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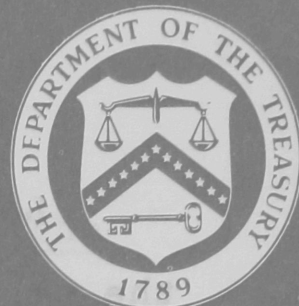

FOR IMMEDIATE RELEASE
10:00 A.M. EST
MONDAY, JANUARY 23, 1978

REMARKS BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

The International Economic Situation

The general issue of international debt and the question of debts owed to the United States, which are the topics of these hearings, must be viewed in the context of the present pattern of international trade and financial flows. The oil price increases in 1973 and 1974, and the subsequent recession in the industrialized countries, produced sizable imbalances in international trade. A handful of countries accumulated foreign assets at an unprecedented pace. These assets in turn were used to finance the deficits of oil-importing countries through private financial intermediaries in the industrialized market economies. The external indebtedness of oil-importing countries escalated. Many countries had to adopt stabilization policies that temporarily constrained growth rates in order to lay the foundation for attaining long-term employment and consumption objectives.

Last spring, in testimony before the Congress, I outlined the strategy of the Carter Administration for dealing with these problems and thereby enhancing the stability of the world economy. I would like to briefly review our progress to date in six major areas, as an essential framework for considering the complex issues of international debt which are of concern to this Subcommittee:

Our first priority has been the adoption of a U.S. energy program which would help reduce our own trade imbalance, strengthen the dollar and thereby greatly enhance international financial stability. The U.S. trade deficit totaled about $30 billion in 1977, and our oil imports totaled about $45 billion -- up from less than $5 billion in 1972. Lagging economic growth in some of our major markets abroad was an important factor behind the sizable increase in the U.S. trade deficit in 1977, but oil imports increased further as a consequence of continued policy inaction. The President's energy program is designed to lessen U.S. dependence on imported oil, and we believe it is critical that legislation implementing this first part of a comprehensive U.S. energy program emerge from the Congress in the very near future. In addition, we have urged OPEC countries to avoid further oil-price increases which might adversely affect world economic stability.

Our second objective has been to urge those industrial countries having large current-account surpluses -- particularly Japan but also Germany -- to adopt policies that would help reduce their surpluses and thereby reduce the pressure on

deficit countries, relieving the buildup of debt around the world. We have had intensive discussions with the Japanese on how this can be accomplished, and they have adopted policy measures which seek to cut their surplus in half in 1978 and reduce it further thereafter, aiming at equilibrium under current conditions. Germany has also moved to stimulate its domestic economy. In the meantime, both the yen and the mark have appreciated considerably against the dollar, which will help attain the needed adjustments.

Third, we have urged deficit countries to adopt prudent adjustment policies and thereby reduce their debt buildups. Here there has been considerable success. The United Kingdom and Italy, in particular, are in much stronger positions today than a year ago. Among the developing countries, remarkable improvement has occurred in Brazil and Mexico. Though a number of countries are still in difficulty, we anticipate a smaller, more evenly distributed deficit in the non-OPEC countries in 1978.

Fourth, to assure an adequate information base for monitoring the international debt situation, we have sought to improve the availability of data on international lending activities and on the economic and financial situations of individual countries. Progress has been made in this area, especially in connection with international bank lending. The data released last week on foreign lending by large U.S. banks is one result of our efforts. Moreover, the regulatory

agencies have improved their capacity to assess and regulate the international lending activities of commercial banks.

Fifth, we have worked to augment the resources available to the IMF to enable it to work even more effectively with countries running balance of payments deficits. One of the most important decisions we made in 1977 was to support the establishment of a new Supplementary Financing Facility in the IMF, known as the "Witteveen Facility," designed to encourage countries with severe payments problems to adopt effective adjustment programs. Seven industrialized countries and seven OPEC countries agreed last year to provide about $10 billion for this Facility. Legislation to authorize U.S. participation in the amount of SDR 1,450 million, or approximately $1.7 billion, is now before the Congress. We believe that the establishment of this Facility in 1978 is essential to strengthen the international monetary system. We also anticipate that the sixth IMF quota increase will go into effect early in 1978. Discussions on a further increase in quotas are in process.

Finally, we have participated in the rescheduling of external debt for individual countries that were unable to meet their debt-service obligations. Fortunately, only two countries in the past year were forced to reschedule -- Sierra Leone and Zaire. Pakistan has formally requested a rescheduling in 1978, and an additional rescheduling

for Zaire may be necessary. We hope that no other countries will have to reschedule in the near future.

International Debt

This review of our approach to the overall problem of international economic and financial stability is essential to place in perspective the issues of international debt, and debts owed to the United States. International debt management is a complex, but essential aspect of international economic cooperation. A decade ago, the industrialized countries were generally creditors and the developing countries were debtors. Now, however, a few oil-exporting developing countries have emerged as major international creditors, holding an estimated $175 billion of foreign assets at the end of 1977. At the same time, most of the industrialized countries (including the United States) are -- for the time being -- net recipients of external financial flows. The distinction between creditors and borrowers has taken a sharp turn.

The best source of data on international debt is the World Bank, which publishes statistics on the medium and long-term government and government-guaranteed debt of 84 developing countries that borrow from the Bank. At the end of 1975, the latest year for which complete data are available, the amount of this debt was $121 billion. Almost 60 percent of this amount was owed to official creditors (governments and international organizations), and the

remainder was owed to private creditors. Our own studies of LDC debt, as detailed in our annual report which will be transmitted to the Congress shortly, have revealed some interesting conclusions:

-- First, economic growth and expanding exports have increased the capacity of the developing countries to service their external debts. The information we have on public debt indicates that the debt-service ratio of these countries as a group was no higher in 1976 than it was in 1973.

-- Second, inflation has substantially reduced the burden of previously-incurred debt measured in real terms.

-- Third, the bulk of the increase in borrowing by the developing countries since 1973 has been accounted for by a small group of relatively more advanced countries including Argentina, Brazil, Chile, Korea, and Mexico. In particular, this group accounts for almost all of the increase in borrowing by non-oil LDCs from commercial banks.

-- Fourth, the non-oil developing countries have been able to increase their official reserves by almost 80 percent since 1973, to a current level of about $50 billion.

Of course, there have been a few cases where countries have been unable to meet their debt-service obligations, and it has been necessary for them to seek debt relief. I would like to address this matter and explain our policy in such situations.

Debt Relief

Since the mid-1960's, the United States has participated in negotiations to reschedule the external debt of 12 countries on 26 separate occasions. Remarkably, the pace of these reschedulings has actually declined in recent years, in spite of the global economic difficulties. In 1972 alone, there were six debt-reorganization exercises. By comparison, there have been only two reorganization exercises per year in each of the last three years (1975-1977).

U.S. policy on debt reorganization is clear, and has four major elements:

1. Debt-service payments on international debt should be reorganized on a case-by-case basis and only in extraordinary circumstances where necessary to ensure repayment. Debt relief should not be given as a form of development assistance.

2. Debt-service payments on loans extended by the United States Government or guaranteed by the United States Government will normally only be reorganized in the framework of a multilateral creditor club agreement.

3. When a reorganization takes place that involves U.S. Government credits or government-guaranteed credits, the United States will participate only if:

(a) the reorganization agreement incorporates the principle of non-discrimination among creditor countries, including those that are not party to the agreement;

(b) the debtor country agrees to make all reasonable efforts to reorganize unguaranteed private credits falling due in the period of the reorganization, on terms comparable to those covering government or government-guaranteed credits;

(c) the debtor country agrees to implement an economic program designed to respond to the underlying conditions and to overcome the deficiencies which led to the need for reorganizing debt-service payments.

4. The amounts of principal and interest to be reorganized should be agreed upon only after a thorough analysis of the economic situation and the balance of payments prospects of the debtor countries.

5. The payments that are reorganized normally should be limited to payments in arrears and payments falling due not more than one year following the the reorganizing negotiations.

Meanwhile, we have sought to discuss the whole issue in a responsible international context. The Development Committee of the World Bank and the IMF has, largely at

the initiative of the United States, agreed to study the role of external borrowing in financing development. We are hopeful that this effort will lay the foundation for clear international agreement on the steps that should be taken, by both borrowers and creditors, to manage external borrowing even more effectively in the future and help avoid debt problems.

Debts Owed to U.S. Banks

Commercial banks in the leading market economies have played a major role in using OPEC surpluses to finance the current account deficits of oil-importing countries. The intermediation function performed by the international banks has become a central element in the world economy. U.S. banks have been significant participants in this process.

In fact, the foreign claims of U.S. banks have grown at rates exceeding 15-20 percent per year during the past few years. As a result, considerable public attention has been drawn to this issue, and questions have been raised about the prudence of the international lending policies of the banks.

We believe these concerns are greatly exaggerated, and will continue to prove to be unfounded. Losses on foreign loans have been small. In fact, loss experience has been better on foreign loans than on domestic loans. Moreover, with the recent improvements in the international payments pattern and successful adjustment effort in a number of

deficit countries, U.S. bank lending abroad has been growing at a much slower pace. In the first nine months of 1977, the increase was at an annual rate of only 10 percent compared with 24 percent in 1976.

An important part of our effort to improve the information available in this area has been the United States Government's collection of new, more comprehensive data on the exposure of U.S. banks in foreign countries. Through these new data, we have attempted to measure the claims of U.S. banks which are subject to cross-border or country risk. This is done principally by re-allocating claims on foreigners on the basis of where the ultimate obligation for repayment rests. In quite a few cases, a loan made to the resident of one country is guaranteed by a resident of another foreign country. In addition, loans in local currencies to residents of countries in which the lending U.S. bank operates are excluded from the cross-border exposure of the U.S. bank, because such lending is not subject to the risks that foreign exchange shortages abroad would entail.

U.S. bank claims on foreigners subject to cross-border risk as of June 30, 1977 amounted to $150 billion. About $47 billion of this amount consisted of claims on other foreign banks, so that the cross-border exposure of U.S. banks to private non-bank foreign borrowers and foreign governments is about $100 billion. About $39 billion of this represents claims on residents in the non-oil developing

countries. The new data also show that U.S. bank exposure abroad is heavily in the area of short-term maturities. Nearly two-thirds of all U.S. bank claims on foreigners have maturities of one year or less.

Debt Owed to and Guaranteed by the U.S. Government

Let me turn now from the international lending of U.S. private banks to the loan activity of the United States Government. The prompt and complete repayment of all foreign debts owed to the Government is a policy goal of the highest priority for the Treasury Department and other U.S. agencies. For the most part, foreign debts have been repaid on schedule; payment on only a small portion of this debt is in arrears.

The Treasury Department does not collect payments on debts, but rather oversees the collection process through the compilation of data on U.S. loans and foreign debt arrearages and the review of individual debt problems through the National Advisory Council (NAC), which Treasury chairs. The responsibility for collection of foreign debts lies initially with the creditor agency. If the creditor agency's efforts are unsuccessful, the Department of State may provide assistance.

All foreign debts owed the United States Government arise from Congressionally mandated programs. For convenience, outstanding debts can be separated into two categories:

1. debts contracted during or after World War II;
2. debts relating to our activities during and immediately after World War I.

Post World War II Debts

As of September 30, 1977, the total principal outstanding on post-World War II debts to the United States Government was $42.1 billion, primarily in the form of long-term credits. Only $107 million of the total was in short-term credits, and $374 million in accounts receivable. The debt is largely a result of U.S. Government foreign aid and export credit programs of the last 30 years. Some $14 billion was contracted under the Foreign Assistance Act (and predecessor legislation); $4 billion under the Foreign Military Sales Act; $6.5 billion under Public Law 480; and over $11 billion under the Export-Import Bank Act. Another $1.4 billion arose from activities related to World War II, primarily lend-lease and surplus property disposal.

Given the objectives of these programs, it is not surprising that loans to non-oil developing countries account for nearly 65 percent of the total value. The largest individual debtors among the developing countries are: India ($3.6 billion), Israel ($3.3 billion), Pakistan ($2.6 billion), Brazil ($2.4 billion), Korea ($1.9 billion), Indonesia ($1.8 billion), and Turkey ($1.7 billion).

Arrearages and Delinquencies

The great bulk of these debts have been paid on time. At your last hearings on this subject, you were given information on arrearages as of the end of 1974. From January 1, 1975 through September 30, 1977, the United States collected some $6.5 billion

in principal and interest due on long-term credits, and the equivalent of about $500 million in principal and interest on foreign currency loans.

As of September 30, 1977, the latest date for which complete data are available, the total principal and interest delinquent on post-World War II debts was $591 million, compared with $657 million at the end of 1974. Nearly 69 percent of the total outstanding arrearages represent special problems, including those of a political nature, which have made collection difficult. The State Department will address the problems underlying arrearages in payments by China, Cuba, and Indochina, as well as arrearages by Iran and Zaire (which together account for $56 million in outstanding debt).

By far the largest arrearage in this group, $199 million, relates to military logistical support provided by the United States to other nations during the Korean conflict. While most countries have agreed to repay such assistance, six developing countries (Columbia, Ethiopia, Greece, the Philippines, Thailand, and Turkey) have not. Without going into the details, I would like to note that a 1973 report of the House Committee on Government Operations concluded that:

> "It is improbable that as less developed nations they (the six nations) ever implied a willingness or ability to pay. There is no reason for continuing to carry

these claims as debts on U.S. Treasury records."

In 1976, the Thirty-Seventh Report by the same commitee recommended that:

> "Congress should consider legislation removing the Korean War debt claim against Colombia, Ethiopia, Greece, the Philippines, Thailand, and Turkey from the Treasury Department's category of outstanding U.S. debts."

The National Advisory Council has endorsed this recommendation, and we intend to consult with the Congress regarding the passage of such legislation.

A further $130 million in arrearages derives primarily from technical and administrative problems, rather than hardcore delinquencies.

World War I Debt

There is another $25 billion owed to us in connection with foreign loans at the time of World War I. This figure takes into account unpaid interest charges, which now exceed the amount of the original borrowing, as well as repayments of $3 billion.

During and immediately after World War I, the Allied Powers borrowed about $10 billion from the United States. After the war the United States Government collected about $1 billion on these borrowings. Collection was complicated, however, by the general financial disorders which prevailed

in the postwar period, and the United States concluded debt-funding agreements with most of these countries during the 1923-30 period. Most debtor countries fulfilled their commitments under these debt funding agreements until 1933-34. But only a few have made any payments since that time. Total collections under these funding agreements amounted to about $2 billion as of September 30, 1977.

The principal debtor governments (except the Soviet Union, which in January 1918, repudiated all foreign debt incurred during the former Czarist regime) have never denied the legal validity of the debts. As a practical matter, however, they are inextricably linked to the question of German war reparations and the intra-European debts generated during World War I. Many European countries are net creditors on account of World War I indebtedness, with Germany owing more to them than they in turn owe to the United States. Since the early 1930's, these countries have steadfastly maintained that they would resume payments on their war debts to the United States only if the issue of Germany's World War I reparations were satisfactorily settled.

Under the 1953 London Agreement on German external debts, to which the United States is a party, resolution of the problem of intergovernment claims against Germany arising from World War I was deferred "until a final general settlement of this matter." This agreement was ratified by the United States Senate and has the status of a treaty.

Guarantee Programs

The Subcommittee has requested that I also address the subject of the foreign guarantee programs of U.S. Government agencies. These guarantees of foreign loans are not debts in the true sense, since they do not include an obligation to repay the United States Government on the part of foreign countries. More importantly, in most cases these guarantees present no cost to either the United States Government or the taxpayer. It is only in the exceptional case when a default occurs on the repayment of a loan guaranteed by a government agency that the United States Government, as guarantor, must use tax dollars to cover the default.

Treasury is now in the process of completing a report detailing the contingent liabilities of the United States Government on insurance and guarantees of private contracts with foreign obligors. Preliminary findings of this study, which will be forwarded to the Congress upon completion, indicate that some $9 billion of contingent liabilities have been incurred under four different agency programs. Some $7.6 billion of this amount, or over 84 percent, were extended by the Export-Import Bank as a means of facilitating U.S. exports. The remainder consists of $157 million of OPIC guarantees (for commercial risk only), $584 million in Department of Defense guarantees, and $691 million in AID Housing Investment Guarantees. Some ten countries were the recipients of more than 50 percent of the guarantees.

Callable Capital

In addition to the guarantees by U.S. Government agencies just discussed, the United States Government, along with other developed donor countries, guarantees, by the use of callable capital, the bond issues of the international financial institutions of which it is a member -- the World Bank, the Inter-American Development Bank and the Asian Development Bank. Such callable capital is a contingent liability which will almost certainly never have to be drawn, though it is fully appropriated by the Congress.

The subscribed callable capital of the members is not available to these banks for development lending. A bank may call upon the members for their callable capital subscriptions only to the extent necessary to meet its obligations to its bondholders. In other words, callable capital would only constitute a cash outlay by the subscribing countries in the highly unlikely circumstance that a bank was unable to repay maturing issues of its bonds. Given the record of sound financial management of each of the development banks, they should continue to be able to meet their bond obligations from principal and interest payments on development loans and from their other financial resources.

If a bank were faced with defaults on the development loans it had made or guaranteed, it would first draw on its reserves and other available resources to meet payments

on its outstanding bonds or liabilities. Only after these funds were exhausted would the bank be obliged to call upon a portion of the members' callable capital subscriptions. Such a call would be on a pro rata basis. Hence, the callable capital subscribed to the development banks by the United States represents a contingent liability which is virtually certain never to be drawn.

Foreign Ownership of U.S. Government Securities

Data on foreign holdings of U.S. Treasury securities are reported monthly in four places in the Treasury Bulletin:

-- Table OFS-2 summarizes ownership of public debt securities;

-- Tables IFS-4, CMI-2, and CMV-4 give information on the country of residence and type of foreign holder of Treasury securities.

Table OFS-2 shows that total foreign and international holdings of U.S. public debt securities were $100 billion on October 31, 1977, an increase of $24.8 billion from October 31, 1976. Table IFS-4 shows current and past data for holdings of nonmarketable bonds and notes by official institutions of foreign countries. The total as of November 30, 1977, was $20.5 billion. Approximately seven-eighths of these non-marketable securities were held by the government of Germany.

As a matter of policy, we do not disclose official holders of marketable securities without the consent of the foreign government involved. To date, only Canada has given this consent. OPEC countries, however, have invested only about $15 billion, or less than 10 percent of their total financial assets, in marketable U.S. Treasury securities. OPEC holdings represent about 3 percent of total U.S. Government public debt held by non-U.S. Government entities.

All direct foreign and international acquisitions of U.S. Government securities, whether marketable or non-marketable, are handled by Treasury on a non-discriminatory basis. Interest rates on non-marketable securities are determined in accordance with the prevailing yields at the time of issue on marketable securities of comparable maturity.

Foreign official institutions have acquired their holdings of marketable securities in many instances through market purchases. In other cases, acquisitions have been made through add-ons to regular public offerings of marketable securities with a year or more to maturity. These amounts are awarded to the subscribing official insitutions at the average price and yield determined by the market bidding for the public offering.

The purpose of the add-on facility is to minimize the impact of foreign official investment activities on the market for Treasury securities while, at the same

time, providing a mechanism by which these official institutions can readily meet their legitimate investment requirements. A number of countries have taken advantage of this facility; the OPEC countries, whether singly or as a group, have not been the most important users.

Conclusion

I would like to conclude by briefly commenting on the outlook for the world economy in 1978, which sets the stage for the outlook for the international debt situation. While the world economy is not yet on a satisfactory course, considerable improvements should continue to occur during the year:

-- A number of DCs and LDCs have already benefited from stabilization efforts, have re-established their international creditworthiness, have regained their access to private capital markets, and are poised for faster growth than has been possible the last few years.

-- The OPEC surplus, and the resulting offsetting oil importers' deficit, will be smaller than last year due to continuing growth in OPEC imports and expansion of oil production in non-OPEC nations, together with some continued weakness in the economic growth of many European countries.

-- The aggregate deficits needed to offset the OPEC surplus will be distributed in a more sustainable pattern, as most countries which face financing limits are restraining their deficits.

-- International economic cooperation has contributed to a more informed and sounder basis for international debt management in the future, and our own regulatory authorities have improved their capability to fulfill their functions in the international area.

If Congress acts soon on the President's energy program, and if other nations adopt appropriate adjustment policies, I am confident that we can look forward to a more stable and sustainable pattern of international payments in the year ahead.

REPORT ON THE FISCAL IMPACT OF THE ECONOMIC STIMULUS PACKAGE ON 48 LARGE URBAN GOVERNMENTS

U.S. Department of the Treasury
Office of State and Local Finance

January 23, 1978

EXECUTIVE SUMMARY

"FISCAL IMPACT OF THE ECONOMIC STIMULUS PACKAGE ON 48 LARGE URBAN GOVERNMENTS"

Purpose

The purpose of this report is to evaluate the fiscal impact of the key components of the Economic Stimulus Package (ESP) on 48 urban city governments. This review of the ESP includes Anti-recession Fiscal Assistance (ARFA), Local Public Works (LPW), and Public Service Employment Title II and VI (CETA).

This report is designed to provide a sense of magnitude and impact concerning the ESP on urban financial condition. The report does not attempt to assess the programs' economic efficiency in meeting national economic goals.

Policy Implication

Although the data and research are not extensive enough to support a policy recommendation, it is observable from this report that sufficient evidence exists to suggest that further study should be made of the use of state and local governments as instruments of national economic policy. The ESP programs started out as aid-to-the economy programs, but may have become as much aid-to-government programs, particularly for governments under severe fiscal strain.

Summary Finding

The specific utilization of ESP funds by these governments is not ascertainable without extensive field research. However, the analysis does suggest that ESP funds are reasonably well targeted, are not an insignificant portion of the cities' revenue base, and that the more hard pressed governments may be developing a reliance on ESP funds, particularly the portion that supports regularly recurring operations.

Techniques

A mini-model of the finances and basic economic indicators of the 48 largest city governments (LCG's) was established for the evaluation. The model covers five-year history and a three-year forecast of revenues by source revenues; expenditure patterns; capital outlay trends; data on debt issues and outstanding debt; retirement costs; population trends, per capita income; unemployment; and several other key fiscal indicators.

The allocations of ESP funds to these cities has been matched to the model in order to calculate ratios of fiscal reliance. Likewise, measures of fiscal strain have been developed using such indicators as population trend, revenue base mix, and income trends. These were then weighted and the fiscal strain index of each city calculated. The 48 LCG are then grouped by level of fiscal strain.

Chapter Recap

Chapter One provides the background to the paper and summarizes the key findings concerning the overall impact of the ESP and its components, ARFA, LPW and CETA.

Chapter Two discusses the general measures of ESP impact. These measures include property tax and own source revenue substitution and targeting of per capita allocations based on fiscal strain. There is also a discussion of the regional distribution of ESP funds.

Chapter Three gives more detailed descriptions and observations concerning each program together with projections for fiscal years 1977, 1978 and 1979. The programs are also compared to the appropriate local budgetary items, for example, local public works money compared to capital outlay and CETA funding compared to city workforce payroll.

Chapter Four describes the data source and methodology for the analysis of the programs and development of the fiscal strain index.

Chapter Five contains appendices which include fiscal impact calculations, fiscal profiles and strain indicators for each city. Also included is a more detailed survey of four cities and an inventory of other ESP studies.

Fiscal Impact of Economic
Stimulus Package on 48 Large City Governments

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Chapter I

INTRODUCTION

Chapter One provides the background to the paper and summarizes the key findings concerning the overall impact of the Economic Stimulus Package and its components Anti-recession Fiscal Assistance, Local Public Works and Public Service Employment Title II and VI.

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I. INTRODUCTION

A. Background

Purpose

This review of the of the Economic Stimulus Package includes Anti-recession Fiscal Assistance, Local Public Works, and Public Service Employment Title II and VI.

A recurring question of policy relates to the need for these Economic Stimulus programs when the state and local sector shows an excess of revenues over expenditures. On an overall accounting basis using National Income Accounts (NIA), the state and local sector operating account has been in surplus since 1976, and is expected to continue in surplus through 1979. However, the positive status of the sector as a whole masks the financial difficulty which large urban governments are experiencing. For instance, the aggregate state-local sector surplus in the national income accounts includes a number of special funds which are usually not available for general government use. Therefore, this analysis of the fiscal impact of the key components of the Economic Stimulus Package on urban city governments will evaluate cities by category of financial hardship (high, moderate, low fiscal strain) and relate the ESP funding to city government finances as defined by the Census Bureau for general purpose government.

The report is designed to provide a sense of magnitude and impact concerning the ESP on the urban financial condition. The report does not attempt to assess the programs' economic efficiency in meeting national economic goals. If general conclusions about the fiscal impact of ESP on all state and local governments are drawn from this work on 48 large city governments, such conclusions should be drawn with caution.

