, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

3. The provisions of paragraph 1 shall not apply if the person deriving the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. Where, owing to a special relationship between the payer and the person deriving the royalties or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the person deriving the royalties in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13

CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property, as defined in paragraph 2 of Article 6 (Immovable Property), situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in the other State. However, gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers operated by such enterprise in international traffic shall be taxable only in that State, and gains described in Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

3. Gains from the alienation of any property other than those mentioned in paragraphs 1 and 2, shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14

INDEPENDENT PERSONAL SERVICES

Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State unless such services are performed in the other Contracting State and

a) the individual is present in that other State for a period or periods aggregating more than 183 days in the taxable year concerned, or

b) the individual has a fixed base regularly available to him in that other State for the purpose of performing his activities, but only so much of the income as is attributable to that fixed base.

Article 15

DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of Articles 18 (Pensions, Etc.) and 19 (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned,

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and

c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment as a member of the regular complement of a ship or aircraft operated by an enterprise of a Contracting State in international traffic may be taxed only in that Contracting State.

Article 16

INVESTMENT OR HOLDING COMPANIES

If 25 percent or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties. For the purposes of this Article, the source of dividends, interest or royalties shall be determined in accordance with paragraph 3 a), b), or c) of Article 23 (Relief from Double Taxation).

Article 17

ARTISTES AND ATHLETES

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as entertainer, such as theatre, motion picture, radio or television artiste, or musician or athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities do not exceed fifteen thousand United States dollars ($15,000) or its equivalent in   for the taxable year concerned.

2. Where income in respect of personal activities as such of an entertainer or athlete accrues not to that entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. For purposes of the preceding sentence, income of an entertainer or athlete shall be deemed not to accrue

to another person if it is established that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions.

Article 18

PENSIONS, ETC.

1. Subject to the provisions of paragraph 2 of Article 19 (Government Service),

a) pensions and other similar remuneration beneficially derived by a resident of a Contracting State in consideration of past employment shall be taxable only in that State, and

b) social security payments and other public pensions paid by a Contracting State to an individual who is a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned Contracting State.

2. Annuities beneficially derived by a resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

3. Alimony paid to a resident of a Contracting State by a resident of the other Contracting State shall be exempt from tax in the other Contracting State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation

agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

4. Periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of one of the Contracting States to a resident of the other Contracting State, shall be exempt from tax in both Contracting States.

Article 19

GOVERNMENT SERVICE

1. a) Remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof shall be taxable only in that State.

   b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the recipient is a resident of that other Contracting State who:

      i) is a national of that State; or

      ii) did not become a resident of that State solely for the purpose of performing the services;

   provided that the provisions of clause (ii) shall not apply to the spouse or dependent children of an individual who is receiving remuneration to which the provisions of subparagraph (a) apply and who does not come within the terms of clause (i) or (ii).

2. a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof shall be taxable only in that State.

   b) However, such pension shall be taxable only in the other Contracting State if the recipient is a national of and a resident of that State.

3. The provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), and 18 (Pensions, etc.), as the case may be, shall apply to remuneration and pensions in respect of services rendered in connection with any business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20

STUDENTS AND TRAINEES

1. Payments which a student, apprentice or business trainee who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State and who is present in the first-mentioned Contracting State for the purpose of his full-time education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State provided that such payments are made to him from sources outside that State.

2. An individual to whom paragraph 1 applies may elect to be treated for tax purposes as a resident of the first-mentioned State. The election shall apply to all periods during the taxable year of the election and subsequent taxable years during which the individual qualifies under paragraph 1, and may not be revoked except with the consent of the competent authority of that State.

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Article 21

OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income other than income from immovable property as defined in paragraph 2 of Article 6 (Income From Immovable Property), if the person deriving the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services), or Article 17 (Artistes and Athletes) as the case may be, shall apply.

Article 22

CAPITAL

1. Capital represented by immovable property, as defined in paragraph 2 of Article 6 (Income From Immovable Property), owned by a resident of a Contracting State and situated in the other Contracting State may be taxed in that other State.

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services may be taxed in that other State.

3. Ships and aircraft operated by a resident of a Contracting State in international traffic and movable property pertaining to the operation of such ships and aircraft, shall be taxable only in that State.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

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Article 23

RELIEF FROM DOUBLE TAXATION

1. In the case of the United States, double taxation shall be avoided as follows: In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax the appropriate amount of tax paid to ; and, in the case of a United States company owning at least 10 percent of the voting stock of a company which is a resident of from which it receives dividends in any taxable year, the United States shall allow credit for the appropriate amount of tax paid to by that company with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to , but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources outside of the United States) provided by United States law for the taxable year. For purposes of applying the United States credit in relation to tax paid to the taxes referred to in paragraphs 2 b) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes.

2. In the case of , double taxation shall be avoided as follows: In accordance with the provisions and subject to the limitations of the law of (as it may be amended from time

to time without changing the general principle hereof), the shall allow to a resident or citizen of as a credit against the tax the appropriate amount of tax paid to the United States; and, in the case of a company owning at least 10 percent of the voting stock of a company which is a resident of the United States from which it receives dividends in any taxable year, shall allow credit for the appropriate amount of tax paid to the United States by that company with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid to the United States, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the tax on income from sources outside of) provided by law for the taxable year. For purposes of applying the credit in relation to tax paid to the United States the taxes referred to in paragraphs 2 a) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes.

3. For the purposes of the preceding paragraphs of this Article, the source of income or profits shall be determined in accordance with the following rules:

a) Dividends, as defined in paragraph 3 of Article 10 (Dividends), shall be deemed to arise in a Contracting State if paid by a company which is a resident of that State or if paragraph 5 c) of Article 10 (Dividends) applies.

b) Interest, as defined in paragraph 2 of Article 11 (Interest), shall be deemed to arise in the State specified in paragraph 4 of Article 11.

c) Royalties, as defined in paragraph 2 of Article 12 (Royalties), shall be deemed to arise in a Contracting State to the extent that such royalties are with respect to the use of, or the right to use, rights or property within that State.

d) Except for income or profits referred to in subparagraphs a), b), or c), and except for income or profits taxed by the United States solely by reason of citizenship in accordance with paragraph 2 of Article 1 (Personal Scope): income or profits derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention shall be deemed to arise in that other Contracting State.

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Article 24

NON-DISCRIMINATION

1. The nationals of a Contracting State, whether or not they are residents of one of the Contracting States, shall not be subjected in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. For purposes of the preceding sentence, nationals who are subject to tax by a Contracting State on worldwide income are not in the same circumstances as nationals who are not so subject.

2. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

This Article shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest) or paragraph 4 of Article 12 (Royalties) apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other

Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same condition as if they had been paid to a resident of the first-mentioned State. For purposes of this paragraph, the term "other disbursements" shall include charges for amounts expended by such residents for purposes of such enterprise, including a reasonable allocation of executive and general administrative expenses (except to the extent representing the expenses of a type of activity which is not for the benefit of such enterprise, but constitute "stewardship" or "over-seeing" functions undertaken for such resident's own benefit as an investor in the enterprise), research and development, and other expenses incurred by such resident for the benefit of a group of related enterprises including such enterprise.

Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible as if they had been contracted to a resident of the first-mentioned State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. In this Article the term "taxation" means taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

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Article 25

MUTUAL AGREEMENT PROCEDURE

1. Where a resident or national of a Contracting State considers that the actions of one or both of the Contracting States result or will result for it in taxation not in accordance with this Convention, it may, notwithstanding the remedies provided by the national laws of those States, present its case to the competent authority of the Contracting State of which it is a resident or national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the national laws of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree:

a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

b) to the same allocation of income, deductions, credits, or allowances between persons, including a uniform position on the application of the requirements of paragraph 3 of Article 24 (Non-discrimination);

c) to the same characterization of particular items of income;

d) to the same application of source rules with respect to particular items of income; and

e) to a common meaning of a term.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

5. The competent authorities of the Contracting States may prescribe regulations to carry out the purposes of this Convention.

Article 26

EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

1. The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention or of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Article 1 (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes. These persons or authorities may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the first-mentioned State with respect to its own taxes.

4. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the present Convention from taxation imposed by such other Contracting State does not enure to the benefit of persons not entitled thereto.

5. Paragraph 4 of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures

which are of a different nature from those used in the collection of its own tax, or which would be contrary to its sovereignty, security, or public policy.

6. For the purpose of this Article, this Convention shall apply to taxes of every kind imposed by a Contracting State.

Article 27

EFFECT OF CONVENTION ON DIPLOMATIC AND CONSULAR OFFICIALS, DOMESTIC LAWS, AND OTHER TREATIES

1. Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements.

2. This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded--

a) by the laws of either Contracting State, or

b) by any other agreement between the Contracting States.

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Article 28

ENTRY INTO FORCE

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State and instruments of ratification shall be exchanged at ________________________ as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

   a) In respect of tax withheld at the source, to amounts paid or credited on or after the first day of the second month next following the date on which this Convention enters into force,

   b) In respect of other taxes, to taxable periods beginning on or after the first day of January next following the date on which this Convention enters into force.

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Article 29

TERMINATION

1. This Convention shall remain in force until terminated by one of the Contracting States. Either Contracting State may terminate the Convention at any time after 5 years from the date on which this Convention enters into force provided that at least 6 months' prior notice of termination has been given through diplomatic channels. In such event, the Convention shall cease to have effect:

a) In respect of tax withheld at the source, to amounts paid or credited on or after the first day of January next following the expiration of the 6 months' period;

b) In respect of other taxes, to taxable periods beginning on or after the first day of January next following the expiration of the 6 months' period.

DONE at ____________________ in duplicate, in the English and   languages, the two texts having equal authenticity, this ______ day of ____________ 19___ .

FOR THE UNITED STATES OF AMERICA

FOR

Department of the TREASURY NEWS
NGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE May 17, 1976

FIRST MEETING OF ADVISORY COMMITTEE ON FEDERAL CONSOLIDATED FINANCIAL STATEMENTS

Secretary of the Treasury William E. Simon has announced the appointment of fourteen accountants, business executives, and educators to serve on an Advisory Committee on Federal Consolidated Financial Statements.

The Advisory Committee will address major conceptual problems in preparing a reliable set of consolidated financial statements on the accrual basis. Mr. Harvey Kapnick of Arthur Andersen & Co. has agreed to serve as the Committee Chairman. The members of the Advisory Committee will serve without compensation.

The first meeting of the Committee, which will cover administrative matters and some basic conceptual points, will be held Tuesday, May 25, 1976, at 9 A.M. in Room 4121, Department of the Treasury, 15th & Pennsylvania Avenue, N.W., Washington, D.C., and is open to the public. The meeting room will accommodate 52 persons in addition to members of the Committee and Treasury officials.

Since the meeting is in a restricted admittance area, interested persons are asked to call Mr. Michael Smokovich, Acting Director, Regulations and Compliance, Government Accounting Systems Staff, Bureau of Government Financial Operations, on (202) 964-8543 not later than 5 P.M., May 24 for confirmation of space availability and to arrange for access.

A list of the Advisory Committee members is attached.

Attachment

WS-863

ADVISORY COMMITTEE MEMBERS

Dr. Wilton Anderson, CPA
Chairman of Accounting Department, Oklahoma State University
President of American Accounting Association

Mr. John Biegler, CPA
Senior Partner, Price Waterhouse
Board Director, Tokeneke Tax District

Mr. Ivan Bull, CPA
Managing Partner of McGladrey Hansen, Dunn & Co.
Chairman of the Board of American Institute of Certified Public Accountants

Dr. Joseph J. Cramer, Jr., CPA
Chairman, Department of Accounting, Pennsylvania State University
Former Advisor to Financial Accounting Standards Board

Mr. Nathan Cutler
Executive Vice President, Association of Government Accountants
Former Director of Audits, Department of Transportation

Dr. Sidney Davidson, CPA
Director of Business Research, University of Chicago
Past President of American Accounting Association

Mr. Samuel A. Derieux, CPA
Partner, Derieux, Baker, Thompson and Whitt
Past President of American Institute of Certified Public Accountants

Dr. Solomon Fabricant
National Bureau of Economic Research
Former Consultant to General Accounting Office

Mr. Gaylord Freeman
Honorary Chairman of the Board, First National Bank of Chicago
Former Consultant to the Secretary of the Treasury

Mr. Harvey Kapnick, CPA
Chairman, Arthur Andersen and Co.
Board Director, International Executive Service Corps

Mrs. Carole Loomis
Editor, Fortune Magazine
Author of the article "An Annual Report for the Federal Government", 1973

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Dr. Robert K. Mautz, CPA
Partner, Ernst & Ernst
Member of Cost Accounting Standards Board

Dr. Charles L. Schultze
Brookings Institution
Former Director, Bureau of the Budget (now OMB)

Honorable Elmer Staats
Comptroller General of the United States

Mrs. Julia M. Walsh
Vice President, Ferris & Co., Washington, D.C.
Director, U.S. Chamber of Commerce

In addition, Dr. George A. Staubus, Director of Research and Technical Activities, Financial Accounting Standards Board, will serve as an observer at Committee meetings.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE UPON DELIVERY

STATEMENT BY J. ROBERT VASTINE
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR TRADE AND RAW MATERIALS POLICY
AT JOINT HEARINGS OF THE
SENATE COMMITTEES ON ARMED SERVICES,
COMMERCE AND FOREIGN RELATIONS
WEDNESDAY, May 19, 1976

The Chairman and Members of the Committee:

The Treasury Department welcomes this opportunity to discuss with you S. 713, the Deep Seabed Hard Minerals Act and its relation to the Law of the Sea Negotiations.

The Deep Seabed Hard Minerals Act seeks to encourage the development of the hard mineral resources of the deep seabed, pending adoption of an international seabed regime pursuant to Treaty. Before such legislative proposals are acted on, we believe their impact on the following factors must be carefully weighed: 1) the Law of the Sea Negotiations, 2) the precedent that this legislation could create for treatment of investment in other sectors of the economy, 3) and the financial obligations it would create for the Federal Government if present negotiations fail.

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The bill contains five major provisions: 1) a system for licensing eligible firms that intend to develop mineral resources in the deep seabed, 2) a system of rules and regulations governing eligibility and operations in the seabed and licensing procedures, 3) minimum annual expenditures by firms egaged in exploration and development of resources until commercial recovery begins, 4) U.S. Government guarantees for reduction in value of firms' investments because of a future international agreement, and 5) insurance against damages to a firm's investment for which it has no legal remedy. Treasury is interested in all of these provisions; the first three would affect access to the seabed and the performance of firms which are developing the seabed resources, and the last two could affect the competitive relationship between land-based and seabed minerals and could involve costly Government funding of guarantee and insurance programs. The Department would be directly responsible for maintaining the Guaranty and Insurance Fund, created in Section 15. Treasury is also concerned about the customs and tax provisions contained in the legislation.

Treasury Concerns

The Department supports the principle that regulations are necessary to ensure orderly access to seabed resources by mining firms. These principles would be embodied in a successfully negotiated LOS treaty. However, we cannot support S. 713 because it goes far beyond these principles with its guarantee and insurance program, and because now is not the time to install a regulatory licensing and potentially costly guarantee system.

We also believe that the use of investment insurance and guaranty programs could establish an important policy precedent whereby U.S. firms expect the U.S. Government itself to protect them from unforeseen political and institutional changes that affect their operations.

The time is indeed approaching when some firms command the technology to explore and develop seabed mineral resources on a commercial basis. We understand that these firms are concerned about the commercial, and political risks of such exploitation. Nonetheless, we believe that these risks can best be addressed through an appropriate and timely international treaty rather than through domestic action by individual countries. And we are determined that no provision of such a treaty will effectively inhibit development of mineral supplies. Treasury is strongly commited to ensuring that new supplies of raw materials come on stream during future decades to meet market demand and to avoid disrupting shortages.

The Federal Government has pursued a policy of equitable treatment of mineral industries, except for the special case of energy. Treasury believes there is no need to change that policy at this time and give special incentives to a limited segment of the non-fuel minerals industry. We depend upon the market to allocate capital resources efficiently. In some cases the market mechanism is frustrated from performing its role. This occurs when threats of expropriation, or adverse political climates in some countries, deter investments that would otherwise be made. We have relied upon general, not selective solutions to this problem. The Overseas Private Investment Corporation is our basic government insurance program against political risks. It operates virtually worldwide and covers almost all types of investments. And Secretary Kissinger recently proposed at UNCTAD IV a new investment facilitating mechanism, called the International Resources Bank, which would help reduce political risks of direct foreign investments in all types of mineral and energy projects.

In the case of investment in seabed mining we recognize that there are now substantial commercial and political inhibitions against private investment. We believe these inhibitions should be removed, but that the vehicle for removal should be a Law of the Sea Treaty which provides a secure economic and political environment to promote investment which is also consistent with sound environmental practices. Treasury is strongly committed to obtaining a treaty which does provide an environment for successful mining operations. If that treaty is successfully negotiated this year, there will be no need for many of the provisions in S. 713.

If a treaty is not successfully negotiated, we can then consider appropriate action to protect our national interests.

Law of the Sea Negotiations

During the last session of Law of the Sea Negotiations, I participated in the interagency discussions to obtain an acceptable U.S. position on various deep seabed issues. Some issues are successfuly resolved in the single negotiating text but several issues remain for resolution during the intersessional period and at the next session of the Conference in order to secure our economic interests. Proposals for legislation now could affect the momentum of the negotiations, impair the spirit of compromise which we have tried for such a long period to build, and erode the gains that indeed have been made for the U.S. national interest in all three Committees of the LOS Conference.

Secretary Simon has personally followed the developments in these negotiations. If at the end of the summer session their results do not meet U.S. objectives, I can assure you that he will immediately recommend that the Administration review its policy and recommend appropriate action to protect these objectives.

Meanwhile the Treasury will continue to monitor the relationship between the negotiations and the uncertainty which now affects investments in seabed mining activity. It is important that the United States pursue policies in the negotiations that preserve our basic commitment to the market as an efficient allocator of resources in minerals development and exploitation. In the long run, provisions that would likely lead to an inefficient allocation of resources and any provisions that would deter the development of seabed resources would benefit no one. They would lead to unnecessarily high prices for the American consumer and to inefficient industrial production, thus retarding economic growth in both industrial and developing countries. The Administration believes that the United States must, in the forthcoming negotiations, maintain its determination to resist efforts to restrict access to the seabed or to impose restrictive controls on levels of production of its mineral resources.

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U.S. Objectives in Seabed Negotiations

We are determined to obtain certain key objectives in the seabed negotiation. In brief, these are:

- A voting system in the Council which adequately reflects the economic interest of producers and consumers of the deep seabed minerals. In his major address on LOS issues in April, Secretary Kissinger expressed a policy which has been very strongly supported by the Treasury: he said that the United States was dissatisfied with the previous proposal for the Council voting system, and that "voting machinery must be balanced, and equitable, and must insure that the relative economic interests of countries with activities in the deep seabeds be protected, even though these countries may be a numerical minority." This is now the most important unresolved issue in the deep seabed negotiations.

- Open, unobstructed access to deep ocean resources. A cardinal tenet of the United States position has been to insist on nondiscriminatory guaranteed access, with security of tenure, for U.S. and other national firms. In his April speech, Secretary Kissinger emphasized this point when he said, "What the United States cannot accept is that the right of access to seabed minerals be given exclusively to an international authority, or be so severely restricted as effectively to deny access to the firms of any individual nation including our own." The Authority should not have any discretionary power with respect to the issuance of contracts, nor should it have the power to deny contracts for political ends. Therefore, we are inalterably opposed to attempts to impose a system which would arbitrarly restrict U.S. access to the seabed, or which would arbitrarly limit the number of sites that firms of any one signatory can exploit. Such attempts appear to be merely an effort by other industrial countries to constrain the United States' competitive edge in seabed technology and activity.

There are certain other proposals with which we are deeply concerned:

- Price and production controls. Treasury continues to oppose price and production controls that would effectively inhibit development of supplies of seabed minerals. We intend to give continuing close attention to this issue during the remainder of the negotiations.

- Revenue sharing with the Authority. The United States can accept revenue sharing with the International Authority. However, we are opposed to an onerous burden of payments that would impede deep seabed mining activity.

- The Enterprise. The United States has agreed to the creation of an operating arm of the Authority, the Enterprise, which can exploit the deep seabeds under the same conditions that would apply to all mining. At issue is how the Enterprise will be financed, especially during the initial period. Mandatory contributions on the part of States Parties would be an unreasonable burden on the U.S. taxpayers.

Throughout the coming months constant Congressional consultations are essential. If both branches work closely together, the United States will be in a better position to negotiate an acceptable treaty, or if necessary, it will be in a better position to take appropriate action to preserve U.S. economic interests in deepsea mining.

Problems in S. 713

I would like to record some of the Treasury's difficulties with the substance of S. 713.

Our greatest concern is with the potential liability with which the United States Government would be faced pursuant to the guarantee and the investment provisions of this bill. No one knows accurately how much investment will be committed by U.S. firms, though there are estimates of several billion dollars for which the U.S. under the bill could be liable. Neither does anyone know the probability of, or the potential extent of damages that could occur under Section 14.

The provisions for investment guarantees, in Section 13 could compromise the U.S. Government's ability to negotiate freely a satisfactory treaty. For example, we may feel it imperative to negotiate a particular economic provision in the treaty, but this same provision could also make the Federal Government liable to claims under the Act. The existence of such claims could prevent U.S. agreement to the treaty provision even though all might agree that it is in the best interest of the United States.

We are seriously concerned about the effects of both the guarantee and insurance provisions on the behavior of foreign-based firms and foreign governments. The bill could create a meaningful incentive for foreign firms to set up U.S. subsidiaries simply in order to qualify for potential benefits under U.S. law. Foreign governments, in response to the U.S. initiative, could respond with similar schemes to prevent the loss of prestige and financial benefits associated with pioneering efforts in seabed mining. Thus, by this bill, the U.S. could initiate an increase of foreign competition with U.S. firms and a possible influx of foreign seabed miners that would have to be regulated, at cost to the United States. The U.S. has recently been involved in discussions with other industrial nations to limit competitive programs that promote exports through subsidies. It would be ironic, and highly inappropriate to create another such competition among governments in a new field.

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Treasury is greatly concerned about the enactment of any legislation that would establish more than the minimum degree of regulation necessary for deep seabed mining. We believe that further study of the regulatory issues raised by S. 713 is required.

Treasury has objections to the tax and customs provisions contained in the Bill. We believe that the customs provisions are difficult to enforce. Moreover, they place traditional Customs Bureau duties within the Department of the Interior.

We are also concerned about the tax provisions of S. 713. Treating deepsea recovery as though it were recovery within the United States, as in Section 16, does nothing to settle the basic question of whether deepsea minerals are eligible for the depletion allowance. This is because in order to claim the depletion allowance, the claimant must have an economic interest in the minerals in place. The bill does not confer this interest. Conferring access to seabed resources for purposes of exploitation does not confer an economic interest in the conventional sense.

Because of these important shortcomings and objections, we believe more study of this legislation is required. The Administration will consult closely with Congress. After the next session of the Law of the Sea Conference, this summer, we will be in a better position to make the appropriate recommendations.

Mr. Chairman, you requested that we address a number of more detailed questions. Our responses to those questions are attached, which we will be pleased to submit for the record.

QUESTIONS SUBMITTED BY SENATOR MAGNUSON
ANSWERS SUPPLIED FOR THE RECORD ON MAY 19, 1976
BY J. ROBERT VASTINE, DUPUTY ASSISTANT SECRETARY
FOR TRADE AND RAW MATERIALS POLICY
DEPARTMENT OF THE TREASURY

(1) QUESTION: Is the Department of the Treasury opposed to S. 713? Is the Department opposed to any domestic legislation to regulate or promote deepsea mining by U.S. nationals or vessels?

ANSWER: Treasury continues to believe that a comprehensive Law of the Sea Treaty is the best way to protect U.S. oceans interests, provided such a treaty adequately protects the U.S. economic stake in marine living and non-living resources. We are opposed to the bill at this time.

(2) QUESTION: Sections 13, 14 and 16 of the bill would create an investment guaranty and insurance program. What is the Department's view of these provisions?

ANSWER: We recommend against the investment insurance and guarantee programs of S. 713 for several reasons. First, these provisions provide an incentive for investment in a particular activity.

Second, the administration has been striving for common treatment of investment within broad industry groups. In differentiating minerals development in the seabed from minerals activities at land-based sites, these provisions give seabed producers favored treatment. There is no present reason, national security or economic, for such special treatment.

Third, in essence, the bill would indemnify a certain very limited class of producers against an action that their government might take in the future that might impair the investment. This action would be signature and ratification of an LOS treaty. Thus, S. 713 would create precedents which could affect U.S. negotiations in situations unrelated to the law of the sea.

Fourth, we object to these provisions because they create an unknown liability of the U.S. Government under a poorly thought-out insurance scheme. In the Treasury view, the amounts of this liability are indeterminable but they could escalate to several billion dollars, since it is impossible to diversify the risk. In the Law of the Sea this diversification is not possible since an adverse action by only one political entity could injure all of the firms being insured by the United States. We view the creation of such potentially large and unpredictable liabilities as unwise and an inappropriate burden for the U.S. taxpayer. At least part of the risk involved is an ordinary investment risk, albeit a very large one, which is being transferred to the Government. In addition it would be virtually impossible to set a premium that would cover the costs of the insurance program yet could be afforded by the companies.

For these reasons much more study of this and other investment guarantee and insurance schemes is needed. Further study is needed to determine to what extent commercial insurance is available.

(3) QUESTION: Specifically, what is the potential liability of the United States under Section 13?

ANSWER: The scope of the potential liability under Section 13 is impossible to discern from the definition of "investment" given in S. 713 and the description of the investment guarantee in Section 13. The terms "estimated monetary value" (Sec. 3j) and "value of the investment" (Sec. 13) are subject to varying interpretations. Even if we knew the number and value of ships, processing plants and other equipment which had to be insured, it would still be difficult to estimate the potential liability of the United States under the provisions of these sections.

(3a) QUESTION: How do you interpret the term "estimated monetary value" contained in the definition of investment (Sec. 3(j))?

ANSWER: The estimated monetary value could be interpreted to refer just to the value of the recoverable minerals which are left on the site. However, it could include the value which could be placed on potential production from the site. In either case, the amount would be highly subjective and impossible to calculate with accuracy. This provision could mean that the U.S. Government would have to compensate the miner for any revenue sharing obligation in the future treaty.

(3b) QUESTION: How do you interpret the term "value of the investment" used in Section 13? What is the "original investment"?

ANSWER: "Value of the investment" also does not lend itself readily to clear interpretation. Although the cost of research and development is specifically excluded from the definition, it is difficult to tell specifically what could be included. For example, if the loss of a mining vessel means that a land-based processing plant is made inoperative, would the "loss" of the processing plant also be subject to U.S. compensation?

(4) QUESTION: Do you interpret the provisions of this section to apply to a wholly-owned subsidiary of a foreign corporation incorporated under the laws of a State of the United States? If so, is this good policy?

ANSWER: S. 713 would apply to a wholly-owned subsidiary of a foreign corporation incorporated in a State. Thus, if the bill were enacted, the United States could be creating an incentive for foreign corporations to set up U.S. subsidiaries in order to qualify for the benefits that would be provided by this bill. The U.S. taxpayer would then be assuming the financial burden and risk of protecting the assets of foreign firms.

(5) QUESTION: Is there any precedent for this type of investment?

ANSWER: We can find no precedent for the type of investment protection provided in Section 13 of S. 713, which is essentially indemnification in advance for U.S. Government action adversely affecting investment stimulated by the legislation.

(6) QUESTION: What is the nature of the investment insurance program created by Section 14 of S. 713? Is there any existing parallel program being administered by any government agency?

ANSWER: As we stated in response to question 3, it is difficult to define the scope and terms of the investment insurance program as proposed. It is not clear whether loss of part of the assets of an operation, for example, a mining vessel, could give rise to a claim on secure assets like a U.S. nodule processing plant rendered inoperative by the loss.

In a rather limited search, we have been unable to discover any existing parallel insurance program. The Overseas Private Investment Corporation (OPIC) and the merchant marine insurance programs are not very close parallels. The program in S. 713 would be an encouragement to investment, but it covers much more than losses due to random hazards that may occur at sea such as the marine insurance program covers. We understand OPIC is providing answers comparing its programs with the provisions in S. 713.

(6a) QUESTION: Under what conditions does S. 713 make this insurance available? Under what conditions would pay-out on the insurance be made? How do you interpret the phrase "a legal remedy (which) does not exist or is unavailable in any legal forum to which the licensee has access"?

ANSWER: Under the bill, insurance is made available whenever commercial insurance is not available at a reasonable cost for the reasons mentioned in the answer to question 6(b). Treasury believes it is unlikely that commercial insurance will be available at reasonable rates to cover the full range of risks covered in this bill.

Pay-out on the insurance would be made for two types of damage to the value of the investment. The most obvious claim would arise if another company removed minerals from the licensed site. However, the bill would also provide relief for "the impairment of the insured investment." Impairment could arise from many circumstances, such as the availability of cheaper technology, which would otherwise be considered commercial risks.

(6b) QUESTION: What are the problems in determining rates for this type of legislation?

ANSWER: Insurance companies are usually able to establish premiums to cover adequately the probability of a claim and the total value of claims. If they are unable to estimate these probabilities or the claims, then they refuse to write the insurance. Concentration of exposure, certain definition of covered risks, and the ambiguous definition of "value of investment" are likely to defy risk-rating techniques and could lead to a heavily subsidized program.

(7) QUESTION: What U.S. export controls, customs laws, and tax laws are made applicable to deep sea mining operations under Section 16? Is this good policy?

ANSWER: (1) Export Controls -- None of the provisions of this bill affect the export control law and regulations that Treasury enforces.

(2) Customs -- No Customs laws are made applicable to hard minerals taken from the deep seabed by Section 16. 46 U.S.C. 883, which requires that merchandise be transported between ports or places in the United States by means of vessels built in the United States, owned by American citizens, and documented as vessels of the United States, is made applicable to transportation of seabed minerals by Section 16 of the bill. It is not clear whether the navigation laws concerning the entry and clearance of vessels may

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continue to be applied to vessels departing or arriving from operations conducted on the deep seabed under the bill. We foresee no administrative difficulties in permitting hard minerals taken from the deep seabed under a license issued by the United States to be landed in the United States under conditions which would treat the minerals as having been recovered in the United States. However, there may be administrative problems in the control of the vessels involved or in cases where the recovered minerals would be exported directly from the recovery site.

(3) Tax Policy -- Section 16 provides that for purposes of U.S. tax laws, hard minerals recovered from the deep seadbed under a license issued pursuant to the Act will be treated as though they were recovered within the United States. Under present law, the only distinction between hard minerals recovered within the United States and outside it, is that certain minerals are eligible for a higher percentage depletion rate if recovered within the United States. This distinction was enacted as a preference for development of domestic resources in some cases.

Most significantly, however, Section 16 is relevant only if deepsea operations were eligible for any depletion allowance at all. The depletion allowance may be claimed only by a person having an economic interest in the minerals in place.

The legal concept of economic interest has been developed over many years with the more conventional patterns of private ownership and sovereignty in mind. Therefore, its applicability in regard to deep ocean mining is not clear. This question is unsettled under present law, and this bill does nothing to settle that question.

(8) QUESTION: Please provide any other specific comments as to the provisions of S. 713 you care to make.

ANSWER: We should note that though the Treasury is charged by Section 15 with administering the Warranty and Insurance Fund, and is responsible for the Guarantee Reserve, Section 23 appropriates to the Secretary of Commerce the funds for the reserve. In addition, Treasury objects to the placement of traditional Customs Bureau duties within the Interior Department, which is one effect of Section 16.

the Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 3:45 P.M. May 18, 1976

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,100,000,000 , or thereabouts, to be issued May 27, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,500,000,000, or thereabouts, representing an additional amount of bills dated February 26, 1976, and to mature August 26, 1976 (CUSIP No. 912793 A6 3), originally issued in the amount of $3,730,695,000, the additional and original bills to be freely interchangeable.

183-day bills, for $3,600,000,000, or thereabouts, to be dated May 27, 1976, and to mature November 26, 1976 (CUSIP No. 912793 C3 8).

The bills will be issued for cash and in exchange for Treasury bills maturing May 27, 1976, outstanding in the amount of $6,313,555,000, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $2,677,485,000. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Monday, May 24, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on May 27, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing May 27, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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FOR RELEASE AT 3:45P.M. May 18, 1976

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TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for $2,900 million, or thereabouts, of 364-day Treasury bills to be dated June 1, 1976, and to mature May 31, 1977 (CUSIP No. 912793 D5 2). The bills will be issued for cash and in exchange for Treasury bills maturing June 1, 1976.

This issue will provide approximately $500 million of new money for the Treasury as the maturing issue is outstanding in the amount of $2,404 million of which $1,225 million is held by the public and $1,179 million is held by Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities. Additional amounts of the bills may be issued to Federal Reserve Banks as agents of foreign and international monetary authorities. Tenders from Government accounts and the Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities will be accepted at the average price of accepted tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value) and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Wednesday, May 26, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without

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deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on June 1, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing June 1, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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WASHINGTON, D.C. 20220 TELEPHONE 964-2041

For information on submitting tenders in the Washington, D. C. area: PHONE WO4-2604

FOR RELEASE AT 3:45P.M. May 18, 1976 1043

TREASURY TO AUCTION $2.0 BILLION OF 4-YEAR 1-MONTH NOTES

The Department of the Treasury will auction $2.0 billion of 4-year 1-month notes to raise new cash. Additional amounts of the notes may be issued to Federal Reserve Banks as agents of foreign and international monetary authorities at the average price of accepted tenders.

The notes now being offered will be Treasury Notes of Series D-1980 dated June 10, 1976, due June 30, 1980 (CUSIP No. 912827 FR 8) with interest payable on December 31, 1976, and thereafter on June 30 and December 31. The coupon rate will be determined after tenders are allotted. They will be issued in registered and bearer form in denominations of $1,000, $5,000, $10,000, $100,000 and $1,000,000, and they will be available for issue in book-entry form to designated bidders.

Payment for the notes must be made on June 10, 1976. Payment may not be made through tax and loan accounts. Definitive notes in bearer form will not be available on June 10, but will be delivered on or about June 16, 1976. Purchasers of bearer notes may elect to receive interim certificates on June 10, 1976, which shall be bearer securities exchangeable at face value for Treasury Notes of Series D-1980 when available.

Tenders will be received up to 1:30 p.m., Eastern Daylight Saving time, Thursday, June 3, 1976, at any Federal Reserve Bank or Branch and at the Bureau of the Public Debt, Washington, D. C. 20226; provided, however, that noncompetitive tenders will be considered timely received if they are mailed to any such agency under a postmark no later than June 2. Each tender must be in the amount of $1,000 or a multiple thereof, and all tenders must state the yield desired, if a competitive tender, or the term "noncompetitive", if a noncompetitive tender. Fractions may not be used in tenders. The notation "TENDER FOR TREASURY NOTES" should be printed at the bottom of envelopes in which tenders are submitted.