Although the data and research are not extensive enough to support a policy recommendation, it is observable from this report that sufficient evidence exists to question the use of state and local governments as continuing agents of national economic policy. The ESP programs may have begun as aid-to-the-economy programs, but, in some instances, may have become aid-to-government programs, particularly for governments under severe fiscal strain. The CETA and countercyclical revenue sharing programs, especially, tend to become unintentionally coupled with governmental operating budgets below the Federal level, since they often support recurring general operations. This phenomena might easily lead to a reliance by the recipient governments, resulting in an "ad hoc" Federal assistance program.

Focus

The primary focus of this paper is large central cities whose relative fiscal condition mirrors, in many respects, the economic difficulties of urban areas generally. The 48 largest cities in America (based on the 1970 population) were selected because they typify the urban problem and because they represent the cities for which the Bureau of the Census develops considerable financial data in a reasonably consistent fashion on an annual basis. These urban centers comprise 16.7% of America's population and represent approximately 13% of state-local government sector spending.

Reliance

It must be noted that the reliance of any recipient government on ESP funds rests primarily on how the funds are used by the city government. If ESP funds are used to support regularly recurring essential activities of the government, then one might conclude that the government is developing or has developed, a reliance. The precise utilization or application of ESP funds is not possible to determine, however, within the constraints of this analysis.

Reliance, as discussed in this analysis, primarily relates to relative per capita allocations, property tax equivalents, and to a lesser extent, the ratio of ESP monies to general and own source revenues. To further enhance the evaluation of the ESP impact and the 48 city governments' reliance on these funds, each city is categorized by level of fiscal strain, i.e., high, moderate, or low. The effect of national economic trends on local revenues has been forecasted by Treasury's Office of Economic Policy for the years 1977, 1978, and 1979.

In order to measure the impact of the ESP on the fiscal condition of the 48 large city governments (LCG's), a Fiscal Strain Index was developed. Initially, a survey of current research on fiscal indicators was conducted to determine relevant measures of fiscal strain. The indicators selected were ones which maintained a balance between fiscal and socio-economic characteristics, and for which data were readily available from secondary sources. The factors used were change in population, change in city income relative to national income, change in assessable base, and change in debt and tax burdens. To maximize the significance of the high, moderate, and low categories of strain, city rankings from five other urban strain studies were combined with Treasury findings which resulted in a composite fiscal strain index.

B. Summary of Findings

Throughout the report, the Economic Stimulus Package will be referred to as ESP, Anti-recession Fiscal Assistance as ARFA, Local Public Works as LPW and Public Service Employment as CETA.

The following observations as to the effects of the ESP programs on urban fiscal condition should be viewed in the context of the data, which have not been verified by original source recipient governments. The data have been provided by Federal agencies, and have been subject to calculation and estimating techniques, many of which are judgmental.

Overview

o In the aggregate, the ESP is likely to have a significant effect on the economy since nearly $15.8 billion ($3.2 ARFA; $6.0 LPW; $6.6 CETA) is being allocated between January 1977 and September 1978. This amount is roughly equal to one quarter of the budgeted Federal deficit ($57.7 billion) for fiscal 1978. For the 48 large city governments, ESP funds total $3.2 billion (20% of total U.S. allocations) during the life of the programs and represent about 2.9% of the urban governments' total operating revenues, 6.3% of own source revenue, and 21% of Federal aid (see Table 2-f).

o With respect to targeting, the ESP formulas appear to take into account the fiscal need of city governments, whereby (a) 53% of ESP allocations to the 48 cities are received by high strain cities, 37% by moderate strain cities, and 10% by low strain cities; and, (b) on a per capita basis, high strain cities receive $107, moderate strain cities receive $74 and low strain cities receive $51 per person.

o With respect to size, ESP allocations also depend on the size of recipient governments. The high strain cities who receive a larger portion of ESP allocations also tend to be the largest cities.

o In terms of substitution (i.e., additional burdens placed on local resources if cities were to substitute locally-generated revenues for ESP monies), the heaviest burden to sustain the impact of total ESP allocations for FY 1978 would fall on the high strain cities which would have to impose an average 65¢ property tax increase for each $100 of full market value. Moderate strain cities would need a 40¢ increase and low strain cities would need a 24¢ increase in property taxes.

o In terms of a fiscal gap, a significant maintenance of revenue effort or reduction in service levels would be required by these cities when and if the ESP funds expire. For example, own source revenues are estimated to have increased by 50% in the 48 large city governments between 1972 and 1978, but would have to be raised an additional 12% in FY 1978 to cover the gap left by expiration of ESP funds alone. As an alternative, if state supported revenues were required to cover the ESP expiration in FY 1978, an increase of 18% or $2.0 billion in state revenues would be necessary to replace ESP to the 48 large city governments.

o Six of 10 high strain cities, 14 of 28 medium strain cities and 4 of 10 low strain cities, will obtain amounts from the three ESP programs equal to 16% or more of their "own source" revenues. Termination of all three programs would mean that these cities would be forced to: (a) effect at least a 16% increase in their own source revenues by raising local taxes, or in the case of LPW in long-term debt; (b) effect a 16% cut in expenditures and related services; or (c) obtain State aid to replace the ESP funds because local tax bases are not particularly elastic. It should be emphasized that a 16% increase in tax rates would not mean a 16% increase in revenues because uncollectibles would rise and, individual and commercial taxpayers might possibly move out at a faster rate. In addition, a 16% cut in local expenditures may be theoretically possible but in most cases may be undesirable. Moreover, the prospects for increased state aid differs sharply from city to city.

Countercyclical Revenue Sharing (ARFA)

o Of the three components of the ESP, ARFA is the most effective in targeting to cities according to fiscal condition. For high fiscal strain cities, per capita ARFA allocations average $29, while moderate fiscal strain cities receive $12 per capita and low strain cities about $7. The ratio of high strain to moderate and low strain per capita allocations for the three programs is:

	ARFA	LPW	CETA
High to Moderate	2.4 to 1	1.5 to 1	1.1 to 1
High to Low	4.1 to 1	2.7 to 1	1.4 to 1

This illustrates the relatively higher importance of ARFA to cities experiencing financial difficulty. Newark receives the highest per capita allocation of $52. Other cities receiving high per capita allocations include Detroit, New York, Philadelphia, and Baltimore.

o Cities with secularly declining populations, employment, and tax bases are experiencing long term fiscal strain. These cities tend to be more reliant on ARFA revenues to support budgetary gaps because they have limited ability and flexibility to make discretionary tax and expenditure adjustments without further adversely affecting their economic condition. For example, four cities with these secularly declining trends were surveyed in more detail. All four were among the top quartile of the 48 large city governments in terms of reliance on the ESP, as measured by its property tax equivalent.

o If Federal ARFA funds were discontinued, the tax burden of substituting property tax revenue for ARFA would fall heaviest on high strain cities; e.g., an average property tax increase of 15¢ per $100 of full market value would be required in high strain cities, while an average 5¢ increase would be required in moderate strain cities, and only a 2¢ average increase in low strain cities. In certain cities, removal of ARFA funds is the equivalent of significant property tax levies, which would aggravate fiscal strain. These cities include:

Newark	49¢	
Philadelphia	32¢	
El Paso	24¢	
Buffalo	20¢	(cents per each $100
St. Louis	20¢	of full market value)
Detroit	19¢	
Pittsburgh	19¢	
Baltimore	18¢	
New York	18¢	

o Removal of ARFA funds would create additional burdens for the 48 cities equal to approximately 2% of total adjusted own source revenues in 1978. ARFA allocations to high strain cities represent 2.5% of own source revenues, moderate strain allocations are 1.8%, and low strain allocations are 1.3% of own source revenues.

Emergency Local Public Works (LPW)

o Generally, cities experiencing higher degrees of fiscal stress are unable to borrow sufficient long term funds to meet all of their capital development and investment needs. For most of the 48 large city governments, the local public works program has helped fill the gap between capital needs and resources. The 48 large cities have received LPW assistance in relation to fiscal strain, i.e., per capita LPW allocations are $35 for high strain cities, $24 for moderate strain cities, and $13 per capita for low strain cities. Thus, targeting appears reasonably effective.

o The highest reliance (local public works allocations as a percent of capital outlay) is exhibited by cities with low per capita capital outlay. Newark and Pittsburgh, which exhibited the highest reliance on LPW allocations in 1978, 79.3% and 64.4% of capital outlay, had per capita capital outlay of only $63 and $47, while Nashville and Louisville, which exhibited the lowest reliance on LPW allocations 0.9% and 1.4% of capital outlay, had per capita capital outlay of $268 and $223. Average per capita capital outlay for the 48 city governments was $164.

o Removal of LPW funds would create additional tax and/or debt burdens for the 48 cities equal to approximately 4% of adjusted own source revenues; the burden for high strain cities would equal 3.7% of own source revenues, 5.0% for moderate strain cities, and 4.0% for low strain cities.

o Most of the projects paid for by local public works funds in the 48 large city governments were for the development and repair of "basic infrastructure" such as streets, sidewalks, water and sewer systems, storm drains and bridges, $490.6 million (48.4%). Less priority was given to the construction of buildings for municipal services such as schools, municipal office buildings, police stations and fire stations, $218.3 million (21.6%). Recreational facilities such as parks, gyms and museums appeared to have least priority, $171.6 million (16.9%). The projects which received top priority reflect capital maintenance and improvement as opposed to new capital development. Without LPW, improvements and repairs in infrastructure would probably have been postponed.

o Four of the 48 large cities, New York, Newark, Boston, and Detroit, continued to issue the previously scheduled amounts of long term debt and generally applied the local public works funds to capital projects which had been deferred during past fiscal years for lack of funds. Public works allocations were a significant portion of estimated 1978 capital construction for each of the cities: Newark (44 percent), New York (30 percent), Detroit (20 percent), and Boston (10 percent).

Public Service Jobs (CETA)

o CETA has been minimally effective in targeting funds to cities experiencing "high" fiscal strain as measured by per capita allocations. On a per capita basis, CETA allocations are $43 for high strain cities, $38 for moderate strain cities, and $31 for low strain cities. Targeting effectiveness in terms of per capita allocations may be misleading, since a number of cities are not using monies directly, but the funds are applied through community-based organizations.

o If Federal CETA funds were discontinued, the tax burden of substituting local property tax revenues for CETA would fall heaviest on high strain cities; e.g., a property tax increase of 28¢ per $100 of full market value would be required in high strain cities, a 21¢ tax increase would be required in moderate strain cities, and a 15¢ property tax increase would be required in low strain cities.

o Removal of CETA funds would create additional tax burdens for the 48 cities equal to approximately 6% of total adjusted own source revenues in 1978. CETA allocations to high strain cities represent 4.7% of own source revenues, 7.2% for moderate strain cities and 8.0% for low strain cities. CETA funds are a larger portion of own source revenue for moderate and low strain cities than for high strain cities because the former are required to levy smaller amounts of own source taxation.

o Since 60% of the revenues of the 48 large city governments is own source generated, the burden of maintenance, if CETA (and ARFA) were removed, would fall most heavily on internal resources, i.e., city residents. The four city survey revealed that only about 25% of CETA funds for those cities might be supplanted with own source revenues.

o Withdrawing funds for CETA public service jobs would have a significant impact on city services, particularly for those experiencing "high" fiscal strain. Jobs created under CETA Title II and VI programs represent an average 13% of the city work force for the 48 large city governments. CETA jobs apparently represent a larger portion of full time equivalent work force for low and moderate strain cities, 18% and 15%, than the 11% for high strain cities. This percentage must be viewed with caution since the employment base, i.e. number of employees, is very large in the high strain cities (which are the largest cities) thereby making the relative percentage appear lower. The four city case study survey indicates that CETA funds were used to rehire laid off employees, and CETA jobs were assigned to critical city service slots such as police and sanitation.

Chapter II

Analytical Overview

Chapter Two discusses the general measures of ESP impact. These measures include property tax and own source revenue substitution and targeting of per capita allocations based on fiscal strain. There is also a discussion of the regional distribution of ESP funds.

II. Analytical Overview

A. General

The portion of the Carter Administration Economic Stimulus Package which applied to state and local governments, consisted of an extension and expansion of certain existing programs (CETA Title II and VI, Emergency Local Public Works and Countercyclical Revenue Sharing) as a stimulus to the national economy. The entire program is due to expire at the end of September 1978.

In 1978, at a level of full impact, the ESP will provide an additional 35% of direct Federal assistance to the 48 large city governments. Regional impact of ESP allocations shows that the northeast and northcentral cities are receiving above average amounts of ESP dollars per person ($114.30 and $83.50, respectively). One city, Newark, is receiving over $200, and 12 cities are receiving over $100 e.g., Boston, Buffalo, New York, Pittsburgh, Washington, D.C., Detroit, Atlanta, Miami, St. Louis, San Francisco, and Oakland. (See Table 2-h).

Given the data constraints, refinements, and classifications as discussed herein, the following factors are used as measures of the fiscal impact of the ESP on the 48 large cities:

Targeting

- o Total ESP Allocations
- o Per Capital Total ESP Allocations

Substitution

- o Estimated 1978 ESP Allocations as an Equivalent Increase in Property Tax
- o Estimated 1978 ESP Allocations as % of Adjusted Own Source Revenues

B. Targeting

The programs under study have the general purpose of stimulating local economies. Calculations were made to gauge the relative effectiveness of Federal targeting of monies to areas of highest fiscal strain and economic need.

Total Allocations -- In terms of average and absolute dollars, the total ESP appears to be relatively on target according to need. Of the ESP allocations to all 48 of the large city governments, the 10 high strain cities receive 53% and an average per city allocation of $170 million; the 28 moderate strain cities receive 37% and an

average of $42 million per city; and, the 10 low strain cities receive 10% for an average of $32 million per city. Allocations are also a function of size as much as strain since the high strain cities also tend to be the largest cities. An analysis of the component programs reveals that the ARFA program is most effective in targeting funds to high strain cities at 67% of allocations to the 48 cities, while the CETA program distributes 46% of allocations to these same cities.

Cities receiving in excess of $150 million over the life of the ESP (1977-1979) included:

	$ Millions
New York	$832
Los Angeles	205
Chicago	199
Philadelphia	168
Detroit	151

Table 2-a.

IMPACT OF ESP ALLOCATIONS ON 48 LARGE CITY GOVERNMENTS BY CATEGORIES OF FISCAL STRAIN

	Fiscal Strain				
	HIGH (10 cities)	MODERATE (28 cities)	LOW (10 cities)	ALL 48	NATIONAL
Total ESP Allocations 1977-1979 ($ Millions)					
ARFA	$458.7	$189.0	$41.5	$686.6	$3,200.0
LPW	556.5	374.6	82.2	1,013.3	6,000.0
CETA	684.3	597.5	192.0	1,473.8	6,600.0
TOTAL	$1,699.5	$1,161.1	$315.7	$3,173.7	$15,800.0

Program Allocations as a % of Total ESP Allocations	HIGH	MODERATE	LOW	ALL 48
ARFA	27.0%	16.3%	13.2%	21.6%
LPW	32.7%	32.3%	26.0%	31.9%
CETA	40.3%	51.4%	60.8%	46.5%
	100.0%	100.0%	100.0%	100.0%
% of All 3 ESP Programs	53.5%	36.6%	9.9%	20.1%

Average Allocations to a City Within Category ($ Millions)	HIGH	MODERATE	LOW	ALL 48
ARFA	$45.9	$6.8	$4.2	$14.3
LPW	55.7	13.4	8.2	21.1
CETA	68.4	21.3	19.2	30.7
Total	$170.0	$41.5	$31.6	$66.1

Per Capita Allocations -- On the basis of population, the total ESP also appears to be relatively well targeted to cities based upon need. The high strain cities receive $106 per person, the moderate strain cities receive $74 per person and the low strain cities receive $51 per person. Again, ARFA is most effective at targeting according to need, giving the high strain cities 300% more per person than the low strain cities, whereas CETA gives the higher strain group only 40% more per person than the lower strain group.

Table 2-b.

IMPACT OF PER CAPITA
ESP ALLOCATIONS ON 48 LARGE CITY GOVERNMENTS
BY CATEGORIES OF FISCAL STRAIN

Per Capita Total ESP Allocations	HIGH	MODERATE	LOW	ALL 48	NATIONAL
ARFA	$28.65	$12.01	$6.65	$18.04	$14.68
LPW	34.76	23.80	13.16	26.60	27.53
CETA	42.74	37.96	30.74	38.69	30.28
Total	$106.15	$73.77	$50.55	$83.33	$72.49

Cities with the highest per capita ESP allocation included:

Newark	$223
Buffalo	155
San Francisco	146
Detroit	125
Oakland	124
Washington, D.C.	120
Boston	113

C. Substitution

The difficulties of evaluating the reliance of the 48 large city governments on the ESP over a period of time are discussed in the methodology section. Measurements were developed which assess the relative fiscal impact of the ESP in terms of substitution; i.e., what additional burdens would be placed on local resources if the cities were to substitute locally-generated revenues for discontinued Federal ESP monies?

Property Tax Equivalent -- For the 48 large city governments, property taxes would have to increase an average of 46¢ per hundred dollars of full market value, in order to sustain the impact of total ESP allocations for FY 1978. Increased tax burden (for each $100 of full market value) is in direct proportion to fiscal strain, whereby (a) the high strain cities would experience the heaviest burden with an average increase of 65¢, (b) the moderate strain cities would have an average 40¢ increase, and (c) the low strain cities would experience an average 24¢ increase. These increases would further aggravate the tax burden of residents of high strain cities who pay aproximately 6.0% (see Table 2-c) of their income in property taxes, while residents of moderate and low strain cities pay only 2.4% and 1.5%, respectively, of their income in property taxes. (Note: Equivalent full market values for 1976 were developed from assessed value and equalization rate information as published in Moody's 1977 Municipal Credit Reports).

Those cities which would be required to make the greatest effort in property tax substitution if ESP funds were totally removed include:

	Property Tax Equivalent of ESP Funds Per $100 FMV
Newark	$2.58
Buffalo	1.56
Philadelphia	1.32
Pittsburgh	1.11
El Paso	1.08

Table 2-c.

IMPACT OF ESP ALLOCATIONS ON PROPERTY TAX BURDEN OF 48 LARGE CITY GOVERNMENTS BY CATEGORY OF FISCAL STRAIN

Estimated 1978 ESP Allocations as an Equivalent Increase in Property Taxes (per $100 FMV)	HIGH	MODERATE	LOW	ALL 48
ARFA	$.15	-$.05	$.02	$.08
LPW	.22	- .14	.07	.16
CETA	.27	.21	.15	.22
Total	$.65	$.40	$.24	$.46
Property Tax Collection Compared to Full Market Value (per $100 FMV)	$2.61	$.95	$.51	$1.47
Per Capita Property Tax (1976) Compared to Per Capita Income (1974)	6.0%	2.4%	1.5%	3.6%
Per Capita Property Tax	$250.47	$113.91	$74.77	$167.08

Increases in Own Source Revenue -- Estimated total ESP allocations for FY 1978 represent an average 12% of own source revenues (adjusted for school taxes) for the 48 large city governments. This substitution increase in local revenues for urban governments would be substantially higher than a national average increase of 9% in own source revenues for all local governments.

Estimated 1978 ESP Allocations as % of Adjusted Own Source Revenues	HIGH	MODERATE	LOW	All 48	NATIONAL
ARFA	2.5%	1.8%	1.3%	2.1%	1.6%
LPW	3.7	5.0	4.0	4.1	3.7
CETA	4.7	7.2	8.0	5.8	4.1
Total	10.9%	14.0%	13.3%	12.0%	9.3%

D. Fiscal Profiles and ESP Withdrawal

In comparison to national statistics, the 48 large governments in this study, as a whole, have socio-economic characteristics which indicate greater general urban fiscal strain (national statistics caluculated from Census & BLS source data). Such characteristics include:

	48 City Governments	National
Declining Population (Avg., 1970-1976)	.9% Decrease	.8% Increase
Higher Unemployment (1976)	8.2%	7.7%
Slower Growth in Per Capita Income (Avg., 1969-1974)	8.9%	9.3%
Lower Per Capita Income (1974)	$4,561	$4,572

Among the 48 cities, fiscal characteristics of "high strain" cities which would tend to increase fiscal strain if ESP were removed include:

o Greater reliance on external sources of revenue for city government operations - e.g., external source revenue as a % of general revenue is 45% for the high strain cities and 36% for the low strain cities;

o Limited ability to tap state sources for sustainment of ESP-type activities - e.g., high strain cities are already receiving 37% of their general

revenue from state sources, whereas low strain cities are receiving 23% from the state. Therefore, the burden of sustaining stimulus programs would fall heaviest on taxpayers within the high strain cities (see Table 2-d);

o Greater reliance on income taxes as a source of locally-generated revenue - e.g., income taxes are 17% of own source revenue for high strain cities and only 4% of own source revenue for low strain cities. As income tax revenues are directly related to the state of the economy, high strain cities are more vulnerable to economic downturns (see Table 2-d);

o High tax burden, notably (a) property taxes per hundred dollars of full market value are $2.61 for high strain cities but only 51¢ for low strain cities, (b) per capita property tax is $251 in high strain cities, and $75 in low strain cities, and (c) between 1972 and 1976, own source revenues were growing at 160% of per capita income in high strain cities, but only 94% in low strain cities (see Table 2-d);

o Higher cost level for providing similar public services - e.g., an average 16 public service functions cost a high strain city resident $975 while a low strain city resident pays $299 for an average 15.2 functions (see Exhibit B-4).

o Greater socio-economic decline, notably (a) between 1972-1976, high strain cities lost an average 1.8% in population, while low strain cities gained 1.4% in population, (b) per capita income grew an average 6% in high strain cities and an average 8% in low strain cities between 1969-1974, and (c) the average 1976 unemployment rate was 11% in high strain cities, and 8% in low strain cities (see Table 2-d).

Table 2-d. **FISCAL PROFILES OF 48 LARGE CITY GOVERNMENTS BY CATEGORIES OF FISCAL STRAIN**

	FISCAL STRAIN				
	HIGH (10)	MODERATE (28)	LOW (10)	ALL 48	NATIONAL
General Revenue Profile (Average '72 - '76)					
Own Source Revenue as % General Revenue	55.1%	62.8%	64.4%	58.1%	69.2%
Δ Own Source Revenue as % General Revenue	-5.7	-7.1	-4.9	-6.1	
Federal Revenue as % General Revenue	7.8	18.4	13.1	11.3	6.3
State Revenue as % General Revenue	37.0	18.8	22.5	30.6	34.0
Own Source Revenue Profile (Average '72 - '76)					
Property/Own Source Revenue	42.6%	36.1%	33.4%	39.8%	52.8%
Sales/Own Source Revenue	16.5	17.7	22.8	17.4	6.2
Income/Own Source Revenue	17.3	9.2	3.9	14.0	3.0
(Average Annual Compound - '72-'76)					
Property Tax Growth	6.7%	4.7%	9.8%	6.3%	
Sales Tax Growth	11.4	10.5	10.7	11.0	
Income Tax Growth	8.9	11.2	10.9	9.4	
Profile of Tax Burden					
Δ Assessed Value (Avg., '71-'76)	1.4%	12.0%	11.0%	6.9%	
Δ Full Market Value (Avg., '71-'76)	3.9%	5.9%	14.6%	7.6%	
Property Tax Collections/ Fair Market Value ('76) - $/$100 FMV	$2.61	$.95	$.51	$1.47	
Per Capita Property Tax/Per Capita Income	6.0%	2.4%	1.5%	3.6%	
Per Capita Property Tax ('76)	$250.41	$113.91	$74.77	$167.08	
Δ Per Capita Own Source Revenues/ Per Capita Income ('72 - '76)	160%	99%	94 %	117%	100%
Profile of Services					
Variable Function (Average)	6.0	4.6	5.2	5	
Per Capita General Purpose Expenditure ('76)	$975	$451	$299	$655	
Socio-Economic Profile (Average)					
Δ Population ('72 - '76)	1.8%	-.7%	+1.4%	-.9%	+.8%
Per Capita Income ('74)	$4,181	$4,810	$4,850	$4,561	$4,572
Δ Per Capita Income ('69 - '74)	6.3%	7.7%	8.2$	8.9%	9.3%
Unemployment Rate ('76)	11.0%	8.6%	8.3%	9.4%	7.7%

Table 2-e.

ECONOMIC STIMULUS PACKAGE (ESP)
FOR 48 LARGE CITY GOVERNMENTS (48LCG)

Estimated Impact Measures Comparing Allocations
Over the Life of the Programs
to Equivalent Periods

		CETA 1/	LPW	ARFA	TOTAL ESP
1.	Allocation to 48 LCG	$1.5B	$1.0B	$ .7B 2/	$3.2B
2.	Portion Each ESP Component is of Total ESP for 48 LCG	46.5%	31.9%	21.6%	100%
3.	Portion of Total U.S. Allocations Going to 48 LCG	22.7%	16.7%	21.7%	20.1%
4.	Allocation as a % of Total Operating Revenue of 48 LCG	3.5% 3/	1.4% 4/	.8% 5/	5.7%
5.	Allocation as a % of Own Source Revenue of 48 LCG	7.5% 3/	3.1% 4/	1.9% 5/	12.5%
6.	Allocation as a % of Capital Outlay of 48 LCG	---	8.8% 6/	---	---

1/ CETA expenditures are for the 15 month period beginning 5/77.

2/ If annualized for FY 1979 total ARFA would be $.84 billion. $.7 billion is total projected under current legislation.

3/ Compares CETA allocation to a revenue base equivalent to the allocation period.

4/ Round I & II allocations as % of the sum of projected revenue base for fiscal 1977 and fiscal 1978.

5/ Compares total ARFA payments (11/76 - 7/78) to Total Operating Revenues for 48 LCG during period over which ARFA will be received.

6/ Round I & II allocations as % of sum of projected total capital outlay for fiscal 1977 and 1978.

ECONOMIC STIMULUS ALLOCATIONS TO 48 LARGE CITY GOVERNMENTS ($MILLIONS)

ESTIMATED IMPACT MEASURES COMPARING ALLOCATIONS ON A FISCAL YEAR BASIS

	CENSUS FISCAL YEAR			
COMPONENTS:	1977	1978	1979	1977-1979
LPW	$ 315.8	$ 697.5	$ —	$ 1,013.3
ARFA	222.7	362.6	101.9	687.2
CETA	245.6	982.5	245.6	1,473.7
TOTAL STIMULUS PACKAGE	$ 784.1	$2,042.6	$ 347.5	$ 3,174.2
STIMULUS PACKAGE AS % OF:				
FEDERAL AID	17.5%	40.5%	6.2%	21.0%
STATE REVENUE	7.7%	18.4%	2.9%	9.5%
OWN SOURCE REVENUE	5.0%	12.1%	1.9%	6.3%
TOTAL OPERATING REVENUE	2.3%	5.5%	.9%	2.9%

NOTE: This table has been prepared to provide a sense of the magnitude of ESP over the life of the programs. In that allocations have been pro-rated to conform with use of the census fiscal year, figures for 1978 provide an estimation of the full impact of ESP programs at yearly levels. Aggregation is not designed to express a measure of fiscal dependency because only a disaggregated view of the figures will address dependency, as the ESP programs are designed for different purposes and each relates to city finances in a different way.

Table 2-g.

ESTIMATED RELATIONSHIP OF ECONOMIC STIMULUS PACKAGE TO DIRECT FEDERAL ASSISTANCE FOR 48 LARGE CITY GOVERNMENTS (48 LCG)

	Actual	Projected Census Fiscal Years ($ Millions)		
	1976	1977	1978	1979
Total Federal Aid to 48 LCG without Stimulus Package	$4,143.6	$4,490.7	$5,041.1	$5,591.4
Stimulus Package LPW: I & II 1/		34.4	397.0	403.6
CETA:		245.6 2/	982.5 3/	245.6 4/
ARFA: 5/		222.7	362.6	101.9
Total Stimulus Package		$ 502.7	$1,742.1	$ 751.1
Total Stimulus Package as a % of All Non-Stimulus Federal Aid:		11.2%	34.6%	13.4%

1/ Disbursements of LPW money to each City for FY 1977, 1978, and 1979 are determined by multiplying each City's share of the total Round I & II allocations by the estimates national disbursements for each year.

2/ Assuming that the 48 LCG received 1 quarterly payment in FY 1977, 1/6 x $1.473.8 million. Also assuming full staffing.

3/ Because of phase-in and stopping of CETA funds, and the lack of accurate information concerning quarterly expenditure estimates, the total CETA stimulus to the 48 LCG, $1,473.8 million for 18 months, was divided by 18 to get a monthly average, then multiplied by 12 to get annualized figures.

4/ Assuming that one quarterly payment is received by the cities in FY 1979, since program funding expires in 9/78.

5/ Actual disbursements to 48 LCG for quarters 1-6, projected disbursements through last quarterly payment in July, 1978. The first month in the census fiscal year 1979 is July 1978, as reflected by this projection.

Table 2-h.

BY REGION

48 LARGE CITY GOVERNMENTS
PER CAPITA TOTAL ESP ALLOCATIONS

	ARFA	LPW	CETA	TOTALS
TOTALS				
NORTH EAST	$31.2	$40.0	$43.1	$114.3
NORTH CENTRAL	16.1	25.5	41.9	83.5
SOUTH EAST	10.9	17.2	32.5	60.7
SOUTH CENTRAL	6.5	11.6	24.7	42.8
WEST	12.5	23.8	44.3	80.6

	ARFA	LPW	CETA	TOTALS
NORTH EAST				
BALTIMORE	$25.3	$30.1	$36.6	$92.0
BOSTON	22.9	38.1	52.2	113.2
BUFFALO	24.6	58.0	72.4	155.0
NEWARK	52.4	88.4	82.6	223.4
NEW YORK	33.6	39.7	40.9	114.2
PHILADELPHIA	28.3	28.9	39.0	96.2
PITTSBURGH	23.9	30.5	46.2	100.2
Washington, D.C.	23.9	57.6	38.5	120.0
TOTALS	$31.2	$40.0	$43.1	$114.3
NORTH CENTRAL				
CHICAGO	$13.2	$19.4	$35.3	$67.9
CINCINNATI	20.9	28.8	48.7	98.4
CLEVELAND	18.0	19.7	41.8	79.5
COLUMBUS	5.7	13.9	34.3	53.9
DETROIT	38.0	38.4	49.1	125.5
INDIANAPOLIS	5.1	23.3	36.7	65.1
MILWAUKEE	10.8	21.7	36.6	69.1
MINNEAPOLIS	7.1	20.2	48.1	75.4
OMAHA	2.0	34.8	19.7	56.5
ST. PAUL	5.3	14.9	41.3	61.5
TOLEDO	7.4	23.1	39.4	69.9
TOTALS	$16.1	$25.5	$41.9	$83.6

Table 2-h (Continued)

BY REGION

48 LARGE CITY GOVERNMENTS
PER CAPITA TOTAL ESP ALLOCATIONS

Southeast				
Atlanta	$12.7	$24.5	$70.9	$108.1
Birmingham	12.1	15.8	33.8	61.7
Memphis	3.4	7.5	15.9	21.8
Miami	18.9	37.0	53.8	109.7
Jacksonville	4.5	20.7	21.2	46.4
Louisville	9.2	1.9	33.9	45.0
Nashville/Davidson	1.6	7.5	16.2	25.3
New Orleans	27.4	23.7	36.7	87.8
Norfolk	10.1	17.2	25.1	52.4
TOTALS	$10.9	$17.2	$32.5	$60.6
South Central				
Dallas	0	6.7	15.4	22.1
El Paso	19.2	21.9	37.5	78.6
Fort Worth	1.2	12.9	19.0	33.1
Houston	1.8	6.1	17.8	25.7
Kansas City	8.0	18.1	34.3	60.4
St. Louis	27.0	29.2	49.0	105.2
San Antonio	5.7	6.5	25.1	37.3
Tulsa	2.6	4.1	15.1	21.8
Oklahoma City	4.0	17.3	24.6	45.9
TOTALS	$ 6.5	$11.6	$24.7	$42.8
West				
Denver	$11.9	$23.0	$29.0	$63.9
Honolulu	11.2	35.0	33.2	79.4
Long Beach	6.7	15.0	38.3	60.0
Los Angeles	11.7	20.6	44.2	76.5
Portland	20.1	26.6	50.4	97.1
San Diego	10.5	17.6	46.2	74.3
San Francisco	29.2	56.0	61.6	146.8
San Jose	5.5	10.8	29.4	45.7
Seattle	9.8	26.0	48.1	83.9
Oakland	28.3	32.0	68.2	124.0
Phoenix	5.7	11.4	47.6	64.7
TOTALS	$12.5	$23.8	$44.3	$80.6

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Chapter III

Program Analysis

Chapter Three gives more detailed descriptions and observations concerning each program together with projections for fiscal years 1977, 1978 and 1979. The programs are also compared to the appropriate local budgetary items, for example, local public works money compared to capital outlay and CETA funds compared to city workforce payroll.

III. Program Analysis

A. Anti-Recession Fiscal Assistance (ARFA)

Background

The ARFA program is a general purpose revenue supplement intended to fill a void that may be created due to a lagging economy, which causes a contraction of own source revenues. The idea behind supplementation of shrinking own source local revenues is to permit a maintenance of spending effort without resorting to local tax rate increases, or expenditure reductions, which might further retard economic recovery. It is expected that economic recovery will generate sufficient increases in tax collections to cover the loss of ARFA monies as the program is phased out. Nationally, the nine authorized quarters of ARFA payments are anticipated to be about $3.2 billion between July 1976 and September 1978. This represents approximately 1/2 of 1% of state-local revenue for the period.

ARFA was authorized by Title II of the Local Public Works Employment Act of 1976 (PL 94-369), and extended through FY 1978 by Title VI, Intergovernmental Anti-Recession Assistance Act of 1977 (PL 95-30). Quarters 1-4, with payments from November 1976 to April 1977, were funded under the original authorization. Quarters 5 and 6, for which payments were made in July and October, 1977, were substantially larger than earlier payments as a result of program changes recommended by President Carter's Economic Stimulus Package.

Starting with Quarter 5, quarterly total funding levels are set at $125 million plus $30 million for every 1/10% by which the national unemployment average exceeds 6% in the quarter ending 3 months before the funding quarter. If the average national unemployment rate in the reference quarter does not exceed 6%, or if the average national unemployment rate for the last month in the reference quarter does not exceed 6%, then no payments are made. Also, there is a $2.25 billion program ceiling for quarters 5-9, ending in September 1978.

One-third of each quarter's funds are distributed to states, two-thirds to localities. The funds are then distributed according to the allocations of the most recent general revenue sharing entitlements, with an adjustment for unemployment over 4.5%. If a state or locality experiences unemployment below 4.5% as either the average for the reference quarter or for the last month in the reference quarter, it receives no allocation.

Observations Concerning ARFA

o Approximately twenty-two percent of the total national ARFA allocation goes to the 48 LCG; the ARFA program is effectively targeted to high strain cities whereby they receive approximately 67% of ARFA allocations to the 48 cities, moderate strain cities receive 27%, while low strain cities receive 6%. (see Table 3-a).

o On a per capita basis, ARFA allocations over the life of the program average $18 for the 48 cities; again, ARFA provides significant assistance to the high strain cities who receive approximately $29 per person, while moderate strain cities receive $12, and low strain cities receive $7. (see Table 3-a).

o If Federal ARFA funds were discontinued, the tax burden of substituting property tax revenue for ARFA would fall heaviest on high strain cities; e.g., a property tax increase of 15¢ per $100 of fair market value would be required in high strain cities, while a 5¢ increase would be required in moderate strain cities, and only a 2¢ increase in low strain cities. (see Table 3-a).

o Removal of ARFA funds would create additional tax burdens for the 48 cities equal to approximately 2% of total adjusted own source revenues in 1978. ARFA allocations to high strain cities represent 2.5% of own source revenues, moderate strain allocations are 1.8%, and low strain allocations are 1.3% (see Table 3-a).

o If ARFA were annualized for census fiscal year 1979, the 48 large city governments would receive approximately an additional $152.8 million (current legislation extends ARFA to September, 1978, the first quarter of Census fiscal year 1979). This additional money would increase ARFA as a percentage of total operating revenues from 3% to 6%, ARFA as a percentage of own source revenues from .6% to 1.4%, and ARFA as a percentage of general revenue sharing from 13.0% to 32.5%. (see Table 3-b).

TABLE 3-a. ARFA SUMMARY

IMPACT OF ARFA ON THE FISCAL CONDITION OF 48 LARGE CITY GOVERNMENTS

	High Strain Cities	Moderate Strain Cities	Low Strain Cities	All 48
Total ARFA Allocation ($ Millions)	$458.7	$189.0	$41.5	$687.2
% of Total	67%	27%	6%	
Per Capita Total ARFA Allocations	$28.65	$12.01	$6.65	$18.04
Estimated '78 ARFA Allocations as an Equivalent Increase in Property Tax ($/100 FMV)	$.15	$.05	$.02	$.08
Estimated '78 ARFA Allocations as % of Adjusted Own Source Revenue	2.5%	1.8%	1.3%	2.1%

Supporting Schedules in Appendix A.

ARFA IN RELATION TO AGGREGATE FINANCES OF 48 LARGE CITY GOVERNMENTS

	Census Fiscal Years		
	1977 Ending Between 7/1/76 & 6/30/77	1978 Ending Between 7/1/77 & 6/30/78	1979 Ending Between 7/1/78 & 6/30/79
Projected ARFA Payments to 48 LCG ($ Millions)	$222.7	$362.6	$101.9*
ARFA as % of:			
Total Operating Revenues	.7%	1.0%	.3%
Own Source Revenues	1.4%	2.1%	.6%
General Revenue Sharing	25.7%	44.0%	13.0%

* If this figure were annualized for FY 1979, the estimates for ARFA, if the program were extended using the same funding formula, would be $254.7 million.

TABLE 3-b.

ARFA PAYMENTS FORECASTS

Census Fiscal Years 77, 78, 79
($ Millions)

Last day in City Fiscal year	City	1977 Ending 7/1/76 to 6/30/77	1978 Ending 7/1/77 to 6/30/78	1979 (under current legislation)	1979 (annualized) Ending 7/1/78 to 6/30/79
12/31	Atlanta	$ .9	$ 2.3	$ 1.9	$ 1.9
6/30	Baltimore	6.7	12.3	2.0	7.9
8/31	Birmingham	.0	1.9	1.4	1.4
6/30	Boston	6.5	6.6	1.1	4.2
6/30	Buffalo	3.7	4.8	.8	3.2
12/31	Chicago	9.4	19.9	9.6	12.2
12/31	Cincinnati	1.2	4.1	2.9	3.7
12/31	Cleveland	2.1	5.0	3.4	4.3
12/31	Columbus	.7	1.6	.8	1.0
9/30	Dallas	.0	.0	.0	.0
12/31	Denver	1.0	2.8	2.0	2.5
6/30	Detroit	19.9	22.1	3.7	14.8
2/28	El Paso	1.5	4.6	1.8	3.4
9/30	Fort Worth	.0	.4	.0	.0
6/30	Honolulu	3.2	4.4	.8	3.2
12/31	Houston	.4	1.4	.8	1.0
12/31	Indianapolis	.3	1.7	1.6	2.0
9/30	Jacksonville	.0	1.5	1.0	1.0
4/30	Kansas City	1.7	1.8	.2	.8
6/30	Long Beach	.9	1.1	.2	.7
6/30	Los Angeles	12.7	16.0	2.8	11.2
6/30	Louisville	2.0	.8	.1	.2
6/30	Memphis	1.4	.9	.1	.4
9/30	Miami	.0	4.1	3.1	3.1
12/31	Milwaukee	1.2	3.4	2.4	3.0
12/31	Minneapolis	.5	1.2	.7	.9
6/30	Nashville-Davidson	.7	.0	.0	.0
12/31	Newark	2.7	8.2	6.3	8.0
12/31	New Orleans	1.9	6.9	6.1	7.7
6/30	New York City	89.0	133.6	22.7	90.8
6/30	Norfolk	.8	1.6	.3	1.2
6/30	Oakland	3.0	3.9	.7	2.8
6/30	Oklahoma City	1.0	.4	.1	.2
12/31	Omaha	.5	.3	.0	.0
6/30	Philadelphia	16.0	28.6	4.8	17.8
6/30	Phoenix	1.8	2.0	.3	1.3
12/31	Pittsburgh	1.6	5.4	3.2	4.1
6/30	Portland	2.5	3.9	.7	2.8
4/30	St. Louis	3.9	8.1	1.3	5.2
12/31	St. Paul	.3	.7	.4	.5
7/31	San Antonio	.0	2.2	2.7	2.7
6/30	San Diego	3.1	4.8	.8	3.4
6/30	San Francisco	7.5	9.6	1.7	6.7
6/30	San Jose	1.4	1.7	.3	1.2
12/31	Seattle	1.0	2.6	1.6	2.0
12/31	Toledo	.4	1.4	.9	1.1
6/30	Tulsa	.8	.1	.0	.1
6/30	Washington, D.C.	4.9	9.9	1.8	7.1
	Totals	$222.7	$362.6	$101.9	$254.7

TABLE 3-c.

ARFA AS % OF GENERAL REVENUE SHARING

	Census FY 1977	Census FY 1978	Census FY 1979
Atlanta	13.8%	39.0%	35.2%
Baltimore	25.6	47.5	7.8
Birmingham	.0	25.7	19.2
Boston	33.7	36.9	6.7
Buffalo	47.4	64.0	11.1
Chicago	20.0	56.2	40.3
Cincinnati	12.8	45.6	34.1
Cleveland	15.6	41.7	32.1
Columbus	8.0	18.2	8.9
Dallas	.0	.0	.0
Denver	10.6	41.2	47.6
Detroit	51.8	60.2	10.6
El Paso	32.6	131.4	78.3
Fort Worth	.0	14.3	.0
Honolulu	23.9	32.8	6.0
Houston	2.5	9.6	6.1
Indianapolis	2.4	14.3	13.9
Jacksonville	.0	20.8	16.4
Kansas City	13.8	14.6	1.6
Long Beach	25.0	30.6	5.7
Los Angeles	30.1	36.0	6.0
Louisville	20.6	8.6	1.1
Memphis	11.3	7.2	.8
Miami	.0	59.4	50.0
Milwaukee	12.5	47.2	49.0
Minneapolis	11.6	40.0	38.9
Nashville-Davidson	6.1	.0	.0
Newark	37.5	139.0	137.0
New Orleans	12.6	53.5	57.0
New York City	34.3	51.8	8.9
Norfolk	11.3	23.5	4.5
Oakland	53.6	67.2	11.7
Oklahoma City	15.4	6.2	1.5
Omaha	13.9	11.5	.0
Philadelphia	30.9	55.1	9.2
Phoenix	18.7	20.8	3.1
Pittsburgh	13.1	49.5	33.3
Portland	25.8	39.8	7.0
St. Louis	27.5	57.9	9.4
St. Paul	6.1	15.2	9.3
San Antonio	.0	44.9	90.0
San Diego	40.3	60.8	9.8
San Francisco	42.4	56.1	10.3
San Jose	24.6	28.3	4.8
Seattle	12.5	37.1	27.1
Toledo	8.2	30.4	20.9
Tulsa	11.1	1.3	.0
Washington, DC	19.6	41.8	8.0
	25.7%	44.0%	13.0%

Note: The above totals reflect legislated funding through the quarter ending September, 1978. If the 1979 figures had been annualized extend through June, 1979, the total line in FY '79 would have been 32.5%.

B. LOCAL PUBLIC WORKS (LPW)

Background

The LPW program is designed to stimulate the economy through the construction of useful public projects that are in addition to projects already budgeted or approved for bond authority, and would not have been otherwise constructed due to the lack of assignable public resources of sufficient priority. Nationally, $6 billion is allocated to state and local governments for projects commencing between January 1977 and January 1978. This compares to a national state-local capital outlay of approximately $32.5 billion during the fiscal year ending June 30, 1976.

The extent to which projects undertaken with LPW funds are truly incremental to the on-going capital construction as budgeted cannot be determined without extensive field research. However, it is reasonable to assume that cities with a decreasing trend in capital outlay expenditures which may be caused by the inability to borrow or the insufficiency of resources to support higher capital construction expenditures, have used LPW funds as a substitution for their normal borrowing program or to support projects that would have been undertaken except for the scarcity of resources.

Under Round I, 70% of funds were granted for projects submitted by states or local governments with unemployment rates in excess of the national rate. The remaining 30% was granted to states and local governments with unemployment rates equal to or below the national unemployment rate. Projects in areas with an unemployment rate of 6.5 percent or more received priority.

Under Round II, $205 million of the $4 billion total was set-aside for Indian tribes, territories and government administration. 65% of the remaining funds, $3.795 billion, are allocated to each state based on its share of the total number of unemployed persons in all the states with an average unemployment rate greater than 6.5% during the preceding twelve months on the basis of relative severity of unemployment in such states.

The Public Works Employment Act of 1977 (PL 95-28) requires the Economic Development Administration to establish allocations for all state and local governments based on unemployment rates. Under the allocation formula, no total state area can receive more than $500 million, 12.5%, or less than $30 million of the national pool. A State area is defined as the composition of all governmental units within a state and the state government itself. State governments receive 8% of the total State area allocation and $1 million is set aside for each pocket of poverty area (project areas with at least 4,000 persons and unemployment greater than 8% in cities with no prior allocations) up to a maximum $20 million pocket of poverty set aside. The remainder of the State area allocation is distributed to local governments based on the 65/35 formula to primary cities (50,000 or more persons), balance of county, and counties with no primary city.

Concerning eligibility, eligible applicants include all of the states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Trust Territory of the Pacific Islands. The Pacific Islands were not eligible in Round I. At the local level, any political subdivision of a state such as a city, county, township, parish, general purpose unit of government, or school district and any Indian tribe is an eligible applicant.

With regard to project selection, under Round I projects within each state were ranked based on four criteria: the average number of unemployed workers in the project area for the most recent three months (30 percent), the 3 month average unemployment rate in the area (25 percent), the ratio of cost of project to number of man months required to complete project (30 percent), and the level of income in the applicant's project area (15 percent). Under Round II, projects were selected in accordance with the priority ranking submitted by each applicant. Additional criteria for choosing among projects include amount of funds requested compared to the size of the total local allocation, LPW awards under Round I, other projects selected in the area, population in the project area, construction employment impact, time necessary to begin construction, alleviation of critical local needs and long term benefits.

Observations Concerning LPW

o LPW allocations represent 32% of the total ESP funds allocated to the 48 large city governments. High strain cities receive 54.9% of the total LPW allocation, moderate strain cities receive 37.0%, and low strain cities receive 8.1%. (see Table 3-d).

o Per capita allocations to the 48 city governments are $27. High strain cities' per capita allocations are $35, which is higher than the national per capita allocation of $28. Moderate strain and low strain per capita allocations are $24 and $13 respectively, both lower than the national average. (see Table 3-d).

o Removal of LPW funds from high strain cities would require a property tax increase of 22 cents per $100 of full market value for full replacement (maintain same level of capital outlay) unless additional bonds were issued. Full replacement would cost 7 cents for low strain cities. The average increase for all 48 cities would be 16 cents. (see Table 3-d).

o LPW funds are 3.7% of adjusted own source revenues for high strain cities, 5.0% for moderate strain cities and 4.0% for low strain cities. Removal of funds would require equivalent increases in own source revenues or issuance of long term debt to maintain the same level of capital outlay. (see Exhibit A-4).

o Round II LPW allocations are 16% of 1978 capital outlay for the high strain cities, 10% for moderate strain cities and 9% for low strain cities. The lack of such funds in 1978 would have resulted in significant decreases in capital outlay for the high and moderate strain cities during fiscal 1978. The comparison of local public works funds to capital outlay indicates more than a marginal use for such funds but does not necessarily indicate severe fiscal stress if the funds were not available in succeeding fiscal years, since capital outlay may be supported by alternative funds (bonding) phased over longer periods of time. (see Table 3-d).

o Since capital projects are relatively long term (longer than one year) the fiscal life of the local public works program is spread over five city government fiscal years, 1977-1981. Within this time frame, the major fiscal impact on the 48 large cities occurs during City fiscal years 1978 and 1979. (see Table 3-g).

o The local public works allocation formula under Round II appears to provide a more proportionate distribution of funds than Round I. The 48 urban governments received 2.5%, $382 million, (although the program was doubled) more of the national allocation under Round II than Round I. (see Table 3-d).

TABLE 3-d.

LPW SUMMARY

IMPACT OF LPW ON THE FISCAL CONDITION OF 48 LARGE CITY GOVERNMENTS

	High Strain Cities	Moderate Strain Cities	Low Strain Cities	All 48
Total LPW Allocation ($ Millions)	$556.5	$374.6	$82.2	$1,013.3
% of Total	55%	37%	8%	
Per Capita Total LPW Allocations	$34.76	$23.80	$13.16	$26.60
Estimated '78 LPW Allocations as Equivalent Increase in Property Tax ($/100 FMV)	$.22	$.14	$.07	$.16
Estimated '78 LPW Allocations as % of Adjusted Own Source Revenue	3.7%	5.0%	4.0%	4.1%

Supporting Schedules in Appendix A.