Competitive tenders must be expressed in terms of annual yield in two decimal places, e.g., 7.11, and not in terms of a price. Tenders at the lowest yields, and noncompetitive tenders, will be accepted to the extent required to attain the amount offered. After a determination is made as to which tenders are accepted, a coupon rate will be determined at a 1/8 of one percent increment that translates into an average accepted price close to 100.000 and a lowest accepted price above 99.000. That rate of interest will be paid on all of the notes. Based on such interest rate, the price on each competitive tender allotted will be determined and each successful competitive bidder will pay the price corresponding to the yield bid. Price calculations will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final. Noncompetitive bidders will be required to pay the average price of accepted tenders. BIDDERS SUBMITTING NONCOMPETITIVE TENDERS SHOULD REALIZE THAT IT IS POSSIBLE THAT THE AVERAGE PRICE MAY BE ABOVE PAR, IN WHICH CASE THEY WOULD HAVE TO PAY MORE THAN THE FACE VALUE FOR THE NOTES.

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(OVER)

The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations noncompetitive tenders for $500,000 or less, will be accepted in full at the average price of accepted competitive tenders.

Commercial banks, which for this purpose are defined as banks accepting demand deposits, and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, may submit tenders for the account of customers, provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account.

Tenders will be received without deposit from commercial and other banks for their own account, Federally-insured savings and loan associations, States, political subdivisions or instrumentalities thereof, public pension and retirement and other public funds, international organizations in which the United States holds membership, foreign central banks and foreign States, dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon, Federal Reserve Banks, and Government accounts. Tenders from others must be accompanied by payment of 5 percent of the face amount of notes applied for. However, bidders who submit checks in payment on tenders submitted directly to a Federal Reserve Bank or the Treasury may find it necessary to submit full payment for the notes with their tenders in order to meet the time limits pertaining to checks as hereinafter set forth. Allotment notices will not be sent to bidders who submit noncompetitive tenders.

Payment for accepted tenders must be completed on or before Thursday, June 10, 1976. Payment must be in cash, in other funds immediately available to the Treasury by the payment date or by check drawn to the order of the Federal Reserve Bank to which the tender is submitted, or the United States Treasury if the tender is submitted to it, which must be received at such Bank or at the Treasury no later than: (1) Monday, June 7, 1976, if the check is drawn on a bank in the Federal Reserve District of the Bank to which the check is submitted, or the Fifth Federal Reserve District in case of the Treasury, or (2) Thursday, June 3, 1976, if the check is drawn on a bank in another district. Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at a Federal Reserve Bank. Where full payment is not completed on time, the allotment will be canceled and the deposit with the tender up to 5 percent of the amount of notes allotted will be subject to forfeiture to the United States.

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

FOR IMMEDIATE RELEASE

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ADDRESS BY THE HONORABLE GERALD L. PARSKY
TEMPORARY GOVERNOR FOR THE UNITED STATES
AND ASSISTANT SECRETARY OF THE TREASURY
INTER-AMERICAN DEVELOPMENT BANK
CANCUN, MEXICO
TUESDAY, MAY 18, 1976

Mr. Chairman, Fellow Delegates, Distinguished Guests:

The Inter-American Development Bank is about to enter a vital new period in its history. The last 18-24 months have been a period of uncertainty and hesitation for the world economy, for the economies of most member countries and for the Bank. This period of great uncertainty for both the world economy and the Bank now appears to be over. The economies of most developed countries have been expanding rapidly for several quarters and the effects of this expansion on world trade and developing country exports are already being seen. With exports again growing rapidly, most developing countries should be able to reduce their unusually large payments deficits of the past couple years and at the same time increase growth rates. Nevertheless, as a result of the events of the past two years, the world has undergone basic change. With the development of natural resources by some countries and with the transfer of financial resources to others, the world today is truly interdependent. We need not fear this fact. Instead, as the proper response to interdependence, we must build a world-wide framework of cooperation. Development problems remain; but they too can be overcome if we approach them together -- seeking realistic solutions that will benefit all countries.

The period of great uncertainty is also over for the Inter-American Bank as final action on replenishment of its resources and the entry of the nonregional members is clearly in sight. I am pleased to say that we expect the Congress of the United States to complete action this week on the bill authorizing a U.S. vote for the replenishment as well as for the amendments permitting nonregional membership. President Ford will then sign the bill into law and Governor Simon will vote promptly. Everyone in the Bank, especially President Ortiz Mena, deserves a great deal of credit for facilitating the agreement on the replenishment in record time. Negotiations were initiated at our annual meeting last year, and only formal steps now remain to place it into effect by the end of this month.

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Another major development of great significance to the Bank's future is the expansion of the membership to include countries from outside this hemisphere. We have all worked hard to make it possible for these countries to join the Bank. I hope the nonregional countries which have not yet completed their formal processes will move forward as quickly as possible so that we may be able to welcome them as active participants in this institution. Moreover, I would hope that the nonregional countries which have not yet indicated an interest in joining the Bank will soon do so with contributions appropriate to their economic potential.

This annual meeting gives us a unique opportunity to demonstrate to the representatives of these countries which are about to become full members what the Bank does. We are meeting here in an impressive new city sponsored by the Government of Mexico, with the assistance of loans from the Bank for infrastructure such as water supply, housing and roads. Thus, we can all see at first hand how the Bank helps member countries even in an area where there was previously virtually no economic activity or population. On behalf of the United States, I want to thank the Government of Mexico for hosting this seventeenth annual meeting of the Inter-American Development Bank.

International Economic Outlook

The hopes for rapid economic development of each member country depend in large measure on participation in an international economy which itself is growing rapidly. Fortunately the world is now well on the way to recovering from the most severe economic recession since the 1930's. Industrial production in the major industrial countries has been on the rise for several months. For the larger developed countries as a group the rate of real growth in 1976 seems likely to exceed 5 percent. At the same time, however, inflation and unemployment are still unacceptably high in many countries, including the U.S. We must increase our efforts to solve these problems through the pursuit of fiscal and monetary policies aimed at achieving a balanced expansion.

During the past two years, the non-oil exporting developing countries have experienced abnormally large balance of payments deficits as a result of increased oil prices and the accompanying recession in the industrial countries. These deficits on current account were about $28 billion in 1974, and an estimated $35-37 billion in 1975. Normal long-term financing covered only $20-25 million of the gaps in 1974 and 1975, and developing countries have increased their short- and medium-term borrowings from commercial banks. A continuation of such borrowing would increase debt service payments in future years in a way which might create major problems. Fortunately, we are beginning to see a turnaround in the payments positions of many of the developing countries. Just as last year's recession and inventory adjustment had an amplified adverse impact on primary products and developing countries, the strong economic recovery underway in the industrial countries will have an amplified beneficial impact. Our latest estimates are that the deficits of the non-oil developing countries will be reudced to about $28 billion in 1976 with further improvement continuing in 1977.

Recognizing that the adjustment process is not as rapid for all countries, the United States has made a series of constructive proposals to assist the developing countries. Agreements reached four months ago in Jamaica are specifically aimed at the balance of payments needs of developed and developing countries alike. Already it is clear that there will be increased use of International Monetary Fund resources especially compensatory financing, in 1976.

Despite the many strains of the past year, I believe we can all take pride in the fact that most countries have maintained their commitment to open trading arrangements and relatively free international flows of funds. I am particularly impressed by the fact that developing countries have relied heavily on aggregate monetary, fiscal and exchange policies in adjusting to recent difficulties. They have also made excellent efforts to maintain relatively open markets for imports. These policies suggest that most developing countries are increasingly recognizing the advantage to their development of more intensive participation in an interdependent world. We must continue our efforts to increase trade and financial flows directed by market forces.

There's no question that the international economic system can be improved. We in the United States will continue to suggest changes in the monetary, trade, commodities and technology areas which are aimed at strengthening the functioning of market forces. We do not believe that a new institutional framework to deal with developing countries' economic concerns would be practical or helpful. Instead, we feel that we can bring about effective action within the existing international institutions such as the IMF and the international development banks. We will certainly do our part.

The United States fully recognizes the concerns of Latin American exporters over the wide fluctuations in some commodity export prices and the impact such fluctuations have on their export earnings. We believe progress on raw material problems can be achieved in several ways: through commodity by commodity dialogues between interested producers and consumers; through strengthening the market mechanism; and through adequate investment in raw materials production to assure availability of supplies. We have put forward proposals to accomplish these objectives. Further, as part of our efforts to liberalize access to the U.S. market for developing country exports, the United States introduced a generalized system of preferences on January first of this year. This system covers over 2,700 products of which our imports were approximately $2.6 billion from eligible developing countries in 1974.

At the same time, the most significant contribution the United States can make to international economic progress is to sustain rapid growth in our domestic economy while keeping open our markets for growing imports of the products of other countries. Fortunately, the American economy is experiencing a strong recovery. Real output will grow by more than six percent in 1976. Given our close trade ties with Latin America and the end of our inventory adjustment, an acceleration of imports by the United States will contribute to general recovery in Latin America.

For the economic recovery to be sustained, world trade must continue to expand. The benefits of expanding trade are familiar: greater efficiency, more and higher quality jobs, and lower consumer prices. We are hopeful that the new round of multilateral trade negotiations will reduce trade barriers on a broad scale, provide for the special trade needs of the developing nations, and preserve equitable access to supplies at reasonable prices.

U.S. Commitment to Latin America

The Americas have had a unique history of cooperation in the peaceful management of intra-regional relationships for the mutual benefit of all countries in the hemisphere. We support Latin American economic integration efforts and are ready to consider proposals for strengthening intra-regional cooperation.

The United States has a vital national interest in our long and close association with Latin America and we continue to give high priority to the development of the economies of all IDB member countries. Thus, our support for the work of the Inter-American Development Bank is unwavering.

Joining us here today are several distinguished representatives from the United States' Congress. Their presence here and in visiting the Bank's projects evidences the continued interest in the economic development of Latin America by the U.S. Government and our people.

Economic Development in Latin America is succeeding because of the talent, hard work and perseverance of people throughout the hemisphere. While external assistance makes an important contribution to development, a country's ultimate achievement depends upon the efforts of the nation itself. Many of the development success stories of the past quarter century are in Latin America. Latin American countries, as a whole, have been growing at a very impressive rate of almost seven percent per annum in real terms. Since 1960, value added in manufacturing in the region and installed electrical capacity have tripled while primary school enrollments have quadrupled. Adult literacy increased from about 52 percent in 1950 to about 73 percent in 1970, and the number of rural families with access to potable water has tripled. The IDB has been a major factor contributing to most of these accomplishments.

Although the development task in Latin America is well underway, much remains to be done. In particular, Latin America requires an expanded flow of external capital over the next several years to maintain its development momentum.

My fellow delegates will appreciate the fact that, like many Latin American countries, the United States is faced in the next decade with the task of finding enough capital to meet the need for urban renewal, to revitalize our transportation systems, to expand our energy resources and to modernize our industrial plants. The shortage of capital is a problem in your countries as it is mine. Capital is an important and scarce resource. Nevertheless, my country is committed to continue to supply substantial amounts of capital to Latin America as long as capital continues to be used efficiently to expand living standards in Latin America.

In connection with the shortage of capital, it seems to me highly appropriate that greater efforts be made to take advantage of light capital or intermediate technologies. The productive use of idle labor with new methods and less costly tools should allow more effective utilization of scarce capital resources. The IDB has begun to take advantage of intermediate technologies in some of its agriculture projects. We hope to see extension of this approach to other projects and other sectors.

IDB's Role in Latin America

Turning to the IDB's record and its policies for the future, I want to commend the Bank for its achievements over the past year under the impressive leadership of its President, Mr. Antonio Ortiz Mena:

-- Agreement was reached on increasing the Bank's total resources by $6.3 billion - $5.3 billion in capital and $1 billion in the Fund for Special Operations.

-- Arrangements have recently been completed to permit twelve or more countries from outside the region to become donor members.

-- The Bank began development lending from the $500 million fund entrusted by the Government of Venezuela.

-- The Bank initiated a program of complementary financing to increase the flow of private financial resources to development projects in Latin America.

-- The Group of Controllers has continued to make objective and astute evaluation of the Bank's programs and operations. We look forward to the Group's being used more actively to assist the Board of Directors.

In 1975 the IDB authorized $1.4 billion for seventy loans, the highest annual volume of lending in the Bank's fifteen-year history. New commitments in 1975 were three times the 1968 level. While this is impressive, it is important to remember that the level of new loan commitments is not in itself an adequate measure of the Bank's performance. The key measure of a development bank's success is the extent of development that actually takes place as a result of its efforts.

We believe that the Bank should devote more attention to the implementation aspects of its lending operations. Both Management and the Board of Directors should concentrate on improving the quality of loans, improving estimates and control of project costs and increasing supervision of projects underway. The time lag between approval of loans and their implementation could be reduced if the Board of Directors were to insist that projects be sufficiently well prepared before they are brought forward for approval. The Board should also consider cancelling balances in old loans which have not been properly used in order to free up scarce resources.

While more attention to improve procedures and administration is important, we do not believe that more decentralization of the Bank's functions is the answer. Management controls and clear procedures have to be worked out by the management and the Executive Directors. Many important policies, including those detailing procurement, need continuous review, as Minister Beteta properly pointed out yesterday. As we undertake such a review, we should bear in mind that foreign exchange disbursements should be generally for procurement outside the borrowing countries. I also urge the Bank to pursue ex post project evaluation studies to determine where improvement in project implementation can be made.

We continue to believe that the limited resources of the FSO should be reserved for countries that have a genuine pressing need for concessional assistance and have demonstrated by their own self-help efforts that such assistance is justified. It is a sign of basic economic strength that some member countries agreed to discontinue borrowing convertible currencies from the FSO. We applaud their intention to make a portion of their new contributions to the FSO in convertible currencies.

While these are important steps in the right direction, more can be done to concentrate the Bank's concessional resources where they are most needed over the next few years. We believe that the middle income countries should increasingly switch their borrowing to ordinary capital and the Venezuelan Trust Fund. In addition, more ordinary capital loans should be made to the poorest countries for income-generating projects. The use of FSO convertible currencies to meet local costs financing needs in the wealthier countries decline as their ability to mobilize internal resources increases. These measures will free the scarce concessional convertible currencies for the use of the poorest members of the bank. We strongly support the Bank's efforts to expand its lending for agriculture and commend the Bank for directing the largest share of its 1975 lending to the agricultural sector. It is almost gratifying to note that the International Group on Agricultural Development in Latin America, established at the initiative of the Bank, concluded its first formal meeting here in Cancun this past weekend. We look forward to a very useful role for this Group in coordinating efforts to increase agricultural productivity and improve nutrition in the region.

While increased production should remain the chief objective of agricultural loans, we believe the Bank should place special emphasis on projects containing benefits which will be widely shared among rural populations. We are pleased that the Bank has increased its lending to agricultural cooperatives. In addition, the Bank has made significant advances in financing projects for potable water supply, rural electricity, education and health, of which pre- and post-natal maternal care are key elements. We urge the Bank to continue its efforts in these areas. It is these rural development projects and loans to cooperatives and rural credit unions which tend to have the greatest direct benefit to the quality of life of lower-income groups.

The Bank's loan commitments financed by borrowing backed by its capital have increased sharply in recent years and further increases are projected for the replenishment period. These commitments will result in a rise in the annual level of disbursement and borrowing. Thus it is more important now than ever before to assure the Bank's credit worthiness in international capital markets is enhanced. Accordingly, consideration should be given to structuring the Bank's lending rate so that it moves automatically with the cost of capital to the Bank and with a sufficient spread above the borrowing costs to cover administrative and liquidity costs. This would have the added benefit of removing the setting of the Bank's interest rate from the political arena and of providing substantial profits to add to reserves as the Bank grows. Assured income and increasing reserves will make it possible for the Bank to sell its bonds at the most favorable rate and there by itself lend the lowest cost to developing countries.

Although we are focusing in this meeting on inter-governmental relations and affairs of an official lending institution, we should not lose sight of the overwhelming importance of the private sector to Latin American development. Most Latin American countries have a dynamic private sector. We believe that market forces are instrumental in effectively allocating resources and producing a climate which favors individual initiative. A healthy private sector is the most effective means of allocating resources, speeding economic development, and distributing the fruits of economic growth among all the people. The International Finance Corporation, which supports private sector activities in developing countries, lends more in Latin America than any other region. Earlier this month the IFC's Board of Directors approved a major capital increase for the organization. The United States strongly supports this increase because we believe that the IFC is making a notable contribution to the pace of development. For the same reason we believe that the IDB should increase its support to the private sector, through greater lending to productive enterprise outside the public sphere and to domestic development finance companies, which both raise additional domestic capital and re-lend to local industry, commerce and agri-business. The Bank should also support the growth of savings and loan institutions which can be effective in increasing the mobilization of domestic savings.

While we believe the Bank should support the private sector through its lending operations, we do not think it appropriate for the Bank as a development lending institution, to use a significant part of its new resources to finance exports. Export financing should be left to the marketplace and to private businessmen and bankers.

The private sector is the most important source of external capital for Latin America. Approximately three-fourths of net capital flows to Latin America came from private sources last year. We applaud the Bank for its initiative in launching a complementary financing program to channel resources from private investors and banks to its development projects.

We are all New World countries settled and developed by colonists and refugees, from across the Atlantic and Pacific Oceans, both adventuresome and idealistic. In July the United States will celebrate the 200th anniversary of the declaration of our independence. Since our shores were first settled we've experienced a major socio-economic transformation from a pioneer society to an industrial nation. We recognize in the development goals of our Latin American neighbors the same historical imperative which directed our own development. We share your hope for a better life for all your people and we pledge to continue to assist the economic development of this region.

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federal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-964-2615

FOR IMMEDIATE RELEASE May 19, 1976 1054

SUMMARY OF LENDING ACTIVITY

May 1 - May 15, 1976

Federal Financing Bank lending activity for the period May 1 through May 15, 1976 was announced as follows by Roland H. Cook, Secretary:

On May 1, the United States Railway Association (USRA) rolled over Note #3 in the amount of $500,000.00 and borrowed $1,095.89 to pay the interest due. The loan matures May 31, 1976, and bears interest at a rate of 5.163%. USRA borrowings from the Bank are guaranteed by the Department of Transportation.

The Federal Financing Bank made the following loans to utility companies guaranteed by the Rural Electrification Administration:

Date	Borrower	Amount	Maturity	Interest Rate
5/3	Oglethorpe Electric Membership Corp.	$7,421,000	12/31/10	8.147%
5/5	Associated Electric Corp.	4,000,000	12/31/10	8.137%
5/10	Cooperative Power Assn.	6,700,000	12/31/10	8.255%
5/14	Tri-State Generation and Transmission Assn.	3,902,000	12/31/10	8.303%

Interest payments on the above REA loans are made quarterly.

On May 3, the Government of Argentina made a $1,156,151.37 advance from the Bank. The loan bears interest at a rate of 7.490%, and matures April 30, 1983. The loan is guaranteed by the Department of Defense under the Foreign Military Sales Act.

On May 3, the National Railroad Passenger Corporation (Amtrak) made the following drawings from the FFB:

Note	Amount	Maturity	Interest Rate
6	$6,500,000	6/29/76	5.142%
7	4,500,000	6/14/76	5.142%

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Amtrak borrowings are quaranteed by the Department of Transportation.

The General Services Administration made the following borrowings from the Federal Financing Bank:

Date	Series	Amount	Maturity	Interest Rate
5/4	M	$3,912,320.87	7/31/03	8.215%
5/13	L	940,934,43	11/15/04	8.412%

On May 11, the Student Loan Marketing Association (SLMA) borrowed against the following notes:

Note	Amount	Maturity	Interest Rate
32	$20,000,000	8/3/76	5.334%
33	20,000,000	8/10/76	5.334%
34	20,000,000	8/17/76	5.334%

SLMA borrowings are guaranteed by the Department of Health, Education and Welfare.

The Tennessee Valley Authority borrowed $35 million from the Federal Financing Bank on May 14. The note matures August 31, 1976 and bears interest at a rate of 5.363%.

FFB loans Outstanding on May 15, 1976 totalled $22.1 billion.

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FOR IMMEDIATE RELEASE May 19, 1976

PRELIMINARY RESULTS OF AUCTION OF 2-YEAR TREASURY NOTES

The Treasury has accepted approximately $2,250 million of $4,717 million of tenders received from the public for the 2-year notes, Series M-1978, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	7.08% 1/
Highest yield	7.19%
Average yield	7.16%

The interest rate on the notes will be 7-1/8%. At the 7-1/8% rate, the above yields result in the following prices:

Low-yield price	100.082
High-yield price	99.881
Average-yield price	99.936

The $2,250 million of accepted tenders includes 56% of the amount of notes bid for at the highest yield and $369 million of noncompetitive tenders accepted at the average yield.

In addition, $302 million of tenders were accepted at the average-yield price from Government Accounts and Federal Reserve Banks for their own account in exchange for notes maturing May 31, 1976 ($82 million), and from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash ($220 million).

1/ Excepting 6 tenders totaling $7,260,000

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Contact: L.F.Potts
Extension 2951
May 20, 1976

FOR IMMEDIATE RELEASE

WITHHOLDING OF APPRAISEMENT ON KNITTING MACHINERY FOR LADIES' SEAMLESS HOSIERY, FROM ITALY

Assistant Secretary of the Treasury David R. Macdonald announced today a six-month withholding of appraisement on the subject merchandise from Italy, pending determination as to whether the subject merchandise is being sold at less than fair value within the meaning of the Antidumping Act, 1921, as amended.

This decision will appear in the FEDERAL REGISTER of May 21, 1976.

Under the Antidumping Act, the Secretary of the Treasury is required to withhold appraisement whenever he has reasonable cause to believe or suspect that sales at less than fair value may be taking place.

A final decision in this case will be made on or before August 21, 1976. Appraisement will be withheld for a period not to exceed six months from the date of publication of the "Withholding of Appraisement Notice" in the FEDERAL REGISTER.

Under the Antidumping Act, a determination of sales in the United States at less than fair value requires that the case be referred to the U.S. International Trade Commission, which would consider whether an American industry was being injured. Both sales at less than fair value and injury must be shown to justify a finding of dumping under the law. Upon a finding of dumping, a special duty is assessed.

Imports of the subject merchandise from Italy during calendar year 1975 were valued at roughly $3,250,000.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
CALIFORNIA MUSEUM OF SCIENCE AND INDUSTRY AWARDS DINNER
LOS ANGELES, CALIFORNIA - MAY 20, 1976

Thank you Cyril Magnin, President Edgerton, distinguished guests, ladies and gentlemen:

I am honored to be here this evening in such prestigious company. In particular, Mr. Jorgensen and Dr. Taplin, my congratulations to you on your fine achievements, your sense of civic spirit, and the awards you both so richly deserve.

When one contemplates the contributions that American science and industry have made to social and economic progress the list of examples seems almost endless. Yet,one reason,more than any other,explains why so much progress has occurred in our country: We have placed a tremendous emphasis on the incentives needed to reward individual creativity and productivity. Those incentives were made possible because we believe so strongly in the need for individual freedoms -- both political and economic.

I was delighted to learn your distinguished organization is in the process of developing a new exhibit to be known as The Hall of Economics and Finance, supported by the banking industry, brokerage firms, insurance companies, and savings and loan associations.

Recognizing the remarkable contributions of American businessmen to our society is also good sense and I would like to see your effort duplicated in other cities. If there is any subject that is generally misunderstood by an overwhelming number of our citizens, it is the importance of our free enterprise system. In fact, that information gap, or the economic illiteracy of our people, will be the subject of my remarks this evening. But first let me give you an update on the status of our economy.

As I look around this room, I realize that among you are many whose businesses were hard-hit by the recent recession and simultaneous double-digit inflation. The negative impact of that combination of problems represents a terrible price to pay for the many years of economic

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mismanagement. Fortunately, we are now well into the second year of economic expansion following the turnaround in the economy about fifteen months ago. We still have a long way to go to regain the kind of national economy we all desire but at least we are moving in the right direction and we can look for a sustained recovery if responsible policies are followed:

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been sharply reduced and the underlying rate of inflation is now approximately 6 percent. In fact, during the first quarter of this year the overall rate of inflation, as measured by the GNP price deflator, increased at an annual rate of only 3.5 percent. So we have made progress already and we can make more if we continue to follow responsible policies.

-- During the spring of 1975, the unemployment rate reached 9 percent. It has now dropped to 7.5 percent and the trend is clearly downward. Even more important, actual employment has increased rapidly during the past year and a record 87 million people are now working.

-- And the latest figures on the growth of the real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 8.5 percent during the first quarter of 1976. During the last four quarters the output of real goods and services has increased 7.1 percent, a pace well above the underlying capacity of our economy.

Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, imports, business capital investment, and most other measures of economic activity -- all are registering solid gains and this reflects rising public confidence about the economy.

We made considerable headway in 1975, and we will make even more in 1976 if consumers and businessmen remain confident that the government will not apply excessive economic stimulus to gain political advantages. But we still face serious long-term problems and this is certainly no time for complacency. Unemployment is still intolerably high, and inflation is by no means under control.

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Our basic desire for progress, in the form of improved living standards and employment opportunities, will surely be frustrated unless we better control the insidious inflation which has destroyed economic stability by triggering a costly series of booms and recessions. The tragic policy errors of the past and our basic hopes for the future must force us to recognize a basic reality: Inflation is the greatest threat to the sustained progress of our economy and the ultimate survival of all of our basic institutions. There is a clear record from the past: When inflation distorts the economic system and destroys the incentives for real improvement the people will no longer support that system and society disintegrates. I am convinced that our uniquely creative and productive society will also collapse if we permit inflation to dominate economic affairs. There is no tradeoff between the goals of price stability and low unemployment as some critics have erroneously claimed. To the contrary, the achievement of both goals is interdependent. If we are to increase the output of goods and services and reduce unemployment, we must first make further progress in reducing inflation.

The intensity of my feelings about inflation has resulted in some critics labeling me a "fanatic." I readily accept that label if it helps to communicate my deep concerns. We must always remember that it is inflation that causes the recessions that so cruelly waste our human and material resources and the tragic unemployment that leaves serious economic and psychological scars long after economic recovery occurs. It is inflation which destroys the purchasing power of our people as they strive -- too often in a losing struggle -- to provide the necessities of food, housing, clothing, transportation, and medical attention and the desired necessities of education, recreation and cultural opportunities. Inflation is not now, nor has it ever been, the grease that enables the economic machine to progress. Instead, it is the monkey wrench which disrupts the efficient functioning of the system. Inflation should be identified for what it is: The most vicious hoax ever perpetrated for the expedient purposes of a few at the cost of many. There should be no uncertainty about its devastating impact, particularly for low-income families, the elderly dependent upon accumulated financial resources and the majority of working people who do not have the political or economic leverage to beat the system by keeping their incomes rising even more rapidly than inflation. When inflation takes over an economy the people suffer and it is time that this basic point is emphasized by every responsible citizen and the full brunt is brought to bear on their elected officials. Let me assure you that regardless of the rhetoric emanating from Washington, D.C., the spend-spend, elect-elect, syndrome is alive and well.

Of course, when I speak of economic reality I am emphasizing the difference between actual performance and promises. There is already a tendency on our national scene, which shows every sign of intensifying as the elections draw closer, to bring forth appealing claims that new spending programs could quickly reduce the current employment without creating any risk of inflation. These claims are made even though any analysis of economic history -- particularly the disappointing results of the last decade -- clearly indicate the disruptive impact of repeatedly overheating the economy. And there is a seemingly endless stream of political rhetoric about the insensitivity of this Administration for not triggering massive spending programs to demonstrate political leadership through decisive actions intended to solve all our problems before the next election. But for once, let us not fall prey to those who tour the country, their bags brimming with instant quack cures -- self-proclaimed compassionate people whose spending proposals promise everything, but deliver us only one thing: an unwanted boom and recession sequence with excessive levels of inflation and unemployment.

I urge you, as intelligent and objective citizens, to ask yourselves a few fundamental questions. How could the most dynamic economic system in the world become vulnerable to the problems of double-digit inflation and record postwar unemployment simultaneously? As a people where did we lose our way?

Economists argue about this a good deal and most politicians prefer to ignore the question entirely, seeking instead to capitalize on the effects of the problems. But to me there is no real mystery about how we got here, nor what we must do to return to more sustainable patterns of economic growth.

To an objective observer, the first and most glaringly obvious fact is that our economic problems do <u>not</u> stem from a lack of compassion, concern or vision on the part of the Federal government. Since President Eisenhower left office:

-- The number of domestic spending actions for social problems has increased tenfold, from 100 to over 1000 individual programs.

-- The American people have spent over one trillion dollars on social programs for people and communities in a well-intended effort to improve the quality of life even though the level of dissatisfaction continued to increase at an even faster pace.

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-- The staple of our national life has become politicians with grand visions and even grander promises of what can be accomplished if they can just spend more of our money and be given greater authority over our lives.

So over the past 15 years, the government has tried many, many solutions. Yet the problems persist and our people grow more frustrated, disillusioned, and cynical. This doesn't mean there are no answers. It means only, I would suggest, that we have been taking fundamentally the wrong approach. We suffer not from a lack of government action, but from an excess of government action. The trouble with the Federal government is that it is trying to do more than its resources permit, to do many things it cannot do very well, to do some things it should not do at all, and to do all these things at the same time. Excesses in governmental action have been most damaging to three critical areas affecting the economy:

-- fiscal policy

-- monetary policy

-- regulatory policy

No one who has followed the pattern of Federal spending in recent years can fail to be depressed by its explosive growth.

-- The Federal budget has quadrupled in 15 years. In Fiscal Year 1962 Federal spending first topped the $100 billion level. In Fiscal Year 1977 we will see Federal outlays of over $400 billion. Government spending is growing much faster than our ability or willingness to pay for it.

-- We have had 16 budget deficits in 17 years;

-- We have doubled the national debt to over $600 billion during the last ten years. It took 75 years for our national debt to reach one billion dollars. Today, the government spends over $1 billion each day and the national debt increases $1 billion every week. The annual interest on this debt in Fiscal Year 1977 will be $45 billion and will represent the third largest expense in the Federal budget.

The Federal Government today is the nation's biggest single employer, its biggest consumer and its biggest borrower. And if the postwar spending trends were to continue until the end of the century, total government outlays would account for almost 60 percent of the gross national product. That unfortunate pattern would result in the government taxing and spending more than half of the total economic output of America. If the government achieved that degree of dominance over our lives, many of the economic, political and social freedoms we now take for granted would be lost.

The alarming fact is that in every country in which the government's share of economic activity has increased rapidly to a dominating level there has been a tendency to move toward instability, toward minority government and toward a threat to the continuation of a free society.

The issues involved are by no means narrow economic ones. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good the intentions behind the growth are, those intentions are not achieved; instead, the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

The excessive growth of government spending has also disrupted our financial system. Partly to accommodate the federal government's borrowing needs in the private markets, there has been a significant shift in monetary policies. From 1953 to 1965 the money supply of the United States was growing at approximately 2-1/2% and we enjoyed relative price stability. From 1965 to the present, however, the average rate of growth of the money supplv has more than doubled. Is it any accident that during that same period we have had spiraling inflation?

This past decade has also witnessed an accelerating growth in the administrative and regulatory powers of governments at all levels. This is an area of particular concern to you in California, as well it should be. Government agencies now directly regulate over 10 percent of everything bought and sold in the United States and indirectly regulate almost every other part of the private economy. It is increasingly obvious that this cumbersome regulatory system has too often stifled innovation and competition and has added billions of dollars each year to the price of consumer and business products. The government does have a legitimate responsibility to protect the public interest and specific abuses <u>have</u> occurred; but the degree of government intervention has reached such a level of irritation that individuals and businesses are demanding relief from the incredible power of the army of more than 100,000 government regulators. Just to fill out the necessary forms, the American people must now spend over 130 million work hours a year. That translates into an annual cost of approximately $20 billion.

Americans are increasingly aware that something is wrong with the system but they unfortunately don't understand how the economy is supposed to function. It is no exaggeration to state that most Americans are economically illiterate. For example, there has been justifiable concern about the lack of a national energy policy but much of the debate over goals and procedures has been based on dangerous misinformation. Particularly unfortunate have been some of the loud, politically motivated cries for further government controls in the energy field. Such statements are often a poorly disguised call for a Federal Oil and Gas Corporation which would be an incredible blunder.

These cries may yield a few short-term political returns in an election year but they are not in the best interests of the country. Our whole economic system is based on the basic market principle that products which people are willing to pay for will be produced, and that a fair price will produce an adequate rate of return. Things for which people are not willing to pay an adequate price will not be produced. This is not only the essence, but the genius, of the free enterprise system. Arbitrary and politically motivated controls and regulations that strangle the profit motive can only, in the long run, make the consumer as well as the producer suffer. Once the incentive to produce more of a product is removed, supplies inevitably decrease and what follows is sharply higher prices, or rationing, or both.

That is why the Administration feels so strongly about deregulation in general and deregulation of petroleum products in particular. It is also why we continue to oppose those who would inject more federal interference into the energy field.

History clearly demonstrates that free enterprise combined with each citizen's personal commitment to increased conservation are the two strongest forces we have going for us in our efforts to meet the energy challenge. Consider the record to date. Despite inflation and the oil embargo, Americans still pay far less to heat their homes, fuel their cars and meet the growing energy needs of industry than the people of any other major industrial power -- thanks largely to our free-enterprise approach to energy production.

Unfortunately, this record of efficiency and innovation hasn't stopped some vocal critics from tying to make a scape-goat out of the energy industry. It is ironic that these same critics argue for increasing government intervention to cure many of the problems which are the result of earlier government policy mistakes. Imagine, this is the only sector of our economy that is still under price controls. What a monumental con job on the part of political demagogues who have convinced a naive public that you can control prices and encourage production at the same time -- that you can take away the incentive to drill and still expect efficient development of America's untapped energy abundance.

Another striking example of undesirable government interference is the growing chorus of politicians calling for divestiture of the oil industry -- that is break up the existing companies. It seems to me that those who argue for the fractionalization of this complex and crucial industry have a tremendous obligation to show us how -- if at all -- divestiture will benefit the consumer and the nation. So far, they have completely failed to do so, relying instead on anti-business slogans, political rhetoric, and the vague promise that somehow, if we go after the oil companies with a hatchet, the price of gas will go down.

This is illogical and self-destructive. It makes about as much sense as asserting that you can get better mileage out of your car if you chop it up into small pieces. In fact, you will get no mileage at all. And it will cost you more -- not less -- to get the delicate mechanism repaired and back into working order once the damage has been done.

We still have the choice of acting in our own best energy interests instead of reacting to decisions made by foreign countries. We <u>must</u> start thinking of the energy crisis in terms of American jobs, homes, food and ultimately our national security.

Our economic well-being and national security depend upon retaining control of the American economy. We cannot continue to jeopardize our future by avoiding the tough energy choices today. We must pay the price necessary to give us command of

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our own economic destiny. If we have the courage to act now, we can enjoy cheaper prices in the future.

When you objectively add it all up, the facts of excessive govenment spending, excessive expansion of the money supply and excessive governmental regulation, one conclusion seems inescapable: Our inflation and our resulting unemployment were made in Washington, D. C. Our current federal budget is equivalent to about $2,000 for every man, woman, and child in this country. Our national debt equals almost $3,000 for every citizen. And government regulation adds approximately $2,000 to the costs of purchases made by each American family every year. How can anyone make the case that the increase in governmental benefits has in any way kept up with the increase in governmental costs?