LPW IN RELATION TO AGGREGATE FINANCES OF 48 LARGE CITY GOVERNMENTS

	Total	FY '77 (Round I)	FY '78 (Round II)
Allocations ($ Billions)			
National Allocation	$6.0	$2.0	$4.0
48 Largest City Government Allocations	1.0	.3	.7
Allocation to 48 Largest City Areas -- All Governmental Units	1.3	.4	.9
48 Largest City Government Portion of National Allocation	16.7%	15.0%	17.5%
Allocations as % of:			
Capital Outlay		5.7%	12.0%
Long Term Debt Issued		11.3%	26.4%
Total Operating Revenue		.9%	1.9%
Own Source Revenue		2.0%	4.1%

Estimated Disbursements ($ Millions)	1977	1978	1979
National Disbursements	$203.1	$2.347.4	$2,389.0
48 Largest City Governments Disbursements	34.4	397.0	403.6

TABLE 3-e. LOCAL PUBLIC WORKS ALLOCATIONS TO 48 LARGE CITY GOVERNMENTS

City	Round I Amount	Round I Number of Projects	Round II Amount	Round II Number of Projects	Total Amount	Total Number of Projects
Atlanta	$4.8	1	$5.0	1	$9.8	2
Baltimore	5.4	10	19.6	20	25.0	30
Birmingham	2.2	1	2.1	2	4.3	3
Boston	7.6	7	16.0	26	23.6	33
Buffalo	7.9	5	14.0	12	21.9	17
Chicago	22.7	7	34.4	16	57.1	23
Cincinnati	2.5	3	8.8	12	11.3	15
Cleveland	5.0	1	6.5	3	11.5	4
Columbus	2.7	4	4.8	6	7.5	10
Dallas	- 0 -	- 0 -	5.3	2	5.3	2
Denver	3.6	4	7.6	10	11.2	14
Detroit	22.4	5	23.8	12	46.2	17
El Paso	3.5	3	5.5	3	9.0	6
FortWorth	- 0 -	- 0 -	4.3	4	4.3	4
Honolulu	4.1	6	22.2	33	26.3	39
Houston	4.1	6	4.5	2	8.6	8
Indianapolis	4.1	2	12.3	17	16.4	19
Jacksonville	8.5	8	2.9	4	11.4	12
Kansas City	3.2	5	5.1	4	8.3	9
Long Beach	- 0 -	- 0 -	4.9	1	4.9	1
Los Angeles	25.4	33	29.8	48	55.2	81
Louisville	- 0 -	- 0 -	.6	2	.6	2
Memphis	3.5	6	1.7	4	5.2	10
Miami	6.5	2	7.6	2	14.1	4
Milwaukee	5.9	5	8.1	6	14.0	11
Minneapolis	.6	1	6.2	6	6.8	7
Nashville	3.1	3	.1	1	3.2	4
Newark	12.5	2	16.5	4	29.0	6
New Orleans	4.6	4	8.3	10	12.9	14
New York	102.2	49	187.1	80	289.3	129
Norfolk	1.9	1	2.7	5	4.6	6
Oakland	4.9	1	5.3	3	10.2	4
Oklahoma City	- 0 -	- 0 -	6.4	2	6.4	2
Omaha	.1	1	13.7	10	13.8	11
Philadelphia	6.9	5	43.7	31	50.6	36
Phoenix	- 0 -	- 0 -	8.1	12	8.1	12
Pittsburgh	- 0 -	- 0 -	13.0	18	13.0	18
Portland	.3	1	9.1	7	9.4	8
St. Louis	4.1	1	10.3	5	14.4	6
St. Paul	- 0 -	- 0 -	3.9	1	3.9	1
San Antonio	1.4	2	4.2	2	5.6	4
San Diego	1.6	1	12.9	7	14.5	8
San Francisco	6.0	3	30.0	18	36.0	21
San Jose	- 0 -	- 0 -	6.7	3	6.7	3
Seattle	- 0 -	- 0 -	12.1	13	12.1	13
Toledo	- 0 -	- 0 -	8.4	8	8.4	8
Tulsa	- 0 -	- 0 -	1.4	5	1.4	5
Washington, D.C.	10.0	7	30.0	15	40.0	22
Total	$315.8	206	$697.5	518	$1,013.3	724

Table 3-f.

Comparison of Local Public Works Allocations to 48 Large City Governments and Allocation to Total City Area

($ Millions)

	Total Allocation to City Gov'ts		Total Allocation to City Areas	
	Amount	Number	Amount	Number
Atlanta	$ 9.8	2	$ 14.1	5
Baltimore	25 0	30	26.1	31
Birmingham	4.3	3	6.7	6
Boston	23.6	33	32.6	35
Buffalo	21.9	17	23.0	21
Chicago	57.1	23	66.8	33
Cincinnati	11.3	15	19.3	19
Cleveland	11.5	4	18.8	7
Columbus	7.5	10	19.5	21
Dallas	5.3	2	5.3	2
Denver	11.2	14	14.6	20
Detroit	46.2	17	59.6	22
El Paso	9.0	6	11.9	13
Fort Worth	4.3	4	4.3	4
Honolulu	26.3	39	27.9	43
Houston	8.6	8	14.5	10
Indianapolis	16.4	19	18.0	21
Jacksonville	11.4	12	16.4	13
Kansas City	8.3	9	10.2	11
Long Beach	4.9	1	6.6	5
Los Angeles	55.2	81	82.1	103
Louisville	.6	2	8.4	5
Memphis	5.2	10	5.6	11
Miami	14.1	4	28.2	11
Milwaukee	14.0	11	18.2	19
Minneapolis	6.8	7	9.4	13
Nashville-Davidson	3.2	4	3.2	4
Newark	29.0	6	32.1	10
New Orleans	12.9	14	15.8	19
New York	289.3	129	295.0	136
Norfolk	4.6	6	4.6	6
Oakland	10.2	4	24.6	11
Oklahoma City	6.4	2	10.2	7
Omaha	13.8	11	28.0	23
Philadelphia	50.6	36	70.5	49
Phoenix	8.1	12	21.1	24
Pittsburgh	13.0	18	16.2	22
Portland	9.4	8	11.9	12
St. Louis	14.4	6	19.3	7
St. Paul	3.9	1	6.1	6
San Antonio	5.6	4	14.1	12
San Diego	14.5	8	32.4	21
San Francisco	36.0	21	40.3	23
San Jose	6.7	3	12.3	19
Seattle	12.1	13	15.5	17
Toledo	8.4	8	8.4	8
Tulsa	1.4	5	1.4	5
Washington, D.C.	40.0	22	40.0	22
Total	$1,013.3	724	$1,291.1	967

TABLE 3-q.

ESTIMATED LPW DISBURSEMENTS
($ Millions)

	Census Fiscal Year					
	1977	1978	1979	1980	1981	Total
Atlanta	$.3	$3.8	$3.9	$1.3	$.7	$9.8
Baltimore	.9	9.9	10.0	3.1	1.1	25.0
Birmingham	.1	1.7	1.8	.5	.2	4.3
Boston	.8	9.3	9.4	3.0	1.1	23.6
Buffalo	.8	8.7	8.8	2.6	1.0	21.9
Chicago	1.9	22.3	22.7	7.4	2.8	57.1
Cincinnati	.4	4.5	4.5	1.4	.5	11.3
Cleveland	.4	4.5	4.5	1.5	.6	11.5
Columbus	.2	3.0	3.1	.9	.3	7.5
Dallas	.1	2.1	2.2	.7	.2	5.3
Denver	.4	4.5	4.5	1.3	.5	11.2
Detroit	1.6	18.1	18.4	5.9	2.2	46.2
El Paso	.3	3.5	3.6	1.2	.4	9.0
Fort Worth	.1	1.6	1.8	.6	.2	4.3
Honolulu	.9	10.3	10.5	3.4	1.2	26.3
Houston	.3	3.3	3.3	1.2	.5	8.6
Indianapolis	.5	6.3	6.5	2.2	.9	16.4
Jacksonville	.4	4.5	4.5	1.5	.5	11.4
Kansas City	.3	3.3	3.3	1.0	.4	8.3
Long Beach	.2	1.9	2.0	.6	.2	4.9
Los Angeles	1.9	21.6	22.0	7.0	2.7	55.2
Louisville	-	.2	.3	.1	-	.6
Memphis	.2	2.1	2.2	.5	.2	5.2
Miami	.5	5.5	5.6	1.8	.7	14.1
Milwaukee	.5	5.4	5.5	1.9	.7	14.0
Minneapolis	.2	2.7	2.7	.9	.3	6.8
Nashville-Davidson	.1	1.3	1.3	.4	.1	3.2
Newark	1.0	11.3	11.5	3.8	1.4	29.0
New Orleans	.4	5.2	5.3	1.5	.5	12.9
New York	9.8	113.1	115.2	36.9	14.3	289.3
Norfolk	.2	1.9	1.9	.5	.1	4.6
Oakland	.3	4.0	4.1	1.3	.5	10.2
Oklahoma City	.2	2.6	2.6	.7	.3	6.4
Omaha	.5	5.4	5.5	1.8	.6	13.8
Philadelphia	1.7	19.7	20.1	6.5	2.6	50.6
Phoenix	.2	3.3	3.3	1.0	.3	8.1
Pittsburgh	.4	5.2	5.3	1.6	.5	13.0
Portland	.3	3.8	3.8	1.1	.4	9.4
St. Louis	.5	5.6	5.7	1.9	.7	14.4
St. Paul	.1	1.6	1.7	.4	.1	3.9
San Antonio	.2	2.1	2.2	.8	.3	5.6
San Diego	.5	5.6	5.8	1.9	.7	14.5
San Francisco	1.2	14.1	14.3	4.6	1.8	36.0
San Jose	.2	2.6	2.7	.9	.3	6.7
Seattle	.4	4.7	3.8	1.6	.6	12.1
Toledo	.3	3.3	3.3	1.1	.4	8.4
Tulsa	-	.5	.6	.2	.1	1.4
Washington, D.C.	1.4	15.7	16.0	5.0	1.9	40.0
48 LCG Total	$34.1	$397.2	$404.6	$129.0	$48.6	$1,013.3
National Disbursement	$203.1	$2,347.4	$2,389.0	$765.8	$294.7	$6,000.0

TABLE 3-h.

LOCAL PUBLIC WORKS ALLOCATIONS TO 48 LARGE CITY GOVERNMENTS AS A % OF CAPITAL OUTLAY

	Round I Fiscal 1977	Round II Fiscal 1978
Atlanta	6.3%	6.7%
Baltimore	1.9	6.0
Birmingham	5.1	4.6
Boston	5.8	11.1
Buffalo	10.2	16.2
Chicago	16.5	25.7
Cincinnati	3.0	9.5
Cleveland	7.1	8.4
Columbus	7.5	12.6
Dallas	- 0 -	5.1
Denver	3.6	6.8
Detroit	21.9	24.4
El Paso	21.2	32.5
Fort Worth	- 0 -	20.0
Honolulu	4.5	21.3
Houston	2.5	2.4
Indianapolis	7.0	20.1
Jacksonville	5.4	1.6
Kansas City	7.0	11.3
Long Beach	- 0 -	11.6
Los Angeles	7.8	9.2
Louisville	- 0 -	.9
Memphis	3.1	1.4
Miami	25.5	25.7
Milwaukee	15.3	21.4
Minneapolis	1.0	9.4
Nashville-Davidson	3.1	.1
Newark	62.8	79.3
New Orleans	7.2	11.4
New York	7.1	12.9
Norfolk	9.0	15.3
Oakland	17.2	19.7
Oklahoma City	- 0 -	22.5
Omaha	.2	25.8
Philadelphia	3.3	19.1
Phoenix	- 0 -	7.9
Pittsburgh	- 0 -	64.4
Portland	1.7	51.4
St. Louis	18.0	42.9
St. Paul	- 0 -	20.3
San Antonio	.7	1.9
San Diego	3.6	28.1
San Francisco	5.8	27.1
San Jose	- 0 -	15.8
Seattle	- 0 -	22.6
Toledo	- 0 -	20.0
Tulsa	- 0 -	2.0
Washington, D.C.	4.8	12.8
Weighted Average Percent	5.7%	12.0%

TABLE 3-i. LOCAL PUBLIC WORKS ALLOCATIONS TO 48 LARGE CITY GOVERNMENTS AS A % OF LONG-TERM DEBT ISSUE

	Round I Fiscal 1977	Round II Fiscal 1978
Atlanta	9.6%	10.0%
Baltimore	15.0	54.4
Birmingham	3.5	3.2
Boston	10.0	20.8
Buffalo	23.5	41.7
Chicago	23.5	35.6
Cincinnati	11.5	40.0
Cleveland	47.2	52.8
Columbus	10.7	19.0
Dallas	- 0 -	12.8
Denver	9.2	19.4
Detroit	61.2	65.0
El Paso	129.6	203.7
Fort Worth	- 0 -	20.4
Honolulu	18.0	97.4
Houston	5.3	5.8
Indianapolis	17.2	51.7
Jacksonville	13.4	4.6
Kansas City	16.2	26.3
Long Beach	- 0 -	59.8
Los Angeles	10.5	12.3
Louisville	- 0 -	2.2
Memphis	9.1	4.8
Miami	36.1	43.2
Milwaukee	20.3	27.3
Minneapolis	1.6	16.6
Nashville-Davidson	6.3	.2
Newark	62.5	82.5
New Orleans	27.2	49.1
New York	7.8	14.2
Norfolk	47.5	67.5
Oakland	36.3	39.3
Oklahoma City	- 0 -	15.5
Omaha	.8	104.6
Philadelphia	5.6	35.6
Phoenix	- 0 -	11.8
Pittsburgh	- 0 -	92.9
Portland	5.1	154.2
St. Louis	34.2	78.6
St. Paul	- 0 -	17.0
San Antonio	1.3	3.5
San Diego	15.7	114.2
San Francisco	9.4	47.1
San Jose	- 0 -	37.2
Seattle	- 0 -	39.3
Toledo	- 0 -	65.1
Tulsa	- 0 -	5.1
Washington, D.C.	6.8	20.6
Weighted Average Percent	11.3%	26.4%

TABLE 3-j.

SUMMARY OF TYPE, NUMBER AND AMOUNT OF LOCAL PUBLIC WORKS PROJECTS FOR 48 LARGE CITY GOVERMENTS 1/

($ Millions)

Description	Round I		Round II		Total	
	Amount	Number	Amount	Number	Amount	Number
Street, Rd., Highway	$ 49.8	30	$ 94.2	71	$ 144.0	101
Water, Sewer System	33.6	20	82.8	51	116.4	71
Gym, Swimming Pool	7.9	10	40.2	55	48.1	65
Schools 2/	33.1	11	51.5	30	84.6	41
Multiple Utility	30.2	11	26.6	19	56.8	30
Misc, Projects, Structures	19.4	18	56.6	37	76.0	55
Munic Off Bldg, Crthse	1.4	3	43.3	23	44.7	26
Garage, Parking Lot	9.5	5	25.3	11	34.8	16
Police Stations, Jail, Prison	3.3	3	29.7	12	33.0	15
Combo-Wtr/Swr, St/Rd.	13.2	7	21.9	12	35.1	19
Storm Drain	12.3	22	12.5	13	24.8	35
Park Development	3.2	5	14.7	33	17.9	38
Hospital, Clinic, Health Center	7.5	2	19.2	14	26.7	16
Arena, Stadium	5.0	1	12.4	9	17.4	10
Sidewalk, Curb	5.1	3	16.9	14	22.0	17
Community Center	8.6	4	16.1	15	24.7	19
Museum, Cultural Center	8.3	5	17.7	10	26.0	15
Library	.8	1	13.6	8	14.4	9
Auditorium, Theater	5.4	2	12.7	7	18.1	9
Bridge	11.2	6	17.5	16	28.7	22
Ind Bldg, Whse, Mkt	1.0	3	11.2	8	12.2	11
Dwelling Units	5.1	3	8.2	5	13.3	8
Site Development	6.0	3	5.9	6	11.9	9
Electric Power Plant	.8	1	7.6	3	8.4	4
Fire Rescue Station	10.2	13	5.8	9	16.0	22
Right of Way Clearance	5.5	3	4.9	9	10.4	12
Port Facility	5.9	3	15.7	8	21.6	11
Historic Building	.5	1	4.5	5	5.0	6
Drainage Ditch	1.0	2	4.8	4	5.8	6
Air, Rail, Water Terminal	3.5	2	3.5	1	7.0	3
Dams, Levees	4.9	2	---	---	4.9	2
Railroad, Trolley Line	2.6	1	---	---	2.6	1
Total	315.8	206	697.5	518	1,013.3	724

1/ These figures reflect the local public works funds allocated directly to the city government. They do not include LPW funds awarded to a state, county, school district or special purpose government which were spent within the city. The Economic Development Administration includes these amounts in determining a city's total allocation. If these amounts are included, the totals would be $394.0 million and 252 projects under Round I, $897.1 million and 715 projects under Round II, and $1,291.1 million and 967 projects total.

2/ The amount and number of school projects would be higher under Round II because Round II legislation mandated more equitable allocation to school districts which are separate governmental jurisdictions from most city governments.

C. Public Service Jobs (CETA)

Background

The CETA program is designed to afford job opportunities in the public sector to those persons who have difficulty finding employment. These job opportunities are supposed to be largely of a "project" nature, i.e., supportive of essential and basic governmental activities. The CETA concept is to relieve unemployment temporarily by placing persons in public service jobs until the recovery of the economy is sufficient to support fuller employment in all sectors of the economy. Approximately $6.6 billion is allocated through the stimulus component between May 1977 and September 1978 for some 725,000 jobs in the state-local sector. The Carter stimulus component of these totals includes $3.8 billion for 415,000 jobs. This compares with an estimated total state-local work force of approximately 10.5 million, and an estimated national state-local payroll for an equivalent period of $13.12 billion (1976 data).

As reported by the Employment and Training Administration of the Department of Labor, the Comprehensive Employment and Training Act (CETA; PL 93-203) was approved December 28, 1973, and amended by the Emergency Jobs Unemployment Assistance Act on December 31, 1974, (PL 93-607), extended in October 1976, to provide stimulus and sustainment jobs to reduce unemployment (PL 94-444), with current funding levels established by the economic stimulus appropriation of May 1977. The objective of CETA is to improve the utilization of the nation's human resources by providing job training and employment assistance to the economically disadvantaged, unemployed, and underemployed. CETA represents a reversal of the centralized, categorical approach employed in earlier manpower legislation. The CETA delivery system is decentralized, since block grants to state and local authorities enable them to design and operate their programs in a manner best suited to meet the needs of their local constituents.

Title II

Title II authorizes a program of developmental, transitional public service employment and other manpower services in areas with 6.5% or higher unemployment. The allocations are calculated by using the three highest consecutive monthly unemployment rates above 6.5 percent among the latest 12 months for which data are available.

Persons eligible for these Title II jobs must be residents of an area of substantial unemployment and either unemployed (for at least 30 days before applying) or underemployed. Special consideration is given persons who are the most severely disadvantaged in terms of the length of time they have been unemployed and their prospects for finding employment without Title II's assistance. Special consideration is also given veterans, welfare recipients, and former manpower trainees.

Administrative control of the probam is maintained by state and local prime sponsors. Prime sponsors are any state or unit(s) of local government which have been designated by DOL for carrying out CETA programs.

Title VI

Title VI contains the bulk of the public service employment slots under CETA. The jobs are in community agencies such as schools, hospitals, libraries, parks and recreation centers, public works, and police and fire departments. Title VI employees are paid comparable wages for comparable work performed by regular workers and receive the same fringe benefits.

Title VI base funds are being distributed by a three-part formula which requires that:

1. 50 percent be distributed among eligible applicants in proportion to the relative number of unemployed persons who reside in areas within the jurisdiction of the applicant as compared to the number of unemployed persons nationwide;

2. 25 percent be distributed among eligible applicants in accordance with the number of unemployed residing in areas of substantial unemployment within the jurisdiction of the applicant compared to the number of unemployed nationwide; and

3. 25 percent be distributed among eligible applicants based upon the proportionate excess number of unemployed persons who reside within the jurisdication of a specific applicant, compared to the total excess number of unemployed persons who reside within the jurisdiction of all applicants; i.e., each applicant's excess unemployed compared to the sum of all applicants' excess unemployed.

Additional discretionary funds, as under Title II, are available for allocation based on the judgement of the Secretary of Labor as to the severity of unemployment in given areas.

Observations Concerning CETA

o CETA allocations represent 54% of ESP funds allocated to the 48 large city governments. CETA appears to be less effectively targeted to high strain cities than ARFA and LPW. High strain cities receive only 46% of CETA funds to the 48 large cities whereas they receive 67% and 55% under ARFA and LPW respectively. Moderate strain cities receive 41% and low strain cities receive 13% under CETA. (See Table 3-K & Exhibit A-1).

o Per capita allocations under CETA are $43 for high strain cities, $38 for moderate strain cities and $31 for low strain cities. Per capita allocations to all the 48 cities ($38) were higher than national per capita allocations ($31). (see Table 3-k & Exhibit A-2).

o If CETA were discontinued, equivalent increases in property taxes would be 28¢ for high strain cities, 21¢ for moderate strain cities and 15¢ for low strain cities per $100 of full market value. (see Table 3-k & Exhibit A-3).

o In order to maintain the same level of jobs and services if CETA were discontinued, adjusted own source revenues would have to increase an average of 4.7% for high strain cities, 7.2% for moderate strain cities and 8.0% for low strain cities. CETA is a larger percentage of own source revenues for moderate and low strain cities than for high strain cities because the latter have smaller revenue bases. (see Table 3-k & Exhibit A-4).

o CETA employees represent 11% of 1975 full time equivalent workforce for the high strain cities, 15% for moderate strain cities and 18% for low strain cities. Removal of CETA funds would probably cause considerable layoffs and reduced services among the 48 cities, an average of 13%. (see Table 3-A & Exhibit A-5).

o CETA stimulus allocations for Public Service jobs under Titles II and VI represent an average of over 5.8% of total own source revenues for the 48 large cities. This average reflects a high of approximately 17% for Newark, Pittsburgh, Phoenix, and Miami, and a low of approximately 3% for New York, Washington, D.C. and Dallas. (see Exhibit A-4).

o While CETA funds are not intended to support jobs which are functioning in critical city services, it is possible that some CETA positions are used in essential service areas. This could be particularly true for cities that have been experiencing declines in their permanent workforce due to revenue constraints and which have a high ratio of CETA workforce to city workforce.

TABLE 3-k. CETA SUMMARY

IMPACT OF CETA ON THE FISCAL CONDITION OF 48 LCG's

	High Strain Cities	Moderate Strain Cities	Low Strain Cities	All 48
Total CETA Allocations ($ Millions)	$684.3	$597.5	$192.0	$1,473.8
% of Total	46%	41%	13%	
Per Capita Total CETA Allocations	$42.74	$37.96	$30.74	$38.69
Estimated 1978 CETA Allocations as Equivalent Increase to Property Tax ($/100 FMV)	$.28	$.21	$.15	$.22
Estimated 1978 CETA Allocations as % of Adjusted Own Source Revenues	4.7%	7.2%	8.0%	5.8%

Supporting Schedules in Appendix A.

CETA IN RELATION TO AGGREGATE FINANCES OF 48 LCG's

Allocations (Dollars and Jobs)

National Allocation	$6.6 billion
48 Largest City Governments Allocations	1.47 billion
48 Largest City Governments Portion of the National Allocation	22.7%
Jobs Created by CETA - National	725,000
Jobs Created by CETA - City (48 LCG)	106,300
48 Largest City Governments Portion of National Jobs	14.7%
CETA Allocations as a percentage of:	
October Payroll	8.1%
Total Operating Revenue	3.5%
CETA Jobs as a percentage of:	
Baseline Workforce	16.4%

TABLE 3-1.

TOTAL CETA ALLOCATIONS
(5/77-9/78)

	Sustain.[1] (50 - II 260 - VI)	Carter Stim.[2] (75 - II 340 - VI) ($ Millions)	Total Economic Stimulus
Atlanta	$14.8	$13.5	$28.3
Baltimore	7.1	23.5	30.4
Birmingham	2.3	6.9	9.2
Boston	14.2	18.1	32.3
Buffalo	15.1	12.2	27.3
Chicago	40.8	63.1	103.9
Cincinnati	5.7	13.4	19.1
Cleveland	6.8	17.5	24.3
Columbus	4.0	14.4	18.4
Dallas	2.2	10.0	12.2
Denver	3.7	10.4	14.1
Detroit	38.5	20.6	59.1
El Paso	3.4	12.0	15.4
Fort Worth	1.8	4.5	6.3
Honolulu	12.4	12.5	24.9
Houston	5.2	19.7	24.9
Indianapolis	10.5	15.3	25.8
Jacksonville	6.0	5.7	11.7
Kansas City	8.3	7.3	15.7
Long Beach	4.4	8.1	12.5
Los Angeles	55.1	63.4	118.5
Louisville	3.1	7.6	10.7
Memphis	5.4	5.6	11.0
Miami	6.7	13.8	20.5
Milwaukee	12.0	11.6	23.6
Minneapolis	6.6	9.6	16.2
Nashville-Davidson	3.5	3.4	6.9
Newark	13.2	13.9	27.1
New Orleans	18.3	1.7	20.0
New York	130.3	167.7	298.0
Norfolk	2.2	4.5	6.7
Oakland	11.3	10.4	21.7
Oklahoma City	1.5	7.6	9.1
Omaha	2.7	5.1	7.8
Philadelphia	37.8	30.4	68.2
Phoenix	13.5	20.3	33.8
Pittsburgh	9.0	10.7	19.7
Portland	4.7	13.1	17.8
St. Louis	6.3	17.8	24.1
St. Paul	6.6	4.2	10.8
San Antonio	6.4	15.1	21.5
San Diego	19.7	18.3	38.0
San Francisco	22.6	17.0	39.6
San Jose	7.3	10.9	18.2
Seattle	10.6	11.8	22.4
Toledo	4.8	9.5	14.3
Tulsa	1.2	3.9	5.1
Washington, D.C.	15.7	11.0	26.7
	$645.3	$828.5	$1,473.8

1/ Sustainment allocations reflect funding for 50,000 jobs under Title II and 260,000 jobs under Title VI.

2/ Stimulus allocations reflect funding for 75,000 jobs under Title II and 34,000 jobs under Title VI.

TABLE 3-m.

TOTAL CETA JOBS TO 48 CITY AREAS

	Jobs Thru CETA Titles II & VI 1/	Baseline FTE '75 w/o CETA II & VI	CETA as % of Baseline Workforce 2/
	(In Thousands)		
Atlanta	3.1	8.9	34.8
Baltimore	3.3	40.5	8.2
Birmingham	1.0	3.7	27.0
Boston	3.5	24.9	14.1
Buffalo	3.0	13.2	22.7
Chicago	11.3	48.8	23.2
Cincinnati	2.1	17.4	12.1
Cleveland	2.6	12.6	20.6
Columbus	2.0	6.7	29.9
Dallas	1.3	13.3	9.8
Denver	1.5	12.3	12.2
Detroit	6.4	20.5	31.2
El Paso	1.7	3.5	48.6
Fort Worth	.7	4.4	15.9
Honolulu	2.7	8.9	30.3
Houston	2.7	14.3	18.9
Indianapolis	2.8	11.5	24.3
Jacksonville	1.3	10.4	12.5
Kansas City	1.7	6.5	26.2
Long Beach	1.4	5.1	27.5
Los Angeles	12.9	46.9	27.5
Louisville	1.2	5.6	21.4
Memphis	1.2	21.7	5.5
Miami	2.2	3.7	59.5
Milwaukee	2.6	9.7	26.8
Minneapolis	1.8	5.5	32.7
Nashville-Davidson	.8	18.0	4.4
Newark	2.9	18.4	15.8
New Orleans	2.2	10.5	21.0
New York	32.4	347.7	9.3
Norfolk	.7	11.5	6.1
Oakland	2.4	4.4	54.5
Oklahoma City	1.0	3.8	26.3
Omaha	.8	3.7	21.6
Philadelphia	7.4	38.0	19.5
Phoenix	3.7	7.4	50.0
Pittsburgh	2.1	5.6	37.5
Portland	1.9	4.7	40.4
St. Louis	2.6	13.5	19.3
St. Paul	1.2	3.4	35.3
San Antonio	2.3	11.1	20.7
San Diego	4.1	6.9	59.4
San Francisco	4.3	21.6	19.9
San Jose	2.0	3.7	54.1
Seattle	2.4	8.8	27.3
Toledo	1.6	4.0	40.0
Tulsa	.6	3.3	18.2
Washington, D. C.	2.9	45.8	6.3
	160.3	976.3	16.4%

1/ Stimulus jobs derived from: $\frac{\text{Total CETA Allocations}}{\text{Avg. Unit Cost (\$9,200)}}$

2/ Reflects full-time-equivalent employees without CETA jobs, with the exception of cities' portion of 50,000 jobs under Title II sustainment.

TABLE 3-n. CETA JOBS TO 48 CITY GOVERNMENTS *

	Jobs Thru CETA Titles II & VI (In Thousands)	Baseline FTE (w/o CETA Titles II & VI) ('75) (In Thousands)	CETA As % of Baseline Workforce	Total Stim. All. As % Oct. Pay
Atlanta	2.5	8.9	27.5 %	16.8 %
Baltimore	2.6	40.5	6.5	3.6
Birmingham	.8	3.7	21.3	13.4
Boston	2.8	24.9	11.1	4.9
Buffalo	2.4	13.2	17.9	7.9
Chicago	8.9	48.8	18.3	8.8
Cincinnati	1.7	17.4	9.6	6.1
Cleveland	2.1	12.6	16.3	9.8
Columbus	1.6	6.7	23.6	12.3
Dallas	1.0	13.3	7.7	4.2
Denver	1.2	12.3	9.6	4.3
Detroit	5.1	20.5	24.6	3.6
El Paso	1.3	3.5	38.4	22.8
Fort Worth	.6	4.4	12.6	7.0
Honolulu	2.1	8.9	23.9	12.1
Houston	2.1	14.3	14.9	7.4
Indianapolis	2.2	11.5	19.2	12.8
Jacksonville	1.0	10.4	9.9	5.5
Kansas City	1.3	6.5	20.7	11.6
Long Beach	1.1	5.1	21.7	7.9
Los Angeles	10.2	46.9	21.7	8.5
Louisville	.9	5.6	16.9	10.0
Memphis	.9	21.7	4.3	2.4
Miami	1.7	3.7	47.0	20.8
Milwaukee	2.1	9.7	21.2	10.0
Minneapolis	1.4	5.5	25.8	10.7
Nashville-Davidson	.6	18.0	3.5	2.1
Newark	2.3	18.4	12.5	8.1
New Orleans	1.7	10.5	16.6	13.9
New York	25.6	347.7	7.4	3.6
Norfolk	.6	11.5	4.8	3.3
Oakland	1.9	4.4	43.2	14.9
Oklahoma City	.8	3.8	20.8	11.8
Omaha	.6	3.7	17.1	10.9
Philadelphia	5.8	38.0	15.4	7.3
Phoenix	2.9	7.4	39.5	16.7
Pittsburgh	1.7	5.6	29.6	20.5
Portland	1.5	4.7	31.9	14.9
St. Louis	2.1	13.5	15.2	9.9
St. Paul	.9	3.4	27.9	12.1
San Antonio	1.8	11.1	16.4	9.2
San Diego	3.2	6.9	46.9	19.5
San Francisco	3.4	21.6	15.7	7.0
San Jose	1.6	3.7	42.7	15.8
Seattle	1.9	8.8	21.6	10.1
Toledo	1.3	4.0	31.6	16.2
Tulsa	.5	3.3	14.4	6.6
Washington D. C.	2.3	45.8	5.0	2.1
	126.6	976.3	13.0 %	6.4 %

*Based on the national average for city-support vs. community-based organization jobs, City-support jobs are 79% of total jobs. Therefore, CETA jobs supporting city government equal total CETA jobs times .79.

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Chapter IV

Methodology

Chapter Four describes the data sources and methodology for the analysis of the programs and development of the fiscal strain index.

IV. METHODOLOGY

A. Data Collection

Data utilized in carrying out this analysis have been provided by the agencies within the Federal government responsible for administering the programs and by the Bureau of the Census. The data have been used without audit or verification. Significant refinement of the data was required. Such refinement included the use of economic forecasts for projections, normalization of revenues, and development of the fiscal strain index. Census data have not been compared with source material from each city, such as financial statements. Hence, the Census data represent only a close approximation of city finances.

A five-year historical data base containing pertinent revenue and expense information was extracted from the Census publication City Government Finances, 1972 to 1976, for the 48 largest city governments. Information collected included general revenue (e.g., state, local, Federal), own source revenues, and utility revenues. Own source revenues included property, sales, income and other taxes and charges. Expense data included general expenses, utility expenses, employee retirement contributions and debt retirement. Other data collected from City Government Finances included capital outlay, long and short term debt issued and outstanding, and fixed costs.

A five-year history of full time equivalent workforce and payroll for the 48 cities was extracted from the Census publication City Employment, 1972-1976.

Specific data on each program were obtained from the respective agency: ARFA - Office of Revenue Sharing, Treasury Department; LPW - Economic Development Administration, Department of Commerce; and CETA - Employment and Training Administration, Department of Labor.

B. Data Constraints

Reliance

A basic problem associated with this evaluation is the inability to determine actual reliance. The most accurate way to measure reliance is with the use of an historical financial model of the state and local sector. The model would have two components; (a) comparison of the state/local sector to the national economy, and (b) the individual state and local government budgets and economies compared to the national and regional economies. Mathematical analysis would be used to observe historical changes in state/local fiscal condition and the impact of the ESP programs.

Without such a model, however, it is difficult to isolate the effects of the ESP programs individually or collectively.

Another problem is the use of national source data instead of local source data to develop a timely and uniform evaluation. The best measures of reliance would combine field surveys with modeling in arriving at a judgment on reliance.

There are different definitions of reliance among researchers and among local governments themselves. Primarily, this study estimates local reliance, i.e., dependency, using per capita allocations and revenue substitution as measured against the property tax. Secondarily, ESP funds as a percentage of local revenues are used to measure reliance.

Normalization

The ESP programs will have a different fiscal impact on local governments depending upon the number and type of services provided by the various jurisdictions. Governments responsible for the provision of education, welfare and hospitals would appear to be less reliant on ESP than governments which do not provide such services because the former would have a comparatively higher revenue and expenditure base against which the size of the ESP would appear smaller.

To correct for different levels of services provided, "normalization" should adjust for all variable local services so that revenues supporting common services provided by all governments could be compared. Limitations of data, however, on the revenue-side of local government finances restrict the comparative analysis of local revenues. Nonetheless, this study did attempt "normalization", by adjusting own source revenues for education taxes (see p. 47).

Local Fiscal Years

Another difficulty in comparing local governments actual ESP impact results from the wide range of local fiscal year endings among the 48 city governments. This reports uses the Census definition of June 30 fiscal year end and accordingly converts the 48 governments fiscal years ending on 2/28, 4/30, 6/30, 7/31, 8/31, 9/30, and 12/31 to a common June 30 year.

Fungibility

Since monies from the three ESP programs are fungible, it is difficult to determine the actual use and thus the reliance of specific local programs and services on ESP. This is especially true for ARFA and CETA which are closely tied to the subsidization of current operating expenses and payrolls and frequently cannot be readily distinguished from other local revenues.

There is also fungibility between CETA and ARFA. The payrolls of urban governments are directly subsidized (in some cases, in excess of 20 percent of total payrolls) by the CETA programs for meeting city service levels. However, since ARFA is an unrestricted revenue source for these governments, and also taking into account the basic fungibility of operating revenues, ARFA assistance in practice also subsidizes payrolls.

LPW is less fungible than both CETA and ARFA. Nevertheless, while local public works funds are not intended to replace local funds appropriated for capital projects, there is evidence that some substitution of LPW projects for local capital budget items and for issuance of long-term debt for capital projects has occurred.

C. DATA REFINEMENTS AND ADJUSTMENTS

Normalization of Revenues

In order to enhance comparability, own source revenues for the 48 large city governments were adjusted to net-out school taxes. Utilizing the Office of General Revenue Sharing method for adjusting total taxes, school taxes were calculated by taking the ratio of tax revenues to total revenues in the general fund, and multiplying that ratio by the amount of expenditure or transfer of monies for educational purposes from the general fund. The nine cities affected by this adjustment included Baltimore, Boston, Buffalo, Memphis, Nashville, Newark, New York, Norfolk and Washington, D.C. While other adjustments are desirable in order to arrive at improved normalized data, such as adjusting for welfare responsibilities, data limitations prevented anything other than the school tax adjustment.

Economic Projections of Own Source Revenue

Problems of the national economy bear heavily on the 48 large city governments. For example, recession impacts upon the budgets of urban governments primarily by depressing sales and income tax yields, and by pushing welfare, unemployment, and related costs up. Moreover, inflation is a significant cost-push factor for urban city budgets since nearly three quarters of these budgets are composed of uncontrollable expenses such as salaries, wages, and fringe benefits frequently mandated under negotiated labor contracts.

In the context of the ESP analysis, it was therefore necessary to assess the effect of national economic trends on the local economies of the 48 large city governments. Treasury's Office of Economic Policy undertook the preparation of projections of receipts from property, sales and income taxes for the 48 large city governments for 1977, 1978 and 1979. These projections were limited to economic data only since it was not possible to account for a specific city's revenue authority, or its willingness or ability to annex new territory to increase its tax base.

The projection method involved forecasting the income, sales, and property tax collections in the total state and local sector for 1977, 1978, and 1979. These forecasts were based upon National Income Account variables that are reasonable proxies for tax receipts. An index was developed

to express the relationship of the growth in aggregate state-local tax collections in the forecast period to the actual growth in aggregate tax collections during the period 1972-1976. For example, aggregate actual growth in state and local personal tax and non-tax receipts (NIA's variable used as a proxy for income tax receipts) was 10.5%. This study forecasts a 1977 aggregate national growth at 14.6%. Hence, the 1977 national aggregate growth index for income taxes is 1.4 (14.6 - 10.5), meaning that state and local income tax receipts for 1977 are expected to grow 1.4 times as fast as they did during the 1972-1976 period.

For each individual city in this study the actual growth rate in the three major tax receipt categories was calculated. The appropriate national aggregate growth index for each forecast year and each tax was multiplied times the actual historical growth rate (1972-1976) for each tax to determine a growth rate for tax collections in 1977, 1978, and 1979 for each city.

For example, from 1972 through 1976, income tax receipts in St. Louis grew at 1.5% per year. The adjustment for 1977 is provided by scaling the actual growth in St. Louis' income tax receipts (1.5%) by the 1.4 ratio; i.e., St. Louis' income tax receipts will grow at 2.1% (1.4 times 1.5%) during 1977 over 1976. This projection method was likewise applied to 1978 and 1979 using the following national scaling factors applied to individual city tax receipts:

	1977	1978	1979
Property Tax	1.0	1.0	1.0
Income Tax	1.4	1.1	1.0
Sales Tax	1.0	.71	.85

In general, these scaling factors reflect a stable-to-slowing in state and local personal tax and non-tax receipts for 1978 and 1979, relative to its historical growth for the period 1972-1976. Noticeably, income and sales tax receipts will be more affected by an economic downturn than will property tax receipts. Cities whose sales and income tax receipts are

in excess of 50% of own source revenues will be most significantly affected by an economic slowdown. These cities include Washington, D.C. (64.4%), St. Louis (51.8%), Columbus (51.7%), and Philadelphia (50.5%). Straight line (least squared) projections were used for miscellaneous revenue categories, (e.g., other than sales, income, and property tax).

Economic Projections of State and Federal Payments

State and Federal payments to the 48 cities were estimated based on the historical trend for each city. Three-year straight line projections were made using the average growth rate in state and Federal revenues over the five-year period from 1972 to 1976.

Property Tax Equivalent

Per capita allocations and property tax substitution were used as measures of reliance for all three programs. To determine property tax substitution, the full market valuation of taxable property for each city government was calculated by dividing the 1976 assessed valuation by the local equalization ratio, as listed in Moody's Municipal Credit Reports. The 1978 anticipated allocation for each ESP program was divided by the full market valuation. The result was then restated in terms of cents required per hundred dollars of full market valuation needed to offset each program's funding.

D. ESP Program Data

Using the information obtained from the respective departments, Treasury, Commerce and Labor, allocations to the 48 cities were projected for 1977, 1978, and 1979 for each of the ESP programs. A discussion of each program and the data adjustments that were required follows.

ARFA

Future projections for ARFA are dependent on expectations concerning future quarterly unemployment rates. Projections for future ARFA payments to the 48 cities were developed by determining each city's share of the national payment for quarter 6, assuming that each city would receive that share of the projected national pool for quarters 7 through 9. (Quarter 6 was used as the base for projections because if reflects the most likely distribution pattern for quarters 7 through 9. Quarter 9 ending September 30, 1978 terminates the current program). Projections for the national allotment totals were provided by Treasury's Office of Revenue Sharing.

Once each city's share of each quarter's total allotment was calculated, the quarterly payments were allocated to the appropriate fiscal year for each city. Then, in an effort to comply with the Census figures used for the 48 cities, the city's fiscal year was converted to the proper Census fiscal year. To project receipts for each city's fiscal year, quarterly payments were included on the basis of the timing of each city's fiscal year end as converted into Census fiscal years.

Using the above methodology, the forecasts for Census FY 1977, 1978, and 1979 were compared to the projected levels of revenue for the 48 largest cities to determine impact. Timing differences in the fiscal year ending dates of cities necessitated a two-step approach to obtaining a proper allocation of ARFA payments to each City's fiscal year as defined by Census. Consequently, the only year in which the cities uniformly received a full year of ARFA stimulus payments was Census fiscal year 1978. Birmingham has a fiscal year ending 8/31, and so money received between 9/1/76 and 8/31/77, or quarters 1-5 of ARFA, would be allocated to the 1978 Census fiscal year; this explains why they received no ARFA in Census fiscal 1977. Fort Worth, Jacksonville, Miami, and San Antonio are likewise affected by the timing of their fiscal years.

LPW

The long-term nature of capital projects makes it difficult to isolate the impact of local public works disbursements during particular fiscal years. The impact of an LPW project could be spread over a period of one year to five years depending on the project. LPW

projects also have indirect and induced effects in addition to the direct effects which occur through the purchases of contractors, increased employment, the spending of those persons employed and increased sales and income taxes. These effects on local capital budgets cannot be measured without more sophisticated analytical techniques. Finally, there are difficulties in measuring LPW substitution effects. There is no documentation of the replacement of local funds with LPW funds, local projects with LPW projects or private construction with public construction. This study assumes the stated value of projects reflects the full impact without correcting for substitution.

For local public works funds, Round I and Round II allocations were compared, respectively, to local fiscal years 1977 and 1978 capital outlay projections. The number and type of projects for each city were provided by the Economic Development Administration. Disbursements of LPW money to each city by fiscal year were determined by multiplying each city's share of the Round I and Round II allocation by the estimated national LPW disbursements for each year. Local public works impact was measured by the calculation of local public works allocations and disbursements as a percentage of capital outlay and long term debt issued. City specific LPW allocations were used, after adjusting for areawide allocations.

The Round I and Round II allocations which were made during City fiscal years 1977 and 1978 should be compared to the capital budgets for those years; however, since the capital budgets were not available, allocations were compared to 1977 and 1978 projected capital outlay which is determined by the capital budgets of prior years.

Calculations are based on allocations and disbursements to the city government which tend to understate the areawide impact. Total allocations and disbursements include all governments which used LPW funds within a city including the state, county, school districts, and special purpose governments.

Although local public works funds are not intended to replace local funds appropriated for capital projects, there is a possibility that some substitution of LPW projects for local capital budget items and LPW funds for local issuance of long term debt may have occurred, but this is not known.

CETA

CETA dependency estimates are limited because of lack of specific data by type of employer. Prime sponsors can be either an individual city or an area consortium. Specific city data on allocations were available for only 25 cities which are CETA prime sponsors. CETA allocations for the remaining 23 cities were delineated from area consortiums by Labor's Employment and Training Administration with estimates provided by regional offices. To measure impact, calculations of CETA allocations under Titles II and VI as a percentage of city payroll and estimated jobs as a percentage of 1975 full time equivalent workforce (Census data) were used.

As a result of the time limitation established by the 1976 extension to CETA, Title VI ("projects and jobs shall not exceed twelve months in duration"), CETA job allocations to a specific city are not all assigned to city-support functions. CETA jobs within a given city may be "outstationed" to other governmental units or community based organizations, so that cities may not receive the full benefit of CETA funding. However, no data are available on the city specific split between city functions and "outstationed" jobs. Therefore, the national estimate of the split (79% city -21% other) has been applied, as noted, to the allocations.

For purposes of this study, the full national job target of 725,000 under CETA Title II and VI is considered economic stimulus. That portion of the CETA program, 415,000 jobs, added since January, 1977, is frequently referred to as the "stimulus" portion. However, the bulk of the other 310,000 jobs in place prior to that date, except for 50,000 which were part of the original program, were also initially conceived as stimulus jobs. This portion is now frequently referred to as the "sustainment" protion since these jobs are being continued. The distinction between "sustainment" and "stimulus" has been discussed, and therefore, for purposes of this report the entire program's impact, 725,000, is considered to be the economic stimulus program particularly since both types of programs expire September 30, 1978.

Analysis is further complicated by the lack of a satisfactory aggregate employment demand model and the lack of accurate historical data on subsidized employment for individual state and local governments. Presently, there is no city specific data on turnover rates, distribution of CETA jobs based on local wage and salary scales, the rate at which positions are filled (CETA hiring curve), or levels of salary supplementation.

Average unit costs were used as a proxy for wage and salary scales, but the other data deficiencies remain. The average unit cost of $9,200 for Title II and VI jobs was provided by the Employment and Training Administration and assumes a gradual hiring build-up between 5/77 and 3/78, with the job level maintained through 9/78 for the program.

While CETA funds are allocated by formula, allocations do not necessarily equal disbursements as some cities may not wish to create jobs and spend at allocated levels. Additional reasons for cities receiving less than full benefit from expenditures for CETA jobs are absenteeism and turnover.

E. FISCAL STRAIN CLASSIFICATION

Development of Urban Fiscal Strain Index

Based on the Department of Commerce, Bureau of Economic Analysis, National Income Accounts (NIA), the state and local sector operating account is presently in a surplus condition and is expected to continue in surplus through 1979. The NIA operating account which reflects state and local government receipts and expenditures, net of social insurance funds, has been in surplus since 1976, following deficits in 1974 and 1975. Reflecting the optimistic outlook for the state and local sector, 3rd quarter 1977 receipts are up approximately 29 percent from 2nd quarter 1975 receipts.

NIA data, however, measuring overall receipts and expenditures overlook budgetary action at the local level that may have been necessary to achieve the surplus condition. In addition, much of the calculated surplus is due to the nature of NIA reporting of local financial transactions, which differs significantly from governmental accounting practices. For example, NIA data aggregate financial transactions, while many governments separate special funds which are frequently not available for general use; NIA accounting utilizes a combination of accrual and cash accounting principles, while many governments record transactions on a cash basis; and financial transactions and the purchase and sale of land are excluded from NIA reporting but included by many local governments.

While the recent economic recovery has assisted both the state and local sectors generally, specific governments, particularly older central cities, continue to be under fiscal stress. Urban finance problems stem principally from (1) economic and social problems which eventually are mirrored in financial difficulties, and, (2) inadequacy of prevailing fiscal structures to respond to functional responsibilities occurring at the local governmental level.

Among the more important of these underlying problems are:

o Population shifts, with a tendency for both people and jobs to move away from the pre-1950 industrial city to outlying areas, have left "high cost" citizens in central cities who, at the same time, have the least ability to pay for such services. For example, the five cities losing the most population during 1970-1975 are also the same cities that experienced the lowest growth in assessable base.

o Problems of the national economy, particularly recession and inflation. Recession can reduce local revenues while inflation increases local expenditures.

o Problems of governmental institutional structures, including restrictive revenue composition (e.g., property taxes) and fragmentation of governmental power in urban areas (i.e., overlapping of special purpose governments, counties, municipalities, school districts, etc.) which result in jurisdictional weaknesses.

Specific operational problems evolving from these socio-economic and structural disadvantages include:

o Federal aid programs have become increasingly vital in helping urban governmets meet their service needs. Over the past five years in proportion to total operating revenues, own source revenues of the 48 large city governments have decreased while Federal contributions have expanded.

o Many states do not provide adequate urban aid but rely on out-of-date aid formulae which are unrelated to present urban needs.

o Problems of fiscal management, such as bond market access, are inherent in the overall urban fiscal problem. For example, the inability of some of the larger cities to support additional indebtedness conflicts with the cities' need to make capital improvements and undertake projects which will assist in economic development.