The fact is that governmental excesses of the past]5 years became the strong underlying cause of inflation during the]960's. They remain so today. The rise in spending has added enormously to the aggregate demand for goods and services in the economy, thus forcing up prices. And the government's heavy borrowing needs require it to soak up 80 percent of all new long-term loanable capital, leaving only 20 percent to the entire private sector, which nevertheless must produce virtually all our goods and services and employ 83 percent of our workforce. This massive government demand for funds has been an important factor in the persistent rise in interest rates, and the strains in the financial markets.

The evidence is in and it proves conclusively that big government, far from being our greatest source of prosperity and material security, as some people would have us believe, has now become a direct threat to our survival as a free society. And that is why I must appeal to you this evening not only for your support, but also for your direct participation in a massive effort to preserve the economic freedoms that have given this country both the greatest prosperity and the greatest freedom ever known to man. For what is now at stake is not just the survival of this or that industry. What really hangs in the balance is the survival of the private sector and the individual liberties which have never long survived the loss of economic freedoms.

The problem is a matter of both policy and perception. Bad perception leads inevitably to bad policy, and I am firmly convinved that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times. Unfortunately the perception of what is right or wrong is too often inaccurate, because it is described inaccurately as a superficial division between those who "care" and those who are "callous."

Many of today's young people view those who consistently advocate bigger government as the saviors of the modern world out to rescue the persecuted underdog. On the other hand, those who advocate less government and the strengthening of free enterprise are often dismissed out of hand as greedy exploiters out to make a fast buck for themselves or their companies. Because image is so all-important and bad news is big news, those who supposedly "care" are often afforded greater media exposure to expound on all our social ills and to claim they can cure them by increasing government spending and then having the Federal Reserve System create the credit needed to cover the resulting deficits. In reality, of course, this is no cure at all. It is this same destructive approach that is at the very root of the problems we are struggling with today. Big government isn't the solution; it is the problem.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queque up for hours outside state-owned food and department stores in order to buy a poor slection of overpriced food staples and dreary state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, efficiency and productive competition the average American shopping center would represent to nine-tenths of the world's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and operated agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions guided by the incentives of a free marketplace and feed not only our own people, but millions of others as well.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid; what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried. In essence, a society where the individual has no meaning. For as Alexander Hamilton warned us so long ago, "power over a man's substance amounts to power over his will."

Just as importantly, they have not seen first-hand the political and social aftermath in free societies where the government has destroyed or eroded private enterprise -- the economic decay that follows, the demoralization of the population and often even the massive emigration of skilled workers and professional people indispensible to economic growth and vitality.

Despite this overwhelming evidence of experience, we who insist on the superiority of the free enterprise system, emphasizing its competition, efficiency, and profitability seem to be losing the debate. We tend to converse in slogans and labels, while the proponents of big government speak in more appealing and seemingly more humane terms. This is unfortunate. To me it would be difficult to imagine any greater irony. For even the most cursory glance at history shows us that the American economy is the most successful the world has ever known -- <u>precisely</u> because it is an essentially humane creation of the people, by the people, and for the people.

The performance of our economy proves this. In the period since the early 1960's -- a period during which one abuse after another has been inflicted upon our private sector, it has nevertheless managed to outperform all others.

-- In the last 15 years alone real spendable income has jumped by over 50 percent on a per capita basis, average family income has risen to over $13,000 a year, 20 million new jobs have been created, and we have cut in half the number of people below the poverty line.

-- Our farmers harvest more than twice as much grain with fewer workers compared to a generation ago.

-- Medical science, thanks to men like Dr. Taplin, has added 10 years to our lives over this period.

-- And Americans today have more leisure time for study, recreation and self-improvement than any society in recorded history.

No other country -- no other system -- has achieved so much for its people. Yet these tremendous achievements are the product of the same free-market system that now incredibly finds itself under attack.

Where does the Free Enterprise System stand today? For all the talk about excessive profits, it's a system that, on the average, offers a profit incentive of less than five cents on the dollar; a small reward for all the effort and risk-taking that goes into developing and operating a successful business.

Nevertheless, it remains the real productive source of our nation's wealth, as well as that of each individual American.

Despite the growing influence of government over our lives, the private sector produces the food we eat, the goods we use, the clothes we wear, the homes we live in.

It is the source of five out of every six jobs in America, and it provides directly and indirectly, almost all the revenue for the rest of the jobs in our all-too-rapidly expanding public sector.

It is the foundation for defense security for ourselves and most of the Free World.

It is the productive base that pays for government spending to aid the elderly, the jobless, the poor, the dependent and the disabled. That is why I am sick and tired of apoligizing for free enterprise. For far from being the anti-human caricature painted by political demagogues, the American private sector is in reality the mightiest engine for social progess and individual improvement ever created.

In a nut shell, all of the material and spiritual values that make our country unique and make us so proud to be Americans could not exist without the free enterprise system. Yet many people still fail to understand the crucial link between our economic and our political freedoms. Destroy one, and the other will soon disappear.

I can assure you that this Administration is fighting to ensure the survival of your economic freedoms. But to succeed, we must have the active participation of leaders like yourselves in reopening the lines of communication to the American people. It's been said that communication is the web that holds civilization together, perpetuating its values and traditions.

Never has that function been more important than today. We must -- all of us -- communicate the great story of our free economy.

-- We must dispel the confusion that has made free enterprise a dirty word and convince the public that business, profits and people are all vitally interrelated.

-- We must let our lawmakers and leaders in government know that they cannot continue to work at cross purposes with the very system that generates our wealth, our strength and our freedom.

-- We must make people aware that runaway spending and unending deficits are sopping up much needed capital for more productive jobs in the private sector and are only fueling inflation -- a silent thief that picks every American's pocket, undermines confidence, and turns the desperate to government for still more illusory help.

But these arguments are not enough. Living examples such as Mr. Jorgensen are far more important. That is why I urge each of you:

-- To set a high moral and ethical standard by eliminating any practices in your organizations and operations that may be questionable.

-- To square practices with principles by supporting deregulation across the board, not just selectively; by helping to end government subsidies, quotas and handouts, bailouts or other inducements that offer a superficial promise of security in exchange for freedom.

-- To initiate and, in some cases, to intensify efforts to inform and educate the public about the benefits and realities of private enterprise.

This is the crucial theme that must be communicated broadly and deeply into the national consciousness: The American production and distribution system is the very wellspring of our nation's strength -- the source of abundance and the base on which our hopes for a better future lie. America can solve its pressing problems if it preserves and continues to improve this immensely productive system. But only by committing ourselves to this process can we safeguard the freedoms that made it all possible. Let us make that our common resolve.

Thank you.

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REMARKS OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
FOREIGN TRADE ASSOCIATION OF SOUTHERN CALIFORNIA
LOS ANGELES, CALIFORNIA
THURSDAY, MAY 20, 1976

Thank you President Baer, Distinguished Members of the Head Table, Ladies and Gentlemen. I am pleased to address this distinguished group to share with you my expectations and concerns for future economic progress based on the expansion of trade among all nations. As the premier economy of the world, we have a unique responsibility to provide leadership for the development of a more open and efficient international system of trade and investment. To achieve this desirable goal the United States must do two things:

-- First, we must follow more responsible fiscal and monetary policies to create a strong and stable domestic economy. The strength of the American economic system is a basic factor in the continued progress of other nations. Unfortunately, U.S. economic policies have not provided the necessary stability over the last decade. As a result, our economy has been distorted by recurring booms and recessions marked by excessive inflation and unemployment. Although we are now in the second year of a relatively strong economic expansion inflation and unemployment remain too high and the need for responsible economic policies is more important than ever.

-- Second, in shaping our international economic policies we must emphasize the same principles of open markets and competition that have served America so well during its two-hundred year history. The current monetary and trade reform efforts will determine the world economic system far into the future. We can either promote increased competition, the reduction of tariffs and non-tariff barriers, equitable trading rules and open access to markets and raw materials; or, the world economy will develop unwanted cartels to control prices and supplies and protectionism will once again disrupt the flow of trade and capital.

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In the final analysis there is no difference between domestic and international economic goals. If we rely on our traditional principles of open markets, minimal government controls, intense competition and personal freedom, then economic progress will occur throughout the world economy. But our basic desire for progress, in the form of improved living standards and employment opportunities, will surely be frustrated unless we better control the insidious inflation which has destroyed economic stability by triggering a costly series of booms and recessions. The tragic policy errors of the past and our basic hopes for the future must force us to recognize a basic reality: Inflation is the greatest threat to the sustained progress of our economy and the ultimate survival of all of our basic institutions. There is a clear record from the past: When inflation distorts the economic system and destroys the incentives for real improvement the people will no longer support that system and society disintegrates. I am convinced that our uniquely creative and productive society will also collapse if we permit inflation to dominate economic affairs. There is no tradeoff between the goals of price stability and low unemployment as some critics have erroneously claimed. To the contrary, the achievement of both goals is interdependent. If we are to increase the output of goods and services and reduce unemployment, we must first make further progress in reducing inflation.

The intensity of my feelings about inflation has resulted in some critics labeling me a "fanatic." I readily accept that label if it helps to communicate my deep concerns. We must always remember that it is inflation that causes the recessions that so cruelly waste our human and material resources and the tragic unemployment that leaves serious economic and psychological scars long after economic recovery occurs. It is inflation which destroys the purchasing power of our people as they strive -- too often in a losing struggle -- to provide the necessities of food, housing, clothing, transportation, and medical attention and the desired necessities of education, recreation and cultural opportunities. Inflation is not now, nor has it even been, the grease that enables the economic machine to progress. Instead, it is the monkey wrench which disrupts the efficient functioning of the system. Inflation should be identified for what it is: The most vicious hoax ever perpetrated for the expedient purposes of a few at the cost of many. There should be no uncertainty about its devastating impact, particularly for low-income families, the elderly dependent upon accumulated financial resources and the majority of working people who do not have the political or economic leverage to beat the system by keeping their incomes rising even more rapidly than inflation. When inflation takes over an economy the people suffer and it is time that this basic point is emphasized by every responsible citizen and the full brunt is brought to bear on their elected officials. Let me assure you that regardless of the rhetoric emanating from Washington, D.C., the spend-spend, elect-elect, syndrome is alive and well.

I. THE IMPORTANCE OF TRADE

One of the most significant postwar economic developments has been the rapid expansion of trade among market economies from a level of $55 billion in 1950 to over $800 billion in 1975. The case for free trade is based on the general concept of comparative advantage. Each country exploits its special human and material resources leading to maximum efficiency. A wider selection of goods and services is provided to consumers. Producers gain access to raw materials and expand sales and suppliers of raw materials open up new markets. Competition improves quality and moderates prices. Research, innovation and good management are rewarded. But trade barriers typically reduce or eliminate the beneficial exchange of goods and services which insulates domestic producers from foreign competition so that prices increase and creative product development is stifled. Free trade clearly benefits the people of each participating nation. Nevertheless, mercantilism remains a strong force and those of us who believe in free trade must constantly emphasize the net benefits provided.

Although foreign trade has historically comprised a relatively small share of total economic activity in the United States -- exports totaled approximately 7 percent of our gross national product in 1975 -- we remain the world's largest exporter and importer. However, during the 1960's the historical U.S. merchandise trade surplus gradually eroded because of the overvalued dollar, disadvantageous cost developments and the export promotion efforts of other nations. By 1971 a small trade deficit was reported and the shortfall increased in 1972. A small trade surplus was reported in 1973, following the adjustment of currency exchange rates, but record inventory accumulations and the sharp increase in the cost of oil imports resulted in a swing back to deficit in 1974. In 1975 the United States recorded a record trade surplus in excess of $11 billion as exports increased 9.4 percent to a level of $107.1 billion and imports declined 4.1 percent to $96.1 billion. During 1976 we expect the trade surplus to diminish as the pace of economic recovery in the United States increases the demand for imports more rapidly than the continued growth of our exports. Merchandise trade deficits have been reported each month beginning with January.

Despite the favorable expansion of trade there has been extensive discussion about the future direction of U.S. policies. The major thrust was summarized in the important trade legislation finally approved in January 1975. That benchmark action was a necessary prerequisite for U.S. participation in the current multilateral trade negotiations. Basic provisions include:

1. Authority to negotiate for more open access to markets and supplies with emphasis on equity and reciprocity;

2. Increased flexibility in providing escape clause relief and adjustment assistance for American industries, workers and individual firms suffering injury from import competition.

3. Provisions for diversifying the types of actions the United States can take in responding to unfair international trade practices;

4. Authority to expand normal commercial relationships with the nonmarket economies; and,

5. Authority to fulfill the pledge to establish a plan of generalized tariff preferences for certain trade with developing nations.

I believe that the trade reform legislation was a major step toward a more liberal trade policy. However, there have been expressions of concern in other countries about the growth of protectionism in the United States. We are committed to the development of an open world trading system and there is no movement toward protectionism despite the recent determinations of the International Trade Commission in favor of import relief for a few specific industries and the recent attention given to some countervailing and antidumping investigations. The Treasury Department is required by law to investigate all formal complaints. Such proceedings are authorized by international agreements under the terms of the General Agreement on Tariffs and Trade (GATT). Industries in every nation are protected from injury caused by international dumping of marginal or excess production. Nor should domestic companies be required to compete against government-subsidized imports. The antidumping and countervailing duty laws are designed to prevent such abuses. The current number of investigations is the result of procedural requirements that all pending cases received over the past few years must be completed within a very short time frame under the Trade Act. But of the over eighty petitioners whose cases have been processed under the anti-dumping and countervailing duty laws in 1975, only about 10 percent have been rewarded relief. These facts certainly refute any charges that America is turning protectionist.

The President's recent decision to expedite adjustment assistance for the domestic shoe industry rather than introducing new import barriers is a clear signal of this Administration's determination to pursue a liberal trade policy. The United States pressed for and participated in the multilateral pledge of member nations of the OECD (Twenty-four leading industrial countries in the Organization for Economic Cooperation and Development) to refrain from the proliferation of trade restrictions. The original agreement was made two years ago and renewed last May. Fortunately, there have been only a few protectionist violations of the pledge despite the severity of the recession.

In a very practical sense, I believe that equitable administration of laws covering unfair trade practices actually reduces the pressures for generalized barriers. The Congress and domestic industries must be convinced that responsible agencies will act to prevent specific abuses if we are to successfully avoid generalized restrictions. There is no inconsistency between free trade and fair trade and the assurance of the latter is what enables us to progress in achieving the former.

Nevertheless, it is difficult to convince Congress that tariffs and non-tariff barriers should be reduced if imports are entering the United States supported by special subsidies from foreign governments. I believe that such artificial export subsidies are wrong for several reasons. First, they distort the market forces and interfere with the proper allocation of capital. Second, they are an expensive use of limited government resources which are transferred from the exporting nation to its trading partners in the form of the export subsidy. Finally, the use of export subsidies may force other nations to raise tariffs or create quantitative quotas to provide relief.

As I have said, the United States remains committed to an open world trading and investment system. The rapid growth of trade clearly demonstrates its desirable impact on economic efficiency and on the standard-of-living of people in trading nations. The best way to ensure the continued growth of free trade is through agreement in the multilateral trade negotiations and the discreet use of countervailing and antidumping actions to prevent specific abuses.

II. THE MULTILATERAL TRADE NEGOTIATIONS

As the world gradually recovers from the severe recession and the pace of trade accelerates we must turn our attention to the longer-term policy issues which will shape the international trading system of the future. The basic planning process continues to move slowly ahead at the Multilateral Trade Negotiations (MTN) in Geneva but we must place even greater emphasis on further liberalization of world trade to fulfill the commitments made in Tokyo almost three years ago. The need for more rapid and substantive negotiating progress was clearly recognized at the meeting of heads-of-State and senior economic officials of several major industrial nations at Rambouillet last November. We all agreed to a goal of completing the Multilateral Trade Negotiations during 1977 and to continue to avoid protectionist actions during the difficult worldwide transition from recession to recovery.

The United States is determined to achieve the further reduction of tariff and non-tariff barriers and to improve the international trade framework to prevent trade disputes from escalating into major conflicts between nations. Specifically, our goals at the MTN negotiations in Geneva are:

-- to reach agreement on maximum reciprocal tariff reductions on as wide a range of products as possible;

-- to agree on codes of conduct for product standards, government procurement, subsidies and countervailing actions;

-- to develop rules governing the use of export controls and to attempt to exchange commitments for access to markets and raw materials;

-- to improve the international safeguard mechanism governing the use of import relief actions; and,

-- to pursue general reform of the trading system through coordination of national trade policies to resolve disputes.

The United States has also been involved in the discussions between the developed and developing nations concerning trade. Following two years of strained rhetoric concerning the creation of a new international economic order, a more reasonable consensus was reached at the United Nations Special Session last September leading to the current UNCTAD IV conference in Nairobi. Agreement was also reached to hold a continuing Conference on International Economic Cooperation in Paris which brings together the industrial nations, oil-producing countries and the oil-importing developing nations to discuss energy, raw materials, development and financial issues.

The UNCTAD IV meetings in Nairobi have provided an important forum for discussing commodities, transfer of technology, balance-of-payments problems, official development assistance and the future of UNCTAD. While many constructive actions will probably result from these meetings, I do not agree with the proposal advanced by some nations that the role of governments in controlling trade should be increased. Their recommended "integrated program" argues for the creation of a series of simultaneously negotiated commodity agreements using buffer stocks to regulate prices. In addition to the effort to stabilize raw material prices the plan would require commodity prices to be kept constant, or gradually improved, in <u>real</u> terms relative to the prices of manufactured goods. In other words, prices of commodities would be indexed to mechanically keep pace with other prices.

We agree that it would be desirable to moderate excessive fluctuations in the prices and supplies of raw materials, to improve access to supplies and markets and to encourage the location of efficient processing industries in developing nations. We are also willing to sit down with producers and consumers of specific commodities to work toward the solution of existing problems. However, we cannot support any trading system that requires a prior commitment to commodity agreements based on a system of administered prices and arbitrary government controls that would frustrate market forces. We believe that each commodity is unique, subject to its own dynamics, and that a system of government administered prices would never work in a dynamic world of technological discoveries and changing consumer and investor preferences. The market system is the most efficient means of balancing the supply and demand for commodities and for rewarding economic efficiency. Therefore, the United States has proposed an alternative approach which would help developing nations overcome fluctuations in earnings from exports of raw materials -- and that should be the basic goal rather than the stability of specific prices -- without destroying the clear advantages of the market system. This proposal includes measures to assist countries suffering from flunctuating export earnings, to provide better access to developed country markets for semi-processed and manufactured products using raw materials and increased emphasis on investment in the development of national resources by private interests and the international financial institutions.

These individual actions would help the developing nations solve specific problems but the best way to contribute to their overall economic progress would be to open up the entire trading system. During my recent visit to Brazil I observed an impressive example of what can be done to strengthen trade as a basis for national economic development. In 1968 Brazil was dependent upon exports of coffee for 42 percent of its total exports, in dollar terms. By 1975 this dependency had dropped to 11 percent, although actual dollar earnings from coffee exports had increased. At the same time, the share of Brazilian exports represented by manufactured products rose from 9 to 29 percent, with substantial increases registered by machinery, transport equipment, footwear, cotton fabrics, and fruit and vegetable juices. In terms of actual figures, Brazilian exports of manufactured goods rose from $175 million to $2.5 billion in this 7-year period, and have almost doubled since 1973. Brazil is on the road to development in large part because of its ability to compete in world markets and because it has taken full advantage of this capability.

Other developing countries, I am convinced, can do the same, even if they are not blessed with Brazil's abundance of natural raw material resources. South Korea, Taiwan, and

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and Singapore are other economic success stories that demonstrate the advantages of private enterprise and full participation in the world market economy.

Much more can and should be done in this area of trade. The developing countries should in my opinion place much more emphasis on an aggressive approach to trade liberalization in the MTN than they have done to date. Commodity agreements with fixed shares of markets are not the answer.

We can also pledge that if the developing countries diversify their exports into manufactured goods and compete fairly in our market, we will accept their goods. Even further, we are prepared to grant differential and specialized treatment to their exports during this transitional period to developed nation status.

III. THE FUTURE OF WORLD TRADE

The United States has long been a leading advocate of free and open world trade and investment. I am convinced that a market economic system will provide the greatest benefits for all nations. However, it would be naive to assume that the arguments for free trade are accepted by everyone or that strong protectionist pressures in every country will not continue to threaten its survival. The benefits of free trade are diffused among the entire population but the costs of painful transitions caused by imports are typically borne by specific workers, managers and investors. It is perfectly natural for them to react negatively when their economic security is threatened by competition. Since the benefits are general but the costs are specific, those of us who believe in free trade must constantly emphasize the overwhelming net advantages of this approach. At the same time we must react quickly and decisively to correct specific abuses that injure domestic interests unfairly and we must provide adjustment assistance to ease the transition problems caused by shifting trading patterns.

The recent Presidential decision on shoes was encouraging but the pressures against free trade will persist. The decisions we make now on the need for domestic safeguard actions, the impetus we give to the Multilateral Trade Negotiations, our ability to cooperate meaningfully and in a way that reflects sound economic judgment in our relations with the developing countries, and our efforts to continue to improve our trading relations with the non-market countries will all contribute to the trading environment we must face in the decades to come. It is crucial to make the right decisions and to avoid what may be politically expedient today but disastrous for the world economy tomorrow.

The beginning point in facing up to this challenge is to recognize that the real solutions to our domestic and international economic problems are to be found in the familiar principles of market economics. We will only compound our problems by turning to government controls and new economic orders. The market system works because it allocates resources in response to the interests of the people expressed through their buying and investment decisions. Controlled economies do not work as well because the collectivist approach is not as sensitive to the personal goals of the people. We do not need any new economic theories, international agreements or additional government intervention. Instead, we need to improve the operation of our market system -- including a trading system that is open and efficient -- so that it remains flexible and responsive to the real interests of the people in every nation.

# # #

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The following is a list of the political prisoners released by the Republic of Chile yesterday.

1. Patricio Alvayay Yañez
2. Carlos Ayala Flores
3. Leontina Araya Severino
4. Regulo Bravo Soriano
5. Jorge Burgos Corvalán
6. Salvador Barrientos Muñoz
7. Baltasar Barra Quintupray
8. María Barrientos Muñoz
9. María Bernales Bobadilla
10. Jose Carrasco Vargas
11. Juana Cerna Rivera
12. Juan Carvajal Trigo
13. Hugo Canales Díaz
14. Silvia Calderón Macias
15. Luis Cáceres Cáceres
16. Ricardo Castillo Bozzo
17. Luis Catalán Caviedes
18. Carlos Clerc Urrutia
19. José Cortínez Castillo
20. Carlos Corvalán Rojas
21. Sara Covarrubias Jara
22. Archibaldo Díaz Jofré
23. Rosa Díaz Magaña
24. Verónica Denegri Quintana
25. José Luis Donoso Perez
26. Ramiro Díaz Heredia
27. Francisco Durán Ulloa
28. Marcos Espinoza Quinteros
29. Eudomira Fuentes Gutierrez
30. José Flores Miranda
31. Jorge Gonzalez Trujillo
32. Marcos Leal Valenzuela
33. Reinaldo Navarro Jacobsen
34. Julio Núñez Ferrada
35. Omar Neira Melo
36. Oscar Moreno Becerra

37. Carlos Mujica Araya

38. Oscar Morales Bergueret

39. Helmut Mejías Folch

40. Domingo Rain Painemil

41. José Ramírez Umaña

42. José Rivas Valenzuela

43. Carlos Rojas Toro

44. Elba Ugarte Peralta

45. Ana Valenzuela Campusano

46. Tulio Valenzuela Jimenez

47. Hernán Villegas Reynald

48. René Zorrilla Fuenzalida

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ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE SAN DIEGO JOINT CHAMBER OF COMMERCE
UNIVERSITY CLUB
SANDIEGO, CALIFORNIA - MAY 21, 1976

Thank you, Alan Reed, Mr. Levensen, Vice-Admiral Ray Peet, Mr. Eric Silberstein, Ladies and Gentlemen:

It gives me great pleasure to have the opportunity to address this fine group during World Trade Week. I would also like to offer my congratulations to the Bu-Data Co. for earning the President's "E" Award for Excellence in Exporting. It is through the efforts of firms such as Bu-Data Co. and, I am sure, others represented here today, that the U.S. is competing more effectively in world markets today than at any point in our recent history. Our share of world exports of manufactured goods has risen steadily since 1973. Through your efforts, it will continue to do so.

With world economic recovery, our exporters will benefit not only from the bigger share of the world trade pie they have cut for themselves, but from growth in the pie itself. We can see that economic recovery in the U.S. has already led to increased purchases of domestic goods and imports. As a result, the U.S. trade balance has recently turned into a deficit. This is, of course, a transitory situation. And the recent increase in U.S. import demand will help spread our success.

And it is in this last respect that I would like to share with you some personal observations. I have just returned from a fruitful -- and enlightening -- visit to Latin America. Enlightening because in visiting Latin America and discussing economic developments with its leaders, I gained a fresh perspective on our own economy. From that perspective two truths stood out: The key role of private enterprise in economic growth; and the strength and importance or our economy.

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In the countires I visited -- Chile, Brazil, and Mexico -- I was especially gratified to see increased recognition of the importance of the private sector and of market oriented policies. They are realizing more and more that the strength and capacity of the U.S. economy comes from the private sector. They too want to tap that wellspring in their own countries by adopting domestic policies that will allow the creative and productive forces of the private sector to expand freely.

A second point which was emphasized in my discussions with Latin American leaders was the major role of the U.S. economy in the world. A healthy U.S. economy is critically important for the successful attainment of Latin America economic development goals.

They are counting on an expanding, dynamic market in the United States to earn the foreign exchange they need for development. They also look to U.S. companies and the U.S. capital market as the chief source of foreign investment -- investment which brings new capital to capital-poor economies, along with jobs, modern technology, and foreign exchange. They still consider America the world's greatest power and the major source of global economic stability.

Now I know that there must be those of you in the audience who may question that belief. Many of your businesses were excessively hard-hit by the recent recession and simultaneous double-digit inflation and I can understand your feelings. But perhaps I can cheer you with some words of optimism based on solid facts. For although I will be the first to warn that we still have a way to go, the evidence plainly indicates that we are now well into a period of recovery and expansion.

-- 1975 opened with inflation raging at 13 percent. That rate has been sharply reduced and the underlying rate of inflation is approximately 6 percent. In fact, during the first quarter of this year, January through March, the overall rate of inflation as measured by the GNP price deflator increased at an annual rate of only 3.5 percent. So we have made progress already and we can make more if we continue to follow responsible policies.

-- During the spring of 1975, the unemployment rate reached 9 percent; today it is down to 7.5 percent and the

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trend is clearly downward. Even more important, actual employment increased by 2.4 million people during the first year of the economic expansion.

-- And real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 8.5 percent during the first quarter of 1976.

-- Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, the stock market -- all are registering solid gains and this reflects rising public confidence about the economy.

We made considerable headway in 1975, and we will make even more in 1976 if consumers and businessmen remain confident that the government will not apply excessive economic stimuli to gain political advantages. But we still face serious long-term problems and this is certainly no time for complacency. Unemployment is still intolerably high, and inflation is by no means under control.

Our basic desire for progress, in the form of improved living standards and employment opportunities, will surely be frustrated unless we better control the insidious inflation which has destroyed economic stability by triggering a costly series of booms and recessions. The tragic policy errors of the past and our basic hopes for the future must force us to recognize a basic reality: Inflation is the greatest threat to the sustained progress of our economy and the ultimate survival of all of our basic institutions. There is a clear record from the past: When inflation distorts the economic system and destroys the incentives for real improvement the people will no longer support that system and society disintegrates. I am convinced that our uniquely creative and productive society will also collapse if we permit inflation to dominate economic affairs. There is no tradeoff between the goals of price stability and low unemployment as some critics have erroneously claimed. To the contrary, the achievement of both goals is interdependent. If we are to increase the output of goods and services and reduce unemployment, we must make further progress in reducing inflation.

The intensity of my feelings about inflation has resulted in some critics labeling me a "fanatic", I readily accept that label if it helps to communicate my deep concerns. We must always remember that it is inflation that causes the recessions that so cruelly waste our human and material resources and the tragic unemployment that leaves serious economic and psychological scars long after economic recovery occurs. It is inflation which destroys the purchasing power of our people as they strive -- too often in a losing struggle -- to provide the necessities of food, housing, clothing, transportation, and medical attention and the desired necessities of education, recreation and cultural opportunities. Inflation is not now, nor has it ever been, the grease that enables the economic machine to progress. Instead, it is the monkey wrench which disrupts the efficient functioning of the system. Inflation should be identified for what it is: The most vicious hoax ever perpetrated for the expedient purposes of a few at the cost of many. There should be no uncertainty about its devastating impact, particularly for low-income families, the elderly dependent upon accumulated financial resources and the majority of working people who do not have the political or economic leverage to beat the system by keeping their incomes rising even more rapidly than inflation. When inflation takes over an economy the people suffer and it is time that this basic point is emphasized by every responsible citizen and the full brunt is brought to bear on their elected officials. Let me assure you that regardless of the rhetoric emenating from Washington, D.C., the spend-spend, elect-elect, syndrome is alive and well.

Of course, when I speak of economic reality I am emphasizing the difference between actual performance and promises. There is already a tendency on our national scene, which shows every sign of intensifying as the elections draw closer, to bring forth appealing claims that new spending programs could quickly reduce the current unemployment without creating any risks of renewed inflation. These claims are made even though any analysis of economic history-- particularly the disappointing results of the last decade -- clearly indicate the disruptive impact of repeatedly overheating the economy. And there is a seemingly endless stream of political rhetoric about the insensitivity of this Administration for not triggering massive spending programs to demonstrate political leadership through decisive actions intended to solve all our problems before the next election. But for once, let us not fall prey to those who tour the country, their bags brimming with instant quack cures -- the self-proclaimed compassionate people whose spending proposals promise everything, but deliver us only one thing: An unwanted boom and recession sequence with excessive levels of inflation and unemployment.

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I urge you -- and all of our citizens -- to ask yourselves some very fundamental questions. How could the most dynamic economic system in the world become vulnerable to the dual problems of double-digit inflation and record post-war unemployment. As a people where did we lose our way?

Economists argue about this a good deal and most politicians prefer to ignore the question entirely, seeking instead to capitalize on the effects rather than the causes of the problems. But to me there is no real mystery about how we got here, nor what we must do to return to more sustainable patterns of economic growth.

To an objective observer, the first and most glaringly obvious fact is that our economic problems do not stem from a lack of compassion, concern of vision on the part of the Federal Government. Since President Eisenhower left office:

-- The number of domestic spending actions for social problems has increased tenfold, from 100 to over 1000 individual programs.

-- The American people have spent over one trillion dollars on social programs for people and communities in a well-intentioned effort to improve the quality of life even though the level of dissatisfaction continued to increase at an even faster pace.

-- The staple of our national life has become politicians with grand visions and even grander promises of what can be accomplished if they can just spend more of our money and be given greater authority over our lives.

So over the past 15 years, the government has tried many, many solutions. Yet the problems persist and our people grow more frustrated, disillusioned, and cynical. This doesn't mean there are no answers. It means only, I would suggest, that we have been taking a fundamentally wrong approach. We suffer not from a lack of government action, but from an excess of government action. The trouble with the Federal Government is that it is trying to do more than its resources permit, to do many things that it cannot do very well, to do some things that it should not do at all, and to do all those things at the same time. Excessive governmental activity have been most damaging in three critical areas affecting the economy:

-- fiscal policy
-- monetary policy
-- regulatory policy

No one who has followed the pattern of Federal spending in recent years can fail to be depressed by its explosive growth.

-- The Federal budget has quadrupled in 15 years. In Fiscal Year 1962 Federal spending first topped the $100 billion level. In Fiscal Year 1977 we will see Federal outlays of over $400 billion.

-- We have had 16 budget deficits in 17 years;

-- We have doubled the national debt to over $600 billion during the last ten years. It took 75 years for our national debt to reach one billion dollars. Today the government spends over $1 billion a day and the national debt increases $1 billion dollars every week.

The Federal Government today is the nation's biggest single employer, its biggest consumer, and its biggest borrower. And if the post war spending trends were to continue until the end of the century, total government outlays would account for almost 60 percent of the gross national product. Once government achieves that degree of dominance over our lives, much of the economic and political freedom we now take for granted will have been lost.

For the alarming fact is that in every country in which the government's share of economic activity has increased rapidly to a dominating level, there has been a tendency to move toward instability, toward minority government and toward a threat to the continuation of a free society. The issues involved are by no means narrow economic ones. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good the intentions which underlie the growth, those intentions are not achieved; that, instead, the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government. The excessive growth of government spending has also disrupted our financial system. Partly to accommodate the federal government's borrowing needs in the private markets, there has been a significant shift in monetary policies. From 1953 to 1965 the money supply of the United States was growing at approximately 2-1/2 percent and we enjoyed relative price stability. From 1965 to the present, however, the average rate of growth of the money supply has more than doubled. It is no accident that during this same period we have had spiraling inflation.

This past decade has also witnessed an accelerating growth in the administrative and regulatory powers of governments at all levels. This is an area of particular concern to you in California, as well it should be. Government agencies now directly regulate over 10 percent of everything bought and sold in the United States and indirectly regulate almost every other part of the private economy. It is increasingly obvious that this cumbersome regulatory system has too often stifled innovation and competition and has added billions of dollars each year to the price of consummer and business products. The government does have a legitimate responsibility to protect the public interest and specific abuses have occurred but the degree of government intervention has reached such a level of irritation that individuals and businesses are demanding relief from the power of the army of more than 100,000 government regulators.

Just to fill out the necessary forms, the American people must now spend over 130 million work hours a year. That translates into an annual cost of approximately $20 billion. This regulatory process has become so burdensome, for all business big and small, that it threatens the continued viability of free enterprise. General Motors, for example, recently estimated that it spent more than 1.3 billion dollars in 1974 just to comply with existing government regulations and get ready for new ones. That is more than it cost to run the entire Federal government for all of the first 75 years of our history. But as bad as that is, at least GM can live to fight another day. Smaller businesses have not been so lucky.

Let me give you a typical example of regulatory overkill. Suppose for a moment that you lived in Chicago and borrowed some money to start a small trucking business to carry freight to Cleveland, Ohio. That seems simple enough: Cleveland is not far from Chicago. Should you then rush out and invest in a few trucks? Sorry, the first thing you should do is file a request with the Interstate Commerce Commission. That will cost you $350 in filing fees, and you'll probably need a private lawyer to boot. Well, you say, the request must be only a formality and you can get started in a few weeks time. Sorry, but the request will almost inevitably lead to legal hearings and you will have to prove that existing service to Cleveland is inadequate and that existing carriers cannot be made to provide it.

The average request now takes 10 months to process and some have been known to take ove three years. Protests by existing carriers often lead the ICC to give only restricted approval to requests form new carriers and to deny many requests altogether, especially along well-traveled routes. Undaunted, you wait it out, obtain your approval, and decide that the best way to get a break on your competitors is to reduce the prices you charge to your customers.

Sorry, your proposed rate reduction will probably be protested by other carriers and then suspended by the ICC. In effect, the governmeny will force you to charge higher prices, even though you could afford to charge lower ones. Nonetheless, even with the higher rates you win a few customers with exceptionally good service, and new customers appear, asking that you carry their goods from Cleveland back to Chicago. Good, you say, your business is expanding.

Sorry, the ICC won't allow it unless your original certificate specifically authorized you to carry those products on the backhaul from Cleveland. The ICC requires instead that you drive back to Chicago with an empty truck -- a practice that is still frequent even in this day of high cost energy. Despite all of these problems, you persevere and customers soon want you to carry their goods not only to Cleveland but also downstate to Columbus, Ohio. Sorry, but your ICC certificate says you can only go between Chicago and Cleveland; to drive to Columbus, you'll have to get a new certificate, and that means you'll have to start the whole process all over again -- lawyers, forms, hearings, rate settings, the works.

At that point, you might be justified in throwing up your hands and sending off for that pamphlet which tells you how to collect food stamps.

I wish that I were exaggerating the complexities and frustrations of dealing with the government bureaucracy, but I'm sorry to say that it's all too true -- and something has to be done about it.

For when you objectively add up all those facts of excessive government spending, excessive expansion of the money supply, and excessive governmental regulation, one conclusion seems inescapable. Our inflation and our resulting unemployment were made in Washington, D.C.

Here's just part of what the inflationary cost of government now adds up to. Our current federal budget is equivalent to about $2,000 for every man, woman and child in this country. Our national debt equals almost $3,000 for every citizen. And government regulation adds approximately $2,000 to the costs of purchases made by each American family every year. How can anyone make the case that the increase in governmental benefits has in any way kept up with the increase in governmental costs?

The fact is that governmental excesses of the past 15 years were the strong underlying cause of inflation during the 1960s. They remain so today. The rise in government spending has added enormously to the aggregate demand for goods and services in the economy, thus forcing up prices. And the government's heavy borrowing needs in 1976 will require it to soak up 80 percent of all new long-term loanable capital, leaving only 20 percent to the entire private sector, which nevertheless must produce virtually all our goods and services and employ 83 percent of our work force.

This increasingly massive governmental presence has been an important factor in the persistent rise in interest rates, and the strains in the financial markets. Moreover, it is clear that the cumbersome regulatory procedures of the government have too often only stifled competition and added billions of dollars to the price of consumer goods.

The evidence is in and it proves conclusively to me that runaway big government, far from being our greatest source of prosperity and material security, as some people would have us believe, has now become a direct threat to our survival as a free society. And that is why I appeal to you this afternoon, not only for your support, but also for your direct participation in a massive effort to preserve the economic freedoms that have given this country both the greatest prosperity and the greatest freedom ever known to man. For what is at stake is not just the survival of this or that industry. What really is hanging in the balance is the survival of our private sector, and the individual liberties which have never long survived the loss of economic freedoms.

The problem is a matter of both policy and perception. Bad perception leads inevitably to bad policy, and I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times. Unfortunately the perception of what is right or wrong is too often inaccurate, because it is described inaccurately as a superficial division between those who "care" and those who are "callous."

Many of today's youth view those who consistently advocate bigger government as the saviors of the modern world out to rescue the persecuted underdog. On the other hand, those who advocate less government and the strengthening of free enterprise are often dismissed out of hand as greedy exploiters out to make a fast buck for themselves or their companies. And -- because image is so all-important and bad news is big news -- those who supposedly "care" are often afforded greater media exposure to expound on all our social ills and to claim they can cure them by increasing government spending and then having the Federal Reserve System create the credit needed to cover the resulting deficit. In reality, of course, this is no cure at all. It is this same destructive approach that is at the very root of the problems we are struggling with today. Big government isn't the solution; it's the problem.

Nevertheless, we who insist on the superiority of the free enterprise system, emphasizing its competition, efficiency, and profitability are losing our argument. We tend to converse in slogans and labels, while the proponents of big government speak in more appealing, seemingly more humane terms. This is unfortunate, and to me it would be difficult to imagine any greater irony. For even the most cursory glance at history shows us that the American economy is the most successful the world has ever known -- precisely because it is an essentially humane creation of the people, by the people, and for the people.

The performance of our economy proves this. In the period since the early 1960s -- a period during which one

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abuse after another has been inflicted upon our private sector, it has nevertheless managed to outperform all others.

-- In the last 15 years, real spendable income has jumped by over 50 percent on a per capita basis, average family income has risen to over $13,000 a year, 20 million new jobs have been created, and we have cut the number of people below the poverty line in half.

-- Our farmers harvest more than twice as much grain with fewer workers compared to a generation ago.

-- Medical science has added 10 years to our lives over this period.

-- And Americans today have more leisure time for study, recreation and self-improvement than any socity in recorded history. We continue to spend about 90 percent of our personal disposable income on ourselves.

No other country -- no other system -- has achieved so much for its people. Yet these tremendous achievements are the product of the same free-market system that now incredibly finds itself under attack.

Where does the free enterprise system stand today? For all the talk about excessive profits, it's a system that, on the average, offers a profit incentive of less than five cents on the dollar, a small reward for all the effort and risk-taking that goes into developing and operating a successful business.

Nevertheless, it remains the real productive source of our nation's wealth, as well as that of each individual American.

Despite the growing influence of government over our lives, the private sector produces the food we eat, the goods we use, the clothes we wear, the homes we live in.

It is the source of five out of every six jobs in America, and it provides directly and indirectly, almost all the resources for the rest of the jobs in our all-too-rapidly expanding public sector.

It is the foundation for defense security for ourselves and most of the Free World.

It is the productive base that pays for government spending to aid the elderly, the jobless, the poor, the dependent and the disabled. Indeed, far from being the

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anti-human caricature painted by political demagogues, the American private sector is in reality the mightiest engine for social progress and individual improvement ever created.

In a nutshell, all of the material and spiritual values that make our country unique and make us so proud to be Americans could not exist without the free enterprise system. Yet many people still fail to understand the crucial link between our economic, social and political freedoms. Destroy one and the others will soon disappear.

I can assure you that this Administration is fighting to ensure the survival of your economic freedoms. But to succeed, we must have the active participation of business leaders like yourselves in reopening the lines of communication to the American people. It's been said that communication is the web that holds civilization together, perpetuating its values and traditions.

Never has that function been more important than today. We must -- all of us -- communicate the great story of freedom.

-- We must dispell the confusion that has made free enterprise a dirty word, and convince them that business, profits and people are all mutually interrelated.

-- We must let our lawmakers and leaders in government know that they cannot continue to work at cross-purposes with the very system that generates our wealth, our strength and our freedom.

-- We must make people aware that runaway spending and unending deficits are sopping up much-needed capital for productive jobs, and are only fueling inflation -- a silent thief that picks every American's pocket, undermines confidence and turns the desperate to government for still more illusory help.

But words are certainly not enough. The living example is much more meaningful. That is why I urge each of you:

-- To set high moral and ethical standards by eliminating any practices in your organizations and operations that may be questionable.

-- To square practices with principles by supporting deregulation across-the-board, not just selectively; by helping to end government subsidies, quotas and handouts, bailouts or other inducements that offer a superficial

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empty promise of security in exchange for sacrifices of freedom and,

-- To initiate and in some cases intensify our efforts to inform and educate the public about the benefits and realities of private enterprise.

This, ladies and gentlemen, is the crucial theme that must be communicated broadly and deeply into the national consciousness: The American production and distribution system is the very wellspring of our nation's strength -- the source of present abundance and the basis for our hopes of a better future. America can solve its pressing problems if it preserves and continues to improve this immensely productive system. And in this process, we'll also be preserving the freedoms that made it all possible. Let us make that our common resolve.

Thank you.

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FOR IMMEDIATE RELEASE

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REMARKS BY THE HONORABLE GEORGE H. DIXON
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
JOINT AMERICAN ENTERPRISE INSTITUTE
AND HOOVER INSTITUTION
CONFERENCE ON INCOME REDISTRIBUTION
STATLER-HILTON, WASHINGTON, D.C.
THURSDAY, MAY 20, 1976

Ladies and Gentlemen:

As a new boy on the block, I count it a privilege to be here this afternoon to address this distinguished group as a representative of the Treasury Department and the Administration.

Some forty years ago, that noted commentator on the American scene, Will Rogers, quipped: "Americans don't get all the Government they pay for . . . and that's probably a very good thing." This afternoon I'd like to share with you a few brief thoughts about one aspect of the Government that Americans <u>are</u> getting, and for which the price-tag as yet remains unknown. It is an issue which has interested me ever since some of my Treasury associates spoke of it, and has to do with the social allocation of capital in this country. What do I mean? I mean any action by the Government that attempts to direct the flow of savings toward some specific investment objective. Let me amplify.

There are four ways by which a Government can affect the flow of savings in financial markets. It can borrow directly in those markets and then re-lend to a Savings and Loan Association, a corporation, a housing authority, or a municipality at either the same rate at which it borrows or at a higher rate. In either case the rate charged is lower than what the ultimate borrower would pay in the market. Perhaps the most famous current example of this is the Federal Government's loan to New York City.

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Another means for socially allocating capital is a guarantee, where the Government guarantees the debt of the borrower to private lenders. A case in point is the Lockheed loan, which is guaranteed by the Federal Government and administered by the Emergency Loan Guarantee Board out of the Treasury.

Capital flows also are affected by regulations. Take, for example, the interest-rate differential on savings accounts whereby savings and loan associations are allowed to pay a somewhat higher rate than commercial banks. The purpose is to direct savings to a mortgage lending institution in order to stimulate housing. For the same purpose, the minimum denomination for purchase of a Treasury bill is normally $10,000. This is meant to limit disintermediation out of savings institutions in times of rising interest rates.

Yet another means for socially allocating capital is a straight subsidy. An example of this is a mortgage subsidy either to the borrower or to the lender. A bill known as the Financial Institutions Act contains a proposal whereby the holder of a mortgage would receive a tax credit for a percentage of the interest income received. This, of course, is to encourage mortgage lending and housing.

Thus, there are four basic methods by which the flow of savings in this country can be directed or nudged to some socially desirable objective: (1) financial intermediation where a government or agency borrows directly in the market and re-lends for the purpose intended; (2) the Federal guarantee of loans; (3) regulations establishing rate ceilings, rate differentials, or the amounts that can be borrowed or loans; and (4) direct subsidies.

Now some say that these arrangements are largely a thing of the past--that they no longer are important, if they ever were. This simply is not the case. Most plans to socially allocate capital in this country were developed within the past five years and new plans are springing up all the time. Consider the following litany of events--not an inclusive listing by any means, but enough to give you a flavor of what has happened in recent times:

- The guarantee of the Lockheed loan occurred in 1971.

- Ginnie Mae was formed in the late 1960's and activity in guaranteed pass-through instruments has mushroomed in the 1970's.

° The activity of Government-sponsored agencies--Fannie Mae, the Federal Home Loan Bank, and the Federal Credit banks--also have grown. While these agencies are not guaranteed by the Federal government and there is no statement of moral obligation printed on any of the instruments they issue, there is--in the final analysis--an implied backing. The Federal government simply will not let them fail. Moreover, Fannie Mae and the Home Loan Bank have the ability to borrow from the Treasury--a "put" option.

° In late 1975, after extensive debate, New York City obtained a $2.3 billion revolving credit arrangement with the Federal government under which it borrows from the Treasury at a rate only slightly higher than that paid by the Treasury.

° The Federal Financing Bank Act of 1973 authorizes most Federal agencies to borrow directly from the Treasury at 1/8 percent above the Treasury borrowing costs for like maturities. Major participants in this program include: the Export-Import Bank; Farmers Home Administration; Amtrak; Rural Electrification Corporation; TVA; and the U.S. Postal Service.

Many of the agencies now borrowing from the Federal Financing Bank previously borrowed in the open markets under Federal government guarantee, but not so easily nor at as favorable a rate. The purpose of the Financing Bank was to assure greater coordination of agency borrowings with overall Treasury borrowings so as to minimize disruption in the financial markets. In this regard, the concept has been successful, but it also has enhanced the social allocation of capital to specific causes.

While these examples give some indication of what has occurred, there are a number of new schemes afoot:

° For one, there is a proposal in the FINE Study (Financial Institutions in the Nation's Economy) for the Federal Home Loan Bank to borrow directly from the Treasury in order to finance the mortgage market.

° There is the proposed establishment of a $100 billion Energy Independence Authority which will provide loans

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and loan guarantees to encourage domestic energy resource development. In essence, the EIA would borrow in the capital markets at favorable interest rates (because it is a Federal government agency) and then re-lend to private sector energy projects.

° Senator Javits recently proposed a bill whereby the Federal government would lend to municipalities in financial difficulty. The purpose here is to direct funds to large cities.

° A bill has been introduced to establish a $1 billion government bank to make loans to consumer cooperatives.

This listing is not all-inclusive, but it does give one an idea of what is transpiring. The social allocation of capital in this country increasingly is coming of age. Special interest groups and politicians see "government banks," "government guarantees" and other devices as a panacea to solve many ills. The logic is simple. By borrowing from the Federal government or with its guarantee, you avail yourself of capital which otherwise might not be available in the marketplace or which would be available only at significantly higher interest rates.

Proponents of these schemes will even tell you that the Federal government gains because it receives a higher rate on its loan than it pays for the money or, in the case of a guarantee, a fee. Have we at last found a way to provide manna from heaven without cost? We know that the housing sector, the city, the energy project, and the consumer cooperative gains as a direct recipient of this allocation of capital. Seemingly everyone gains and no one loses.

But is there really no cost? Can you socially allocate capital to one cause and then another without someone being worse off? The contention of this paper is that you cannot--that there is a cost--that parties not favored in the social allocation formula suffer relatively--that the cost of channeling savings to housing falls heavily on low and moderate income families--and that under most schemes to socially allocate capital, our nation's financial markets become less efficient--which, in turn, hurts us all. In short, there is a very real cost to the social allocation of capital, and unless we recognize this fact, we will soon reach the point where what's at stake is no longer the proverbial division of the eggs, but the salvation of the goose.

Let's take a look at the situation in greater detail, starting with the guarantee arrangement. In the evolution of the New York City matter, the original plea by its proponents was that the Federal government guarantee the financial obligations of the city. Now what would have happened if this had transpired? Well, for one thing it would have made the obligations more valuable than Treasury securities. Not only would they carry the obligation of the U.S. Government, but their interest would be tax-exempt as well. Imagine the windfall gain to investors. Contrast this gain with the return to a person who invests in the securities of a well-run municipality. This investor accepts a lower initial yield because the risk is lower than that of New York City. All of this, of course, is in keeping with equilibration in financial markets according to risk and return. But the relationship between risk and return is altered when the Federal government steps in to guarantee the obligations of one borrower and not those of others.

This alteration explicitly favors a city or corporation which is not well managed financially. If, through political pressure, it is able to get the Federal government to enter the scene and guarantee the securities, it will be able to borrow at a lower rate. This explains what happens to the return; but does the underlying risk go away? Of course not. It is merely shifted from the investor to the Federal government and to taxpayers at large. If default should occur, the Federal government will need to make good on the obligations. Where will it get the funds? Either by foregoing programs, increasing taxes, or increasing the Federal debt. In addition to the future burden on taxpayers, increasing the debt may bring immediate pressure on interest rates paid by all borrowers.

Therefore, there are costs to the guarantee, though they are somewhat hidden. One is the contingent or potential cost to present and future taxpayers. Another is the possibility of increased cost to other borrowers in the financial markets. A third is the increased element of Government risk which accompanies each successive guarantee. And finally, there is the unfair economic advantage that a Government guarantee provides to the guaranteed party.

Guarantees also alter the normal function of financial markets. We know that this function is to efficiently channel savings in our society to the most productive investment opportunities, whether these opportunities be private sector investments or public sector investments with a social return. The mechanism by which funds are channeled is the tradeoff between risk and return. When the Federal government explicitly directs funds to certain investments which, because of the risk involved, would either not be able to attract funds or would be able to attract them only at a higher rate, it tampers with the workings of the marketplace. This tampering can lead to less efficient financial markets with the result that savings are allocated in our society at higher costs and/or with greater inconvenience. In turn, this has adverse implications for capital formation and for economic growth.

From this discussion, it is easy to go to the case of the Federal government, or some agency thereof, borrowing in the financial markets and re-lending to another party. The purpose is to provide funds at a lower rate than the party--individual, city, or corporation--could obtain in the marketplace. In short, the creditworthiness of the Federal government is substituted for that of the party involved.

The effects of this form of socially allocating capital are more or less the same as before. In whole or in part, the Federal government absorbs the risk of default, and this risk ultimately is borne by taxpayers. In addition, other borrowers in the marketplace may be at a disadvantage. Clearly they are at a disadvantage relative to those to whom capital is allocated socially. However, they also may be at a disadvantage in an absolute sense of having to pay a higher interest rate to secure the sums they need.

Again the equilibration mechanism in financial markets is distorted. Funds no longer flow on the basis of risk and return. One set of potential borrowers moves to the head of the line and capital is allocated to them on the basis of government decree, not by the rules of the marketplace. No longer must these borrowers justify a project's social or private rate of return in relation to any market-determined standard of efficiency.

The result is that some projects are undertaken which might be otherwise rejected if the borrower had to compete in the financial markets. In society as a whole, then, investments are undertaken which are not optimal in the sense of economic efficiency. As a result, at the margin there is an adverse impact on the real economic growth of the nation.

Moreover, if distortions in risk-return relationships lead to less efficient financial markets, this also has an adverse effect on economic growth. These markets simply

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become less effective in channeling savings to investment projects on a risk-adjusted return basis. For all of these reasons, economic growth and want satisfaction in our society may be less than otherwise would be the case.

Turning now to Government regulations which divert the flow of savings in our society away from that which would occur in the marketplace, the effect is similar. In this case artificial restraints are established which bias the flow of savings toward socially desirable causes. The best known and most important case is mortgage financing. By establishing ceilings on savings rates of mortgage lending institutions and by making investments in alternative money market instruments more difficult or less attractive, the hope is to enhance mortgage financing at rates of interest lower than what otherwise would be market clearing rates. This, too, results in projects being undertaken that cannot be justified in terms of a market-determined cost of capital. It may also lessen the efficiency of financial markets with results similar to those described before.

However, the direct cost effect is different. Rather than falling on taxpayers in general, it falls on savers who must accept lower interest rates on their savings than would otherwise prevail. In other words, by placing limits on the maximum rate paid and by establishing barriers to investing elsewhere, savers must accept lower rates of interest than market clearing rates in the absence of these restrictions. This is particularly true in times of rising interest rates.

Fortunately, the forces of competition are not long shackled. During the last several years, money market funds, which enable individuals to invest in money market instruments in smaller denominations than is possible with a direct investment in a Treasury bill, commercial paper, or other form of investment, have become quite prevalent. This is truly a financial innovation, for it has filled an unmet need by providing alternatives to traditional depository institution savings programs.

There still exists a barrier to investing elsewhere by low- and medium-income individuals. We said before that the direct cost of socially allocating capital to mortgages falls on savers at savings institutions. More specifically, this cost falls on low- and medium-income people who do not have alternative investments for their savings. They must accept lower savings rates than would prevail in free and competitive financial markets. Who benefits from this social allocation of capital? Homeowners, residential building owners, and, to lesser extent, commercial building owners. These owners typically are medium- to high-income individuals. Comparatively few low-income people own homes.

Is this subisidzation of housing by low to moderate income families likely to continue? Perhaps not on the same scale. With the hoped-for passage of the Financial Institutions Act, greater competition will develop for savings as interest-rate ceilings gradually are lifted over a period of about five years. This will allow market clearing rates of interest to be paid and the burden for subsidizing housing, if it is to continue to be subsidized, will not fall so heavily on savers.

So far we have covered three of the four means for socially allocating capital. The last one I wish to discuss is the interest rate subsidy, which can be either to the borrower or to the lender. If it is deemed appropriate to socially allocate capital toward some objective, I would contend that the interest rate subsidy to the borrower results in the least disruption to financial markets and is the most equitable. Why do I say this? For one thing, the subsidy goes directly to the party you wish to benefit. For example, the Government may not wish to subsidize all borrowers in the mortgage market, but only low to moderate income persons.

If the market clearing rate on a mortgage were, say 10 percent and the subsidy were 2 percent, the effective interest cost would be 8 percent. The risk-return equilibration mechanism in financial markets is not distorted. The borrower must compete for funds, but he knows that part of his interest cost will be picked up by the Government in the form of a subsidy. In other words, the financial markets are allowed to perform their function in the same manner as before. The borrower must attract a loan and pay an interest rate to the lending institution commensurate with the risk involved.

Moreover, the subsidy comes from the Federal government or, more specifically, from taxpayers as a whole. It does not fall directly on low and medium income savers who are forced to accept lower interest rates on their savings than otherwise would prevail. Therefore, it seems to me that it is both more efficient and more equitable to use the interest rate subsidy approach than it is to use any of the other means for socially allocating capital.

The interest rate subsidy also could go to the lender. Here the Government would subsidize certain types, or categories, of loans--such as mortgages or loans to cities. A subsidy of this sort will result in a lower rate of interest on these loans than would otherwise prevail. However, this type of subsidy is more generally a shotgun approach in that it benefits all borrowers in a particular category. While this may be appropriate if you are trying to broadly stimulate housing and construction, it is not so effective if you are trying to enable low-to-medium income individuals purchase housing. Here a subsidy to the borrower is better.

While the subsidy is the most effective way to socially allocate capital, one should not conclude that there are no inefficiencies involved. Projects are accepted which would not be accepted if a market-determined cost of capital were employed. Thus, the subsidy shares with other methods the shortcoming of altering the risk-return acceptance criterion for projects. However, we must bear in mind that by definition the purpose is to socially allocate capital as opposed to allocating it strictly on economic grounds.

In summary, it is important to recognize, if we do not already, that the cries for the social allocation of capital are increasing. The political appeal is irresistable--there seemingly is no cost, or at least the cost is so hidden as to be illusive. Now we all want to do what is socially right with respect to our cities, pollution, the less fortunate or what have you. If there were little or no cost to socially allocating capital, I think we all would agree that it is the right thing to do.

But, as we have established, there is a cost--though it is not readily apparent. As a result, hard decisions are necessary in judging the benefits of a plan to socially allocate capital in relation to the "opportunity cost" to taxpayers, to other borrowers, and to savers. It is paramount that these costs be recognized and evaluated before a decision is made. In that old vernacular, "there is no such thing as a free lunch."

Thank you.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR RELEASE AT 4:00 P.M. May 21, 1976

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills to the aggregate amount of $6,000 million , or thereabouts, to be issued June 3, 1976, as follows:

91-day bills (to maturity date) in the amount of $2,500 million, or thereabouts, representing an additional amount of bills dated March 4, 1976, and to mature September 2, 1976 (CUSIP No. 912793 A7 1), originally issued in the amount of $3,588 million, the additional and original bills to be freely interchangeable.

182-day bills, for $3,500 million, or thereabouts, to be dated June 3, 1976, and to mature December 2, 1976 (CUSIP No. 912793 C4 6).

The bills will be issued for cash and in exchange for Treasury bills maturing June 3, 1976, outstanding in the amount of $6,302 million, of which Government accounts and Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $2,566 million. These accounts may exchange bills they hold for the bills now being offered at the average prices of accepted tenders.

The bills will be issued on a discount basis under competitive and non-competitive bidding, and at maturity their face amount will be payable without interest. They will be issued in bearer form in denominations of $10,000, $15,000, $50,000, $100,000, $500,000 and $1,000,000 (maturity value), and in book-entry form to designated bidders.

Tenders will be received at Federal Reserve Banks and Branches up to one-thirty p.m., Eastern Daylight Saving time, Friday, May 28, 1976. Tenders will not be received at the Department of the Treasury, Washington. Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government

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securities and report daily to the Federal Reserve Bank of New York their positions with respect to Government securities and borrowings thereon may submit tenders for account of customers provided the names of the customers are set forth in such tenders. Others will not be permitted to submit tenders except for their own account. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 2 percent of the face amount of bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Those submitting competitive tenders will be advised of the acceptance or rejection thereof. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and his action in any such respect shall be final. Subject to these reservations, noncompetitive tenders for each issue for $500,000 or less without stated price from any one bidder will be accepted in full at the average price (in three decimals) of accepted competitive bids for the respective issues. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch on June 3, 1976, in cash or other immediately available funds or in a like face amount of Treasury bills maturing June 3, 1976. Cash and exchange tenders will receive equal treatment. Cash adjustments will be made for differences between the par value of maturing bills accepted in exchange and the issue price of the new bills.

Under Sections 454(b) and 1221(5) of the Internal Revenue Code of 1954 the amount of discount at which bills issued hereunder are sold is considered to accrue when the bills are sold, redeemed or otherwise disposed of, and the bills are excluded from consideration as capital assets. Accordingly, the owner of bills (other than life insurance companies) issued hereunder must include in his Federal income tax return, as ordinary gain or loss, the difference between the price paid for the bills, whether on original issue or on subsequent purchase, and the amount actually received either upon sale or redemption at maturity during the taxable year for which the return is made.

Department of the Treasury Circular No. 418 (current revision) and this notice, prescribe the terms of the Treasury bills and govern the conditions of their issue. Copies of the circular may be obtained from any Federal Reserve Bank or Branch.

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the Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
80TH ANNUAL NATIONAL CREDIT CONGRESS
NEW YORK CITY - MAY 24, 1976

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Thank you President Schiller, Mr. McGillicuddy, members of the National Association of Credit Management, ladies and gentlemen:

It is a pleasure for me to be here today to discuss economic issues with a group that is so knowledgeable and so vitally concerned.

What is unique is the nature and importance of the organization you belong to, with its 39,000 members throughout the country, ranging from big to small businesses and covering the entire field of manufacturing, wholesaling, service industries and financial institutions. No group is more a part of, or has a keener understanding of, both the strengths and weaknesses of the American economy. I only wish that more of our fellow citizens shared your working knowledge of this truly remarkable and incomparably productive system of ours.

Unfortunately, many Americans do not. If there is any subject that is generally misunderstood by an overwhelming number of our citizens it is the dynamics of our free enterprise system. In fact, this information gap -- what some authorities have called the economic illiteracy of the American people -- is one of the problems I would like to discuss with you today. But first let me give you an update on the status of our economy

As I look around this room, I realize that among you are many who -- directly or indirectly -- have been hard-hit by the recent recession and double-digit inflation. The negative impact of that combination of problems represents a terrible price to pay for too many years of economic mismanagement. Fortunately, we are now well into the second year of economic expansion following the turnaround in the economy about fifteen months ago. We still have a long way

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to go to regain the kind of national economy we all desire but at least we are moving in the right direction and we can look for a sustained recovery if responsible policies are followed:

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been sharply reduced and the underlying rate of inflation is now approximately 6 percent. In fact, during the first quarter of this year the overall rate of inflation, as measured by the GNP price deflator, increased at an annual rate of only 3.5 percent. So we have made progress already and we can make more if we continue to follow responsible policies.

-- During the spring of 1975, the unemployment rate reached 9 percent. It has now dropped to 7.5 percent and the trend is clearly downward. Even more important, actual employment has increased rapidly during the past year and a record 87 million people are now working.

-- And the latest figures on the growth of the real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 8.5 percent during the first quarter of 1976. During the last four quarters the output of real goods and services has increased 7.1 percent, a pace well above the underlying capacity of our economy.

Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, imports, business capital investment, and most other measures of economic activity -- all are registering solid gains and this reflects rising public confidence about the economy.

We made considerable headway in 1975, and we will make even more in 1976 if consumers and businessmen remain confident that the government will not apply excessive economic stimulus to gain political advantages. But we still face serious long-term problems and this is certainly no time for complacency. Unemployment is still intolerably high, and inflation is by no means under control.

Our basic desire for progress, in the forms of improved living standards and employment opportunities, will surely be frustrated unless we better control the insidious inflation which has destroyed economic stability by triggering a costly series of booms and recessions. The tragic policy errors of the past and our basic hopes for the future must force us to recognize a basic reality: Inflation is the greatest threat to the sustained progress of our economy and the ultimate survival of all of our basic institutions. There is a clear record from the past: When inflation distorts the economic system and destroys the incentives for real improvement the people will no longer support that system and society disintegrates. I am convinced that our uniquely creative and productive society will also collapse if we permit inflation to dominate economic affairs. There is no tradeoff between the goals of price stability and low unemployment as some critics have erroneously claimed. To the contrary, the achievement of both goals is interdependent. If we are to increase the output of goods and services and reduce unemployment, we must first make further progress in reducing inflation.

The intensity of my feelings about inflation has resulted in some critics labeling me a "fanatic." I readily accept that label if it helps to communicate my deep concerns. We must always remember that it is inflation that causes the recessions that so cruelly waste our human and material resources and the tragic unemployment that leaves serious economic and psychological scars long after economic recovery occurs. It is inflation which destroys the purchasing power of our people as they strive -- too often in a losing struggle -- to provide the basic necessities of food, housing, clothing, transportation, and medical attention and the desired necessities of education, recreation and cultural opportunities. Inflation is not now, nor has it ever been, the grease that enables the economic machine to progress. Instead, it is the monkey wrench which disrupts the efficient functioning of the system. Inflation should be identified for what it is: The most vicious hoax ever perpetrated for the expedient purposes of a few at the cost of many. There should be no uncertainty about its devastating impact, particularly for low-income families, the elderly, dependent upon accumulated financial resources, and the majority of working people who do not have the political or economic leverage to beat the system by keeping their incomes rising even more rapidly than inflation. When inflation takes over an economy the people suffer and it is time that this basic point is emphasized by every responsible citizen and the full brunt is brought to bear on their elected officials. Let me assure you that regardless of the rhetoric emanating from Washington, D.C., the spend-spend, elect-elect, syndrome is alive and well.

Of course, when I speak of economic reality I am emphasizing the difference between actual performance and promises. There is already a tendency on our national scene, which shows every sign of intensifying as the elections draw closer, to bring forth appealing claims that new spending programs could quickly reduce the current unemployment without creating any risk of inflation. These claims are made even though any analysis of economic history -- particularly the disappointing results of the last decade -- clearly indicate the disruptive impact of repeatedly overheating the economy. And there is a seemingly endless stream of political rhetoric about the insensitivity of this Administration for not triggering massive spending programs to demonstrate political leadership through decisive actions intended to solve all our problems before the next election. But for once, let us not fall prey to those who tour the country, their bags brimming with instant quack cures -- self-proclaimed compassionate people whose spending proposals promise everything, but deliver us only one thing: an unwanted boom and recession sequence with excessive levels of inflation and unemployment.

I urge you, as intelligent and objective citizens, to ask yourselves a few fundamental questions. How could the most dynamic economic system in the world become vulnerable to the problems of double-digit inflation and record postwar unemployment simultaneously? As a people where did we lose our way?

Economists argue about this a good deal and most politicians prefer to ignore the question entirely, seeking instead to capitalize on the effects of the problems. But to me there is no real mystery about how we got here, nor what we must do to return to more sustainable patterns of economic growth.

To an objective observer, the first and most glaringly obvious fact is that our economic problems do <u>not</u> stem from a lack of compassion, concern or vision on the part of the Federal government. Since President Eisenhower left office:

-- The number of domestic spending actions for social problems has increased tenfold, from 100 to over 1000 individual programs.

-- The American people have spent over one trillion dollars on social programs for people and communities in a well-intended effort to improve the quality of life even though the level of dissatisfaction continued to increase at an even faster pace.

-- The staple of our national life has become politicians with grand visions and even grander promises of what can be accomplished if they can just spend more of our money and be given greater authority over our lives.

So over the past 15 years, the government has tried many, many solutions. Yet the problems persist and our people grow more frustrated, disillusioned, and cynical. This doesn't mean there are no answers. It means only, I would suggest, that we have been taking fundamentally the wrong approach. We suffer not from a lack of government action, but from an excess of government action. The trouble with the Federal government is that it is trying to do more than its resources permit, to do many things it cannot do very well, to do some things it should not do at all, and to do all these things at the same time. Excesses in governmental action have been most damaging to three critical areas affecting the economy:

-- fiscal policy

-- monetary policy

-- regulatory policy

No one who has followed the pattern of Federal spending in recent years can fail to be depressed by its explosive growth.

-- The Federal budget has quadrupled in 15 years. In Fiscal Year 1962 Federal spending first topped the $100 billion level. In Fiscal Year 1977 we will see Federal outlays of over $400 billion. Government spending is growing much faster than our ability or willingness to pay for it.

-- We have had 16 budget deficits in 17 years;

-- We have doubled the national debt to over $600 billion during the last ten years. It took 75 years for our national debt to reach one billion dollars. Today, the government spends over $1 billion each day and the national debt increases $1 billion every week. The annual interest on this debt in Fiscal Year 1977 will be $45 billion and will represent the third largest expense in the Federal budget.

The Federal Government today is the nation's biggest single employer, its biggest consumer and its biggest borrower. And if the postwar spending trends were to continue until the end of the century, total government outlays would account for almost 60 percent of the gross national product. That unfortunate pattern would result in the government taxing and spending more than half of the total economic output of America. If the government achieved that degree of dominance over our lives, many of the economic, political and social freedoms we now take for granted would be lost.

The alarming fact is that in every country in which the government's share of economic activity has increased rapidly to a dominating level there has been a tendency to move toward instability, toward minority government and toward a threat to the continuation of a free society.

The issues involved are by no means narrow economic ones. They concern fundamental principles of equity and of social stability. The problem of growing government spending is that however good the intentions behind the growth are, those intentions are not achieved; instead, the growth in government spending makes low-income people worse off, undermines social cohesion and threatens the very foundation of a free and representative government.

The excessive growth of government spending has also disrupted our financial system. Partly to accommodate the federal government's borrowing needs in the private markets, there has been a significant shift in monetary policies. From 1953 to 1965 the money supply of the United States was growing at approximately 2-1/2% and we enjoyed relative price stability. From 1965 to the present, however, the average rate of growth of the money supply has more than doubled. Is it any accident that during that same period we have had spiraling inflation?

This past decade has also witnessed an accelerating growth in the administrative and regulatory powers of governments at all levels. Government agencies now directly regulate over 10 percent of everything bought and sold in the United States and indirectly regulate almost every other part of the private economy. It is increasingly obvious that this cumbersome regulatory system has too often stifled innovation and competition and has added billions of dollars each year to the price of consumer and business products. The government does have a legitimate responsibility to protect the public interest and specific abuses <u>have</u> occurred; but the degree of government intervention has reached such a level of irritation that individuals and businesses are demanding relief from the incredible power of the army of more than 100,000 government regulators. Just to fill out the necessary forms, the American people must now spend over 130 million work hours a year. That translates into an annual cost of approximately $20 billion.

Americans are increasingly aware that something is wrong with the system but they unfortunately don't understand how the economy is supposed to function. It is no exaggeration to state that most Americans are economically illiterate.

Our whole economic system is based on the basic market principle that products which people are willing to pay for will be produced, and that a fair price will produce an adequate rate of return. Things for which people are not willing to pay an adequate price will <u>not</u> be produced. This is not only the essence, but the genius, of the free enterprise system. Arbitrary and politically motivated controls and regulations that strangle the profit motive can only, in the long run, make the consumer as well as the producer suffer. Once the incentive to produce more of a product is removed, supplies inevitably decrease and what follows is sharply higher prices, or rationing, or both.