- o A mismatch between urban fiscal capacity and urban service level requirements. Sizeable expenditures required of urban governments in connection with certain functional responsibilities, such as welfare and education may appropriately be funded at either the Federal or state levels.

Recognition of these problems has led to the development of several indicators which "signal" or measure urban fiscal strain. These indicators are significant tools in the evaluation of the fiscal impact of the ESP on the 48 largest city governments. In order to categorize the cities according to fiscal strain, it was necessary to (1) develop an index of urban strain that incorporated the socio-economic and financial characteristics of each city, (2) compare the resulting index of cities with currently available fiscal strain indices as developed by experts in the field, and (3) develop a composite index of urban fiscal strain.

ESP Strain Index

First, a survey of fiscal indicators used by others, including the Brookings Institution, The Urban Institute, The National Planning Association, Moody's and the ACIR, was conducted to determine relevant measures of fiscal strain. This yielded a number of possible fiscal measures such as tax yield by major source; dependency on external financing; incremental Federal aid as a percent of incremental revenues; tax rate changes; tax collection rates; tax burden; age of capital assets; revenue-expenditure gap; and, provision of municipal services. A number of socio-economic measures such as population; leadership/decision making pattern; income; public sector employment; unemployment rate; number of poor residents; and number of poor vs. dependent residents were also identified.

The indicators selected to measure the impact of the ESP on urban fiscal strain were ones which maintained a balance between fiscal and socio-economic characteristics, and for which data were readily available from secondary sources. The variables used were population, income, city own source revenue and long-term debt outstanding and the full market value of property. The indicators developed from these variables were:

(1) AVERAGE CHANGE IN POPULATION BETWEEN 1972 AND 1976.

There is a relationship between population change and fiscal condition as discussed by many urban experts. Generally, cities with declining or slowing population growth have greater fiscal strain. (see Exhibit B-5)

(2) AVERAGE CHANGE IN CITY PER CAPITA INCOME COMPARED TO AVERAGE CHANGE IN NATIONAL PER CAPITA INCOME FOR THE PERIOD OF 1969-1974.

As a determinant of taxable wealth and level of economic activity, measurement of income growth would gauge each city's economic position relative to the nation, as well as to each other. If the income of one city is growing slower than national income and in comparison to the income of another city, the city with slower growth is in a relatively weaker economic position.

(3) AVERAGE CHANGE IN OWN SOURCE REVENUE FROM 1972-1976, COMPARED TO AVERAGE CHANGE IN PER CAPITA INCOME FROM 1969-1974.

This indicator would gauge the tax burden of local cities relative to their ability-to-pay. Cities with higher growth in own source revenue than growth in income place a greater tax burden on their citizens than cities with a lower ratio.

(4) AVERAGE CHANGE IN PER CAPITA LONG-TERM DEBT OUTSTANDING FROM 1972-1976, COMPARED TO AVERAGE CHANGE IN PER CAPITA INCOME FROM 1969-1974.

The relationship of these factors would measure the debt burden of local residents by comparing a city's obligations (debt)with residents' ability-to-pay. Higher growth in long-term debt than income indicates a decreasing ability to support future debt service.

(5) AVERAGE CHANGE IN FULL MARKET VALUE FROM 1971-1976.

Growth in property value would gauge economic activity (commercial and residential expansion), and therefore, taxing ability of the 48 cities. Cities with slower growth or actual delines in full market value have deteriorating economic bases which results in heavier tax burdens for their residents.

Each of the above-mentioned fiscal strain indicators was weighted as follows:

	Indicator	Points
1.	Change in population	37
2.	Change in city per capita income compared to change in national per capita income	27
3.	Change in per capita own source revenue compared to change in per capita income	12
4.	Change in per capita long-term debt outstanding compared to change in per capita income	12
5.	Change in full market value	12
		100

Weights were assigned based on the relative significance of each indicator in determining fiscal condition after analyzing factors used by other urban researchers in developing indices of fiscal strain. Change in population was given the greatest weight because it was the concensus of other researchers that this was the single most important variable influencing fiscal condition.

Statistical z scores (value for each city minus mean for all cities divided by the standard deviation from the mean) were developed for each city for each indicator. The weighted z scores were summed for each city to obtain a total fiscal strain value. Each city was ranked based on its single final fiscal strain score. (The z score is a standard value used in statistical analysis which facilitates comparisons between variables that have different base values or different measures).

Comparison of Strain Indicators

When compared to the findings of researchers who have studied urban strain (see Table 4-a), six of the ten highest ESP fiscal strain cities also appear in the top ten high strain cities for most indicators. These indices are the currently available tools for measuring financial and socio-economic strain of urban governments. A brief summary of the variables measured by the five external indices is as follows:

Brookings - measured strain through an "Urban Condition Index" which considered population change, poverty, and pre-1939 housing; and, a "Hardship Index" which considered unemployment rate, population under 16 and over 64 years of age, education, income, crowded housing, and poverty (two separate indices were developed which compared City-to-SMSA, and compared City-to-City). The Brookings work served as the base for HUD's "needy city" index.

University of Chicago - Terry Clark - measured fiscal strain on the basis of four indicators, including per capita long-term debt, short-term debt, nine common function expenditures, and own source revenues compared to taxable property sales value.

National Planning Association - considered property assessed value, population migration, budget deficits, short-term debt, and Moody's bond ratings.

Urban Institute - combining and measuring tax rate increases and city government workforce decline, the Urban Institute grouped cities according to categories of fiscal strain, but did not sequentially rank them or assign relative indexes. In order to arrive at Treasury's Composite Index an index or rank for each city was derived from Urban Institute sources using the aforementioned two factors plus deficits as a ratio of general fund expenditures.

TABLE 4-a

COMPARATIVE RANKINGS
(Studies on Urban Strain)

City	Treasury Ranking	Urban Conditions Index (Brookings)	Hardship Index (Brookings)	Clark Study	NPA Study	Derived Urban Institute Index
New York	1	16	17	1	1	6
Newark	2	2	1	3	11	8
Los Angeles	3		27	9	12	16
Buffalo	4	3	9	5	9	14
Cleveland	5	4	7		6	7
Long Beach	6			18	28	26
Oakland	7	17			26	19
Chicago	8	13	14	13	2	
Detroit	9	12	8		4	1
Boston	10	7	16	2	17	4
Toledo	11	28	22		24	2
Minneapolis	12	18	35	15	23	10
Seattle	13	29	37	7	19	12
St. Louis	14	1	2	12	7	
Kansas City	15	22	25		22	
San Francisco	16	15	36	4	16	
Fort Worth	17		19	20	37	
St. Paul	18	24		14		
Atlanta	19	23	12	6	36	21
Dallas	20		33		30	
Louisville	21	14	10		27	17
Cincinnati	22	8	11		10	22
Philadelphia	23	11	13		3	3
Indianapolis	24		23		14	
Washington, D.C.	25	19			13	
Pittsburgh	26	6	15	16	8	13
Birmingham	27	10	5	11		25
New Orleans	28	5	3		18	5
Tulsa	29					29
Oklahoma City	30		29		39	
Milwaukee	31	21	20	17	15	9
Baltimore	32	9	6		5	18
Portland	33	20	28		25	15
Norfolk	34	27	18			24
Denver	35	26	34		21	
Columbus	36		31		35	11
Nashville-Davidson	37				40	
Omaha	38		30			
San Diego	39		32		31	
Houston	40		26		29	
Honolulu	41					28
El Paso	42					
Jacksonville	43			8	20	
Memphis	44			10	33	27
Miami	45	25	4			20
San Antonio	46				32	23
Phoenix	47		24	22	34	
San Jose	48		21	21	38	

ESP Composite Index

To maximize the significance of the categories of fiscal strain, city rankings from the six urban strain studies were combined. (see Table 4-a). A composite ranking was developed by (a) using the raw rankings of the six indices, (b) applying a "median polishing" technique to insert missing rankings, and (c) determining the composite rank based on resulting median ranks. For purposes of this study the 48 large city governments were classified according to relative fiscal strain among these 48 cities. The cities are grouped according to high, moderate, and low degrees of fiscal strain although it might be argued that any one city, independently, may not be under any fiscal strain relative to all cities in America.

Grouping of cities by categories of high, moderate, and low strain was accomplished based on their deviation from the average for the 48 cities (z scores), whereby:

(1) the 10 cities whose composite z scores were more than -.675 (75th percentile) were categorized as high strain cities,

(2) the 10 cities whose composite z scores were more than +.675 were categorized as low strain cities, and

(3) the remaining 28 cities were categorized as moderate strain.

The composite index is used in this respect to classify cities according to fiscal strain since it blends soci-economic indices and financial condition indices and thereby more accurately reflects the overall fiscal environment of the 48 large city governments. (See Appendix C). The cities are grouped alphabetically within categories of fiscal strain because the composite index is not intended to provide an absolute ranking of strain, but a relative ranking based on characteristics of strain.

Chapter V

Appendices

Chapter Five contains appendices which include fiscal impact calculations, fiscal profiles and strain indicators for each city. Also included is a more detailed survey of four cities and an inventory of other ESP studies.

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Appendix A - Fiscal Impact Conditions

Exhibit A-1 - Total ESP Allocations

Exhibit A-2 - Per Capita ESP Allocations

Exhibit A-3 - Estimated 1978 ESP Allocations as an Equivalent Increase in Property Tax

Exhibit A-4 - Estimated 1978 ESP Allocations as a % of Adjusted Own Source Revenue

Exhibit A-5 - ESP Program Impacts

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EXHIBIT A-1

Total ESP Allocations
($ Millions)

Cities by Strain Category	ARFA	LPW	CETA	TOTAL
High				
Boston	$14.2	$23.6	$32.3	$70.1
Buffalo	9.3	21.9	27.3	58.5
Chicago	38.9	57.1	103.9	199.9
Cleveland	10.5	11.5	24.3	46.3
Detroit	45.7	46.2	59.1	151.0
New Orleans	14.9	12.9	20.0	47.8
New York	245.3	289.3	298.0	832.6
Newark	17.2	29.0	27.1	73.3
Philadelphia	49.4	50.6	68.2	168.2
St. Louis	13.3	14.4	24.1	51.8
Moderate				
Atlanta	5.1	9.8	28.3	43.2
Baltimore	21.0	25.0	30.4	76.4
Birmingham	3.3	4.3	9.2	16.8
Cincinnati	8.2	11.3	19.1	38.6
Dallas	0	5.3	12.2	17.5
El Paso	7.9	9.0	15.4	32.3
Fort Worth	.4	4.3	6.3	11.0
Honolulu	8.4	26.3	24.9	59.6
Indianapolis	3.6	16.4	25.8	45.8
Jacksonville	2.5	11.4	11.7	25.6
Kansas City	3.7	8.3	15.7	27.7
Long Beach	2.2	4.9	12.5	19.6
Los Angeles	31.5	55.2	118.5	205.2
Louisville	2.9	.6	10.7	14.2
Miami	7.2	14.1	20.5	41.8
Milwaukee	7.0	14.0	23.6	44.6
Minneapolis	2.4	6.8	16.2	25.4
Nashville-Davidson	.7	3.2	6.9	10.8
Oakland	7.6	10.2	21.7	39.5
Omaha	.8	13.8	7.8	22.4
Pittsburgh	10.2	13.0	19.7	42.9
St. Paul	1.4	3.9	10.8	16.1
San Antonio	4.9	5.6	21.5	32.0
San Francisco	18.8	36.0	39.6	94.4
Seattle	4.6	12.1	22.4	39.1
Toledo	2.7	8.4	14.3	25.4
Tulsa	.9	1.4	5.1	7.4
Washington, D.C.	16.6	40.0	26.7	83.3
Low				
Columbus	3.1	7.5	18.4	29.0
Denver	5.8	11.2	14.1	31.1
Houston	2.6	8.6	24.9	36.1
Memphis	2.4	5.2	11.0	18.6
Norfolk	2.7	4.6	6.7	14.0
Oklahoma City	1.5	6.4	9.1	17.0
Phoenix	4.1	8.1	33.8	46.0
Portland	7.1	9.4	17.8	34.3
San Diego	8.7	14.5	38.0	61.2
San Jose	3.4	6.7	18.2	28.3
Total Allocations				
High	458.7	556.5	684.3	1,699.5
Moderate	189.0	374.6	597.5	1,161.1
Low	41.5	82.2	192.0	315.7
All 48	687.2	1,013.3	1,473.8	3,174.3
National (all local governments)	$3,200.0	$6,000.0	$6,600.0	$15,800.0

EXHIBIT A-2

Per Capita ESP Allocations

Cities by Strain Category	ARFA	LPW	CETA	TOTAL
High				
Boston	$22.9	$38.1	$52.2	$113.2
Buffalo	24.6	58.0	72.4	155.0
Chicago	13.2	19.4	35.3	67.9
Cleveland	18.0	19.7	41.8	79.5
Detroit	38.0	38.4	49.1	125.5
New Orleans	27.4	23.7	36.7	87.8
New York	33.6	39.7	40.9	114.2
Newark	52.4	88.4	82.6	223.4
Philadelphia	28.3	28.9	39.0	96.2
St. Louis	27.0	29.2	49.0	105.2
Moderate				
Atlanta	12.7	24.5	70.9	108.1
Baltimore	25.3	30.1	36.6	92.0
Birmingham	12.1	15.8	33.8	61.7
Cincinnati	20.9	28.8	48.7	98.4
Dallas	0	6.7	15.4	22.1
El Paso	19.2	21.9	37.5	78.6
Fort Worth	1.2	12.9	19.0	33.1
Honolulu	11.2	35.0	33.2	79.4
Indianapolis	5.1	23.3	36.7	65.1
Jacksonville	4.5	20.7	21.2	46.4
Kansas City	8.0	18.1	34.3	60.4
Long Beach	6.7	15.0	38.3	60.0
Los Angeles	11.7	20.6	44.2	76.5
Louisville	9.2	1.9	33.9	45.0
Miami	18.9	37.0	53.8	109.7
Milwaukee	10.8	21.7	36.6	59.1
Minneapolis	7.1	20.2	48.1	75.4
Nashville-Davidson	1.6	7.5	16.2	25.3
Oakland	28.3	32.0	68.2	124.0
Omaha	2.0	34.8	19.7	56.5
Pittsburgh	23.9	30.5	46.2	100.6
St. Paul	5.3	14.9	41.3	61.5
San Antonio	5.7	6.5	25.1	37.3
San Francisco	29.2	56.0	61.6	146.8
Seattle	9.8	26.0	48.1	83.9
Toledo	7.4	23.1	39.4	69.9
Tulsa	2.6	4.1	15.1	21.8
Washington, D.C.	23.9	57.6	38.5	120.[illegible]
Low				
Columbus	5.7	13.9	34.3	53.9
Denver	11.9	23.0	29.0	63.9
Houston	1.8	6.1	17.8	25.7
Memphis	3.4	7.5	15.9	26.8
Norfolk	10.1	17.2	25.1	52.4
Oklahoma City	4.0	17.3	24.5	45.9
Phoenix	5.7	11.4	47.6	64.7
Portland	20.1	26.6	50.4	97.1
San Diego	10.5	17.6	46.2	74.3
San Jose	5.5	10.8	29.4	45.7
Averages (weighted)				
High	28.65	34.76	42.74	106.15
Moderate	12.01	23.80	37.96	73.77
Low	6.65	13.16	30.74	50.54
All 48	18.04	26.60	38.69	83.33
National (all local governments)	$14.68	$27.53	$30.28	$72.49

EXHIBIT A-3

Estimated 1978 ESP Allocations As An Equivalent Increase in Property Tax ($/100 FMV)

Cities by Strain Category	ARFA	LPW	CETA	TOTAL
High				
Boston	$.12	$ .29	$ .40	$ .81
Buffalo	.20	.59	.77	1.56
Chicago	.05	.09	.18	.32
Cleveland	.05	.06	.15	.26
Detroit	.19	.21	.34	.74
New Orleans	.11	.13	.21	.45
New York	.18	.26	.27	.71
Newark	.49	1.00	1.09	2.58
Philadelphia	.32	.49	.51	1.32
St. Louis	.20	.25	.39	.84
Moderate				
Atlanta	.03	.06	.24	.33
Baltimore	.18	.29	.30	.82
Birmingham	.06	.07	.20	.33
Cincinnati	.07	.15	.22	.44
Dallas	0	.05	.07	.12
El Paso	.24	.29	.55	1.08
Fort Worth	.01	.09	.09	.19
Honolulu	.04	.20	.15	.39
Indianapolis	.03	.20	.27	.50
Jacksonville	.03	.06	.17	.26
Kansas City	.04	.11	.22	.37
Long Beach	.02	.08	.14	.24
Los Angeles	.04	.08	.21	.33
Louisville	.03	.02	.22	.27
Miami	.11	.21	.38	.70
Milwaukee	.05	.11	.22	.38
Minneapolis	.03	.15	.25	.43
Nashville-Davidson	0	.01	.06	.07
Oakland	.07	.10	.28	.45
Omaha	.01	.42	.16	.59
Pittsburgh	.19	.46	.46	1.11
St. Paul	.02	.13	.23	.38
San Antonio	.04	.08	.28	.40
San Francisco	.08	.24	.21	.53
Seattle	.04	.17	.20	.41
Toledo	.03	.19	.21	.43
Tulsa	.01	.04	.10	.15
Washington, D.C.	.13	.38	.23	.74
Low				
Columbus	.01	.06	.14	.22
Denver	.04	.12	.14	.30
Houston	.01	.01	.05	.07
Memphis	.02	.03	.13	.18
Norfolk	.07	.13	.21	.41
Oklahoma City	.01	.17	.16	.34
Phoenix	.03	.11	.31	.45
Portland	.08	.18	.24	.50
San Diego	.04	.12	.23	.39
San Jose	.03	.10	.18	.31
Averages				
High	.15	.22	.28	.65
Moderate	.05	.14	.21	.40
Low	.02	.07	.15	.24
All 48	$.08	$.16	$.22	$.46

EXHIBIT A-4

Estimated 1978 ESP Allocations as a % of Adjusted Own Source Revenue

Cities by Strain Category	ARFA	LPW	CETA	TOTAL
High				
Boston	1.8%	4.3%	5.8%	11.9%
Buffalo	4.2	12.2	15.9	32.3
Chicago	2.3	4.0	8.1	14.4
Cleveland	2.4	3.2	7.9	13.5
Detroit	4.8	5.2	8.6	18.6
New Orleans	4.3	5.2	8.3	17.8
New York	2.0	2.8	3.0	7.8
Newark	7.5	15.2	16.6	39.3
Philadelphia	4.2	6.5	6.8	17.5
St. Louis	3.8	4.9	7.6	16.3
Moderate				
Atlanta	1.5	3.2	12.0	16.7
Baltimore	3.8	6.0	6.2	16.0
Birmingham	2.0	2.2	6.5	10.7
Cincinnati	1.5	3.2	4.6	9.3
Dallas	0	2.2	3.3	5.5
El Paso	7.2	8.6	16.2	32.0
Fort Worth	1.3	5.5	5.4	12.2
Honolulu	2.1	10.8	8.1	21.0
Indianapolis	1.1	8.2	11.4	20.7
Jacksonville	1.0	1.9	5.0	7.9
Kansas City	.9	2.7	5.5	9.1
Long Beach	.9	3.9	6.6	11.4
Los Angeles	1.7	3.2	3.6	13.5
Louisville	.7	.5	6.1	7.3
Miami	5.1	9.5	17.2	31.8
Milwaukee	2.9	6.8	13.2	22.9
Minneapolis	1.2	6.0	10.5	17.7
Nashville-Davidson	0	.7	3.4	4.1
Oakland	3.4	4.7	12.8	20.9
Omaha	.4	19.1	7.2	26.7
Pittsburgh	6.8	16.5	16.6	39.9
St. Paul	.9	5.1	9.4	15.4
San Antonio	2.0	3.7	12.7	18.4
San Francisco	1.9	6.0	5.3	13.2
Seattle	1.6	7.2	8.9	17.7
Toledo	1.8	10.7	12.1	24.6
Tulsa	.1	1.4	3.5	5.0
Washington, D.C.	1.5	4.5	2.7	8.7
Low				
Columbus	1.3	3.8	9.8	14.9
Denver	1.0	2.8	3.4	7.2
Houston	.4	1.2	4.3	5.9
Memphis	.7	1.3	5.6	7.6
Norfolk	1.7	2.9	4.8	9.4
Oklahoma City	.5	7.6	7.2	15.3
Phoenix	1.5	6.1	16.9	24.5
Portland	4.1	9.6	12.6	26.3
San Diego	3.1	8.3	16.3	27.7
San Jose	1.4	5.5	10.0	16.9
Averages				
High	2.5	3.7	4.7	10.9
Moderate	1.8	5.0	7.2	14.0
Low	1.3	4.0	8.0	13.3
All 48	2.1	4.1	5.8	12.0
National (all local governments)	1.6%	3.7%	4.1%	9.3%

ESP Program Impacts

EXHIBIT A-5

Cities by Strain Category	CETA Jobs as % of '75 Full-Time Equivalent Workforce	LPW Round II Allocations as a % of '78 Capital Outlay
High		
Boston	11.1%	11.1%
Buffalo	17.9	16.2
Chicago	18.3	25.7
Cleveland	16.3	8.4
Detroit	24.6	24.4
New Orleans	16.6	11.4
New York	7.3	12.9
Newark	12.5	79.3
Philadelphia	15.4	19.1
St. Louis	15.2	42.9
Moderate		
Atlanta	27.5	6.7
Baltimore	6.5	6.0
Birmingham	21.3	4.6
Cincinnati	9.6	9.5
Dallas	7.7	5.1
El Paso	38.4	32.5
Fort Worth	12.6	20.0
Honolulu	23.9	21.3
Indianapolis	19.2	20.1
Jacksonville	9.9	1.6
Kansas City	20.7	11.3
Long Beach	21.7	11.6
Los Angeles	21.7	9.2
Louisville	16.9	.9
Miami	47.0	25.7
Milwaukee	21.2	21.4
Minneapolis	25.8	9.4
Nashville-Davidson	3.5	.1
Oakland	43.2	19.7
Omaha	17.1	25.8
Pittsburgh	27.6	64.4
St. Paul	27.9	20.3
San Antonio	16.4	1.9
San Francisco	15.7	27.1
Seattle	21.6	22.6
Toledo	31.6	20.0
Tulsa	14.4	2.0
Washington, D.C.	5.0	12.8
Low		
Columbus	23.6	12.6
Denver	9.6	6.8
Houston	14.9	2.4
Memphis	4.3	1.4
Norfolk	4.8	15.3
Oklahoma City	20.8	22.5
Phoenix	39.5	7.9
Portland	31.9	51.4
San Diego	46.9	28.1
San Jose	42.7	15.8
Averages		
High	10.7	15.5
Moderate	15.3	9.9
Low	17.6	9.1
All 48	13.0%	12.0%

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Appendix B - Fiscal Profiles

Exhibit B-1- General Revenue Profile

Exhibit B-2- Own Source Revenue Profile

Exhibit B-3- Property Tax Burden

Exhibit B-4- Profile of Services - City Government Responsiblity for Variable Functions in Additon to 10 Common Functions

Exhibit B-5- Socio-Economic Profile

Exhibit B-1

General Revenue Profile
(Average, 1972-1976)