When you objectively add it all up, the facts of excessive government spending, excessive expansion of the money supply and excessive governmental regulation, one conclusion seems inescapable: Our inflation and our resulting unemployment were made in Washington, D.C. Our current Federal budget is equivalent to about $2,000 for every man, woman, and child in this country. Our national debt equals almost $3,000 for every citizen. And government regulation adds approximately $2,000 to the costs of purchases made by each American family every year. How can anyone make the case that the increase in governmental benefits has in any way kept up with the increase in governmental costs?

The fact is that governmental excesses of the past 15 years became the strong underlying cause of inflation during the 1960's. They remain so today. The rise in spending has added enormously to the aggregate demand for goods and services in the economy, thus forcing up prices. And the government's heavy borrowing needs require it to soak up 80 percent of all new long-term loanable capital, leaving only 20 percent to the entire private sector, which nevertheless must produce virtually all our goods and services and employ 83 percent of our workforce. This massive government demand for funds has been an important factor in the persistent rise in interest rates, and the strains in the financial markets.

The evidence is in and it proves conclusively that big government, far from being our greatest source of prosperity and material security, as some people would have us believe, has now become a direct threat to our survival as a free society. And that is why I must appeal to you this morning not only for your support, but also for your direct participation in a massive effort to preserve the economic freedoms that have given this country both the greatest prosperity and the greatest freedom ever known to man. For what is now at stake is not just the survival of this or that industry. What really hangs in the balance is the survival of the private sector and the individual liberties which have never long survived the loss of economic freedoms.

The problem is a matter of both policy and perception. Bad perception leads inevitably to bad policy, and I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central underlying problem of our times. Unfortunately the perception of what is right or wrong is too often inaccurate, because it is described inaccurately as a superficial division between those who "care" and those who are "callous."

Many of today's young people view those who consistently advocate bigger government as the saviors of the modern world out to rescue the persecuted underdog. On the other hand, those who advocate less government and the strengthening of free enterprise are often dismissed out of hand as greedy exploiters out to make a fast buck for themselves or their companies. Because image is so all-important and bad news is big news, those who supposedly "care" are often afforded greater media exposure to expound on all our social ills and to claim they can cure them by increasing government spending and then having the Federal Reserve System create the credit needed to cover the resulting deficits. In reality, of course, this is no cure at all. It is this same destructive approach that is at the very root of the problems we are struggling with today. Big government isn't the solution; it is the problem.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and dreary state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, efficiency and productive competition the average American shopping center would represent to nine-tenths of the world's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and operated agricultural system, cannot even feed its people without turning to American farmers who own their own land, make their own decisions guided by the incentives of a free market place, and feed not only our own people, but millions of others as well.

They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid; what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried. In essence, a society where the individual has no meaning. For as Alexander Hamilton warned us so long ago, "power over a man's substance amounts to power over his will."

Just as importantly, they have not seen first-hand the political and social aftermath in free societies where the government has destroyed or eroded private enterprise -- the economic decay that follows, the demoralization of the population and often even the massive emigration of skilled workers and professionals indispensible to economic growth and vitality.

Despite this overwhelming evidence of experience, we who insist on the superiority of the free enterprise system, emphasizing its competition, efficiency, and profitability seem to be losing the debate. We tend to converse in slogans and labels, while the proponents of big government speak in more appealing and seemingly more humane terms. This is unfortunate. To me it would be difficult to imagine any greater irony. For even the most cursory glance at history shows us that the American economy is the most successful the world has ever known -- <u>precisely</u> because it is an essentially humane creation of the people, by the people, and for the people.

The performance of our economy proves this. In the period since the early 1960's -- a period during which one abuse after another has been inflicted upon our private sector, it has nevertheless managed to outperform all others.

The private sector is the source of five out of every six jobs in America, and it provides directly and indirectly, almost all the revenue for the rest of the jobs in our all-too-rapidly expanding public sector.

It is the foundation for defense security for ourselves and most of the Free World.

It is the productive base that pays for government spending to aid the elderly, the jobless, the poor, the dependent and the disabled. That is why I am sick and tired of apologizing for free enterprise. For far from being the anti-human caricature painted by political demagogues, the American private sector is in reality the mightiest engine for social progress and individual improvement ever created.

In a nutshell, all of the material and spiritual values that make our country unique and make us so proud to be Americans could not exist without the free enterprise system. Yet many people still fail to understand the crucial link between our economic and our political freedoms. Destroy one, and the others will soon disappear.

This is the crucial theme that must be communicated broadly and deeply into the national consciousness: The American production and distribution system is the very wellspring of our nation's strength -- the source of abundance and the base on which our hopes for a better future lie. America can solve its pressing problems if it preserves and continues to improve this immensely productive system. But only by committing ourselves to this process can we safeguard the freedoms that made it all possible. Let us make that our common resolve.

Thank you.

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The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

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FOR IMMEDIATE RELEASE May 24, 1976

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2.5 billion of 13-week Treasury bills and for $3.6 billion of 26-week Treasury bills, both series to be issued on May 27, 1976, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 26, 1976			26-week bills maturing November 26, 1976		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.616	5.475%	5.63%	97.002 a/	5.898%	6.16%
Low	98.609	5.503%	5.66%	96.993	5.915%	6.18%
Average	98.611	5.495%	5.65%	96.997	5.908%	6.18%

a/ Excepting 1 tender of $100,000

Tenders at the low price for the 13-week bills were allotted 100%.
Tenders at the low price for the 26-week bills were allotted 71%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted	Received	Accepted
Boston	$ 30,115,000	$ 20,360,000	$ 16,200,000	$ 7,200,000
New York	3,985,280,000	2,187,675,000	5,951,855,000	3,285,105,000
Philadelphia	19,940,000	19,940,000	51,815,000	6,815,000
Cleveland	32,300,000	30,550,000	164,235,000	14,815,000
Richmond	62,155,000	44,595,000	71,885,000	9,685,000
Atlanta	38,515,000	29,000,000	54,790,000	18,370,000
Chicago	180,395,000	51,620,000	500,325,000	124,825,000
St. Louis	47,215,000	20,215,000	75,275,000	30,275,000
Minneapolis	27,480,000	5,480,000	36,060,000	3,060,000
Kansas City	30,090,000	23,465,000	29,695,000	18,895,000
Dallas	42,335,000	19,335,000	32,695,000	11,695,000
San Francisco	459,060,000	47,060,000	396,865,000	71,080,000
TOTALS	$4,954,880,000	$2,499,295,000 b/	$7,381,695,000	$3,601,820,000 c/

b/ Includes $351,755,000 noncompetitive tenders from the public.
c/ Includes $168,575,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

WS-878

13-Wk.

This Week 5.495%

Last Week 5.250%

Highest Since
12/8/75 5.633%

26-Wk.

This Week 5.908%

Last Week 5.726%

Highest Since
12/15/75 5.914%

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FOR IMMEDIATE RELEASE May 24, 1976

Remarks by F. Lisle Widman
Deputy Assistant Secretary
International Monetary Affairs
at the World Trade Institute
World Trade Center - New York

U.S. BALANCE OF PAYMENTS POLICY

It is quite a privilege to open the World Trade Institute seminar on "Operating in an Environment of Variable Exchange Rates." I see from the program that you plan to move swiftly into some of the very specific practical problems with which a corporation engaged in international trade or financial transactions must deal. I hope that my remarks will provide a useful setting for your examination of these important questions and assist you in arriving at conclusions.

You are meeting just at the close of what has been designated as "World Trade Week," a time when there is special emphasis on the transactions that cross national political boundaries and necessitate the pricing of one currency in terms of another. With U.S. international transactions in goods and services alone running at more than $300 billion a year, there is ample reason for such emphasis.

You asked me, as a representative of the Treasury Department, to talk about the balance of payments policy of the United States. I want to interpret that phrasing rather broadly because balance of payments policy is inextricably linked with international monetary policy which, in turn, is inextricably linked to domestic economic policy. Actually, the key to an understanding of current balance of payments policy is an understanding of agreements concluded at Rambouillet, France, last November and at Kingston, Jamaica, in January 1976 which provide for a new international monetary system. Thus I think it may be best to begin with a bit of history and a brief explanation of the Rambouillet and Jamaica agreements.

Thirty-two years ago, in 1944, most of the world's trading nations met in a monetary conference at Bretton Woods, New Hampshire, and agreed on a set of rules to serve as the basis of the post-war international monetary system. Their basic objectives were to promote international monetary cooperation, to promote international exchange stability, to eliminate restrictions on foreign exchange transactions and to encourage the growth of world trade. They established the International Monetary Fund as the institutional focus for the operation of the system, gave it financial resources with which to provide medium-term balance of payments support and induce balance of payments adjustment, and they wrote out a very detailed operational charter which became known as the Articles of Agreement of the IMF.

The fundamental approach incorporated in the Bretton Woods system was one of seeking to promote stability through the maintenance of relatively fixed rates of exchange among the currencies of member countries. All countries were expected to designate par values for their currencies, expressed in terms of gold and U.S. dollars -- which were presumed to be related at the immutable figure of $35 per fine troy ounce. Monetary authorities were to keep the exchange rates within 1 percent of the par value by buying or selling their currencies against gold or a currency such as the dollar which was convertible into gold. Countries were expected to pursue domestic policies that would facilitate the maintenance of these par values, borrowing from the IMF where necessary in order to provide time to reap the lagged benefits of changes in policy. The par value itself was not altered unless and until it became abundantly clear that a fundamental change in economic relationships had occurred and it was clearly impractical to restore the original relationship.

For many years the world economy was sufficiently stable to allow this system to work reasonably well. The world experienced an unprecedented period of growth and progress; trade and payments restrictions were materially reduced; the volume of world trade jumped dramatically and world financial markets underwent a simultaneous process of expansion and integration.

But other changes occurred as well. The economies of Europe and Japan rose up from the ashes of war while we ourselves were drawn into wars. Both the magnitude and the pace of change quickened. The goals of preserving official par values for currencies were overshadowed by more powerful political and economic forces, by governmental mismanagement, or by sheer political weakness. The par value system was not flexible enough to adapt to these pressures. In particular, currency adjustments were primarily on the down-side -- often agonizingly and belatedly, countries with payments surpluses felt no incentive to appreciate their currencies, the world became dependent on U.S. payments deficits, and the U.S. could no longer afford to maintain an overvalued currency at the expense of its own economic welfare. In 1971 the par value system, which had in fact already failed, came to an end when the U.S. officially suspended the convertibility of the dollar into gold.

After the breakdown of Bretton Woods, it took the world four years to build a consensus around a new system. Not until the Rambouillet conference of the heads of state of six major nations was there agreement among the large industrial nations and it was at the Kingston, Jamaica, meeting of the Interim Committee of the IMF last January that this consensus was broadened to include all of the 127 countries which are members of the IMF.

The Governors of the IMF have now approved major changes in the original Articles. These changes are currently being put before the parliaments of the world for formal ratification. They will come into effect when that process has been completed. The proposals were formally put before the Congress on May 15 and we expect the first hearings to be held next week. Our goal is to achieve complete and final action at this session of the Congress.

The new system does not alter or weaken the basic objectives of Bretton Woods but it differs fundamentally on the method of achieving those objectives. It is this conceptual difference which is particularly significant. Under the old system the monetary authorities of a country set a par value for their currency, accepting an implied obligation to pursue whatever domestic policies might be needed to maintain that rate, whatever happened at home or abroad. The new system does not focus on exchange rates directly, but on the achievement of stability in underlying economic and financial conditions in individual countries. It is based on the recognition that you cannot -- indeed, should not try to -- maintain an unchanged exchange rate relationship between two currencies if the basic trends in the two domestic economies are moving in different directions. Thus it reflects the conclusion that the way to stabilize exchange rates -- the only way to stabilize exchange rates -- is to stabilize underlying economic and financial conditions.

This becomes very explicit when one looks at the policies for intervention by monetary authorities. The potential for a contribution to exchange rate stability by monetary authorities is expressly recognized. But the purpose of such intervention is limited to transactions designed to counter disorderly market conditions -- conditions which would be likely to cause erratic fluctuations in rates of exchange. Intervention to affect trends in exchange rates which result from changes in underlying conditions, would not meet this standard.

This approach -- this concept -- is fundamental to our understanding of current balance of payments policy. Under the par value system any imbalance in a country's international transactions which tended to cause its exchange rate to fall led instead to a loss of official reserves. When market pressure brought the exchange rate to the edge of the accepted margin around the par value the monetary authorities were obliged to step in and use their reserves to buy a sufficient quantity of their currency to prevent the rate from falling further.

In balance of payments statistical presentations great emphasis was placed on what was called the "official settlements" or "official reserve transactions balance." This balance indicated the gain or loss in official reserves and thus in the resources available to defend the exchange rate. Much attention was focused on this balance. When it signaled trouble, governments looked for ways to alter their international transactions so as to change that balance.

Sometimes governments recognized that the proper response was a change in domestic fiscal and monetary policies; sometimes they did not. Sometimes the primary cause lay, not in the policies of the country in deficit, but in the levels at which its trading partners had set their par values. Sometimes efforts were made to correct the balance through solutions or specific balance of payments policies which were in basic conflict both with the objectives of an open trade and payments system and with long-range progress in the domestic economy.

In the 1960s for instance, the U.S., in an effort to reduce a balance of payments "deficit," (1) imposed restrictions on investments abroad by Americans, (2) put limits on bank lending to foreigners; (3) expanded subsidized export credit, (4) reduced duty free allowances for tourists, (5) deliberately "twisted" the yield curve on debt instruments, (6) increased preferences accorded domestic suppliers in government procurement and (7) took a number of other specific actions in an effort to maintain a fixed exchange rate which was not consistent with the underlying economic and financial factors prevailing in the American economy and in those of our major trading partners. Yet many countries were reluctant to face up to the need for change. It was not until the failure of this policy became obvious, when the unsustainability of the rate became so apparent that companies found it essential to hedge all their foreign currency liabilities and speculators moved in for the easy kill that the United States was able to insist on basic modifications.

The new system obviates the necessity for this type of balance of payments policy. We do not want limitations on capital transactions any more than on transactions in merchandise trade. The subsidization of export credit has no defense beyond a plea to match the subsidy of a competitor; domestic preferences for government procurement can be justified, if at all, only by the argument that other nations do the same or by the contention that there is inequity in too abrupt a change of rules. Balance of payment polices under today's system can be expressed quite simply: pursue fiscal and monetary policies which will lead to sustainable economic expansion with reasonable stability of prices and accept the balance of payments results.

You may have noted that just last week the Office of Management and Budget announced a major change in the statistical presentation of the U.S. balance of payments designed to reflect the new monetary system. The tables in the Survey of Current Business will no longer contain any balances. Memorandum items will be shown which give several partial balances: on merchandise trade, on goods and services, on goods, services and remittances, and on current account. Nowhere, however, will the tables show the previous overall balances on current and long term capital account, net liquidity, or official reserve assets transactions. These balances have no particular meaning under the new system and it is wrong to try to characterize the strength or weakness of the U.S. payments position by referring to any of them.

As the Advisory Committee on the Presentation of the Balance of Payments Statistics concludes in its report, "A meaningful picture of U.S. international transactions can be obtained only from an analysis of information on several if not all of the categories of transactions, rather than by concentrating on one or more of several overall balances." Though the partial balances which will continue to be shown as memorandum items are valid and significant for particular purposes, it is important that they not be misused.

There are those who feel that the U.S. might appropriately have objectives or aims as to the structure of its payments positions even if there is no meaningful overall balance. Some have contended that the U.S. should seek a surplus on current account -- attempt to be a net exporter of goods and services -- in the belief that such a surplus will mean more jobs for Americans and less unemployment.

On the other hand some have contended that the U.S. should attempt to allevaite the shortage of domestic capital by importing funds from abroad.

Obviously we cannot do both at the same time. When we have a surplus on current account we are exporting capital, net. We are providing goods currently in exchange for a financial claim which can only be paid off at some future date by a net import of goods and services to the U.S. Thus those who advocate the net borrowing of funds from abroad to alleviate a domestic capital shortage are arguing for a deficit on current account -- an excess of imports over exports. They are saying that the U.S. should seek to receive a net inflow of goods currently, giving in exchange an I.O.U. to be paid in goods at some later date.

Who is to say which of these situations would best serve the economy at any particular moment in time? The economic advantage could shift with changing circumstances. And so we say, "Let the marketplace decide." Let the outcome be the net result of the millions of individual transactions in goods, services, and financial assets, responding to price and other normal commercial considerations and without official interference on the exchange rate. The price of the currency will rise or fall until a balance is struck between supply and demand and the striking of that balance will not turn on whether the funds are sought to pay for goods or to pay for a financial asset. If the balance is struck at a level which involves an excess of exports of goods and services with a net export of capital, so be it; or if an excess of imports of goods and services with an inflow of capital, so be it.

This policy -- this system -- has significant implications for individual firms -- and for the individuals within firms who must make decisions about procurement and sales and investments. Later in your seminar you will examine the factors which influence exchange rates and discuss forecasting techniques. Let me say quite frankly that the U.S. Government does not believe it possible to calculate in advance the exchange rates which would reflect underlying economic and financial sectors in any particular situation. We do not believe it possible to quantify and relate all of the many factors which influence rates day to day, week to week and month to month. The techniques are not even available to measure competitiveness of goods, let alone services and capital transactions. We are not able to measure and incorporate in a rate determination exercise all the effects of income elasticities, of expectations with respect to inflation rates and interest rate differentials, of the market appraisal of the prospect of changes in governmental policy in an important country, or the impact of unexpected political developments.

This impossibility of determining the "right rate" is being recognized increasingly by monetary authorities, although some are still reluctant to abandon the attempt. Occasionally we still see some government attempting to maintain through central bank intervention what it believes to be an appropriate rate. Sooner or later, however, these attempts fail. There have been occasions when efforts to maintain a particular rate actually disrupted the market and cost the government involved a pretty sum of cash.

The U.S. holds no illusions whatsoever about the capability to determine the "right rate." The Treasury has given clear and firm assurance that the U.S. will intervene only when it appears necessary to counter disorderly conditions in the foreign exchange markets or to acquire foreign exchange to repay debts. Under this policy we will not attempt to keep the exchange rate at any particular figure or within any particular zone or range. We will leave the exchange risk where it belongs: with the employer of venture capital.

I should qualify this statement by noting that if the structure of our payments position were being sharply affected as a result of the manipulation of the system by one of our trading partners we would be very much concerned. We would be concerned by any form of either active or passive resistance to needed payments adjustment. An interdependent world will only prosper in an open trade and payments framework, not with myriad restrictions and controls on trade or investment. This is why we are pressing strongly for further liberalization of trade in the MTN and why we are working for a consensus or "code of conduct" on investment.

It is also why there is a specific prohibition in the proposed new text of the IMF Articles of Agreement against manipulation of the monetary system. One of the principal responsibilities of the IMF under the new system will be to monitor the operation of the system so as to ensure that there is no manipulation. We ourselves will be on the lookout constantly to ensure that this does not happen.

A second point I would add is that if the oil cartel succeeds in maintaining an artificially high price level it is likely that several of the major oil producers with relatively small populations will, for several years, continue to receive foreign exchange income far beyond their needs -- or indeed, their physical capacity to absorb imported goods. For them there is no practical alternative to a surplus on current account. In 1976 the surplus of these few countries could total as much as $45 billion. That means that for the rest of the world collectively there must be current account deficits totalling an equal sum.

When a country has a current account deficit the excess of imports is paid for by borrowing. The surplus oil producers will be lending -- somewhere in the world -- even if some of that lending is no more than unspent bank deposits in foreign banks. The countries in current account deficit will have to borrow externally, not necessarily directly from the oil producers but from someone, somewhere. An increasing number of countries are approaching the limits of the amounts which they can afford to borrow -- or which creditors will lend to them. These countries are thus faced with the necessity of pursuing policies which will eliminate their current account deficits.

If the system is to work, if there are not to be breakdowns or the spread of restrictions on trade and payments, those countries which have the strength to attract foreign capital must be prepared to accept substantial current account deficits. They must not resist or counter the efforts of the weaker nations to adjust. The U.S. is one of quite a number of countries in that position.

Our current account position has shifted dramatically in the last two years. We had a small deficit, $500 million, in 1974, when for most of the year the economy was straining at capacity and there was a huge speculative buildup of inventories. In 1975 we had a current account surplus of nearly $12 billion as our economy wallowed in recession and we went through perhaps the sharpest reduction in inventories in 50 years. Now that pattern has changed again. The U.S. economy is expanding strongly -- a few months ahead of its major trading partners. Prices of industrial raw materials are rising. Some rebuilding of inventories may be under way.

In the first three months of the year our trade deficit -- measured on a balance of payments basis -- was $1.6 billion. While the data are not yet available, it is probable that our current account was in deficit during the first quarter by several hundred million dollars. That situation seems likely to continue for some time. If it does, we will be borrowing, net, to supplement the domestic funds available for investment and consumption. We will be making it easier for some of the developing countries and weaker industrial countries to avoid restrictions or further curtailment of their domestic economies. If this happens it will be through the operation of market forces and a U.S. balance of payments policy which is good for the nation and good for the world.

There is one very important aspect of the Rambouillet agreement which I have not mentioned. That is, the intensification of cooperation among the finance ministries and central banks of the major nations. The spirit of Rambouillet is very much alive. Consultations among the major nations are much more satisfactory now than they have ever been -- more frequent, more open and frank, more comprehensive in their coverage than ever. We are learning a great deal about each other's economies, about each other's policies and about the implications of those policies for the rest of the world. We are learning to understand how the concepts of the new monetary system apply in practice. We are learning that we do not know what the exchange rates ought to be at any particular time and that there is no valid way to calculate in advance a "right exchange rate" on the basis of which a central bank could recognize and counter an "erratic fluctuation".

No one should have been surprised at changes in exchange rates since Rambouillet, and no one should be surprised if other rate changes occur. Rambouillet did not promise instant stability of rates. In fact, it warned that rate stability could not be expected until underlying conditions had been stabilized. At this point underlying economic and financial conditions around the world are not stable -- but very unstable. For example, consumer prices in 1975 rose 4% in Germany; 9% in the U.S.; 12% in France and Japan; 17% in Italy and over 24% in the U.K. In most cases the differentials have narrowed somewhat in the past few months but they remain substantial and it will require all the skill and all the courage which governments can muster to bring inflation rates down to the level needed for sustained economis expansion and stability of rates of exchange. For the United States, that stability is the goal both of domestic policy and of balance of payments policy.

To sum up very briefly: U.S. balance of payments policy is directed toward:

(a) fostering economic and financial stability in our own economy

(b) preserving an open trade and payments system

(c) guarding against the manipulation of the system by other nations,

(d) cooperating closely with others in the pursuit of stability in underlying economic and financial conditions, and

(e) allowing market forces to determine both the standard of our balance of payments positions and the rate of exchange at which balance is achieved.

We firmly believe that this policy will provide a framework within which international trade and payments can flourish to the benefit of this nation and the world at large.

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Contact: D. Cameron
Extension 2951
May 25, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES FINAL COUNTERVAILING DUTY DETERMINATION ON CHEESE FROM NORWAY

Assistant Secretary of the Treasury David R. Macdonald announced today the issuance of a final determination in the countervailing duty investigation of cheese from Norway. It was determined that bounties or grants exist with regard to cheese imported from Norway, and that the bounties or grants have been eliminated on Jarlsberg cheese by virtue of price adjustments that are being made by the Norwegians. Additional duties on cheese other than Jarlsberg are being waived under the provisions of the Trade Act of 1974. Notice of this action will be published in the <u>Federal Register</u> of May 28, 1976.

On November 26, 1975 a preliminary affirmative determination on cheese from Norway was published in the <u>Federal Register</u>. Interested persons were given an opportunity to submit written comments on the preliminary determination. No information was received to change the basis for the preliminary determination that the consumer subsidy, basic support subsidy, and freight subsidy constitute bounties or grants.

Accordingly, this final determination indicates that bounties or grants within the meaning of the Countervailing Duty Law, are being paid or bestowed on the manufacture, production or exportation of cheese other than Jarlsberg from Norway. Based on the price adjustment made on Jarlsberg cheese and on the condition that imports of other cheeses not exceed historic marketing levels, a temporary waiver of countervailing duties under section 331 of the Trade Act of 1974 has been issued for cheese other than Jarlsberg.

In 1975, imports of cheese from Norway were valued at approximately $15.3 million.

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REMARKS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE
AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS
NEW ORLEANS, LOUISIANA
MAY 26, 1976

Thank you Governor Edwards, President Kilkenny, Dr. Frey, Commissioner Sutton, the very Reverend Richard Rowland, ladies and gentlemen:

As always, I'm delighted to be back in Louisiana and to see, of course, my good friend Governor Edwin Edwards -- a man who thoroughly understands our energy problems, and isn't afraid to tell it like it is.

And I'm equally happy that your distinguished organization has invited me to your luncheon this afternoon. I feel a special sense of admiration for the people here today, for I believe you are gifted with the kind of character and experience that understands America. You know that the gifts of our past and promise for our future both flow from an ever present spirit of vitality, self-reliance, individuality, and integrity. As I look around this room I see living proof of that philosophy. For without the skills and commitment of men and women like you, our country could not have weathered the first brunt of the energy crisis, much less prepare for the new and dangerous challenges that still lie ahead. America owes you a debt of gratitude.

I also have a special sense of purpose today. With the election campaign rapidly heating up I thought you deserved to hear from at least one out-of-state speaker who isn't running for President.

So here I am, asking not for your votes, but for a few minutes of shared thoughts on some of the basic facts and

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problems facing America -- the sort of thing that sometimes gets buried in the political rhetoric of an election year.

Let me begin with a subject of enormous importance to the country: some straight talk about energy. Lord knows there's been an awful lot of talk about energy lately, much of it dangerously misinformed. Particularly misinformed have been some of the loud, politically motivated cries for further government controls in the energy field.

These cries may yield a few short-term political returns in an election year, but they are not in the best interests of the country. Our whole economic system is based on the simple market principle that products which people are willing to pay for will be produced, and an adequate price will insure an adequate return. Things for which people are not willing to pay an adequate price will <u>not</u> be produced. This is not only the essence, but the genius of free enterprise. Arbitrary controls and politically motivated regulations that strangle the profit motive can only, in the long run, make the consumer as well as the producer suffer.

That is why the Administration I serve feels so strongly about deregulation in general and deregulation of petroleum in particular. It is also why we continue to oppose those who would inject more federal interference into the energy field.

For the facts show that free enterprise is the strongest force we have going for us in our efforts to meet the energy challenge. Consider the record to date. Despite inflation and the oil embargo, Americans still pay less to heat their homes, fuel their cars and keep the mighty wheels of industry turning than any other major industrial power -- thanks to our free enterprise system of energy production.

Unfortunately, this hasn't stopped some people from trying to make a scapegoat of the energy industry. Imagine, this is the only sector of our economy that is still under price controls. What a monumental con job on the part of political demagogues who have convinced a naive public that you can control prices and encourage production at the same time -- that you can take away the incentive to drill and still expect efficient development of America'a untapped energy abundance. And the problem is much bigger than controls alone.

Another striking example of heedless government interference is the growing chorus of politicians and pundits calling for divestiture of the oil industry.

It seems to me that those who urge the fractionalization of this complex and crucial industry have a moral obligation to show us how -- if at all -- divestiture will benefit the consumer and the nation. So far, they have utterly failed to do so, relying instead on anti-business slogans, political rhetoric, and the vague promise that somehow, if we go after the oil companies with a hatchet, the price of gas will go down.

This is illogical and self-destructive. It makes about as much sense as asserting that you can get better mileage out of your car if you chop it up into small pieces. In fact, you will get no mileage at all. And it will cost you more -- not less -- to get the delicate mechanism repaired and back in working order once the damage has been done.

So I repeat to you my personal commitment to the principles of free competition and minimum government interference in the energy field. But I also remind you that neither I nor the Administration I serve can win this battle alone.

We still have the choice of acting in our own best energy interests instead of reacting to decisions made by foreign countries. We must start thinking of the energy crisis in terms of American jobs, homes, food and financial security.

Our economic well-being and national security depend upon American control of the American economy. We cannot jeopardize the future by avoiding the tough energy choices today. We must pay the price necessary to give us command of our own economic destiny.

We need your help in getting our side of the story across to the public. And I hope that each of you as individuals and as businessmen and women with a strong personal stake in the energy industry, will devote more of your time and efforts to getting that story across.

If you don't do it, who will?

But, in the last analysis, energy is only one important part of the overall economic picture. No matter how well we cope with the energy challenge, our general economic health as a nation depends on other factors as well. In the past few years, our economy has undergone trials that have made for some unpleasant results both in unemployment and inflation. But, despite this our country remains the world's greatest economic power -- and, believe me, the world knows it. Even today, we are proving our basic strength by the speed and the security of our recovery from the recession as compared with other industrial nations around the world.

-- 1975 opened with inflation raging at nearly 13 percent. That rate has been sharply reduced and the underlying rate of inflation is now approximately 6 percent. In fact, during the first quarter of this year the overall rate of inflation, as measured by the GNP price deflator, increased at an annual rate of only 3.5 percent. So we have made progress already and we can make more if we continue to follow responsible policies.

-- During the spring of 1975, the unemployment rate reached 9 percent. It has now dropped to 7.5 percent and the trend is clearly downward. Even more important, actual employment has increased rapidly during the past year and a record 87 million people are now working.

-- And the latest figures on the growth of the real GNP, that is, total output after adjusting for inflation, increased at an annual rate of 8.5 percent during the first quarter of 1976. During the last four quarters the output of real goods and services has increased 7.1 percent, a pace well above the underlying capacity of our economy.

Other signs point to an economy that is gaining increasing momentum: Personal income, industrial output, housing starts, retail sales, imports, business capital investment, and most other measures of economic activity -- all are registering solid gains and this reflects rising public confidence about the economy.

We made considerable headway in 1975, and we will make even more in 1976 if consumers and businessmen remain confident that the government will not apply excessive economic stimulus to gain political advantages. But we still face serious long-term problems and this is certainly no time for complacency. Unemployment is still intolerably high, and inflation is by no means under control.

Our desire for progress, in the form of improved living standards and employment opportunities, will surely be frustrated unless we better control the insidious inflation which has destroyed economic stability by triggering a costly series of booms and recessions. The tragic policy errors of the past and our hopes for the future must force us to recognize a basic reality: Inflation is the single greatest threat to the sustained progress of our economy and the ultimate survival of all of our basic institutions. There is a clear record from the past: When inflation distorts the economic system and destroys incentives for real improvement the people no longer support that system and society disintegrates. History is littered with the wreckage of societies that have failed to deal with this problem. I am convinced that even our uniquely creative and productive society will collapse if we permit inflation to dominate economic affairs. There is no tradeoff between the goals of price stability and low unemployment as some critics have erroneously claimed. To the contrary, the achievement of both goals is interdependent. If we are to increase the output of goods and services and reduce unemployment, we must first make further progress in reducing inflation.

Because I feel so strongly about inflation some critics have labeled me a "fanatic." I readily accept that label if it helps to communicate my deep concern although I am not so much fanatical as I am downright antagonistic. The apologists for big spending really want bigger government even though bigger deficits would result from their fuzzy political thinking. We must always remember that it is inflation that causes the recessions that so cruelly waste our human and material resources and the tragic unemployment that leaves serious economic and psychological scars long after economic recovery occurs. It is inflation which destroys the purchasing power of our people. It is inflation that drives up the cost of food, housing, clothing, transportation, medical attention, education, recreation and cultural opportunities. Inflation is not now, nor has it even been, the grease that enables the economic machine to progress. Instead, it is the monkey wrench which disrupts the efficient functioning of the system. Inflation should be identified for what it is: The most vicious hoax ever perpetrated for the expedient purposes of a few at the cost of many. There should be no uncertainty about its devastating impact. Low-income families, the elderly dependent upon accumulated financial resources and the majority of working people who do not have the political or economic leverage to beat the system by keeping their incomes rising even more rapidly than inflation are the hardest hit of all. When inflation takes over an economy the people suffer and it is time that this basic point is emphasized by every responsible citizen and the full brunt is brought to bear on their elected officials. Let me assure you that regardless of the rhetoric emanating from Washington, D. C., the spend-spend, elect-elect, syndrome is alive and well.

The ruinous inflation that crested in 1974 was the chief cause of the severe recession of 1975; if we embark once again on excessive fiscal and monetary policies resulting in double-digit inflation, I guarantee you we will have an even worse recession than before. Let us hope that it will never be said that the pain and suffering of the 1974-75 recession were in vain because the politicians in Washington refused to face the economic facts of life.

The problem is not confined to politicans alone. It may seem strange, and it is certainly ironic, but at a time when Americans are enjoying such great abundance and such great opportunity, too many of us have lost sight of the principles and institutions that have made our way of life possible. Somewhere along the line, there has been a dangerous breakdown in communications.

Too many Americans -- especially those born into an affluent society which seemed to have no beginning or end, no cause and no effect -- have lost sight of, or have never been taught, the dynamics of prosperity in a free society.

Today, when nearly everyone takes the fruits of the free enterprise system for granted -- the abundance, the opportunity, the freedom of choice, the unprecedented opportunities for learning, travel, and general upward mobility -- not everyone understands the basic economic facts of life that create all these benefits.

Small wonder then, that when economic difficulties like the recession hit, millions of otherwise reasonable people fall for the quack nostrums of politicians who are more interested in promising than performing, and for quick-fix government spending that provide some short-term relief but only aggravate the long-term economic ills of inflation and stagnation in the private sector.

Because of this, I believe that the time is ripe for an economic heart-to-heart talk with the American people. And I believe that organizations like yours must do even more than they are now doing if such a national dialogue is to succeed.

What is at stake is not just the future of this or that industry. At stake is the survival of the private sector, and the individual liberties which have never long survived the collapse of a society's free enterprise system.

Unless we get the facts across today, the America of tomorrow -- of our children and grandchildren -- will be doomed to a system of economic and political bondage that is the very opposite of all that we hold dear.

The problem already exists, as I have had ample opportunity to observe, and it is getting worse, not better. It is a question of both policy and perception, for faulty perception of the economy makes faulty economic policy almost inevitable.

And I am firmly convinced that, taken together, misunderstanding and misdirection of the American economy have become the central, underlying problem of our times.

Part of it is a matter of image. Frequently, and especially to youthful idealists, those who support bigger government spending and more government domination of the private sector are perceived as concerned, socially progressive men and women who "care." In a nutshell, they are seen as the humane champions of the persecuted underdog.

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On the other hand, those who warn that the government should not -- and cannot -- effectively solve every new problem that comes down the pike, and who advocate instead the strengthening of the free enterprise system are seen as either outdated theorists or a new generation of economic exploiters, indifferent to human suffering and only out to make a fast buck for themselves and their companies.

To make matters worse, surface appearances often tend to confirm this inaccurate impression. Advocates of big government are able to wax eloquent for hours about the ills they imagine they can cure by cranking out more currency and soaking up more credit through massive deficit spending. They have as many arguments as there are social, economic and political problems -- even though the spending they advocate is the problem not the solution.