Cities by Strain Category	Own Source Revenue as % of General Revenue	Change in Own Source Revenue as % of General Revenue	Federal Revenue as % of General Revenue	State Revenue as % of General Revenue
High				
Boston	67.3%	-5.6%	26.6%	20.8%
Buffalo	40.8	-6.6	11.9	47.2
Chicago	71.0	-1.6	14.4	14.6
Cleveland	71.5	-1.7	16.8	11.8
Detroit	59.1	-2.8	24.0	16.9
New Orleans	65.4	-6.1	14.5	28.1
New York	50.7	-1.5	4.8	44.5
Newark	46.5	-7.5	4.4	49.1
Philadelphia	68.6	-4.9	16.4	15.0
St. Louis	75.1	-4.0	13.7	11.2
Moderate				
Atlanta	74.8	-2.6	13.8	11.3
Baltimore	37.7	-3.3	10.6	51.7
Birmingham	76.4	-2.8	13.0	10.6
Cincinnati	65.5	-5.7	12.3	22.2
Dallas	87.6	-3.7	9.4	3.0
El Paso	83.4	-4.9	13.4	3.1
Fort Worth	83.4	-7.3	13.4	3.5
Honolulu	74.4	-4.7	18.7	6.9
Indianapolis	61.3	-7.5	14.5	24.2
Jacksonville	69.2	-7.3	14.2	16.6
Kansas City	77.8	-2.8	17.6	4.6
Long Beach	80.6	-2.7	5.2	14.2
Los Angeles	76.0	-2.1	10.9	13.1
Louisville	64.6	-4.4	28.4	7.0
Miami	78.4	-6.3	6.1	13.3
Milwaukee	52.8	-3.9	10.9	36.3
Minneapolis	61.8	-2.8	12.2	26.0
Nashville-Davidson	67.9	-1.2	10.6	21.5
Oakland	67.0	+5.1	21.5	11.5
Omaha	65.0	-4.5	20.5	14.5
Pittsburgh	62.4	-1.4	24.6	13.0
St. Paul	63.9	-3.1	9.0	27.1
San Antonio	73.7	-.7	24.4	2.9
San Francisco	61.0	-.9	12.9	26.1
Seattle	69.8	-.8	14.2	16.0
Toledo	69.6	-2.1	20.3	11.1
Tulsa	72.1	-6.2	20.8	7.1
Washington, D.C.	53.5	-2.2	44.8	1.7
Low				
Columbus	73.0	-1.9	14.5	12.5
Denver	65.8	+1.5	15.1	19.1
Houston	85.2	-3.0	13.0	1.8
Memphis	33.0	-4.0	7.0	52.5
Norfolk	49.7	-.9	17.8	32.5
Oklahoma City	74.0	-5.0	18.6	7.3
Phoenix	62.3	-6.3	16.9	20.8
Portland	65.4	-2.6	22.3	12.3
San Diego	65.1	-2.9	16.8	18.1
San Jose	69.1	-.7	14.9	16.7
Averages (weighted)				
High	55.1	-5.7%	7.8	37.0
Moderate	62.8	-7.1	18.4	18.8
Low	64.4	-4.9	13.1	22.5
All 48	58.1	-6.1	11.3	30.6
National (all local governments)	69.2%	-	6.3%	34.0%

Exhibit B-2

Own Source Revenue Profile
(Average, 1972-1976)

Cities by Strain Category	Diversification of Taxes: Property/ Own Source Revenue	Sales/ Own Source Revenue	Income/ Own Source Revenue	Tax Growth Rates ('72-'76): Property	Sales	Income
High						
Boston	79.1%	-	-	4.1%	-	-
Buffalo	76.4	1.9%	-	4.0	12.8%	-
Chicago	41.4	26.0	-	1.1	12.9	-
Cleveland	21.7	-	28.8%	.1	-	7.3%
Detroit	38.1	5.8	25.5	1.8	10.4	3.2
New Orleans	22.1	34.6	-	5.8	9.8	-
New York	43.6	23.5	21.0	8.7	11.6	10.0
Newark	70.7	13.0	-	-2.4	12.2	-
Philadelphia	17.7	-	50.5	.7	-	5.1
St. Louis	18.1	31.7	20.1	-1.9	12.6	1.5
Moderate						
Atlanta	35.5	13.2	-	6.7	14.1	-
Baltimore	49.9	7.2	13.3	1.8	12.0	10.7
Birmingham	13.9	20.6	19.5	8.5	13.0	10.5
Cincinnati	10.1	-	24.6	-1.8	-	9.8
Dallas	50.5	22.8	-	6.6	9.5	-
El Paso	37.8	20.7	-	9.9	11.2	-
Fort Worth	43.7	21.3	-	6.6	8.4	-
Honolulu	67.4	7.2	-	9.7	7.7	-
Indianapolis	59.7	-	-	-1.4	-	-
Jacksonville	30.4	13.0	-	9.3	1.5	-
Kansas City	13.5	27.2	22.4	3.0	19.0	6.3
Long Beach	22.3	18.2	-	5.7	9.1	-
Los Angeles	34.9	23.1	-	8.5	11.9	-
Louisville	17.9	2.0	33.9	4.7	5.4	10.6
Miami	45.8	23.8	-	5.6	8.8	-
Milwaukee	63.0	-	-	-1.7	-	-
Minneapolis	60.6	6.1	-	4.7	9.1	-
Nashville-Davidson	48.8	3.0	-	7.7	8.2	-
Oakland	34.6	19.1	-	4.9	7.4	-
Omaha	45.1	26.1	-	5.7	8.8	-
Pittsburgh	58.2	8.6	-	-1.6	16.8	-
St. Paul	49.5	11.5	-	1.6	11.7	-
San Antonio	37.5	21.9	-	7.9	16.8	-
San Francisco	46.9	14.2	-	5.1	5.3	-
Seattle	23.4	21.1	-	7.1	9.2	-
Toledo	9.1	-	47.9	.4	-	7.0
Tulsa	13.3	44.0	-	.8	16.8	-
Washington, D.C.	20.4	31.2	33.2	8.5	9.9	14.3
Low						
Columbus	9.6	-	51.7	7.1	-	10.7
Denver	23.2	26.8	-	8.2	8.6	-
Houston	43.7	24.6	-	13.3	15.2	-
Memphis	44.6	10.4	-	8.0	7.4	-
Norfolk	35.8	27.7	-	5.3	5.7	-
Oklahoma City	28.9	28.5	-	9.0	10.9	-
Phoenix	28.4	36.8	-	16.4	5.1	-
Portland	49.9	7.6	-	8.0	14.6	-
San Diego	32.9	7.5	-	9.6	15.0	-
San Jose	29.2	26.9	-	6.4	14.2	-
Averages (weighted)						
High	42.6	16.5	17.3	6.7%	11.4%	8.9%
Moderate	36.1	17.7	9.2	4.7	10.5	11.2
Low	33.4	22.8	3.9	9.8	10.7	10.9
All 48	39.8	17.4	14.0	6.3	11.0	9.4
National (all local governments)	52.8%	6.2%	3.0%	-	-	-

Exhibit B-3 Property Tax Burden

Cities by Strain Category	Per Capita Property Tax ('76)	Property Tax Collections/ Fair Market Value ($/100-'76)	Change In Fair Market Value ('71 - '76)
High			
Boston	$512	$5.99	6.6%
Buffalo	224	3.85	25.1
Chicago	103	.84	-4.6
Cleveland	62	.48	87.8
Detroit	122	1.40	9.2
New Orleans	58	.52	23.5
New York	401	3.76	46.0
Newark	295	6.03	8.9
Philadelphia	61	.80	25.7
St. Louis	66	.83	-10.5
Moderate			
Atlanta	122	.68	60.6
Baltimore	214	2.86	29.7
Birmingham	36	.32	5.9
Cincinnati	61	.43	36.1
Dallas	129	.93	30.3
El Paso	52	1.05	24.9
Fort Worth	82	.63	38.2
Honolulu	166	.90	109.8
Indianapolis	117	1.32	23.3
Jacksonville	70	.77	65.1
Kansas City	47	.47	2.1
Long Beach	75	.61	6.0
Los Angeles	97	.70	25.3
Louisville	50	.52	22.0
Miami	91	.88	88.9
Milwaukee	114	1.04	38.0
Minneapolis	149	1.32	12.6
Nashville-Davidson	204	1.14	39.5
Oakland	105	.66	17.6
Omaha	75	.85	32.4
Pittsburgh	94	1.51	21.1
St. Paul	122	1.10	8.5
San Antonio	44	.69	127.7
San Francisco	304	1.50	38.6
Seattle	69	.48	47.3
Toledo	17	.10	14.5
Tulsa	29	.29	42.8
Washington, D.C.	207	1.97	73.9
Low			
Columbus	18	.11	186.9
Denver	107	.79	44.2
Houston	99	.72	122.3
Memphis	80	.96	39.8
Norfolk	128	1.70	25.3
Oklahoma City	56	.54	54.4
Phoenix	46	.43	110.5
Portland	116	.82	49.4
San Diego	57	.39	80.6
San Jose	53	.44	55.4
Averages (weighted)			
High	250.47	2.61	23.4
Moderate	113.91	.95	35.6
Low	74.77	.51	87.3
All 48	$167.08	$1.47	38.2%

Exhibit B-4

Profile of Services
City Government Responsibility for Variable Functions in Addition to 10 Common Functions

	Local Schools	Higher Education	Public Welfare	Hospitals	Health	Housing	Urban Renewal	Libraries	Airports	Mass Transportation	Water and Sewer	Total Variable Functions	Per Capita General Purpose Expenditures (1976)
High													
Boston	x	x	x	x	x		x	x			x	8	$1,024
Buffalo	x					x	x				x	4	678
Chicago					x		x	x	x	x	x	6	306
Cleveland					x		x		x	x	x	5	348
Detroit				x		x	x	x	x	x	x	7	418
New Orleans			x		x			x	x		x	5	337
New York	x	x	x	x	x	x	x	x		x	x	10	1,625
Newark	x							x	x			3	948
Philadelphia			x	x	x		x	x	x	x	x	8	482
St. Louis				x				x	x		x	4	426
											Average	6.0	$975
Moderate													
Atlanta							x	x	x		x	4	343
Baltimore	x	x	x	x			x	x	x		x	8	911
Birmingham						x	x		x		x	4	256
Cincinnati		x				x	x			x	x	5	843
Dallas								x	x	x	x	4	220
El Paso					x			x	x		x	4	128
Fort Worth								x	x	x	x	4	183
Honolulu		x	x	x	x	x	x	x		x	x	9	291
Indianapolis			x	x	x				x		x	5	306
Jacksonville			x	x	x	x	x	x			x	7	300
Kansas City			x						x		x	3	354
Long Beach							x	x	x		x	4	420
Los Angeles				x			x	x	x		x	5	282
Louisville						x	x	x			x	4	329
Miami												0	218
Milwaukee				x	x	x	x	x			x	6	267
Minneapolis						x		x				2	310
Nashville-Davidson	x		x	x	x			x		x	x	7	498
Oakland							x	x	x			3	363
Omaha								x				1	194
Pittsburgh							x	x			x	3	256
St. Paul								x		x		2	306
San Antonio					x	x	x	x	x	x	x	7	219
San Francisco			x	x			x	x	x		x	6	955
Seattle					x		x	x			x	4	426
Toledo					x		x		x		x	4	351
Tulsa							x		x	x	x	4	380
Washington, D.C.	x	x	x	x	x	x	x	x			x	9	2,166
											Average	4.6	$451
Low													
Columbus			x		x		x	x	x		x	6	256
Denver				x			x	x	x		x	5	577
Houston					x				x	x	x	4	196
Memphis	x		x		x			x		x	x	6	402
Norfolk	x		x	x	x	x	x	x	x	x	x	10	606
Oklahoma City				x			x		x	x	x	5	212
Phoenix						x		x	x		x	4	227
Portland							x				x	2	301
San Diego						x	x	x	x	x	x	6	265
San Jose							x	x	x		x	4	253
											Average	5.2	$299
											All 48 Average	5.0	$655

Exhibit B-5 **Socio-Economic Profile**

Cities by Strain Category	Change In Population (Between '72 and '76)	Per Capita Income ('74)	Change In Per Capita Income ('69-'74)	Unemployment Rate ('76)
High				
Boston	-.7%	$4,157	34.4%	10.9%
Buffalo	-12.0	3,928	36.5	11.2
Chicago	-8.0	4,689	37.8	9.0
Cleveland	-14.9	3,925	39.1	9.5
Detroit	-11.8	4,463	39.5	13.1
New Orleans	-5.7	4,029	48.9	8.4
New York	-5.3	4,939	33.6	11.2
Newark	-11.1	3,348	34.3	17.7
Philadelphia	-6.9	4,330	43.5	11.3
St. Louis	-15.6	4,006	47.0	12.8
Moderate				
Atlanta	-12.3	4,527	43.4	10.3
Baltimore	-6.0	4,330	50.6	10.3
Birmingham	-8.2	4,023	56.7	7.7
Cincinnati	-3.8	4,517	44.2	10.4
Dallas	-3.7	5,285	43.0	4.9
El Paso	19.7	3,479	45.6	10.7
Fort Worth	-8.9	4,527	39.9	5.4
Honolulu	11.9	5,065	45.6	9.4
Indianapolis	-4.0	4,843	41.0	7.2
Jacksonville	6.2	4,618	61.9	6.4
Kansas City	-6.9	4,736	42.3	7.2
Long Beach	-6.4	5,652	42.7	8.9
Los Angeles	-2.9	5,277	33.6	9.9
Louisville	-7.2	4,302	45.4	6.9
Miami	9.0	4,416	56.5	8.7
Milwaukee	-7.2	4,680	47.0	10.8
Minneapolis	-13.0	5,161	48.2	7.6
Nashville-Davidson	-.6	4,606	53.4	5.0
Oakland	-8.5	5,034	39.2	13.8
Omaha	7.1	4,887	49.5	5.3
Pittsburgh	-11.8	4,426	44.1	10.3
St. Paul	-9.8	4,931	45.2	7.2
San Antonio	18.2	3,601	48.4	8.2
San Francisco	-7.2	5,990	41.5	11.4
Seattle	-8.2	5,800	43.1	9.1
Toledo	-4.2	4,571	46.0	8.7
Tulsa	.4	5,173	48.1	5.5
Washington, D.C.	-5.9	5,659	47.3	7.1
Low				
Columbus	-.8	4,333	43.2	7.4
Denver	-5.9	5,585	58.0	6.9
Houston	7.6	5,110	51.0	5.7
Memphis	6.1	4,383	56.9	5.9
Norfolk	-6.9	4,233	51.6	6.5
Oklahoma City	-.8	4,731	46.2	6.3
Phoenix	14.3	4,942	51.9	9.8
Portland	-6.3	5,192	47.0	9.6
San Diego	11.0	5,016	42.6	12.4
San Jose	24.7	4,972	46.5	8.7
Averages				
High	-7.4	4,181	37.7	11.0
Moderate	-3.0	4,810	46.2	8.6
Low	+5.6	4,850	49.4	8.3
All 48	-3.7	4,561	44.6	9.4
National (all local governments)	+3.1%	$4,572	46.6%	7.7%

Appendix C - Fiscal Strain Indicators

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Fiscal Strain Indicators

Cities by Strain Category	Annual Average Population Change ('72 thru '76)	Average Δ Per Capita Income/Avg. Δ National PCI ('69 - '74)	Average Δ Per Capita Own Source Revenue/Avg. Δ PCI ('72 - '76)	Average Δ Per Capita Long Term Debt Outstanding/ Avg. Δ PCI ('72 - '76)	Avg. Δ Fair Market Value ('71 - '76)
High					
Boston	-.1%	77%	82%	187%	1.3%
Buffalo	-3.1	81	92	95	4.6
Chicago	-2.0	83	126	46	-.9
Cleveland	-3.9	87	232	-43	13.4
Detroit	-3.0	86	117	48	1.8
New Orleans	-1.4	104	141	21	4.3
New York	-1.3	75	200	320	7.9
Newark	-2.9	76	94	99	1.7
Philadelphia	-1.8	94	70	116	4.7
St. Louis	-3.9	101	119	37	-2.2
Moderate					
Atlanta	-3.2	94	113	116	9.9
Baltimore	-1.5	107	182	-30	5.3
Birmingham	-2.1	118	163	208	1.2
Cincinnati	-2.3	96	118	20	6.4
Dallas	-.9	93	137	102	5.4
El Paso	4.7	98	96	82	5.7
Fort Worth	-2.2	88	136	50	6.7
Honolulu	2.9	98	74	22	16.0
Indianapolis	-1.0	89	72	78	4.3
Jacksonville	1.5	127	129	75	10.5
Kansas City	-1.7	92	157	77	2.0
Long Beach	-1.6	93	138	362	1.5
Los Angeles	-.7	75	185	70	4.6
Louisville	-1.8	98	145	55	5.1
Miami	2.2	118	59	140	13.6
Milwaukee	-1.8	101	43	45	6.7
Minneapolis	-3.3	103	119	285	2.4
Nashville-Davidson	-.2	112	108	74	6.9
Oakland	-2.2	86	131	187	3.3
Omaha	1.8	105	74	80	5.8
Pittsburgh	-3.0	96	3	100	3.9
St. Paul	-2.5	97	109	193	1.6
San Antonio	4.5	104	82	90	17.9
San Francisco	-1.8	91	105	252	6.7
Seattle	-2.1	94	166	211	8.1
Toledo	-1.1	89	115	250	2.7
Tulsa	.1	103	161	92	7.4
Washington, D.C.	-1.5	101	115	314	11.7
Low					
Columbus	-.2	94	116	47	23.5
Denver	-1.5	120	136	213	7.6
Houston	1.9	107	161	79	17.3
Memphis	1.5	119	21	54	6.9
Norfolk	-1.7	109	95	-15	4.6
Oklahoma City	-.2	99	120	86	9.1
Phoenix	3.5	110	74	76	16.1
Portland	-1.6	100	113	-158	8.4
San Diego	2.7	93	85	-23	12.5
San Jose	5.9	100%	81	-32%	9.2
Averages					
High	-1.8		160		3.9
Moderate	-.7		99		5.9
Low	+1.4		94		14.6
All 48	-.9		117		7.6%
National (all local governments)	+.8%		100%		

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Appendix D - Four City Case Study of Fiscal Impact of ESP

Exhibit D-1 - Introduction

Exhibit D-2 - ESP Summary - Four City Survey

Exhibit D-3 - Recap: Four City Case Study of Fiscal Impact of ESP

Four City Case Study of Fiscal
Impact of ESP

Exhibit D-1

Introduction

An in-depth case study of four cities was conducted to obtain local officials' perceptions of the impact of the ESP programs. The survey does not explore managerial or other alternatives available to local officials to deal with the unavailablity of ESP funds. The cities included:

New York	Fiscal Year Ends June 30
Newark	Fiscal Year Ends Dec., 31
Boston	Fiscal Year Ends June 30
Detroit	Fiscal Year Ends June 30

Purpose of Four City Case Study

This survey was conducted from October through November 11, 1977. The answers reflect respondents' views at the time, which are subsequently subject to revision and update. The purposes of the study were:

1. To ascertain the general financial condition of each city during their current fiscal year and as projected for the next fiscal year.

2. To determine relationship of ESP to the revenue and expenditure pattern for the general fund of the city. (Since LPW monies are applied to capital outlay spending, these funds require a view from a slightly different perspective.

3. To consider the extent of economic recovery (or lack thereof) in each city, and the relationship of the economy to city revenues and expenses viewed in the context of ESP funds.

Results

The four cities surveyed are special cases in that each of them is generally perceived as particularly "hard pressed" among American cities. Consequently, the results of this survey, as might be expected, indicate that these four cities consider ESP funds, especially CETA and ARFA, important in order to avoid tax increases or service cut backs. Moreover, these cities have indicated that LPW funds are a source of resources available to meet a backlog of capital needs for city infrastructure facilities.

Exhibit D-2

ESP Summary - Four City Survey
($ Millions)

	New York	Newark	Boston	Detroit
Total Estimated Allocation (Program Life Jan. 1977 - Sept. 1978)				
LPW	$289.3	$29.0	$23.6	$46.2
CETA (Titles II & VI)	298.0	27.1	32.3	59.1
ARFA	245.4	17.2	14.2	45.7
Total	$832.6	$73.3	$70.1	$151.0

	New York	Newark	Boston	Detroit
Dependency Ratios Based on F.Y. 1978 Estimates				
ARFA as a % of:				
Own Source Revenue	1.7%	5.9%	1.4%	4.8%
Total Operating Revenue	.8	1.9	.8	2.4
CETA as a % of:				
Own Source Revenue	2.5	12.8	4.7	8.6
Total Operating Revenue	1.1	4.2	2.6	4.2
1975 October Payroll	3.9	8.8	6.1	11.2
LPW as a % of:				
Capital Outlay	12.9	79.3	11.1	25.1
Total ESP as a % of:				
Own Source Revenue	6.6	30.5	9.6	18.6
Total Operating Revenue	3.0	10.1	5.3	9.3
Federal Aid	43.2	167.1	32.2	40.5

Exhibit D-3

RECAP: FOUR CITY CASE STUDY OF FISCAL IMPACT OF ESP

	New York City	Newark	Boston	Detroit
General Statement:	CETA and ARFA funds used to supplement and maintain essential services; LPW has significant impact but needs remain enormous.	CETA and ARFA maintain public services and preclude the need for massive layoffs similar to those of four of the previous six years. LPW funds have not reduced the [illegible]'s own capital spending and inordinate needs still exist.	ESP funds are essential to avoid property tax increase (property tax is already, economically disfunctional). Service reductions are difficult. (Workforce already reduced 10% in two years).	CETA and ARFA funds used to supplement and maintain essential services. LPW has significant impact [illegible] needs remain enormous, especially for construction of projects that set stage for further economic development.
QUESTIONS:		FISCAL CONDITION		
What is the effect [illegible] City did not have any ESP funds?	Reduction of capital construction by 30%; cause layoffs of about 22,000 employees; force City to raise property tax to legal maximum (which is an "impossible" choice); or possibly to withdraw $110 million Economic Recovery Plan	LPW: Deferral of capital projects; CETA: Layoffs of 22%, of total workforce of 9,000 employees, or equivalent expenditure reduction; ARFA. Layoffs of another 10% of workforce, or equivalent expenditure reduction approximately $14 million.	Without funds, severe cutbacks in jobs (approximately 11% of 13,000 city employees) and construction (water, sewer, and streets, $15 to $19 million) would occur. Current budget can not handle costs of essential services provided for by ESP funds because of inability to raise sufficient additional taxes.	Deferral of capital projects; 2/3 of CETA jobs would be laid off, or over 2,000 jobs. (1/3 of the jobs could be funded with own source revenues now applied to CETA salary supplementation.
Latest current year revenue estimate vs. budget?	As budgeted except for few minor differences	Is generally on target with modest improvement.	As budgeted, with a few minor differences	Small increase over budget due to conservative budget estimates.
Current revenue collection pattern vs. three prior fiscal years?	Same pattern as prior years, except for tax increases. Slight growth in absolute dollars, no real growth.	Inconsistent prior three year pattern. Modest increase currently.	Same pattern as prior years, except for tax increases. Slight growth in absolute dollars, no real growth.	Normal growth pattern at [illegible]

	New York City	Newark	Boston	Detroit
Any surplus?				
From last year?	No.	Cash deficits in 1971, 1974 and 1975. A non-cash surplus (fund balance) available but not for the purpose of exceeding legal limits on expenditures during Fiscal 1977.	No.	1978 budget contains one time $11.6 million surpl carryover from 1977. This was sixth surplus in last 25 years. Surplus due to fact that fiscal years 1975 and 1976 were depression years thus causing '77 estimates to be conservative; but, ARFA came along, auto industry picked up, and income tax picked up resulting in one time surplus.
Anticipated this year?	No.	Yes. At end of Fiscal 1977. Surplus is less than 5%, any significant surplus is unusual.	No.	No.
Expected next year?	No.	Yes. At end of Fiscal 1978. (Modified accrual accounting system is primary reason for reversal in surplus picture).	No.	No.
Revenue outlook for next fiscal year?	Slight decrease (3%).	Modest improvement, perhaps 5%, but less improvement than current year over last year which was approximately 8%.	Nominal growth (1% to 1.5%). No real growth.	Minor increases tied to inflation rate.
Four year revenue growth trend?	No real growth; slight growth in absolute dollar amount.	Inconsistent, current year tentative figures demonstrate a potential reversal in downward property tax trend.	Absolute dollar growth minimal. Real growth is negative. Heavily dependent on property tax.	Normal growth pattern at 6%, except for property tax which has stabilized (property tax is 38% of own source revenue).

	New York City	Newark	Boston	Detroit
Key economic indicators: Affecting revenues?	Slower decline in assessed valuation will result in slight decrease in 1979 tax collections. City retail sales grew less than national retail sales during past year, promising no real growth in NYC sales tax receipts Decrease in number of employed persons during past year indicates stagnation in personal income tax receipt growth.	Size of payrolls, which are taxed; air traffic at airport (only has potential for affecting revenues); percentage of property tax levy collected.	Two negative indicators: (a) increased vacancy rates (b) bank foreclosures. Both lead to high tax delinquency rates.	These indicators: (a) down town renovation; (b) automotive production; (c) energy legislation as it effects auto industry are causing both downward and uncertain revenue estimates.
Affecting expenditures?	NYC unemployment in August 1977 was 9.0%, down 2% from August 1976, indicating less welfare expenditure growth; U.S. GNP deflator projections indicate inflationary forces which increase service costs.	Structural decline has more impact than cyclical factors. Health and welfare costs are affected by unemployment. $2.5 million increase in welfare costs from 1976 to 1977. As businesses or residents abandon property there is lag effect on expenditures city must incur to assume management of property.	Unemployment increases health and welfare costs. Housing abandonment has caused demolition costs to increase as much as one million annually.	Effects are indirect. Health and Hospital would have most direct cost impact of slowed down economy. Other basic services are police, fire, sanitation, recreation, and water and sewer which are all remote from direct savings in economy.
Status of taxing authority?	Property tax is 98% of legal maximum. Container and liquor tax are only remaining additional potential taxes. Other taxes at economically feasible maximum. Counter-productive to increase any tax.	No maximum on property tax rate; state-approved 1% payroll tax must be renewed each year, payroll tax at .75% during 1977; state-approved parking lot receipts tax at 15% max; state-approved gas and liquor taxes are currently not used to prevent relative economic disadvantage associated with payroll tax. Taxes are beyond economic and political limitations.	Boston has no "tax max" yet it is politically and economically unfeasible to increase taxes more than 2-3% per year. City has no unused taxing authority.	Tax levies at maximum allowable rates under law Property tax, income tax, and utility tax have all been at "max" since at least 1972, some before.