Those of us who recognize the fallacy of the big government approach have only one argument. It's the right one, but, by dint of repitition, people are getting tired of hearing about it. For we constantly invoke the free enterprise system, too often without defining the freedoms and the opportunities that it, and it alone, provides. We chant a slogan, a label, without defining it in comprehensible, human terms.

We can talk about the free enterprise system until we are blue in the face, but it still won't mean anything to those who do not understand what it really is and what makes it work. It's like trying to sensibly discuss the birds and the bees with someone who is unshakable in his belief that babies are delivered by the stork.

People who have never seen what happens to countries with state-controlled economies simply have no standard for comparison.

They have never witnessed the long lines of workers and housewives who have to queue up for hours outside state-owned food and department stores in order to buy a poor selection of overpriced food staples and dreary state-manufactured clothing and merchandise.

They don't realize what a miracle of variety, economy and productive competition the average American shopping center would represent to nine-tenths of the earth's people.

They have never asked themselves why a country like the Soviet Union, with some of the largest, richest tracts of grainland in the world, but with a government-owned and run agricultural system,cannot even feed its people without turning to American farmers who own their own land, make their own decisions and feed not only our own people, but millions of others as well.

Too often they have been taught to scoff at the very profit and property motives which make our prosperity possible. They have never lived in countries where the seemingly idealistic dream of a non-profit, propertyless society has turned into a nightmare reality -- where the state and the state alone dictates what kind of education you will receive; whether or not you will be allowed to travel; what kind of job you can have; what you will be paid; what merchandise you can buy with your earnings; where you will live; where you will receive medical treatment; and, ultimately, where you will be buried.

They have not seen first-hand the political and social aftermath in democratic societies that have pursued the idea of a welfare state and state controlled economy. For the personal rights all Americans cherish -- freedom of worship, freedom of speech and freedom of association -- have never long endured once economic freedom has been destroyed. As Alexander Hamilton warned so long ago, "Power over a man's substance amounts to power over his will."

The truth is that regimented societies inflict upon their citizens not only a political regime that reduces the individual, in Churchill's phrase, to a mere fraction of the state. They also inflict an economic regime that smothers enterprise and breeds inefficiency.

Without the individual profit motive, people simply do not work as hard, produce as much, or bother to come up with as many new improvements. Whether we like it or not, it is an immutable law of human nature.

Unfortunately, like clean air, economic freedom is something most people don't really appreciate until it begins to run out -- and then it is often too late.

So we have reached the point where, although the free enterprise system works, and works better than any other economic system in effect anywhere in the world -- and although it feeds, clothes and houses more people more affluently than any other while serving as the underpinning of our free society -- it is somehow losing the war to an alien philosophy of government control and economic irresponsibility that has never worked but has somehow managed to preserve an aura of idealism and altruism that attracts many young idealists.

All of these misconceptions would be unimportant if they were not so misleading -- so blatantly phoney. My experience in Washington has convinced me that almost every man and woman in a position of high public trust cares deeply about the well being of our people, especially those who are impoverished or face disadvantages because of their sex or the color of their skin.

The central question is not who cares the most, but rather how we broaden prosperity and reduce human hardship without sacrificing our freedom or destroying the most successful economic system that man has ever known.

I submit to you today that if America continues down the road toward greater governmental spending and greater governmental control over our economy and our lives -- a road that we have been moving steadily down for several decades -- then our children will be robbed of their personal and economic freedoms. And, in the meantime, all of us will be condemned to an economy riddled by chronic inflation and incurable unemployment.

That is really what is at issue underneath the semantics and the misleading labels, and of course young Americans have an even greater stake in the outcome than the rest of us.

Let's look at a few facts about government spending. For most of our history, the Federal budget stayed somewhere below the $100 billion mark -- usually way below it.

Then, in 1962, we finally hit $100 billion -- and that was only the beginning. Seven years later, the budget broke the $200 billion barrier and then, only four years after that, we hit the $300 billion mark. And now, in our bicentennial year, we have reached the point where the Federal Government is spending $1 billion a day and going into debt $1 billion every week.

And as the budget grows, the government comes to occupy a more and more dominant role within our society.

In 1930, government spending at all levels -- Federal, state and local -- amounted to about 10 percent of the Gross National Product. Today, government accounts for nearly 40% of our entire national output, and if recent trends prevail, the government's share of the total economy will reach 60 percent before the end of this century.

For taxpayers, the burden of paying the government's bills has become so heavy that many are now in open rebellion. In the 1974 general elections, for example, voters across the country turned down some three quarters of all bond issues on the ballot. But we in government get around this public opposition by voting more federal spending without increasing taxes.

The result has been a string of Federal Budget deficits that are unparalleled in our history. In 16 of the last 17 years, the budget has been in the red. And now, just when a balanced, healthy economic recovery has begun, the advocates of big spending would have us launch another round of reckless spending and runaway inflation.

It is up to us to stop them.

I wish that there was some way for television cameras to portray this story as vividly as they did the war in Vietnam or the race riots of earlier years. For, while the visual images are less dramatic, the problem is every bit as pressing and important.

But, as the great 19th century historian Thomas Carlyle once said, political economics is the "dismal science." On the surface, it seems nothing more than a pile of charts and a jumble of numbers so large as to be incomprehensible in everyday terms. To put it mildly, economics seldom makes "sexy" news stories. And yet the economy is the one thing that affects every other aspect of American life -- the food we eat, the quality of our education, our mobility, our freedom of choice in careers, services and merchandise, and our material and personal sense of pride and independence.

The smallest shock to the economy is felt in every limb of the body politic. And that is a big story, if only a graphic gripping way of telling it could be found.

Consider the case of the Federal debt and its impact. As the debt climbs rapidly upwards, we have to pay higher and higher interest cost on it. By the end of fiscal year 1976 we will have spent $36 billion in interest payments alone and in fiscal 1977 it will reach $45 billion.

That's more than we spent in any single year on the war in Vietnam. It's almost half of our national defense budget. And it is money that could be better spent on improvement in public transportation, health care or any of a dozen worthy purposes.

This heavy borrowing by the government has also aggravated inflation and increased interest rates, creating strains in money and capital markets. This, in turn, affects everyone from the businessman interested in expanding his plant to create new jobs, to the young couple trying to buy their first home without paying an arm and a leg in mortgage interest.

Reckless government spending is the basic cause of inflation, and inflation was the underlying cause of the worst recession our country has experienced in a generation.

It was inflation that caused a loss of real income and the confidence of consumers, prompting the sharpest drop in consumer spending since World War II. And it was inflation that helped dry up the flow of savings into our thrift institutions, driving up interest rates and causing the housing industry to collapse.

So one of our prime concerns as we proceed with the economic recovery is to avoid another dose of the poison that brought the recession on in the first place -- rampant inflation fed by runaway federal spending.

But spending isn't the whole problem. There is also the matter of government control and regulation, for, as government spending has grown by leaps and bounds, so too has federal red tape.

Did you realize that government agencies now directly regulate more than 10 percent of everything bought and sold in the United States and indirectly regulate almost every other sector of the private economy?

Did you know that it costs private industry -- and that means each one of us as consumers -- approximately $20 billion a year just to do the paper work demanded by Federal bureaucrats?

Some of the regulations are, of course, necessary. But many of them are counter-productive, wasteful, or obsolete. And as President Ford has repeatedly stated, those regulations and regulatory bodies that no longer serve a useful purpose should be abolished, before we strangle in our own red tape.

Let me conclude with these few observations:

As we enter our third century as a nation, I believe the time has come not to reappraise our dedication to a better life for all -- that dedication is clear -- but to reappraise what we can pay for and how we can do it.

We can pay for what we now have and provide for the future only if our great capitalist economy does its job -- produces goods in a free market and makes a sufficient profit.

I am sick and tired of apologizing for the free enterprise system. It has given this country the highest standard of living and the greatest prosperity ever known, and of most importance, has helped to give us the greatest freedom ever known to man. And it will continue to do that unless it is crushed by the juggernaut of big Government. What we need are not fewer but more capitalists in the United States -- more people with a real and direct stake in the profits generated by a productive economy. We cannot continue to have more and more of our citizens involved only in receiving benefits from the government and fewer and fewer people responsible for paying for the benefits. We must broaden the base of those who work and narrow the base of those who are able but don't want to work.

President Ford urged that we strike a "new balance" in our national life:

-- A balance that favors greater freedom and vitality for our private enterprise system.

-- A balance that favors greater honesty and realism in dealing with the challenges of our time.

These are great goals -- goals worthy of the greatest nation on earth. We should not begin our Bicentennial year by retreating into the past, but by going forward into the future with a combination of patience, realistic hope, courage and common sense.

If we work together with common purpose and conviction -- with pride in ourselves and our nation -- the goals we share today can become the first achievements of our third century together.

President Ford has set a course which points us in the right direction and will permit us to get a grip on these problems, but it will take several years, not months, to bring this about. Unfortunately, the election is only a bit over five months away. There will be calls from the opposition for "sweeping changes" and "broad new initiatives" which will really mean bigger governmental control of the economy. We must persuade the American people that this course is wrong and that the other approach is much sounder in the long run.

The real choice is between greater government control or greater individual freedom. That is the decision before us.

Thank you.

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FOR RELEASE UPON DELIVERY

STATEMENT BY JOHN M. NIEHUSS
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR ENERGY POLICY
BEFORE THE
HOUSE COMMITTEE ON BANKING, CURRENCY AND HOUSING
SUBCOMMITTEE ON ECONOMIC STABILIZATION
WASHINGTON, D.C.
MAY 26, 1976 AT 10:00 A.M.

Financial Incentives for Synthetic Fuels

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss H.R. 12112 and, in particular, the question of Federal financial incentives to encourage the commercial demonstration of various types of energy facilities. Although the proposed bill would provide Federal guarantees for synthetic fuels production, energy conservation, renewable energy resources and geothermal development, I would like to focus my remarks today on the synthetic fuels area. I will concentrate on (1) an assessment of the reasons for Federal assistance, (2) the proper structure of such assistance, and (3) the impact of Federal incentives on the capital markets.

The Administration Program

In his January 15, 1975 State of the Union Message the President proposed a number of measures designed to help achieve energy independence and reduce our vulnerability to the OPEC cartel. One of the key measures was a program to accelerate the development of synthetic fuels. The program is based on the belief that our domestic conventional fuel supplies should be augmented by developing, demonstrating and bringing to commercial production the emerging synthetic fuel technologies. In proposing his program, the President specifically endorsed the use of Federal financial incentives where necessary to encourage commercialization. The President reaffirmed the importance of this activity in his February 26th Energy Message this year.

An Interagency Task Force on Synthetic Fuels last year undertook a comprehensive study of how best to assure early initiation of the Commercial Demonstration Program. One of the major tasks of the Task Force was to identify and evaluate the need for various types of financial assistance to assure commercial development of synthetic fuels. The draft report of the Task Force concluded:

> "In the absence of Federally provided economic incentives or other policies creating a stable and favorable investment environment, significant amounts of synthetic fuels are not likely to be produced by 1985."

We believe that it is important to proceed with a significant commercial demonstration program as part of a national effort aimed at reducing our vulnerability to a cut-off in imports of oil. Further, we concur in the Task Force conclusion that incentives are needed to accomplish the basic objectives of this program.

However, in carrying out the incentives program, we believe that special care should be taken to (1) keep the use of Federal assistance for commercial demonstration facilities to a minimum level necessary, (2) ensure that the impact of Federal incentives on the capital markets is minimized, and (3) ensure that the adoption of a Federal incentives program does not impede movement toward the fundamental actions needed to improve the climate for private investment in the energy sector--e.g., regulatory reform, continued emphasis on research and development, and decontrol of energy prices. We believe that these more basic actions are the most cost effective long-run solutions to the problems of attracting private capital to develop synthetic fuels. However, we also recognize that major actions like regulatory reform take time and that, until such reform is achieved, Federal incentives are necessary to overcome market uncertainty and to ensure that certain types of plants are constructed. In order to understand how a proper balance can be achieved between providing needed incentives now and ensuring that longer-term actions are taken, I would like to explore each of those areas.

<u>Type of Federal Assistance Needed</u>

The exact type of financial incentive needed to achieve the President's goals will vary from situation to situation depending on the technology, the regulatory environment, the nature of the companies involved, and competitive market

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considerations. For example, in the case of projects which would provide fuel to a nonregulated sector of the energy industry, the major uncertainty is the future course of prices of competitive fuels. In such cases, some form of price guarantee may be needed to protect the large capital investment should market prices of competitive fuels fall to a low level. In contrast, for projects which will operate in a regulated environment, price guarantees may not be needed but loan guarantees may be necessary to secure financing for the first commercial size plants to overcome the technological risk, concerns over the large size of the projects in relation to the net worth of the participating companies, and the regulatory uncertainties involved. ERDA should, therefore, have a number of incentives available to it and should also have administrative flexibility to choose the appropriate incentive based on specific situations. Different technologies or industries might require different incentives at different times, and it cannot now be predicted with certainty which form of incentive will be best. Accordingly, a range of incentives, including loan guarantees, are necessary to achieve the early commercialization of synthetic fuels.

We continue to believe, however, that every effort must be made to minimize the cost of such a program to the American people. Therefore, it is important that whatever financial incentives are deemed necessary be granted by competitive bidding to the extent possible. By using competitively bid loan and price guarantees wherever possible, the government will be able to minimize the amount of Federal subsidy involved.

Minimizing the Impact on Capital Markets

Furthermore, as the proposed program is implemented, we must minimize the impact on our capital markets. Any type of Federal financial assistance resulting in the undertaking of energy projects which would not otherwise have been undertaken will lead to some redirection of resources in our capital markets. Such incentives increase the demand for capital while having little or no effect on the overall supply of capital. They tend to cause interest rates to rise and channel capital away from more economic to less economic uses. In short, the proposed program of Federal incentives will direct capital from other areas of our economy into synthetic fuels production.

This diversion, however, is the intended objective of the incentives program which is specifically designed to attract capital into projects for the commercial demonstration of synthetic fuel technologies. The magnitude of the impact of such diversion, will, of course, depend on the amount of money involved and the length of time over which such money is raised. H.R. 12112, as reported by the House Committee on Science and Technology, calls for $4 billion in loan guarantees spread over an 8-10 year period as plants are constructed. The guarantees provided for in H.R. 12112 should, therefore, not cause a great disruption in the capital markets. Given the fact that the annual U.S. investment rate in 1975 was over $200 billion, the program is not likely to have a major impact on the general cost or availability of capital. In addition, FEA estimates that as much as $600 to 800 billion will be invested in the energy sector over the next ten years. When viewed in relation to this amount, the capital investment expected to be induced into the initial phase of the synfuels program is not large.

However, almost 50 percent of the $200 billion net flow of funds in U.S. credit markets is already being taken to finance existing government programs. These heavy government borrowing pressures will continue. Therefore, in order to help minimize the impact of ERDA guarantees and price supports in our capital markets, we believe that it is essential that the Secretary of the Treasury have the authority to approve the timing and substantial terms and conditions of each loan and price guarantee and any other financial incentive that would have a similar impact. Loan and price guarantees result in new issues of bonds, notes or other government backed obligations in the capital markets which impinge upon Treasury and other Federal agency financings and which can have significant market impact. Prior approval of the timing and terms by the Treasury will ensure effective coordination with the management of the Federal debt and will help minimize the impact of such incentives on the capital markets. H.R. 12112 contains the necessary authority with respect to guarantees for synthetic fuels, conservation equipment and impact assistance. However, H.R. 12112 is incomplete in its treatment of the Treasury role with respect to geothermal energy projects. We strongly urge an amendment making the geothermal loan program conform to the synfuels loan guarantee program by requiring Treasury approval of the issuance of guarantees. This amendment is particularly important in light of the current provisions of Section 18(b)(1)(D) of H.R. 12112 which would remove the ceilings on the size of individual geothermal loan guarantees.

Treatment of Foreign Investors

In addition, we are concerned by the fact that, with some exceptions, the legislation prevents non-U.S. citizens from obtaining guarantees under the program. This prohibition is contrary to our traditional policy of nondiscrimination against foreign investors. We follow an open door policy towards foreign investment and once foreign investors are established here they are afforded national treatment--that is, treated equally with domestic investors. This policy is based on the premise that the benefits of investments are not dependent on the nationality of investors. We should maximize our opportunity for obtaining capital and technology from whatever source rather than making discriminations on the basis of nationality which serve no economic purpose.

This is especially true in the present case where the purpose is to encourage the development of plants to demonstrate the commercial viability of new energy technologies at the least cost to the U.S. taxpayers. It follows that we should seek the most promising technology from those firms most capable of undertaking such projects. To completely prohibit foreign investors from taking advantage of the program would deny the U.S. the benefits of their technologies without obtaining any compensating benefits and with possible additional costs for American taxpayers.

We do recognize that the legislation gives the Administrator of ERDA the discretion to grant guarantees for investments by citizens from countries who are participants in the International Energy Agreement. While this is an improvement over a blanket prohibition on foreign investment, it is still contrary to our basic policy of national treatment for foreign investors. Therefore, we suggest that the restrictions with respect to the nationality of program participants be eliminated and that all foreign investors who otherwise meet the qualifications established by ERDA be eligible for guarantees under the program.

Necessity for Regulatory Reform

The proposed incentives program, Mr. Chairman, is important but should not be seen as a substitute for needed regulatory reform. The level of Federal financial assistance that will be required to bring about certain types of first generation synthetic fuels plants and, more importantly, the ability of the synthetic fuels industry to free itself from Federal financial assistance, will be determined to a great extent by how rapidly we develop a more favorable regulatory climate. Energy prices should reflect the real costs of producing energy if we are to achieve the needed increases in supplies of energy and to discourage the wasteful uses of energy. With respect to synthetic fuels in particular, the difficult problem of arranging private financing for high BTU coal gasification plants has been handicapped because of regulatory commission policies which refused to allow appropriate all events cost of service tariffs for first generation synthetic fuels plants. I would hope this barrier will be removed so that once demonstration plants are proven to operate satisfactorily, the financing of future plants can be handled completely by the private markets.

Likewise, the Interagency Synthetic Fuels Task Force Report indicated that a major barrier to electric utilities undertaking medium BTU coal gasification projects is the inability of these companies to attract capital due to their low level of profitability resulting from regulatory policies. Again, the best long-run answer is regulatory reform. In addition, expediting various environmental and other regulatory procedures would significantly assist the private capital market in responding to our Nation's energy needs. The faster we can move on these needed improvements in the regulatory environment, the less will be the need for Federal Government financial assistance. We do, however, recognize that these improvements will take time and that there is currently a clear need for carefully chosen and implemented range of incentives in order to assure the private financing of demonstration facilities in the interim. Therefore, we urge enactment of the loan guarantee authority contemplated in H.R. 12112 so ERDA will have the flexibility to provide the assistance needed to induce the construction of these facilities.

Mr. Chairman, that concludes my prepared statement, and I will be glad to respond to any questions you might have.

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Contact: L.F. Potts
Extension 2951
May 26, 1976

FOR IMMEDIATE RELEASE

TREASURY ANNOUNCES TENTATIVE NEGATIVE DETERMINATION IN ANTIDUMPING INVESTIGATION ON INDUSTRIAL VEHICLE TIRES FROM CANADA

Assistant Secretary of the Treasury David R. Macdonald announced today a tentative negative determination in the investigation of industrial vehicle tires from Canada under the Antidumping Act, 1921, as amended. Notice of this decision will appear in the Federal Register of May 27, 1976.

Comparisons based on purchase price and home market price during the period July through December 1975, have yielded no margins.

Imports of the subject merchandise from Canada during calendar year 1975 were valued at roughly $1 million.

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FOR RELEASE UPON DELIVERY

REMARKS BY THE HONORABLE GERALD L. PARSKY
ASSISTANT SECRETARY OF THE TREASURY
BEFORE
THE JOHNS HOPKINS UNIVERSITY
WASHINGTON, D. C.
THURSDAY, MAY 27, 1976, AT 1:00 P.M.

A View of Divestiture

It is indeed a pleasure to have the opportunity to share with this gathering of experts my thoughts on the subject of energy industry divestiture. The timing of your conference is particularly appropriate because of the current public and Congressional debate on the issue.

Several weeks ago we convened a special task force within the Treasury to take an objective look at some of the potential consequences of various divestiture proposals. Our analysis is almost completed, and I would like to share with you today some of the preliminary conclusions. We have purposely concentrated on the financial and economic effects of the divestiture issue, particularly the likely effects on capital formation in the energy industry. We have also examined the effects on the structure and operations of the domestic and international energy industry as well as considered some of the legal aspects of divestiture.

I would like to offer you our views on each of these subjects; but in the end, I believe the most important consideration should be the effect of divestiture on the U.S. energy objectives.

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As I will discuss later in some detail, we have concluded that divestiture would seriously hinder the achievement of our national energy goals, while not fulfilling the objectives claimed by proponents of divestiture.

Divestiture and Our Free Enterprise System

In order to appreciate fully the consequences of divestiture, it is important to view the proposed legislative actions as part of a general policy choice that faces all of us today. Although legislated divestiture of the oil industry is not a new idea, I believe the present level of support for this proposal is part of a growing willingness by many people to inject the government into the activities of our private sector. It seems that everywhere we turn today, someone is calling for the government to do what our economic system has previously asked the private sector to do -- whether that be government allocation of credit or government control of price and supply of resources or government redistribution of wealth or government determination that the oil industry should be broken up.

What I am saying is that I believe the explanation for the divestiture movement runs deeper than a politically motivated attack on the oil industry. It reflects a more serious and fundamental problem affecting our society today, namely a serious weakening of the confidence of many Americans in private enterprise as the most efficient vehicle for furthering our economic objectives.

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We seem tempted to turn more and more to the Government to solve our real or perceived problems at whatever cost -- either to our pocketbooks or more importantly, to our freedom. Not enough people have recognized that more often than not, the government "solutions" lead to further problems and yet more government involvement to undo the effects of earlier "solutions." Our 200 years of experience with the free enterprise system in the United States has demonstrated that the system works, and works better than any other economic system in effect anywhere in the world. It feeds, clothes and houses more people more efficiently than any other. Most important of all, our free enterprise system also serves as the underpinning of our free society. The fact is that in every country in which the government's share of economic activity has increased there has been a tendency to move toward instability, toward minority government and toward a threat to the continuation of a free society.

The area of energy policy provides a good example of the problems caused by excessive government control and intervention. The simple fact is that this country has been without a coherent energy policy for too long -- not because we didn't know what to do from an economic standpoint but because we have lacked the collective political will to take the necessary action. Make no mistake about it, policy in the energy field cannot be made by the executive branch alone. It takes the cooperation and support of the executive branch, the Congress and the American people. In

January 1975, the President put forward a comprehensive energy policy. It called for maximum reliance on market forces in order to increase domestic supplies, reduce wasteful use of energy and minimize our vulnerability to foreign suppliers. Unfortunately, it was not accepted and much of the energy legislation that has been proposed or enacted would move us toward more government control rather than less.

Again and again, we seem to choose the easy solution -- to legislate new controls and more government regulations. However, the experience of the past two or three years should demonstrate that further controls will only handicap and impede the energy industry in its ability to increase energy supplies and reduce our reliance on expensive and unreliable oil imports.

Similarly, the politically easy solution is to seek to maintain energy prices below their competitive market levels even though this encourages continuation of the wasteful use of energy and discourages development of new supplies. As is often the case, the appealing solution politically is not always the right one economically. This brings me back to the main subject of my talk, divestiture. In my view, the divestiture proposals now before Congress reflect a "solution" which may be politically attractive, but is counterproductive to our energy objectives.

General Arguments For and Against Divestiture

The basic arguments of the proponents of energy industry divestiture are couched in terms of enhancing competition.

For example, the preamble to one of the recent bills argues that "existing antitrust laws have been inadequate to maintain and restore effective competition in the petroleum industry." So it is proposed that the laws be changed "to require the most expeditious and equitable separation and divestment of assets and interest of vertically integrated major petroleum companies." Another bill is designed to "create competition in the petroleum industry, thereby, breaking the economic stranglehold of monopoly power" and "to prevent in advance the aggrandizement of monopoly power over alternative domestic sources of energy."

The Treasury's strong support for strengthening our free enterprise system should leave no doubt about our desire to maintain and enhance competition in our economy. In my judgment, however, our antitrust laws, which are designed to ensure that competition is fostered on an industry-by-industry basis, have been effective, and I support their continued rigorous enforcement. However, the preambles of most of the recently introduced energy divestiture bills imply that our antitrust agencies have been dilatory and ineffective because they have not found sufficient evidence of monopoly power in the oil industry to support a national antitrust complaint under existing law -- so Congress needs to take independent action. In effect, the Congress is legislating a guilty verdict and a harsh penalty without trial.

It seems to me that the positions of the antitrust agencies can also be taken as evidence that effective competition does exist in the oil industry. The type of incursion into our economic freedom reflected in these divestiture proposals would be quite serious in any event, but to pursue such a disruptive course in the critical energy industry at a time when our economic and our national security require a strong domestic energy industry able to reduce our reliance on foreign oil makes bad policy even worse.

Conclusions of the Treasury Analysis

The central question in the divestiture debate is whether any benefits that might be derived from divestiture outweigh the anticipated considerable costs of such a measure. The proponents of divestiture claim that it will increase competition, leading to lower energy prices, greater energy supplies and a reduced influence and dominance of the oil producing countries. We have concluded quite to the contrary: that with divestiture, it is more likely that domestic prices will increase instead of decrease and that domestic energy supplies will decline rather than rise. In addition, we have concluded that divestiture, particularly vertical divestiture, would seriously affect the ability of a major sector of our energy industry to meet our energy supply requirements, particularly over the critical period of the next 10 to 15 years. The result, we have concluded, is that divestiture will increase our reliance on imported oil and that OPEC influence over the international energy market will likely increase. We, therefore, have come to the conclusion that divestiture would hinder the achievement of our national energy goals and would not be in the public interest.

Detailed Findings of the Treasury Analysis

Let me now outline a few of the specific conclusions of the Treasury divestiture analysis. As I noted, we have examined the financial, economic, legal, and energy market effects of the vertical and horizontal divestiture proposals. We considered the likely effects both in the transitional period, which could be quite lengthy, and in the longer run when a new equilibrium will presumably be reached.
The financial effects would be most pronounced during the transition period but there would be many adverse financial effects in the longer term as well.

(more)

Transition Effects - Legal. In examining the consequences of divestiture during the transition period, we looked first at the legal and administrative problems in implementing divestiture under the legislation before Congress. Divestiture, of course, has been used as an anti-trust remedy in the past and the resulting legal and administrative problems, while complex, have been manageable. What is different in this case is the scope of the undertaking, the nature and structure of the affected industry, and the critical time at which divestiture of this vital industry would be ordered.

Although the leading divestiture bills call for a transition period of 5 years for vertical divestiture and 3 years for horizontal divestiture, legal challenges to the constitutionality of the legislation and to the fairness of specific divestiture plans could suspend or impede full implementation of divestiture until due process is given and the legal issues resolved. Thus, it is likely that the transition period could extend for 10 or more years.

Another issue that likely will be the subject of extensive and lengthy litigation is whether existing loan covenenants and indenture agreements are actually violated by divestiture plans. Lenders who are relying on a company's overall creditworthiness as security for investments may see their interests as being adversely affected under divestiture and might litigate or attempt to enforce their rights under existing loan agreements which generally place restrictions on the sale or spin-off of assets. While negotiated solutions to such problems with lenders will eventually be arranged in most cases, creditors would be in a position to threaten to accelerate the repayment of outstanding debt. In some cases, they may decide acceleration is necessary to protect their interests. In addition, the negotiated solutions which are achieved will likely often entail shorter repayment schedules, security against some of the corporation assets and higher interest rates.

There are a number of other difficult legal problems which are important to consider, including particularly difficult problems relating to foreign entities and the treatment of the foreign assets and liabilities of U.S. companies.

Transitional Effects - Financial. Eventually all of these problems will be resolved, but it is important to emphasize that there will be a lengthy period of uncertainty about the structure of the new firms, their relationships with existing creditors and equity owners, and their future creditworthiness, all of which will have a detrimental effect on the access to capital markets and availability of external capital to these firms. Moreover, the capital that is available both during the transition period and afterward can be expected to cost more, due to the increased risk and uncertainty as to the future prospects of these firms.

Specifically, we believe that the financial effects of divestiture upon the affected companies during the transition period would include the following:

First, it will be difficult for new unsecured long-term debt issues (including the refinancing of maturing issues) to be sold until lenders could ascertain: (1) what corporate entity would be responsible for debt repayment, and (2) what the existing assets and liabilities of that corporate entity would be. Under current bills, this hiatus could run 1-1 1/2 years, or longer if legal delays are encountered.

Second, even after this point is reached, it still may be difficult for some companies to raise capital since uncertainties will prevail also about the earnings potential of the divested companies. The return to divested oil companies might well be lower since economies of scale which have been advantageous to the integrated oil companies may no longer be available. Efficiencies which were possible in a larger, diversified company, for example, in such activities as planning, resource allocation, and research may no longer be available.

Third, it may be possible for these companies to raise some amount of secured long-term debt. However, since the basic security of loans would be the particular asset rather than the creditworthiness of the company, the potential volume of such financing would appear to be limited by the specialized nature of many of the oil companies' assets and possible efforts of creditors to block such financing in order to protect their existing investments.

The financial problems will clearly vary from firm to firm, but generally, we believe that there will be a significant reduction in the ability of these firms to finance energy investments during this period. Moreover, and just as important, corporate management will have to direct a significant amount of its effort and attention to preserving or realizing on values of assets rather than expanding energy supplies. As a result, priorities for the vigorous expansion of domestic oil and gas resources will be downgraded, which will delay the development of these resources and result in a continued increase in oil imports. While we would expect that most projects now underway would be completed, the uncertainty created by divestiture could delay, and perhaps prevent, some projects. This would be especially true in the case of projects where financing was not completed. For example, divestiture might create major problems for the timely completion and financing of the Alaskan oil pipeline.

My discussion thus far has concentrated on the financial affects of vertical divestiture, for it is this form of divestiture which would have by far the greater effect on the ability of and incentive for affected companies to make investments. Horizontal divestiture, mandating the divestment of

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non-petroleum energy sector operations, would also adversely effect the levels of investment in the non-oil energy operations of these companies (i.e., the operations that should be developing the important alternative energy sources this country requires).

Long-Term Effects. It is the transition period effects on investment that we see as the most critical. This transition period, which, I would emphasize could extend for the next 10 years or more. is the same period during which the domestic energy industry must make massive investments if the nation is to reduce its dependence on foreign oil. In our judgment, the adverse transitional effects are a sufficient reason for opposing divestiture. However, we also examined longer-term, post-transitional period financial effects of divestiture. First, the existing integrated companies would have a greater debt capacity than the aggregate debt capacity of the divested component companies since an integrated company has greater stability in its level of cash flow and is viewed as offering a greater likelihood for principal and interest payments on debt to be met. Also the case of horizontal divestiture, the divested non-oil firms would lack the financial backing of their former parent firms. Second, in the case of vertical divestiture, the required levels of working capital probably would also rise. Finally, with respect to incentives to invest, the size and output thresholds imposed by divestiture would effectively place growth ceilings on firms approaching those limits.

Effect of Divestiture on Energy Objectives

These are some of the financial aspects of divestiture which we believe should be given careful consideration. As I mentioned earlier, however, the ultimate test of whether we should undertake divestiture is whether it would further our energy objectives of increasing supply at the lowest cost to the American consumer. In this regard, I believe the burden of proof should be on those who are calling for this costly restructuring of the energy industry to establish the benefits that would result. I have seen no such evidence. I think it is time that we begin to ask some of the right questions:

-- First, would divestiture result in an increase in competition in the oil industry? Clearly, it would increase the number of firms in the industry and end the corporate ties between the functional components. But what has not been shown is how this will result in lower domestic energy prices or increased domestic supplies. The horizontal structure of the oil industry will not necessarily be changed by vertical divestiture. Thus, even if there were an abuse of market power in one horizontal level which existing antitrust laws or, regulation could not handle, vertical divestiture would certainly not be the appropriate remedy. Moreover, if our antitrust laws or our regulatory policies are deficient in any way, then such deficiencies should be rectified. We should all

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support the rigorous enforcement of our antitrust laws and sound regulatory policies but let's not substitute divestiture legislation for such a policy.

-- Second, would divestiture result in lower domestic prices through increased competition? We have been unable to uncover any even evidence that divestiture would lower prices. On the contrary, our analysis shows that the likely direction for oil prices as a result of divestiture will be up, not down. The likely adverse effects on investment in new energy supply capacity would tend to put upward pressure on prices directly, and indirectly, by increasing our dependence on foreign oil. Further, we have seen no evidence that there are significant inefficiencies existing in the present oil industry due to any lack of competition. On the other hand, there are important economic efficiencies in integrated oil operations which are recognized world-wide. In fact, because of these efficiencies, many other governments are seeking to increase the degree of integration of their oil industries. These efficiencies would be lost under vertical divestiture.

-- Finally, would divestiture help increase the development of alternative supply sources? Again we believe the legislation would have the contrary effect, with the financial uncertainties resulting from divestiture increasing the cost of capital to affected firms and reducing their ability to raise external capital for investment in alternative energy supply sources.

There are many other implications of the divestiture proposals which I haven't tried to cover today. We are certainly not able to answer all the difficult questions relating to the divestiture issue. At the minimum,however, we would hope our analysis will help focus attention on the very serious questions that must be addressed before such drastic action is undertaken.

Today, as never before, energy policy has become intertwined with national and international political concerns. For some, the emotions of the political arena have distorted the economic realities of the marketplace. As we consider the divestiture issue, I would urge that we minimize the superficial political rhetoric and maximize the objective economic analysis, and I believe that your conference will be of tremendous help in this effort.

Last 5/4 5.645 %

Today 6/1 6.309 %

Highest Since 12/16 6.439 %

The Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 964-2041

FOR IMMEDIATE RELEASE

May 26, 1976

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RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $2,900 million of 52-week Treasury bills to be dated June 1, 1976, and to mature May 31, 1977, were opened at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	93.652	6.278%	6.69%
Low -	93.593	6.337%	6.75%
Average -	93.621	6.309%	6.72%

Tenders at the low price were allotted 50%

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

District	Received	Accepted
Boston	$ 49,130,000	$ 38,130,000
New York	3,480,720,000	2,488,220,000
Philadelphia	26,800,000	11,800,000
Cleveland	107,760,000	52,760,000
Richmond	29,720,000	4,720,000
Atlanta	6,655,000	5,655,000
Chicago	336,925,000	176,925,000
St. Louis	27,075,000	11,075,000
Minneapolis	29,270,000	19,270,000
Kansas City	10,240,000	6,240,000
Dallas	14,295,000	4,295,000
San Francisco	241,395,000	81,395,000
TOTAL	$4,359,985,000	$2,900,485,000

The $2,900 million of accepted tenders includes $ 75 million of noncompetitive tenders from the public and $ 785 million of tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities accepted at the average price.

An additional $20 million of the bills will be issued to Federal Reserve Banks as agents of foreign and international monetary authorities for new cash.

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WASHINGTON, D.C. 20220 TELEPHONE 964-2041
THE DEPARTMENT OF THE TREASURY 1789

May 24, 1976 1167

REMARKS OF SECRETARY OF THE TREASURY
WILLIAM E. SIMON AT THE OPENING MEETING
OF THE ADVISORY COMMITTEE ON CONSOLIDATED FINANCIAL STATEMENTS

I would like to thank each of you for coming to lend us your assistance. It is obvious that the Treasury is striking a good bargain in getting your services. Over the long haul we all have an opportunity to profit from this effort, because we have an opportunity to improve the way our government functions.

The idea of preparing business-like financial statements for government is not new; it has surfaced a number of times in the past. But unfortunately, the need for such statements was not clearly recognized. Our public institutions have been through a period of go-go years like many private companies but now the pendulum has swung in the other direction. Like easy profits, easy borrowing is gone -- governments have, in many instances, over-extended themselves. This has been particularly prevalent at the state and local levels because, unlike the Federal Government, they have no printing press.

The unfortunate thing is, it is not something that happened all of a sudden -- it has been creeping up on us.

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And, even the people we hire and elect to manage our affairs were not aware until financial crises struck.

There is a motel ad being run that has a catchy phrase -- the best surprise is no surprise! Well, there are a lot of federal, state and local government officials who probably would support that 100%. That is what this effort is all about -- eliminating some of the surprising, shocking revelations that we have all endured lately.

I do not want to create the illusion that a set of financial statements is going to cure what ails us; but I do want to do everything we can to dispel the illusion held by many that the status quo is good enough. I will be frank, the idea of preparing consolidated financial statements is not receiving 100% support but I do not believe that government is so different from business that we can continue to operate for long without knowing what our financial position really is and know it has changed through time.

For those who have been in any way associated with government, one of the overwhelming phenomena is the amount of information that exists. A common complaint is not that there is not enough, but that there is too much information -- that it is overwhelming. Most of the information that is generated is geared to some expert user, or to some particular interest group. There are few, if any, reports that let the man on the street, or the manager who is new to a top position in government, know what the overall condition of government really is and how it relates to the resources that the government has pulled out of the nation's income stream through taxes and additions to debt, and returned to the stream through current expenses and additions to capital.

While there are reports on economic impact, and reports on the debt, and on cash receipts and expenditures, there is no report that puts all the parts into a total perspective. An overall perspective that is critical to the congressman, the taxpayer, and the decision maker in Government -- that is what we need. Something that gives all those who are interested in government the facts concerning the size of government, the nature and quality of its assets and its liabilities, and how the government affects the flow of income. More than ever we need to know how much of our nation's future resources we are tying up with today's decisions.

Telling the people how the government stands financially is an important goal in itself, but I believe that it is also a first step toward improving the decisionmaking processes of government. The Federal Government has a pervasive influence on the allocation of the national output. Its decisions in this role fundamentally affect the national welfare. State and local governments also play a large role in allocating the national output, and an even larger role in allocating the output of their respective geographic areas. Unfortunately, debates about setting national economic policies are too often limited to arguments about the allocation of functions between the public and private sectors. In considering national economic priorities a much broader perspective is required. The total productive capability of the entire economy must be first identified before attempting to rank and select specific claims against that potential output. Measuring the total economic capacity of the system avoids the simplistic arguments that additional government programs can be continuously created to meet every claim by simply shifting resources from the private to the public sector. There can be no single "best" allocation of resources. Differences of opinion among people are inevitable, and they are not of a character that can be resolved objectively. They must, however, be reconciled, and it is the function of the democratic process to do this. That process works best when the citizenry is well-informed.

I believe that the financial statements we are going to develop, with your help, will serve that end because they will measure the financial operations of government in the same way that financial operations of the private sector are measured.

Before you embark on your work, I would like to lay down a few general guidelines for you to consider in your deliberations.

We are looking toward a set of statements that gives us a picture of financial operations for each fiscal year and where we are at the end of the year. We recognize that government purposes are different from those of private enterprise. Government is not in business to make profits and therefore an excess of government revenue or expense does not have the same meaning as corporate profit or loss. It does have meaning, however -- for tax, expenditure and debt management policies, for example, and for the economic goals of containing inflation and fostering high employment. The fiscal responsibility of public management can be judged in relation to goals such as those, just as corporate management can be judged in relation to profit and other business goals.

The statements ought to be simple enough so that they are useful to a broad spectrum of users. The experts are always informed -- they have staffs of other experts. Our democratic process works best when all of our people have knowledge and information. In the end they are the ones who influence decisions; the statements must serve them.

The statements must be consolidated. To the extent that you determine the appropriate coverage of the statements they should capture all of the revenues and expenses and all of the assets and liabilities of those governmental organizations included in the statements. But the focus ought to be on the aggregates, not on the individual organizations.

Finally, the statements are to be on the accrual basis. I do not claim to know much about accounting theory. But I know a lot about business, and I know that you cannot run a successful business without knowing what you own and what you owe and how those things are changing from period to period. I also know a lot about government, and I know that you cannot run a sound government without knowing those same things.

In fact there is even more reason to know in government. If a business is not well-managed, it goes bankrupt, closes its doors, and disappears. It cannot force its customers to keep it alive. If a government is not well-managed, it can avoid financial bankruptcy for years by overcharging the taxpayers.

A lot of taxpayers are getting fed up with paying for the waste caused by bad public management. And they are tired of being surprised to find their governments suddenly on the brink of bankruptcy.

This does not have anything to do with politics. Democrats and Republicans may argue about what government should do and how it should be financed; but however that argument comes out, everybody wants to know whether or not their government is in sound financial condition. That is what this project is all about: Telling the American public in a simple business-like way what the financial condition of their government is and thereby inviting them to join more actively in making decisions about matters that vitally affect their welfare.

I just cannot tell you how much I appreciate having all of you take time out of your very busy schedules to come here to consult with us. But I feel sure that you will earn the appreciation of the American people for this great public service.

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OTA Papers

Issues in the Taxation
of Petroleum and Natural Gas Income

Seymour Fiekowsky
U.S. Treasury Department

OTA Paper 2 September 1974

THE DEPARTMENT OF THE TREASURY 1789

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Preface

The design of rules for taxing oil and gas income has posed controversial legislative and administrative problems almost from the outset of Federal income taxation in 1916. This is not surprising, for the process by which oil and gas reserves are brought into productive use is more nearly akin to a research and development undertaking, than to a straightforward industrial project. A conceptual distinction may be drawn between investment in the discovery of new information to reduce risk, and investment in well specified items of plant and equipment to produce reasonably well defined products. Income accounting procedures for the latter kind of investment are not without controversy since expected useful lives and residual values are not certain. But the range of difference in possible income accounting rules[1/] is not so great as to excite heated debate. Thus, in the case of measurement of income from petroleum refining, notwithstanding the large investment in plant and equipment,

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1/ Income accounting rules are used to synchronize flows of receipts and expenditures for the purpose of producing periodic estimates of income. The receipts of a particular time period have to be attributed to activities of the current, future, and past periods; and expenditures of the present period have to be similarly attributed. It is the excess of current period receipts (and claims) over current period expenditure of resources (whether "paid" in the current period or not) which is "income" of the current period.

there has been no history of Congressional and administrative controversy over refinery-specific income accounting rules.

But the tax treatment of investment in discovery and development of petroleum has been, and continues to be, the subject of bitter controversy. And, as frequently happens in the course of tax controversies that spill over into popular debate, mythology comes to replace fact, and sloganeering supplants analysis. It is a mark of the deplorable state of public discussion that most of the debate has centered on "percentage depletion", although percentage depletion is scarcely the most significant rule for measuring taxable income from investment in oil and gas reserves. These notes attempt to puncture prevailing myths by identifying the issues of income measurement and by examining the slogans offered by proponents and opponents of percentage depletion.

I. Income measurement issues.

A. A simplified description of the investment process.

For expository purposes, suppose investment in discovery and development of petroleum and natural gas reserves, and a given productive capacity, takes the following form. Someone makes outlays of $20 million over a period of 10 years. These outlays are for geological and geophysical survey work, for drilling test cores and wells, for equipping those wells which are productive, and for installing storage

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and related facilities. At the completion of this investment program, it is established that the field will produce 10 million barrels of oil. Under these simplified assumptions, and ignoring the mathematics of comparing present and future values, each barrel of oil "costs" the investor $2; this is the capital cost per barrel which should be accounted for in determining the investor's income as the oil is extracted and sold. For example, if in a subsequent year 1,000 barrels are pumped-out at an additional cost of $2,000 and sold for $5,000, the income for that year would be $1,000 ($5,000 less $2,000 production cost and less $2,000 "depletion" of investment cost at $2 per barrel for the 1,000 barrels extracted).

In sum, the rules used for income accounting in this simplified description of the investment process were: (1) Capitalize all costs connected with discovering and developing the reserves of oil; (2) divide this cost by the total quantity of recoverable minerals discovered, the quotient being the capital cost, or depletion charge, per unit of the mineral; (3) subtract this depletion charge, plus any additional costs of extracting the mineral, from gross receipts attributable to extraction to derive net income. Obviously, if it costs $2 per barrel to discover and develop oil and another $1 to lift it, still ignoring the mathematics of discounting, the price of oil will have to be at least $3 per barrel, else

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investors will not devote their resources to the search. If the price is expected to rise substantially above $3, more resources will be invested, more oil found, and the price will be driven down to the normal rate of return level, $3 in the example just described.

B. Complications.

There were two critical elements in this simplified example which gave rise to a correspondingly simple (and fundamentally correct) income measurement rule: (1) The investment process has an easily identifiable beginning and end; (2) after the investment period has ended, the amount of extractable mineral is known with certainty. Unfortunately, the actual conditions of investment and the search for reserves so greatly differ from these simplifying assumptions that the simple income measurement rule is not operational.

(1) The sequential nature of the investment process.

Imagine a geographic region in which there has been no previous discovery of petroleum and gas reservoirs. Suppose that a skilled prospecting company makes preliminary observations and concludes there is a reasonable probability that subsurface petroleum and gas reserves may be found. The would-be prospecting company must then purchase exploratory rights from the landowner, and this purchase of mineral rights usually takes the form of a mineral lease wherein the owner (who becomes the lessor) exacts the highest possible cash payment (called a "bonus") plus a share of future minerals which may be discovered (called a "royalty").

In negotiating a mineral lease, the would-be prospector faces a serious problem: though he suspects the existence of underground reservoirs, he can be sure neither of its exact location nor of its geographic extent. The larger the surface acreage for which he purchases rights, the greater his expense, particularly if, as in the United States, surface rights may be privately held in small plots. On the other hand, if a prospector does not secure rights to a large acreage, the reservoir he may find could extend beyond the boundaries of his lease, and he will fail to capture the full value of the mineral he is principally responsible for discovering. The prospector must, therefore, make a difficult decision, the quality of which will determine his ultimate gain. If, as in the case of auctions of leases on public lands, the total acreage offered for exploration and development is large, individual companies may pool their initial risk (uncertainty about the precise location and extent of underground reservoirs) by jointly bidding on several parcels, and they may engage in similar loss hedging arrangements with neighboring lease holders on private lands.

In any event, from the point of view of potential oil discoverers, the initial outlay for rights to explore is a "capital" expenditure, part of the cost to be cumulated as the ultimate capital cost of a discovery, if any. Under all conventional rules of income accounting, these initial outlays to purchase mineral rights should be capitalized. This is also the case under tax accounting rules by which lease bonuses are capitalized as part of the "depletable basis" of a mineral property, to be recovered by depletion allowances whenever mineral production occurs.

Once mineral rights have been secured, the discovery process entails further expenditures for geological and geophysical surveys and tests to select a likely site for drilling a "new field wildcat," a well to discover a new reservoir. These expenditures are not unlike expenditures made by industrial firms in connection with the design and development of a new product or industrial process: they are generalized expenditures on scientific research intended to produce information of future value. The accounting treatment of this class of expenditures is not universally agreed on, however. Some managements regard research and development as ephemeral outlays, a current cost of doing business deductible from current gross income; others regard them as capital expenditures, to be cumulated as the investment cost of an ongoing project. Although the tax law generally permits current deduction of research and development expenditures, these outlays with respect to oil and gas discovery projects must be capitalized and become a part of the depletable basis of mineral properties.

After one or more drilling sites have been selected, the process next entails drilling of wells. Experience with wildcat well-drilling is highly variable, but overall statistics on domestic drilling indicate that only one of ten or eleven wildcat wells will strike oil or gas and be completed as a productive well; the others will be "dry-holes." It is clear that the cost of drilling all wells, the dry-holes along with the successful discovery well, should be capitalized as part of the investment cost, for even the drilling of a dry-hole yields information of value. In principle, there is no difference between the cost of scrappage inevitably encountered in the manufacture of a machine or other capital asset and the cost of drilling dry-holes; both are a social and private cost of creating productive capital assets and both should be accounted for in that way.

But the completion of a successful new field wildcat does not end the investment process, even if oil and gas begin to flow. It is further necessary to define the size and characteristics of the reservoir, and this requires additional wells. Once the existence of a field has been established, a much higher fraction of the subsequent wells drilled will be successful, perhaps 60 percent. In a real sense, part of the cost of the succeeding wells, which may be called "development" wells, is further investment cost designed to provide additional information about the oil and gas field, little different from prior expenditures with which they should be cumulated. But, in another sense, these additional wells are closely related to current costs of production, for they make possible a higher current rate of production from the reservoir.[1/]

1/ Readers unfamiliar with the nuances of tax accounting may wonder at the need for a distinction between the cost of investment in the "mineral" and investment in "productive capacity." While this distinction has no particular utility from the point of view of investment decisions or mine management, it is critical to tax accounting because property rights in minerals are separable from rights in "movables" under the law, and being separable, they may be exchanged independently. In the event there is an exchange, it becomes necessary to account for gain, or loss, realized by the seller which requires that his "adjusted basis"--original cost of the property right, less allowances for depletion or depreciation--be continuously accounted for. Moreover, the cost of the mineral rights, as distinguished from other property purchased by the new owner, must be established so that tax income accounting for capital consumption may proceed. Since there is no functional economic distinction between the two kinds of rights corresponding to the property law distinctions, an infinite number of strategies may be devised which will outwit the tax collector. A similar need to artificially value "land" and "buildings" bedevils administration of the tax laws with respect to real property.

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(2) Uncertainty of reservoir content.

The indeterminate shading between investment in additional knowledge of reserves and investment in productive capacity from known reserves poses the problem that, if income from current production is to be measured, the cumulative prior cost of establishing the reserves must be divided by the quantity of reserves to derive an appropriate "depletion" charge. But if the very act of producing from an underground reservoir adds to knowledge of recoverable reserves, it is obviously impossible to distinguish further investment in reserves from mere costs of production. Lacking a definite end of the investment process, when all "reasonable" men, including the tax collector, can agree that a specific quantity of recoverable reserves is in place, the only unambiguous measure of income from the reservoir is the measure that would be derived when production from the reservoir ceases. At that point, the cumulated expenditures of all kinds, from the initial bonus, through geological and geophysical surveys, drilling, pumping, secondary and tertiary recovery, and for labor and materials could be subtracted from cumulative sales to determine aggregate income derived from the field. But a delayed accounting would satisfy neither stockholders and creditors of oil companies, nor the tax collector, all of whom demand annual income statements.[1/] On the other hand, any set of accounting rules which purport to measure annual income from oil and gas production will create opportunities for broad disagreement.

There is a final complication in the oil and gas investment process worthy of note in connection with income measurement. Although some discovery projects aim to find oil only and others aim to find gas only, the two minerals are frequently found in association. How does one usefully allocate an investment cost between two minerals whose values are determined in different markets, particularly when the rates of production of the two are interdependent?[2/] If there is no useful way to allocate the separate costs of minerals found together, there is no useful way to separately account

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1/ In a tax-free world, an investor contemplating an investment project, whether in oil and gas reserves or any other form of productive capital, does not need to measure periodic income for decision purposes. All he needs are time-phased schedules of expected receipts and outlays which he may discount. But in the real world, the investor needs to schedule expected outlays for income tax, and, therefore, must make a side calculation of "taxable income". Thus, the tax treatment of outlays becomes critical for investment decisions because it determines the time pattern and level of outlays for taxes, and this significantly affects the expected profitability of any particular investment project.

2/ For investment decision purposes in a tax-free world, this allocation of costs would be unnecessary. The investor, as noted before, merely schedules outlays and receipts so he may compare the difference in discounted values. He need not label particular expenditures nor particular receipts, except as this facilitates his estimation process.

for depletion costs.[1/]

(3) Summary.

The process of investment in oil and gas reserves, and hence in capacity to provide annual flows of oil and gas, does not easily lend itself to the measurement of annual income. When an expenditure is made, it is seldom unambiguously clear at that time whether the outlay is for the purpose of establishing the quantity and quality of underground reserves, and thus a "cost" of acquiring the minerals, or for the purpose of providing a capacity to produce the minerals known to exist. While inability to make this kind of distinction is no barrier to rational investment decisions, it prevents the formulation of income accounting rules that will be universally accepted as reasonable and unambiguous. The implication of this conclusion is that normative judgments about particular sets of income accounting rules for investment in oil and gas productive capacity, particularly tax accounting

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1/ Frequently, oil and natural gas are aggregated on a btu basis. While this may be acceptable for certain gross descriptions of energy production and consumption, it is unacceptable for any economic accounting purpose. Economic activities are not managed for the purpose of maximizing or minimizing btu consumption or production; they are managed to minimize cost or maximize gain, and for this purpose, it makes a difference how btu's are embodied, whether in oil, gas, coal, uranium, or wood.

rules, are equally difficult to make. Nevertheless, some useful conclusions can be drawn from a critical examination of the battery of tax accounting rules that have evolved.

II. Evolution of tax accounting treatment of oil and gas investment and income.

A. Economic policy aspects in the taxation of oil and gas companies.

From an economic policy point of view, tax rules must be evaluated in terms of their impact on investment decisions, for in the long run tax policies determine the relative size of the private capital stock invested in oil and gas capacity and hence the price of these resources. The investment impact evaluation is complicated, because taxes are paid by enterprises which are simultaneously engaged in one or more stages of the investment process: they may be currently producing only from fields discovered and developed long before, or they may be maintaining, or adding to, existing productive capacity by additional exploration and development, or they may be newly entering the oil business, discovering and developing their first field. Depending on their circumstances when the income tax law was first enacted, or now when changes in tax rules may be enacted, different firms will experience different immediate effects in their tax returns, just as these firms have fared differently since 1973 when oil prices have risen sharply. Obviously, a firm producing from existing reserves will immediately benefit more from an oil investment tax reduction or an oil price increase than will a firm heavily engaged in a large investment program; and all firms presently in the oil business will benefit more than those newly attracted to the industry by the tax reduction or price increase.

Rewards from oil and gas discovery are highly variable. Most firms in the oil business, as in any industry, enjoy modest success; their capital earns little more than it might earn if invested in any other industry. Many firms, attracted by the possibility of riches, are probably net losers; their capital would earn more if invested in government bonds. A few firms; either through luck or a "nose" for oil, are exceptionally prosperous even though the industry-wide average return in the oil business is no higher than the average for all industries. Firms at the margin of profitability will be more immediately affected by adverse tax or price movements; and since they are always more numerous than the few highly profitable firms, they will raise loud cries of "unfair destruction of competition" whenever taxes are raised or prices fall. Ironically, the fact that changes do affect numerous marginal firms is proof that the industry is competitive, and that compensatory changes in investment will occur in response to tax and price changes. But not only are company financial records highly variable, the ventures

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undertaken by a single company are also highly variable. For a cross-section of producing oil properties at some point in time, the implicit rates of return on those properties will be far above average simply because they represent the successful ventures whose returns must offset numerous but uncounted unsucessful ventures. Every industrial firm has produced its share of duds, but only in the minerals industry is the individual "property" an invariant accounting unit; an oil company "consolidates" its properties in its tax returns, but capital accounts, depletion, and abandonment losses are recorded by "property"[1/]. Thus as a statistical anomaly, it will appear that the "value"of mineral deposits in use greatly exceeds the "cost" of discovery and developing those properties.

1/ An industrial firm can group its assets in depreciation cla without regard to geographic location, and it need not associate depreciation allowances with any particular kind of business it carries on, or with any administrative division of the enterprise itself. But an oil producer must aggregate its operational data by property so that it can compute the "income from each property" separately. In industrial enterprises, particular investment "mistakes" are typically consolidated with "successes"; in mineral enterprises "mistakes" are segregated from "successes".

B. The tax treatment of expenditures for the discovery and development of oil and gas reserves.

Present income tax rules applicable to oil and gas properties are fundamentally irrational because the rules for classifying investment expenditures evolved separately from the rules governing capital recovery (or depletion). Detailed rules for classifying outlays made in connection with taxing a trade or business are usually developed administratively, and this was the case with oil and gas investment. Meanwhile, Congress independently legislated capital recovery rules with respect to minerals as early as 1916, and specifically with respect to oil and gas in 1926. Normally, the administrative determination of which kinds of expenditure are regarded as "capital" and are classified as "current expenses" would display little if any inconsistency with separately legislated capital recovery rules. But, in the present instance, definitional compromises promulgated by first-generation income tax administrators produced a public policy disaster when they were mixed with the independent legislative decisions regarding cost recovery, or depletion.

Even before Congress invented percentage depletion in 1926, the Treasury and then Bureau of Internal Revenue were settled on a course which ultimately yielded the conclusion that approximately 70 percent of the outlays for discovery and

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development of oil and natural gas productive capacity are classified as current expense, about 20 percent are capitalized as "depletable basis", and 10 percent are capitalized as "depreciable basis", that is, expenditures for machinery and equipment, largely pumps, pipes and the like, which are replaceable (subject to wear-and-tear and obsolescence) but which are separable from the oil and gas extraction operation itself.[1/]

The 70 percent of total oil and gas investment outlays allowed as a current deduction includes some 40 percent related to dry-holes--outlays for drilling and a pro-rata share of geological and geophysical expenses. Our earlier discussion of the investment process concluded that dry-hole costs should be aggregated by project. In the interests of administrative convenience, however, the view was taken that each well

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1/ These figures are nationwide averages reflecting pre-1970 experience. For some investment projects, such as those undertaken near prior discoveries, the percentage of total investment cost currently expensed may exceed 70 percent. Moreover, because of the multiplicity of mineral interests, it is possible for mineral rights owners to "package" property rights in such a way that more of the "deductible" investment costs accrue to one class of investor than anoth Thus, even though the average deductible investment cost may be 70 cents to $1 total investment, some investors may be provided the legal opportunity to deduct as much as 90 cents of each dollar they supply. Of course, they pay for this privilege by accepting less of any future income produ by the property, just as creditors who demand substantial collaterial "pay" for this lessening of lenders' risk by accepting a lower rate of interest from the borrower.

constitutes a single project; and since investment in an unsuccessful venture is customarily considered a "loss", that loss should be deductible from gross income when recognized. It is unclear why a lease-aggregation rule was not imposed on each taxpayer, since lease bonuses and other mineral rights acquisition costs have always been capitalized.

Perhaps the reason why dry-hole write-offs continue to be tolerated is that, for reasons that defy rationalization, it was also ruled that "intangible drilling" costs are deductible when incurred.[1/] Since the bulk of the cost of dry-holes was already allowed as current deductions, the write-off of some little geological and geophysical expense seemed not worth contesting. But current deductibility of drilling costs for wells completed as productive now accounts for the remaining 30 of the 70 percent of investment cost currently deductible. This provision must be regarded as an unnecessarily generous compromise with the vicissitudes of oil and gas investment

1/ The "intangibility" of the drilling costs presumably was inferred from the fact that labor and contractor services were hired to drill the hole, and since the product of all this expenditure was a "hole" nothing "tangible" resulted. Fortunately, income tax accounting has not generally followed this tortured reasoning in other circumstances; apart from the incentive provisions for research and development expenditure, it is seldom held that the cost of "intangible" capital assets can be expensed. Indeed lease acquisition costs, which are "intangible" when purchased must be capitalized, along with geological and geophysical survey expenditures, which are also "intangibles."

accounting. However uncertain may be the result of drilling a particular well, the cost of drilling a productive well cannot, by any standards of income accounting, be considered a current expense of income production. Nor can such expenditures be compared with industrial research and development outlays. A reasonable compromise with the inherent uncertainties would have provided some guidelines formula permitting a pattern of write-offs over the expected life of at least the cost of completing productive wells.

The implications of this tax treatment of investment outlays may be illustrated by reference to the simplified example presented earlier. Again setting aside the mathematics of discounting, the firm spending an illustrative $20 million to discover and develop an oil field with total recoverable reserves of 10 million barrels would have been allowed to deduct currently $14 million of that amount during the investment period under tax accounting rules. If the firm was then operating other fields, engaged in transportation, refining, or marketing, or <u>any other</u> economic activity producing taxable income during the period of its investment in a new oil field it would have aggregated these deductions (called "net operating losses") relating to the property being developed with the otherwise taxable income, thereby reducing its taxable income by $14 million, and saving $7 million in current tax payments (assuming a 50 percent income tax rate). Of the remaining $6 million of capital outlays, about $4 million would be the "depletable basis", or 40 cents per barrel, while $2 million would be the depreciable basis which might be written-off over 11 years by any allowable depreciation method. Assuming an annual production of about 600,000 barrels in the early years of this hypothetical field, and a price of $5 per barrel produced and sold, the comparative income measures are shown in Table 1.

Table 1

Effect of Investment Cost Accounting on Annual Income

	Income Accounting Methods	
	"Ideal" rules	Tax rules a/
Gross income (600,000 bbls. at $5)	$3,000,000	$3,000,000
Less: Lifting costs, total . . .	600,000	600,000
Capital cost depletion . .	1,000,000 b/	240,000 c/ 360,000 d/
Annual income, early years . . .	1,200,000	1,800,000 e/

a/ This is not taxable income; percentage depletion exceeds cost depletion and would be taken. See the example in the next section.

b/ $2 per barrel.

c/ $0.40 per the barrel.

d/ Assumed depreciation allowance.

e/ In the event the taxpayer had been unable to deduct the $14 million of pre-production "tax losses", these would be carried forward to reduce income during the period until they had been used up.

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In this example, income measured under tax rules results in a $600,000 excess comparison with income measured under ideal rules. 1/ The ideal rules start measuring income when oil starts flowing, not when the first dollar is spent on discovering the field. Whereas, the tax method shows "losses" during the investment period, the ideal method produces lower incomes during the productive period. In both cases no more than $20 million will be deducted from gross receipts as capital cost. But the tax accounting rules grossly misallocate income from oil and gas investment over time; they may be said to "defer" recognition of income due to premature deduction (recognition) of cost.

C. Statutory allowances for depletion.

It is difficult at this late date in the history of income taxation to appreciate how difficult it must

1/ The reader will note that under "ideal" rules there is only one figure for capital consumption, $1,200,000, whereas both depletion and depreciation cost are shown under tax rules, a total of $600,000. In this simplified example, the total investment cost of $20,000,000 is attributed to the mineral whose extraction occasioned the investment. When the 10 million barrels have been extracted, the total investment will be worthless, and since we are not here concerned with discounting, the extraction of each barrel represents a "consumption" of $2 of capital. It should also be remembered that lifting costs shown are total costs of operating the field, including repairs to machinery and equipment, assumed to be adequate to carry the whole investment project to its productive end.

have been to manage the introduction of a net income tax applicable to businesses already in existence. Today, virtually all assets held by enterprises have been acquired since March 1, 1913, the starting date for the present income tax. But the Revenue Act of 1913 imposed an income tax on enterprises employing assets which were acquired before tax accounting rules had to be applied. Capital consumption allowances had to be based on March 1, 1913 asset values, or cost if acquired on or after that date. For pre-existing assets, this requirement entailed a massive valuation task. This same requirement was imposed on owners of mineral properties in the Revenue Act of 1916, and if this had been the final word of Congress, much of the controversy that has ensued would not have occurred.

It is important to understand how the 1916 rule applied. Again referring to the simplified example previously described, suppose that the $20 million investment had been completed before March 1, 1913, and the oil field had begun operations January 1, 1913. On March 1, given the facts previously described, and still ignoring the effects of discounting for simplicity, the <u>value</u> of the property would have been $40 million or $4 per barrel for 10 million barrels. As the comparative income statistics in the previous section indicate, the net

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income per barrel (at a market price of $5) was $2 and in addition there was a capital recovery allowance of $2 per barrel. For such a firm in production before March 1, the depletion allowance under the 1916 rule would have been $4 per barrel, and it would have had a taxable income per barrel of zero. Now suppose the same firm with the same set of facts starts operations with post-1913 investment. In this case the cost of acquiring the 10 million barrels of oil would have been $20 million, (ignoring administrative rules for the treatment of investment expenditures) and the proper depletion allowance would have been $2 per barrel, leaving a taxable income of $2 per barrel. (Of course, had the tax treatment of investment expenditures been used, taxable income would have been $3 per barrel unless the prior deduction of investment costs had resulted in a net loss carry-forward).

At first glance, these disparate results seem unfair. Two identical firms, one which found and developed an oil field before March 1, 1913, the other some time later, are assessed radically different tax bills: the early firm pays no income tax; the later firms pays a tax on $2 per barrel. But recall that the former firm found its oil before there was an income tax: it spent $20 million to find oil worth $40 million in the ground and, on this account earned $20 million, or $2 per barrel,

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before the income tax was enacted. This firm should not retroactively be assessed an income tax simply because, under the conventional rules of income accounting, the income is not "recognized" until received. In contrast, the other firm engaged in its activity after the income tax was imposed, and if it spent $20 million to find $40 million worth of oil, it earned $20 million, or $2 per barrel, under the aegis of an income tax and should pay tax accordingly. Salaries earned in 1912 were not taxable; the same salaries earned before March 1, 1913 were.

Thus, whether by chance or by deliberate thought, Congress promugated the correct rule in 1916. Subsequent events suggest that Congress hit on the right rule by chance, for within two years they succumbed to the argument that "discovery value" depletion, namely a depletion allowance based on the value of the deposit discovered, would yield equitable treatment as between post-1913 and pre-1913 oil field production. In effect, Congress agreed in 1918 that the income from investment in oil and gas should be exempt from tax. But, when depletion "discovery value" was coupled with the administrative rules regarding investment outlays then being developed, the result was more than complete exemption of oil and gas income from tax. If adding the $40 million of total "discovery value" depletion allowances to the $14 million of expensed exploration and develc ment outlays and the $2 million of depreciation deductions, net

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taxable income would be negative over the life of the project. The utter inanity of this state of affairs quickly became apparent in the tax returns of oil producers who were concurrently engaged in any degree of discovery and development investment. The deduction of discovery value depletion invariably produced net operating "losses"; and the first "tax shelter" was born. Offended by this result, Congress moved to "correct the abuse" in a manner which has since become characteristic: rather than repeal the erroneous administrative tax treatment of investment and its own legislative mistake in allowing "discovery value" depletion of the post-1913 properties Congress instead limited allowable discovery depletion to an amount which reduced taxable income to zero. Allowable discovery depletion could not exceed 100 percent of taxable income computed without regard to depletion. This limitation was later stiffened to a maximum of 50 percent of taxable income computed without regard to depletion.

Since this kind of response to perceived "abuses" has become characteristic, it is worth explaining why such cures are more deadly than the imagined disease. In order to maximize the expected profitability of an investment under this kind of income tax constraint, discoverer-developers are driven to select investment programs conditioned by their momentary tax status--whether they are currently producing oil, how much, and at what lifting costs. As a consequence, investment programs selected are likely to be socially inefficient. For example, investors producing little oil relative to their current investment program are forced by the income limitation to sacrifice tax benefits as compared with investors producing large amounts of oil; thus, the former investors are confronted by effectively higher investment costs for reasons completely unrelated to their judgment or skill. Moreover, income limitations on depletion have the perverse effect of penalizing oil producers who happen to operate properties with physical characteristics that impose higher lifting costs, as commonly happens toward the end of the productive life of a field. If there must be an arbitrary statutory rule for depletion allowances, economic efficiency requires that it be made fully available to all producers, without reference to taxable income.

But the demise of discovery value depletion did not come about because an enlightened Congress came to understand the error it had committed in 1918. Rather, discovery value depletion was repealed because it proved administratively unworkable. As noted earlier, an inherent characteristic of the oil and gas investment process is great uncertainty concerning the extent

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of recoverable reserves at virtually every stage before an oil field is abandoned. Not only is the size of recoverable reserves uncertain at the time a well begins to produce, but the value of the reserves in place (the \$4 figure in the example) is at least as uncertain. The value of a discovery depends on the expected future price of oil, on the amount of the recoverable reserves, and the characteristics of the field which determine the time pattern of recovery and how much it will cost to lift the oil. Absent a bona fide sale of the total interest in a mineral property, a rare event which almost never occurs immediately after a discovery, there is no easily determinable "discovery value," plus quantity of recoverable oil, on which the taxpayer and revenue agent could agree. Taxpayers, naturally, had an interest in establishing a high "discovery value" and low initial estimates of reserves (which could be revised upward in later years), while revenue agents were eager to establish lower values and higher estimates of reserves to "preserve the revenue." In order to put an end to the growing backlog of unsettled tax disputes, Congress invented percentage depletion in 1926 as a substitute for discovery depletion. The rationale for percentage depletion, if one accepts the reasoning of discovery depletion, was that, on the average, the value of oil in the ground is some fraction of market price; and since market price is more readily determined than the value of oil in the ground, application of the percentage depletion rate to the market price of the oil would provide a "fair" depletion allowance. Of course, the "correct" percentage depletion rate is as variable as oil field productivity and, for any given field, would vary as the market price of oil rose and fell with market demand. Nevertheless, Congress initially determined that 27 1/2 percent of the market price of any oil produced anywhere in the world by an American taxpayer could be taken to represent depletion, provided it did not exceed 50 percent of taxable income computed without respect to depletion. In 1969, the percentage depletion rate for oil and gas was reduced to 22 percent and in 1975, percentage depletion as a general principle was repealed, but an important "small producer" exemption was preserved.[1/]

Neither discovery depletion nor its successor, percentage depletion, is the exclusive allowable method; "cost depletion" is always permissable and is sometimes used. Occassionally, when a field is first brought into production, and the estimate of recoverable reserves is extremely low, the annual production is

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1/ The so-called small producer exemption applies to the first 2,000 barrels of average daily oil production (or 12,000,000 cubic feet of natural gas). This figure is to be phased down until it reaches 1,000 barrels in 1980. The depletion rate is to be phased down from 22 percent to a permanent level of 15 percent in 1984.

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a large fraction of estimated reserves, and the fraction of capitalized costs attributed to the well may exceed percentage depletion. Moreover, when a reasonably productive property is sold at a price which represents the present value of recoverable reserves, the buyer will often find cost depreciation preferable to percentage depletion. But in the overwhelming majority of cases, including those instances when cost depletion allowances have exhausted the capitalized depletable basis, percentage depletion is taken.

D. Summary

Table 2 summarizes the effect of tax accounting rules on the amount of income which would be reported for a property described in the simplified reference example and compares these amounts with an ideal income accounting result. Clearly, in this example, percentage depletion yields the taxpayer a lower taxable income than "cost depletion." Indeed, since cost depletion in any year represents a pro-rata deduction of the beginning-of-year depletable basis reduced by all tax depletion allowances taken in prior years, once the taxpayer begins to take percentage depletion, he rapidly exhausts the depletable basis thereby ensuring that percentage depletion will be taken in the future. Unlike conventional capital cost recovery procedures, percentage depletion is not limited to recovery of a fixed base.

Table 2

Effect of Depletion Allowances on Annual Income

	Income accounting methods		
		Tax rules	
	"Ideal" rules	Cost depletion	Percentage depletion
Gross income (600,000 bbls at $5)........	$3,000,000	$3,000,000	$3,000,000
Less: Lifting costs, total.............	600,000	600,000	600,000
Capital consumption:			
Depletion......................	1,200,000	240,000	660,000
Depreciation..................	---	360,000	360,000
Annual income........................	$1,200,000	$1,800,000 a/	$1,380,000 a/

a/ In the event the taxpayer had been unable to deduct the $14 million of pre-production "tax losses," these "losses" would be carried forward to reduce production period tax income accounting figures until exhausted.

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In this example, the 22 percent depletion allowance rate does not equal "discovery value" depletion, for the taxpayer ends up with taxable income of $1,380,000 rather than zero. This is not surprising, for the logic of discovery value depletion was to completely exempt the income from mineral discovery and development from tax. If it could be operationally applied, discovery value, fully reflects the natural differences in quantity and quality of minerals that would be produced by the highly uncertain investment process. The percentage depletion allowance, being a fixed percentage of selling price, does not account for these differences. And since the market price of any particular barrel of oil is independent of the lifting cost of that barrel, the expected percentage depletion allowance per barrel from prolific discoveries is substantially less generous, viewed prospectively, than for run-of-the-mill discoveries.

When this aspect of percentage depletion is combined with the tax treatment of investment expenditures, under which lease bonuses and geological and geophysical expenditures must be capitalized while drilling costs are not, it becomes clear that tax rules discriminate against that kind of investment process which is likely to be most socially productive, namely the search for large and productive reservoirs, and favor the search of accessible reserves and the overdevelopment of existing reserves.

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Under our tax laws, the lesser the portion of the investment dollar devoted to extensive geological and geophysical search for good prospects, the greater the potential tax benefit per dollar spent. But the lesser the effort devoted to this fundamental mineral R&D expenditure, the more costly is the oil ultimately found. It is in this sense that percentage depletion must be judged an inefficient tax subsidy.

Finally the observation may be made that because the tax treatment of oil and gas investment so grossly distorts the timing of income for tax purposes, it wastefully distorts utilization of existing reserves. So far as the tax cost of producing an additional barrel of oil productive capacity is concerned, it is "cheaper" to look for a new deposit than to adopt measures (secondary and tertiary recovery techniques) which will extract more oil from existing deposits.

III. Economics of oil and gas investment decisions and the effects of taxation.

Notwithstanding the uncertainties related to investment in oil and gas reserves, the process may be characterized in a manner which permits its analysis by the usual model of rational decision making. Discovery and development is neither an art nor a random process. Although "everybody" cannot expect to achieve average success in finding oil by drilling holes in the ground, neither can "everybody" achieve average success in farming, establishing a manufacturing business, or even a grocery store. Investment decisions require skill in assessing uncertainties and specific knowledge of technology and markets. Not "everybody" is equipped to make the hard decisions called for in investment choice. But those who are equipped do make choices, and this implies the use of a rational procedure. The investor seeks to acquire those assets which promise to yield <u>him</u> a rate of return which is greater than the rate of return <u>he</u> might earn buying other assets--not all other assets, but those of which he has knowledge. He is thus concerned with the outlays he must make to acquire assets and with the stream of receipts and outlays to which the purchase of the assets commits him. He chooses among opportunities known to him, each opportunity consisting of paired outlay and revenue streams.

In the example used in previous sections, the investor who could earn 10 percent in the most profitable of the alternative investments known to him would undertake the discovery and development of that oil field only if his assessment of the expected costs and gains yield him a higher return. The assessment involves reducing each of the streams to a single value at a common date. In the following paragraphs we shall employ the basic methodology used by any investment decision maker, but we shall do so now to demonstrate how the terms of taxation affect the costs and benefits.

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Fundamental to this analysis is the assumption that entry into the oil business is as free as entry to farming, manufacturing, or any other industry. Objective evidence suggests that this is not an heroic assumption. In the oil business a host of risk-pooling devices have evolved which make it possible for anyone with the requisite skills to enter; there need be no more risk of catastrophic failure in oil than there is in, say, farming, given the infinite divisibility of property rights in minerals. Moreover, available statistics reveal that large numbers of firms enter and leave the oil producing business in response to changes in economic conditions. Finally, there is no evidence whatever that rates of return to investment in oil and gas reserves have been higher than in other industries--although some oil firms, at some times, have earned more than average, as previously noted.

The critical role of this competitive assumption arises from the approach we will take below. If the expected return from oil is above average, given a set of investment cost conditions, more investment will be made, output of oil will increase to drive the price of oil down, or investment costs will rise until the rate of return in oil is no higher than average. And if conditions change to make the expected rate of return below average for a given set of investment cost conditions, investment will be reduced, and output of oil will decline, forcing prices up, or investment costs will decline until the rate of return is no lower than average. Thus, in what follows we adopt the long-run view: rates of return are normal, and, to keep the exposition simple, cost conditions remain unchanged. Therefore, prices of oil will be adjusted to compensate for the rate of return impact of tax rules.

A. The simplified example recast to account for time and rate of return.

Investment decisions are made at some specified time with respect to actions that will occur over a subsequent period. These actions are outlays with respect to an economic activity and corresponding receipts. We have used the example of $20 million expended on the discovery and development of an oil field which contains 10 million barrels of recoverable reserves extractable at some additional cost. But the $20 million will be expended over a span of time, and when the field begins to produce, its flow will also span a future number of years. To analyze this example, then, we must adopt a reference point in time and make additional assumptions necessary to relate events to this reference point.

First, we will continue to use the simplifying assumption that investment is made over some period of time, and that when this period ends, production begins. The point at which production begins will be taken as the reference point.

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We assume that investment outlays are made at the rate of \$4 million per year for 5 years. At the end of the investment period, using a discount rate of 10 percent, this expenditure has a cumulated value of \$24,420,400, which is the real cost to the investor after 5 years. If the investor had made these outlays in alternative projects, his net worth at the end of 5 years would have increased by \$4,420,400. However, in accordance with conventional historic accounting rules, the total "basis" of this investment remains \$20 million.

We assume that the oil found will be produced by this field over an approximate 15 year period, and the flow will decline at approximately 10 percent per year. This implies the first year production will be about 1.2 million barrels (nearly 3,300 barrels per day), and each succeeding year's output is 90 percent of the prior year's.

For simplicity, we finally assume that the lifting cost per barrel is constant at \$1 per barrel. Although this is unrealistic since the lifting cost per barrel tends to be low early in the productive life of a field and then to rise as natural reservoirs are depleted, it simplifies calculations and does not severely affect the results.

Since, at the point production is to begin, investment cost is \$24,420,400 and we know the pattern of output which will result along with the associated lifting costs, it is a simple algebraic exercise to determine what the selling price per barrel must be so that the present value of the receipts, discounted at 10 percent, will cover lifting costs, also discounted at 10 percent, and be equal to $24,420,400. That price turns out to be $5.026 per barrel. If the future prices of oil are expected to be at least this high, the investment will yield at least 10 percent. As shown in column (1) of Table 3, if all 10 million barrels are sold at $5.026 per barrel, the present value of gross receipts at the time production begins would be $30,485,560, and subtracting from this the present value of future lifting costs equal to $6,065,160 yields net future excess of receipts over outgo of $24,420,400. This is exactly equal to the investment cost evaluated at the same time. Thus, the investor would be assured a rate of return of 10 percent if the oil is sold at $5.026; if the expected future price were higher, the investor would earn more than 10 percent; if the expected future price were less than $5.026, he would earn less than 10 percent.

When the <u>entire</u> span of investment and production is examined, as it must by a prospective investor, no specific allowance need be made for "capital consumption." Capital consumption is inherent in the calculation: the investor has expended $20 million over 5 years, and he recovers his investment,

Table 3

Necessary Price Per Barrel of Oil to Yield 10 Percent, with Associated Financial Data

Item	Without income tax:	With 50% income tax:		
			Tax rules	
	"Ideal" rules (1)	"Ideal" rules (2)	Cost depletion (3)	Percentage depletion (4)
Necessary price per bbl	$ 5.026	$ 7.053	$ 5.634	$ 5.110
	Discounted values, when production begins (thousands)			
Gross receipts (10 million bbls)........(a)	$30,486	$42,776	$34,173	$30,993
Less: Lifting costs........(b)	6,065	6,065	6,065	6,065
Net taxes paid........(c)	--	12,290	3,687	508
Taxes during production........(d)	--	12,290	12,234	9,055
Tax saving during investment....(e)	--	--	(8,547)	(8,547)
Investment cost = (a)-(b)-(c)	$24,420	$24,420	$24,420	$24,420

Note: Individual items may not add to totals due to rounding.

with interest at 10 percent, by selling 10 million barrels of oil over 15 years at $5.026 per barrel, after which his investment is worthless. He has recovered his cost, plus interest.

B. Introducing taxes into the investment decision.

Imposition of an income tax introduces an additional annual outlay which an investor must take into account when determining whether to select an investment. What needs to be added to the above calculations therefore, is a computation of the annual income tax payment which will be demanded if the project is undertaken, and since this involves a set of accounting rules to determine taxable income, we must explicitly set forth the income tax formula. As suggested above, we could apply an "ideal" set of accounting rules and apportion the aggregate investment of $20 million (undiscounted) to the 10 million barrels of oil to calculate an annual depletion allowance as the oil is extracted. Alternatively, we could apply tax accounting rules, which allow the write-off of $14 million of investment cost when incurred, and then determine an annual depletion allowance by either "cost depletion" (combining depreciable basis with depletable basis for ease of calculation) or percentage depletion. We take up each of

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of these variants in order.

(1) Taxation with "ideal" accounting.

Each year we compute a tax liability, at an income tax rate of 50 percent, that would be generated by selling the quantity of oil produced that year at a price such that, after allowing for the tax and the lifting costs, the after tax net recipts will have a present value of $24,420,400. Since the income tax formula is specified, we merely deduct from each year's gross receipts the lifting cost plus $2 per barrel "ideal" cost depletion and multiply by 50 percent to determine taxes paid. And only a slightly more complicated algebraic problem must be solved to determine the necessary selling price of oil, which is found to be $7.053. Why this is the necessary price to yield the investor a 10 percent rate of return is shown in column (2) of Table 3. Selling 10 million barrels of oil at $7.053 per barrel will yield a present value of gross receipts of $42,775,640, and this is sufficient to cover the unchanged lifting costs plus $12,290,080 in income tax and leave him $24,420,400 which represents a 10 percent return on investment.

It is worth pausing a moment to compare the before and after tax result. Imposing an income tax in this illustrative case implies that the price of oil must go up by $2.027 per barrel, if the rate of return is not to be reduced. Why would this happen? Unless one is persuaded that investors will undertake investments without regard to rates of return, one must accept the consequence that an income tax imposed on the return from reproducible capital raises before tax rates of return - in other words, causes prices embodying capital costs to rise - in order to ensure the same after tax rate of return. 1/

Consider the probable response of investors to a situation in which the going price for oil has been $5.026 and a tax is imposed. Investors need not drill for oil with the resources at hand; they could retire and convert their capital into an annuity. Suppose that some of them do so. Not only will a reduction of discovery and development activity reduce future flows of oil, but also the signal provided by lesser investment activity will be observed

1/ The assumption that after tax rates of return remain the same implies that the supply of savings for capital formation is highly elastic. While there is no agreement on the likely elasticity of supply of savings, it is difficult to argue it is zero, that the same amount of saving will occur regardless of the return that may be earned. So long as it is not zero, the imposition of an income tax must cause before tax rates of return to be higher than rates of return would be in the absence of tax. That is, some of the "burden" of the income borne by non-capital owners, and the gist of the argument in the text stands.

by those who own producing fields. Anticipating that future prices will be higher, some of the current producers will conclude that oil may be worth more "in the ground" than in a pipeline to the refinery. As they cut-back some of their current output, upward pressure on prices begins, and the process continues until, at a price which assures the necessary rate of return to investors, a sustainable rate of production is achieved. When the adjustment is complete, a length of time roughly proportional to the severity of the initial disturbance, after tax rates of return will have been partially or wholly restored.

(2) Taxation with tax accounting.

If instead of "ideal" accounting we apply tax rules for the treatment of investment expenditures, we may recompute tax liabilities with "cost depletion," when the depletable costs are 30 percent of the total investment, or $6 million. In this event, as shown in column (3) of Table 3, the necessary price of oil required to yield an unchanged 10 percent return to the investor is only $5.634 per barrel. Under the current tax accounting rules, almost the same amount of taxes are paid during the production period as under "ideal" accounting, but a <u>negative</u> tax, or "tax saving," is incurred during the investment period. Net taxes paid are reduced, and this permits the lower price to prevail. For the same

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reasons that imposition of a tax may be expected to raise prices, diminution of a tax may be expected to reduce prices.

If percentage depletion is substituted for "cost depletion," a further diminution of tax liability results, in this instance during the production period. The lower tax makes possible a price of $5.110, which is only 7.4 cents higher than the necessary price <u>without</u> taxation. Thus, under the cost assumptions of this example, tax rules have almost succeeded in exempting oil and gas investment income from taxation.

It is instructive to evaluate the relative tax benefits conferred by the tax treatment of expenditures and by percentage depletion. Taking the "ideal" accounting procedures as the norm, 1/ expensing of investment expenditures reduces the necessary price per barrel by $1.393, while substituting percentage depletion for "cost depletion" reduces the necessary price by an additional $0.524. Thus, of the entire $1.917 reduction in necessary price per barrel made possible by the package of tax rules, expensing of capital outlays accounts for 73 percent, percentage depletion for only 27 percent.

1/ The reader is reminded that only by virtue of simplifying assumptions is it conceivable that ideal income accounting rules might be employed. In particular, the text ignores the effect of uncertainty and diverse property rights in minerals on the identification of investment outlays, and it assumes that the investment period is discrete and precedes the production period.

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As noted in the Preface, although public debate has focused on percentage depletion, percentage depletion is not the most significant element in the tax treatment of oil and gas.

C. Summary

Investment in oil and gas reserves and productive capacity, though it is subject to unique risks, is a rational process. Investors who are qualified by skill, training and experience make choices among known alternatives, each of which may be described as a stream of paired expected outlays and receipts. The investment decision first requires an evaluation of alternatives by converting the time streams of outlays and receipts to values at a common date (normally the decision date), and then selecting that alternative which promises the greatest increment in the investor's expected net worth.

Income taxation affects the investment process by altering the streams of outlays and receipts. But the impact of a tax on income from capital depends upon the rules used for measuring taxable income. As it happens, the rules which have evolved for measuring taxable income from oil and gas investment effectively exempt that income from taxation, largely because so much investment expense is allowed as a current deduction in computing taxable income.

So long as investment in oil and gas reserves and productive capacity is a rational process, and so long as entry into the industry is free, limited only by the willingness of qualified investors to undertake projects, tax burdens are ultimately reflected in the price of oil and gas. The presence of tax is not an "impediment" to investment; it merely requires that prices adjust to provide investors an expectation of normal return. Nor is the absence of tax burden, whether through the expensing of investment outlays or through percentage depletion an aid to financing investment; these devices merely facilitate the existence of a lower price of oil than would otherwise prevail. With or without taxation, the investor must find the financial means to carry out an investment project. When he is at the initial stage of investment evaluation, deciding whether to plunge ahead, the financial resources he may tap consist mainly of his credit worthiness and his liquid assets. If the investor has a substantial net worth which generally signifies a history of successful investment decisions he can readily find coinvestors or borrow needed funds. His access to external financial resources will be enhanced if his current liquidity is high, somewhat diminished if his liquidity is low. But none of these determinants of an investor's access to financial resources is especially dependent on the terms of taxation.

For example, assume that the data in Table 2 represents the condition of an oil producing enterprise before taxes are levied. The pre-tax cash flow is $2,400,000, no matter how "income" is accounted for: in each case, $600,000 of $3,000,000 gross income is paid out for lifting costs. If a 50 percent tax was then levied on each of the three measures of "net income," the net cash flow would be reduced by $600,000 in the case of "ideal" income measurement, by $900,000 in the case of tax accounting with cost depletion, and by $690,000 in the case of tax accounting with percentage depletion. And explained earlier, compensating changes in cash flows resulting from tax and other changes may be expected in the price of oil, and a rational investor is indifferent as to whether his rate of return is generated by gross sales at future higher prices, or by reduced tax payments at future lower prices.[1/] In the final analysis, the

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1/ It might be observed, however, that a businessman instinctively prefers a future state of affairs in which the prices at which he has to sell will be lower rather than higher. This is probably due to the widespread understanding by businessmen (in contrast to legislators) that more can be sold at lower prices, and that any single business firm is more secure in a broader market. Even though businessmen know that higher costs, whether for labor, materials, or taxes will ultimately be reflected in higher prices, they resist changes which force this outcome. But the narrow interest of businessmen is not a suitable guide to public policy formation.

terms of taxation have no significant effect on the ability and willingness of qualified investors to undertake projects provided that evaluations of <u>future</u> prices and outlays result in favorable profit expectations.

IV. Slogans

The foregoing sections have set forth the proposition that taxing the investment income from oil and gas production is not a simple exercise of taxing "oilmen." Notwithstanding the popular and fallacious notion that "income taxes" are "direct" and hence cannot be shifted, a tax on income from capital imposes a cost like any other which must eventually be reflected in prices. Capital is mobile--it can be shifted to a wide variety of applications--and it is ultimately variable in quantity; more or less capital will be accumulated depending on the reward capital owners are provided.

Without inquiring into the broader question whether a <u>general</u> income tax on capital is more or less absorbed by <u>all</u> capital owners, or partially by capital owners and partially by sellers of personal services (wages and differential returns to human capital), we may take it as incontrovertible that discriminatory income taxation of a particular form of capital <u>will not</u> be borne by those who own that particular form of capital. If, as in the case of oil and gas, the burden of tax has been made preferentially <u>low</u>, this does not "enrich" oil and gas property owners. The preferential taxation will have served only to attract more investment, to a point where after tax rates of return are no different from rates of return in other nonpreferred investments.

This state of affairs is a serious cause for concern, not because "oilmen" escape taxation, which generally speaking they do not, but because the tax system is overtly used to misallocate capital from the more fully taxed sectors of the economy to the least taxed. For example, in the figures shown in Table 3, net taxes paid represent 29 percent of total payments by purchasers for oil if "ideal" income accounting methods are applied, only about 11 percent under tax accounting with cost depletion, and only 1.65 percent under tax accounting with percentage depletion. 1/ What all this means is that consumers are misled by the tax laws to believe that oil costs less

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1/ Using the "ideal" data as a norm, it is apparent from Table 3 that $42,776,000 must be equal to the present value of lifting costs plus capital consumption plus income on investment plus income taxes, all pertaining to the 15 year production period. It may be deduced that the "proper" present value of future capital consumption allowances is $12,131,000, and we may therefore compute "before tax income" under the three tax regimes of Table 3 as follows:

Income Accounting Methods

Gross income	"Ideal rules"	Tax Rules: Cost depletion	Tax Rules: Percentage depletion
Gross income	$42,776	$34,173	$30,993
less: Lifting cost	6,065	6,065	6,065
Capital consumption	12,131	12,131	12,131
Before tax income	$24,580	15,977	$12,797
Net tax paid	12,290	3,687	508
After tax income	$12,290	12,290	$12,290

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while other products, produced by capital which is more fully taxed, cost more. Accordingly, too much oil is produced and consumed, and too little of the other goods. Everyone would be better off if this state of affairs had been avoided by better tax policy-making; "oilmen," other owners of capital,

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1/ continued from page 46

Note: It might assist readers unfamiliar with the mathematics of discounting to consider the analogy of an installment sale, or mortgage loan. The present value of compensation to the owner of the property, to equal his cost of $24,420 (from Table 3) and yield him a 10 percent return on investment, has to be a series of payments whose present value is $24,420, "interest plus return of capital." In this example, $12,131 is the present value of the return of capital portion, $12,290 the "interest," or income, portion. He must "net" this regardless of the tax rules, and he may do so under different terms of relaxation if his gross receipts compensate him.

Because "before tax" incomes are not independent of the terms of taxation, this example serves to illustrate why the popular diversion engaged in by economists and legislators alike, when they appeal to published financial statements to compute "effective tax rates," is so useless as a guide to policy formulation. Not only are financial statement incomes produced by rules that already reflect major adjustments to the effects of taxation, but also the results they report for a particular year show "income" and "tax" figures which are not synchronized. For example, an oil company currently investing heavily in new properties will report "low taxes" that year, an irrelevant fact for any long term analytical purpose in view of the time span required to assess the outcome of this year's decisions.

and all wage earners would have benefited. They would also benefit in the future if corrective action were taken now.

Although this paper is now complete as a review of the issues which must be dealt with in the future evolution of tax policy in this controversial area, it may be useful to critically review slogans most commonly repeated both by those who regard efforts to correct tax policy mistakes as suicidal and by those who evangelically preach the gospel that everyone should "pay his fair share of income tax."

A. "Repeal of percentage depletion would deprive the oil (hard minerals, sand, gravel, etc.) industry of capital needed to increase domestic capacity."

Those who wave the banner emblazoned with this slogan take great pains to show that annually their firms spend at least as much on exploration and development as the tax saving from percentage depletion. If they could not take these deductions and thus had to "pay" higher taxes, they would have to cut their investment.

(1) The kernel of truth and its triviality.

After a set of tax rules has been in effect for a long period, prices of products and therefore gross receipts become adjusted to the tax regime and rates of return are normalized. Then, if the tax rules are stiffened, as by elimination of percentage depletion, firms currently engaged in producing the preferred product will immediately suffer a reduction in net cash flows. The same result would occur if wage rates, money market rates, severance and property tax rates, or any other cost rose. Whether any of these changes in the economic environment will impede investment is determined less by their impact on current year's cash flows than by their anticipated effect on the long-term profitability of investment.

Presently, when the current and near term market price of oil is well above expected future levels, the impact of a tax or other cost increase on current cash flows of oil companies can have little consequence for investment decisions.

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Even with a substantial tax increase, their net cash flows after the price changes would still be far above their net cash flows before the price changes. Additionally, the increased value of existing assets provides the companies with a windfall increase in net worth that further enhances their access to capital markets. Moreover, firms not presently producing oil cannot be affected by a repeal of percentage depletion; they must weigh investment prospects for a future without percentage depletion in the same way present producers do. And if they agree with present producers that the future price of oil will be adequate, they will invest with no more difficulty than they might if there were percentage depletion.

But addressing the problem more generally, elimination of percentage depletion <u>should</u> retard investment if all qualified investors believe that less oil will be demanded in the future at higher prices. If consumers will reduce their demand for oil with an end of subsidized prices, it would be a waste of scarce social capital to invest now to produce the unwanted quantities. On the other hand, if the market will pay an unsubsidized price with no reduction in quantity purchased, investors will proceed, just as they would in the face of other rising costs of production.

In sum, the sine qua non of capitalism is that the capitalist risks his capital for which he earns a rate of return in the future. He will undertake this risk of his capital, when justified, whether his future return is supplied by tax subsidy, cash subsidy, or simply market price. There is no magic in percentage depletion (or in any other tax preference).

B. "Repeal of percentage depletion falls hardest on "independent" oilmen who do the most drilling and who maintain competition in the industry."

Technically, an "independent" oil producer is one who sells all his output to others, i.e., is not engaged in either transporting, refining, or marketing of oil products. But, in practice, an "independent" is considered to be a firm producing less oil per day than the smallest of the oil companies whose names are household words because they sell branded oil products. As a consequence, many "independents" are large businesses, whether measured by assets, sales, or income, while others are operators of stripper wells producing a few barrels of oil a day, but otherwise not engaged in reserve discovery and development. "Independent" is the oil business euphemism for "small business," which often seems to mean an enterprise smaller than the 500th in the Fortune list of the largest U.S. corporations.

It is argued by spokesmen for this interest group that they drill upwards of 80 percent of "exploratory" wells, and that they depend heavily on capital raised from investors to whom the deductibility of percentage depletion, and drilling costs, is extremely important. Denied these preferences, the argument goes, the independents would be driven from the field and oil production would be monopolized by a few giant oil companies.

(1) Separating truth from fiction: "Independents drill more than 80 percent of all exploratory wells."

Just as "independent" is a treacherous descriptive term, so is "exploratory well." In the discussion of Section I, the term "wildcat" was used to identify an exploratory well drilled to find a new reservoir. Technically, such other wells as "outpost" wells--wells drilled subsequent to completion of a successful wildcat to establish limits of the field discovered--and wells drilled in existing fields to discover deeper or shallower pools of oil are also "exploratory" wells. But it is the successful new field wildcat that makes significant additions to reserves and productive capacity.

One reason why "independents" are touted as drillers of more than 80 percent of all exploratory wells is that many of the wells they drill are not wildcats but rather "farm-outs" from companies engaged in wildcatting, or they are wells drilled in established oil-bearing regions. New reserves discovered with such wells are, more likely than not, piddling fields, barely worth commercial production.

On the basis of studies concerning genuine wildcatting, it was concluded that "independents" and "minor" oil companies ("small" producers which also engage in other stages of the oil business) have accounted for no more than 75 percent of wildcat drilling. But, what is more significant, these "independents" and "minors" account for only about 20 percent of geophysical and geological survey work done. As a consequence, their success rate is lower than that of the so-called "majors," and the fields they discover are less prolific. The "majors," though they account for relatively less drilling, have succeeded in <u>finding</u> more than 60 percent of the recoverable reserves.[1/] As noted earlier, most firms in

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1/ McKie, J.W., "Petroleum Conservation in Theory and Practice," <u>Quarterly Journal of Economics</u>, Vol. LXXVI (February, 1962). Erickson, E.W., <u>Economic Incentives, Industrial Structure and the Supply of Crude Oil in the United States</u>, 1946-58/59, unpublished Ph. D. dissertation, Vanderbilt University, 1968.

the oil business enjoy modest success, a few attain outstanding successes. It is not surprising that the successful grow to "major" status. Nor is it necessary that numerous moderately successful firms stay in business to assure wholesome competition. All that is necessary for competitive vigor is that entry be open to all who would venture the expense of a careful search for oil. For this, neither tax preferences nor other subsidies are necessary.

(2) A kernel of inconsequential truth: "Independents" rely on investors to whom oil tax deductions are important.

In recent years, a remarkable "growth" industry has been the marketing of shares in limited partnerships in "oil ventures." Frequently, the general partner responsible for organizing these "ventures" is a small, "independent," oil company which utilizes the legal arrangement as a convenient device for selling to the limited partners the right to deduct immediately drilling expenses. In the event production ensues, the limited partners will have a share in production (and production expense) entitling them to percentage depletion deductions. By aiming the distribution of such limited partnership interests to individuals with otherwise highly taxable incomes--from professional or other personal services or other investments--the general partner ("independent") is able to highly advertise the resultant deductions--"you get back 70-90 cents for each dollar you invest and tax-sheltered income if we strike oil!"

If the sponsoring general partner really lets all these passive investors who are utter strangers to him fully share the potential rewards for successful discovery, he obviously can gather capital more cheaply than if he appealed to investors for whom the value of tax deductions would be lower. But, as recent experience with certain oil funds amply demonstrates, general partners are content to market the deductions and retain for themselves the lion's share of the rewards, a mode of behavior which sooner or later becomes apparent to would-be "investors." As statistics on actual subscriptions to "funds" registered with the SEC indicate, a quick peak to such marketings was reached some years ago; hardly enough is currently marketed each year to maintain the capital stock already subscribed.

Thus, this source of "capital" for the independents, which never was very large in terms of annual investments made in the oil industry, is back to its former negligible level. For "independents," as for others who undertake oil ventures, reliance for additional capital will remain where it belongs, among those insiders who have demonstrated a capacity for undertaking such ventures and among outsiders able to carefully judge the qualifications of those with whom they invest. If neither depletion nor other oil tax preferences accounted for significant infusions of oil capital during the past 30 years, when rates of return from oil investment were merely normal, their absence will not impair the flow of capital to this industry in the future, and particularly not in the immediate future when rates of return are spectacularly high.

C. "Repeal of percentage depletion will initiate tax-minimizing sales of properties by independent oilmen, and the majors will monopolize the production of oil."

Although this slogan is less widely disseminated, it is taken seriously by many because the warning comes from persons well-versed in the intricacies of tax law. In essence, this contention is based on the following chain of reasoning: Repeal of percentage depletion leaves "cost depletion" as the only allowable tax accounting procedure; since the discoverer-developer-producer of oil from existing fields has little depletable basis to recover via cost depletion from future production, he will sell to another party because the other party, being able to "deplete" the purchase price over the remaining life of the well, can offer a price higher than the value of the property in the original owner's hands.

(1) Analysis of the problem.

Suppose that the information about a property is equally well-known to both the present owner and a potential buyer. The present owner will sell the property if, and only if, the price the buyer would be willing to pay, less the capital gains tax which the original owner would have to pay if he sells, exceeds the value to the original owner if he does not sell. The price of oil and the expected production pattern are data known to both the present owner and potential buyer. For simplicity, let us assume that both parties to the potential transaction are equally efficient operators, are in the same tax bracket, and let us ignore depreciation and assume that all capital recovery takes place through percentage depletion. What price would induce the present owner to sell when percentage depletion is abolished?

If the present owner were to retain the property, its present value to him would be comprised of two parts: (a) the present value of the after tax stream of gross income receipts (in the absence of any capital recovery allowance) minus lifting costs, plus (b) the present value of the "cost depletion" tax savings he might accrue over the remaining life of the property. This present value equals the original owner's reservation price.

If the same property were purchased by another, its present value to the new owner would be comprised of two parts: (a) the present value of the after tax stream of gross income receipts (in the absence of any capital recovery allowance) minus lifting costs, which is the same for the new owner as the original owner, plus (b) the present value of the purchaser's tax savings due to "cost depletion" of the price he would be willing to pay. Then, in order for a sale to occur, the purchaser's offer price less capital gains tax must exceed the present owner's reservation price.

It can be demonstrated that the critical determinants for the occurrence of a sale are: (a) the adjusted basis of the property in the hands of the seller at the time in question; (b) the capital gains tax rate to which the present owner would be subject in the event of sale; and most critically, (c) the producing characteristics of the property, which we may simply call the "decline rate," which will determine the present value of cost depletion deductions.1/

1/ In general, the slower the production decline from an oil property, the more productive the well. Imagine that there is an oil well presently producing 3 barrels a day and which has been producing at that rate for the last 20 years. Since its production obviously depends on natural seepage from surrounding formations, there is no basis for expecting the output to decline below 3 barrels for the foreseeable future. The "cost depletion rate" for such a property ought to be zero: neither the present owner, nor a prospective purchaser could claim cost depletion on the basis of a decline in productive capacity. Given its output characteristics, this is a "highly productive" well, provided it costs less to pump up the seepage than the oil is worth above ground. Similarly, a large reservoir with highly propulsive "natural drive", if properly managed, holds

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The fears expressed that elimination of percentage depletion would result in the wholesale exchange of oil properties which would then end up in the hands of a few large oil companies are grossly exaggerated because:

(a) The mathematics of the exchange strongly imply that the only properties likely to be sold are those which have two characteristics: they are in a sharp state of decline, and the owner has no depletable basis remaining.

1/ continued from page 58

forth the prospect of a large yield (per day and aggregated over tens of thousands of days) which will decline only slowly over many years before reaching a stage of rapid decline. In its early years, cost depletion of such a property will be minimal, only a tiny fraction of recoverable reserves will be extracted each year, and only much later will annual output begin to markedly exhaust remaining reserves. The present value of this stream of depletion deductions will be extremely low, if evaluated at the beginning of the field's productive life, and almost as low as the slow producer just described. In neither of these cases would the prospect of cost depletion be worth much to an owner and rightly so, for each, in its own way, is a veritable perpetual fountain of wealth.

Ironically, only in the case of fields subject to rapid decline, no matter what the initial flow rate, is the present value of tax savings related to cost depletion of calculable significance. Obviously, such a field cannot be a prolific producer, and each of the first years' output represents a considerable fraction of its lifetime output. For example, a field with a 10 percent per year decline rate and a life of about 15-20 years would have produced half of its total output in a little more than 5 years. Even with a 25-30 year life, a field with a 10 percent decline rate would have produced half its output within 6.5 years; but a field with a similar life but a decline rate of only 5 percent would not have produced half its output before 9 years.

(b) In the case of newly developed properties, only those are likely to be sold to minimize taxes which have little depletable basis (because little more was spent than for drilling) and which have a short expected life (and thus a high decline rate). There may be large numbers of properties possessing these characteristics, but the total annual capacity they represent is trivial and in no event are they the kind of properties a large oil company would seek, since they are costly to manage. Indeed, one of the results of eliminating percentage depletion will be a more rapid divestment by large oil companies of many of their currently marginal propertie

D. "Repeal of percentage depletion will make the tax system fairer and make oil companies pay their fair share of taxes.

Just as the sloganeers who insist that percentage depletion is vital to finance investment are deluded, so are those who argue that "oilmen" somehow evade their fair share of taxes. It is incontrovertible that depletion deductions and other artificialities of the tax rules governing investment are worth more to high income investors that to low, and it is equally incontrovertible that the after tax rates of return in oil, like those elsewhere, are determined by the behavior of the marginal investor, not the wealthiest. It therefore follows that the net benefit conferred on the wealthy is the difference between <u>their</u> tax benefit and that of the marginal investor, not the full benefit of "nontaxability." For example, suppose that the marginal investor is someone with a tax rate of about 40 percent, and suppose his after tax rate of return is 10 percent. Prices of products are adjusted so that, with the battery of tax deductions, whatever they might be, the 40 percent taxpayer nets the 10 percent norm. A 50, 60 or 70 percent bracket taxpayer will receive the same price as the 40 percenter, experience the same actual outlays, but his tax bill will be reduced more, for the artificial tax deductions lower his taxable income by the same amount but "save" him more. Instead of paying the higher tax appropriate to his income status, he pays no more than the 40 percenter. He is not relieved of all tax, but only the extra tax that would otherwise by imposed on him by the progressive income tax.

From one point of view, this degradation of the progressivity of income tax is deplorable. It seems schizophrenic on the part of Congress to enact steeply progressive income taxes and then to proceed to enact tax subsidies which blunt the progressivity. The only way to avoid this result is to make all tax subsidies, whatever their intent, not exemptions of income from tax, but, rather, taxable subsidies.

From another point of view, this result of percentage depletion and other artificial accounting rules is desirable. Saving and capital accumulation is the supply of a socially beneficial resource, no different from the supply of personal services. In both cases the supplier should be paid the same price for rendering a specified service regardless of his personal circumstances; but a progressive income tax precludes this result. In the absence of tax preferences, under a progressive income tax, the supplier of an additional dollar of capital nets less if he is wealthy than if he is not, just as his sale of an additional dollars' worth of personal service nets him less. A purely proportional income tax, coupled with a system of transfer payments not conditioned on economic services supplied, would avoid this inherent inefficiency of progressive income taxation and achieve the equity goals espoused by proponents of progressive income taxes.

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