	New York City	Newark	Boston	Detroit
New developments in state aid?	Requesting increased state aid of $351 million for next fiscal year.	State Income tax which funds state revenue sharing and school costs expires 6/30/78 and has to be renewed; state payments in lieu of taxes ($3.8 million) recently approved and due next year.	State is now in the process of absorbing county court costs (5% of city budget); hospital costs for general relief clients formerly paid by state but no longer - has put city hospitals in a deficit. A new local aid package is being considered by the State. These will marginally help the finances of Boston.	Hoping for $8.7 million additional in urban aid program from the State.
Expenditures: Budget vs. actual this year?	City and MAC debt service $35 million over budget. Other items are within budgeted amounts.	Holding to budget except for welfare ($5.3 million budgeted vs. $7.0 million estimated actual) and abandoned property expenses ($1.1 million budgeted vs. $1.6 million estimated actual).	Most items are within budgeted amounts	Insignificant variations
Expenditures: Next year's outlook?	Uncontrollable costs will increase causing need for yet unidentified revenues or expense cuts. Most labor contracts expire at end of June 1978. Transit contract expires March 1978.	No expected gap between revenues and expenditures next year, with assumptions that current level of Federal and State aid will continue; 40% of expenditure increase next year is result of salary increases; recent annual salary increases are less than cost of living.	Probably can not hold the line and will experience a $25 million increase in uncontrollable costs. This may necessitate a tax increase.	Inflationary increases and labor contracts driv expenses. Anticipate future layoffs in order to "hold the line" on overall expenses.
Are "fixed costs" fully funded?	Unfunded pension liability is now being funded according to actuarial recommendations. It is unknown whether other fixed costs, ie., hospital costs, are currently fully funded.	Pension funds not fully funded; workmen's compensation is on pay-as-you-go basis.	Yes, except for pension liability. Pension system is essentially pay-as-you-go.	Yes.

ESP DEPENDENCY

QUESTIONS:	New York City	Newark	Boston	Detroit
Are your future financial plans dependent on ESP funds?	Yes. ARFA and CETA funds particularly.	Yes. ARFA and CETA funds particularly.	Yes. ARFA and CETA funds particularly.	Yes. ARFA and CETA funds particularly.
Effect of not having ARFA funds?	Equivalent of 9,000 lay-offs. 4.8% of estimated 1978 FTE workforce, and reduced services.	900 layoffs, 10% of estimated 1977 FTE workforce.	Without funds, major layoffs would be necessary (esp. police & fire departments). Perhaps 1/2 of lost ARFA funds could be made up by tax increases, but no more.	Layoffs. ARFA funds translate into an equivalency of about 1,000 jobs, and 3/4 of city budget is personal services costs. No growth in own sourc revenues, thus jobs would be first area to cut. Perhaps small cuts in other expenses
Are CETA funds used in lieu of basic payrolls?	CETA was used to rehire layed off employees.	City would not have had own source revenues to establish the level of payroll supported by CETA.	Approximately 11% of all FTE jobs are funded by CETA and to some extent supplant basic payrolls, particularly in public works and housing.	City would not have had own source revenues to establish the level of payroll supported by CETA. About 20% of the CETA patterns are in previousl not performed jobs.
Can you continue CETA jobs with own source revenues?	Approximately 3,500 (of 25,600) jobs could be continued assuming $10,000 ceiling on base salaries of CETA employees.	Inadequate own source revenue and legal limitations on expenditures prohibit retention of 100% of CETA employees; would increase already high unemployment rate.	No. Possibly 30% (420 employees) of CETA jobs at most could be funded by increasing taxes.	Inadequate own source revenue to continue jobs 100%. Could retain 1,000 of 3,000 CETA jobs using $25 million of own source supplementation funds.
Are CETA jobs of high enough priority to command own source revenue?	Yes. $35 million included in the 1978 budget to supplement CETA salaries would be available to retain about 3,500 CETA employees.	Some CETA jobs are of high enough priority but some layoffs would occur depending on value of job after looking at entire workforce.	Yes. But own source revenues can only accomodate about 30% of the cost and a tax increase may prove necessary.	Yes. Many CETA jobs are in priority services but the number of jobs to which own source revenue could be applied is limited to about 1,000 jobs due to affordability.

	New York City	Newark	Boston	Detroit
Peak number of CETA jobs: (unadjusted City data)	23,500. 13.6% of estimated 1978 FTE workforce.	2,000. 22% of estimated 1978 FTE workforce.	1,400. 11% of estimated 1978 FTE workforce.	3,000 - 12% of FTE workforc
Are CETA jobs assigned in critical city service slots?	Yes. Uniformed police, teachers, sanitation workers.	Yes. Fire, sanitation, sewerage, water.	Yes. Especially in public works, hospital, and city police and fire departments.	Yes. Uniformed police, recreation, sanitation.
City supplementation of CETA payroll?	Yes. 3,265 jobs covering a wide range of job classifications. Expected to spend $17 million of $35 million budgeted for supplementation on salaries, balance may be required for fringe benefits for all CETA employees.	Yes. Few fire positions currently, possible 150 others in future. Minimal dollar amount.	Less than 5% of CETA slots are supplemented by the city. Supplementation is used to hire silled tradesmen with construction skills.	Yes. 1/3 supplementation, $25 million, nearly all CET positions are supplemented,
Are LPW funds applied to essential infrastructure facilities?	Yes. Majority of LPW funds are applied to infrastructure.	Yes. 37.5% to street repair.	Yes. Streets, water lines, city hospitals.	Yes. Majority of LPW fund are applied to infrastruct
LPW funds applied to previously budgeted projects?	Most LPW projects were in existing capital programs but no city funds had been appropriated for them.	For some, less than one half, bonds had been authorized but not issued. The rest had not been budgeted.	Used for projects which could not be funded in the budget, but were in future program.	Not much. Priority was gi to projects which establis a base for longer term economic development and these projects were being put off because borrowing limit permitted only budgeting for basic city facilities.
Displaced bond issues?	No. Bonds funds, to the full extent available, are used for construction projects.	No. City is still selling the maximum amount of bonds.	No. Without the funds, Boston was planning to put off the projects until 1979 or 1980.	No. The city is still selling the maximum amount of bonds.

	New York City	Newark	Boston	Detroit
Impact of no future LPW funds?	LPW supported 30% of contracts awarded in fiscal 1977. Left with enormous backlog of facility needs.	Basic capital projects will be deferred; $50 million backlog, including water and sewer main repair.	Water, sewer, street and school construction would be seriously curtailed. Maximum bond funds are being applied already.	Capital construction will continue to be ignored. Important developmental projects will continue to be deferred. Limited borrowing authority requires application of bond funds to critical city.
LPW funds used to offset operating costs or cash flows?	Yes. $8-$10 million used to support administrative costs in operating budget associated with LPW projects.	No.	Yes. Approximately $1.1 million applied to offset contract supervision costs incurred in general fund.	No.

Appendix E - Inventory of Related ESP Evaluations

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E. Inventory of ESP Evaluations

In addition to this report on the fiscal impact of the three Economic Stimulus programs on the 48 large city governments, the agencies administering the programs and related organizations are also conducting ESP evaluations. This appendix is not intended to be an exhaustive listing of all ESP studies. Rather, the purpose of this section of the report is to identify Federal, and other ESP evaluations, of which we are aware, that are completed or in progress at the time of this report.

Most of the other evaluations mentioned herein are of longer duration than this fiscal impact evaluation. Accordingly, the final reports and conclusions of most are not expected until at least the spring-to-summer of 1978.

General Evaluations

1. "Countercyclical Aid Study," Advisory Commission on Intergovernmental Relations and Congressional Budget Office.

The purpose of the study is to develop recommendations leading to a coordinated countercyclical policy between Federal, state and local governments. It is a joint effort of the Advisory Commission on Intergovernmental Relations and the Congressional Budget Office at the request of Congress. The ACIR is investigating the problems of fiscal coordination and the effects of recession on state and local governments, while the CBO is responsible for targeting, triggering and evaluation of the aid mechanisms.

2. Council of Economics Advisors

The Council of Economic Advisors has created a Stimulus Evaluation Group (SEG) consisting of CEA, Treasury, Commerce, Labor and OMB to monitor the components of ESP. This evaluation will study the economic dimensions of ESP impact. Particular activities of the SEG include providing comprehensive descriptions of the stimulus programs and monitoring current program activity.

ARFA Evaluations

1. "Antirecession Assistance is Helping But Distribution Formula Needs Reassessment," General Accounting Office, July 20, 1977.

This report summarizes the impact that assistance payments have had on selected state, city and county governments and discusses the need for an improved formula for distributing funds. Three detailed reports on selected states, counties and cities from which the summary is drawn will be released later. An additional report on triggering, distribution and macroeconomic impact will also be released at a later date.

2. "Evaluation of the Antirecession Fiscal Assistance Program," The Department of the Treasury, September 14, 1977.

The report is part of an evaluation by the U.S. Treasury Department with assistance provided by the Urban Institute of countercyclical fiscal assistance, general revenue sharing and other Federal assistance programs to state and local governments. The evaluation includes a national overview of ARFA as an economic stimulus tool, an analysis of the impact of allocation patterns on state and local governments, and a discussion of administrative problems associated with ARFA at the Federal level and at the state and local level.

3. "Evaluating Countercyclical Revenue Sharing," Edward M. Gramlich, University of Michigan.

The paper was prepared for the November, 1977 Brookings Institution Conference on the Countercyclical Stimulus Package. The paper suggests undertaking an empirical macroeconomic evaluation of ARFA, and outlines the objectives and key questions that should be answered by such an evaluation. The evaluation as suggested by Gramlich would use standard statistical econometric procedures instead of the more traditional questionnaires, reports and field observers.

4. Senate Subcommittee on Intergovernmental Relations Survey.

Information provided includes the number of layoffs prevented, public employees rehired and services maintained for 360 localities and 28 states. Questionnaires were sent to 1,200 localities and 50 states. Findings are based on state and local public officials' perceptions of ARFA impact.

5. "Study of the Antirecession Fiscal Assistance Program," Peat, Marwick, Mitchell and Company.

Peat, Marwick, Mitchell and Company will study the uses and economic impacts of ARFA for the Office of Revenue Sharing. This partially fulfills the requirement that the Treasury Department make an annual report to Congress on the program. The study will be conducted for 8 states and 42 local governments using an advance questionnaire to collect standard data and on-site interviews with officials of the 50 jurisdictions to determine impact.

LPW Evaluations

1. "Approaches to Evaluating the Local Public Works Programs," Jeffrey M. Perloff, University of Pennsylvania.

This paper reviews proposed Department of Commerce plans for evaluating the Local Public Works program and suggests alternative approaches for microeconomic evaluations. No recommendations are made concerning macroeconomic evaluations.

Perloff suggests that an econometric model would be helpful in studying the direct and indirect effects of LPW on construction employment and unemployment, the cost of construction, substitution between public and private construction, productivity and other program efficiency related issues.

Perloff also suggests that a survey of LPW project employees combined with Current Population Survey data could be used to evaluate the equity of LPW allocations based on the distribution of unemployment, income and race between LPW employees and all construction workers and between areas which received LPW funds and other areas.

Fiscal substitution and other financial issues were also proposed to be studied through models such as those used by Gramlich/Galper, "State and Local Fiscal Behavior and Federal Grant Policy" and Johnson/Tomola, "The Fiscal Substitution Effect of Alternative Approaches to Public Service Employment Policy."

2. "Microeconomic LPW Evaluation," Department of Commerce.

This study is designed to determine LPW substitution and fiscal impact at the state and local level and also evaluate the impact of LPW expenditures on persons employed by LPW projects. Evaluations of LPW employees are conducted through surveys.

3. "Macroeconomic LPW Evaluation," Chase Econometrics.

This study is being conducted to determine the impact of LPW on the national economy and national unemployment, especially in the construction industry, for the Department of Commerce.

CETA Evaluations

1. "Evaluating the CETA Public Service Employment Program," Michael Wiseman, University of California, Berkeley.

This paper summarizes Department of Labor evaluations of the ability of CETA Titles II and VI to provide a net increase in employment by state and local governments of workers of specified types under current guidelines.

2. "Employment and Training Act Reporting System," Department of Labor.

The CETA PSE reporting system is designed to monitor contract compliance and to provide relatively timely information on participation and outlays. Reports are made by prime sponsors to regional Department offices on a weekly, monthly and quarterly basis with annual summaries. Data collected include program enrollment, program status (turnover rates), characteristics of enrollees, financial data and performance indicators.

3. "Continuous Longitudinal Manpower Survey," Department of Labor.

The survey is designed to obtain cross-section profiles of enrollees in programs funded by CETA Titles I, II, VI, and Title II summer youth programs. Information obtained through these samples supplements data collected through the regular prime sponsor network. The CLMS is used to measure the impact of PSE enrollment on worker earnings over time. Eventually, the focus will be on what happens to former CETA PSE employees after leaving the program and whether they enter the private or public job market.

4. "CETA PSE Net Effects Study," National Commission for Manpower Policy.

Determination of the "net effects" of CETA PSE by the National Commission for Manpower Policy has four component studies:

1) Econometric and other estimates of displacement by Michael E. Borus and Daniel S. Hamermesh;

2) Legislative history by Harry Katz;

3) Macroeconomic policy considerations by Robert Solow; and

4) On-site evaluation of PSE by Richard Nathan and Brookings Institution.

5. The National Academy of Sciences.

The NAS proposes a long term evaluation of CETA PSE expansion using field interviews with local CETA officials. Interviews would be conducted through the NAS field associates research network.

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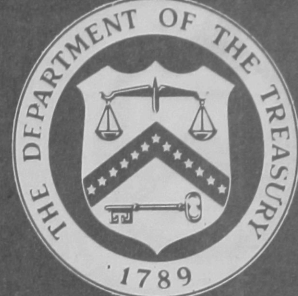

FOR IMMEDIATE RELEASE January 23, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,303 million of 13-week Treasury bills and for $3,501 million of 26-week Treasury bills, both series to be issued on January 26, 1978, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing April 27, 1978			26-week bills maturing July 27, 1978		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.380	6.409%	6.60%	96.615a/	6.696%	7.03%
Low	98.374	6.433%	6.63%	96.603	6.719%	7.05%
Average	98.375	6.429%	6.63%	96.608	6.709%	7.04%

a/ Excepting 1 tender of $500,000

Tenders at the low price for the 13-week bills were allotted 31%.
Tenders at the low price for the 26-week bills were allotted 87%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS AND TREASURY:

Location	Received	Accepted	Received	Accepted
Boston	$ 43,715,000	$ 22,335,000	$ 31,965,000	$ 26,965,000
New York	4,088,810,000	1,970,130,000	4,394,525,000	3,039,725,000
Philadelphia	65,635,000	33,745,000	55,085,000	50,085,000
Cleveland	45,845,000	34,580,000	58,470,000	51,520,000
Richmond	30,375,000	19,375,000	44,715,000	15,715,000
Atlanta	77,400,000	35,880,000	19,475,000	19,275,000
Chicago	237,500,000	43,185,000	231,655,000	70,445,000
St. Louis	58,540,000	30,340,000	44,190,000	23,450,000
Minneapolis	28,480,000	10,720,000	39,980,000	32,980,000
Kansas City	35,345,000	29,550,000	25,970,000	25,970,000
Dallas	18,975,000	16,975,000	11,030,000	11,030,000
San Francisco	202,750,000	50,645,000	434,170,000	129,170,000
Treasury	5,610,000	5,610,000	4,660,000	4,660,000
TOTALS	$4,938,980,000	$2,303,070,000b/	$5,395,890,000	$3,500,990,000c/

b/Includes $411,670,000 noncompetitive tenders from the public.
c/Includes $173,770,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-651

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041

For Immediate Release
Monday, January 23, 1978

Contact: Robert Nipp
566-5328

ISSUANCE OF NEW BOYCOTT GUIDELINES

The Treasury Department today announced the issuance of new guidelines, consisting of questions and answers, relating to the provisions of the Tax Reform Act of 1976 which deny certain tax benefits for participation in or cooperation with international boycotts.

The new guidelines supersede earlier sets of guidelines issued November 4, 1976 (Treasury News Release WS-1156), December 30, 1976 (WS-1239), and August 12, 1977 (B-390), and published in the Federal Register on November 11, 1976, January 5, 1977 and August 17, 1977, respectively.

The new guidelines generally are effective for "operations occurring after," "requests received after," and "agreements made after" November 3, 1976.

The effective date of November 3 affords a retroactive benefit to persons who can claim the advantage of any rule in today's guidelines which is more favorable than previous guidelines.

There are five exceptions to this general effective date, according to Treasury General Counsel Robert H. Mundheim. They are:

First, until February 13, 1978, affected persons will be entitled to the benefits of any previously published Treasury guidelines with respect to any specific issue covered in parts H through M of the guidelines.

Second, in the case of binding contracts entered into before October 25, 1977, operations that do not constitute participation in or cooperation

with an international boycott under any previously published Treasury guideline will not constitute participation in or cooperation with an international boycott until July 1, 1978.

Third, in the case of binding contracts entered into before February 13, 1978, but after October 24, 1977, operations that do not constitute participation in or cooperation with an international boycott under the August 12, 1977 guidelines will not constitute participation in or cooperation with an international boycott until January 1, 1979.

Fourth, in the case of binding contracts entered into before February 13, 1978, guidelines H-1B, H-8, H-29A, H-29B, I-8, J-11, and K-5 of today's guidelines will not be effective until July 1, 1978.

Fifth, if a particular guideline in parts A through G or N through O of today's guidelines results in an increase in the reporting burden or tax liability of a person, that answer will be effective for taxable years ending after January 20, 1978, the date on which the new guidelines were filed with the Office of the Federal Register.

Although the guidelines issued today differ in many respects from earlier guidelines, substantial revisions are reflected in guidelines A-3, A-10B, A-14A, A-14B, A-23, D-3, D-4, D-5, F-2, H-1B, H-2B, H-29A, H-29B, H-32, H-33, H-34, I-8, J-2A, J-2B, J-5, J-11, K-5, M-5, N-1A, N-1B, and N-2.

This announcement and the new guidelines will appear in the Federal Register on January 25, 1978.

Attachment: Questions and Answers on New Boycott Guidelines

DEPARTMENT OF THE TREASURY

GUIDELINES

Boycott Provisions (section 999)
of the Internal Revenue Code

Table of Contents

A. Boycott Reports

B. Definition of "Operations"

C. Definition of "Reason to Know" of Official Requirement of Boycott Participation

D. Definition of "Clearly Separate and Identifiable Operations"

E. Effective Date Provisions

F. International Boycott Factor

G. Determinations

H. Definition of an Agreement to Participate in or Cooperate with a Boycott (section 999(b)(3))

I. Refraining from Doing Business with or in a Boycotted Country (section 999(b)(3)(A)(i))

J. Refraining from Doing Business with any United States Person Engaged in Trade in a Boycotted Country (section 999(b)(3)(A)(ii))

K. Refraining from Doing Business with any Company Whose Ownership or Management is Made Up, in Whole or in Part, of Individuals of a Particular Nationality, Race or Religion (section 999(b)(3)(A)(iii))

L. Refraining from Employing Individuals of a Particular Nationality, Race or Religion (section 999(b)(3)(A)(iv))

M. As a Condition of the Sale of a Product, Refraining from Shipping or Insuring that Product on a Carrier Owned, Leased, or Operated by a Person who does not Participate in or Cooperate with an International Boycott (section 999(b)(3)(B))

N. Reduction of Foreign Tax Credit

O. Subpart F Income

In the questions and answers:

(a) Company A and Company B are companies organized under the laws of one of the states of the United States;

(b) Company C and Company D, unless otherwise stated in the question, are companies organized under the laws of any country, including the United States;

(c) Country X is a boycotting country, which, inter alia, boycotts Country Y;

(d) Country Y is a country boycotted by Country X;

(e) Country Z is any country and may be the United States, a boycotting country or a boycotted country;

(f) All references to "Sections" are to Sections of the Internal Revenue Code of 1954, as amended;

(g) In parts H-M in instances where the action described in the question by itself does not, according to the answer, provide sufficient evidence to support an inference that an agreement under section 999(b)(3) exists, an overall course of conduct which includes such action in addition to other actions could support such an inference; and

(h) In many questions in parts H-M, a person deals with either Country X or the government, a company or a national of Country X. The result reached in the answer to each of those questions would be the same irrespective of whether the person is an individual, a company or any other type of person, and whether the person dealt with is Country X or the government, a company or a national of Country X.

A. Boycott Reports.

A-1. Q: Who must report as required by section 999(a)?

A: Generally, a United States person (within the meaning of section 7701(a)(30)) is required to report under section 999(a) if it--

1. has operations; or

2. is a member of a controlled group, a member of which has operations; or

3. is a United States shareholder within the meaning of section 951(b) of a foreign corporation that has operations, but only if the United States shareholder owns within the meaning of section 958(a) stock of that foreign corporation; or

4. is a partner in a partnership that has operations; or

5. is treated under section 671 as the owner of a trust that has operations

in or related to a boycotting country (or with the government, a company, or a national of a boycotting country). A person (within the meaning of section 7701(a)(1)) that is not a United States person is required to report under section 999(a) if it satisfies any one of the five conditions specified above and it claims either the benefit of the foreign tax credit under section 901 or owns stock of a DISC.

If a person controls a corporation within the meaning of section 304(c) and that person is required to report under section 999(a), then under section 999(e) that person must report whether the corporation participated in or cooperated with the boycott. If the corporation is required to report under section 999(a), then under section

999(e) the corporation must report whether the person participated in or cooperated with the boycott.

A boycotting country is

(i) any country that is on the list maintained by the Secretary under section 999(a)(3), or

(ii) any country not on the list maintained by the Secretary under section 999(a)(3), in which the person required to file the report (or a member of the controlled group that includes that person) has operations, and which that person knows or has reason to know requires <u>any person</u> to participate in or cooperate with an international boycott that is not excepted by section 999(b)(4)(A), (B), or (C). Thus, even if the boycott participation required of the person reporting the operation is excepted by section 999(b)(4)(A), (B), or (C), if that person knows or has reason to know that boycott participation not excepted by section 999(b)(4)(A), (B), or (C) is required of any other person, the country is a boycotting country.

If the person required to file the report (or a member of the controlled group that includes that person) has operations related to a country, but not operations in that country, that country is not a boycotting country unless it is on the list maintained by the Secretary under section 999(a)(3). (For the definition of operations in or related to a country, see the questions and answers under part B.)

A-2. Q: Do the reporting requirements of section 999(a) that refer to "United States shareholders" of foreign corporations require U.S. minority shareholders to report the operations of such foreign corporations?

A: Yes. Under section 951(b) the term "United States shareholder" includes any United States person who owns (within the meaning of section 958(a)), or is considered as owning (by the application of the rules of ownership of section 958(b)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. The reporting requirement applies even if the United States shareholder is a minority shareholder and even if the foreign corporation is not a controlled foreign corporation within the meaning of section 957(a). However, as stated in Answer A-1, the reporting requirement applies only to minority shareholders that actually own some stock within the meaning of section 958(a).

A-3. Q: If one member of a controlled group of corporations (within the meaning of section 993(a)(3)) files a report under section 999(a) with respect to the reportable operations of all members of that group, is this sufficient to discharge the reporting obligation of all members of the group?

A: Yes, provided that the common parent (as defined in the regulations under section 1504) files a consolidated return and the report on behalf of all members of the controlled group. In the absence of a consolidated return, each member of the controlled group must individually file the section 999(a) report. If a consolidated return is filed on behalf of some members of the controlled group, only one report need be filed with respect to those members. However, each

other member must individually file the report.

A-4. Q: If one United States shareholder of a foreign corporation files a report under section 999(a) in respect of the reportable operations of the foreign corporation, is this sufficient to discharge the reporting obligations of all United States shareholders of the foreign corporation in respect of that corporation's operations?

A: No. Each United States shareholder of a foreign corporation must file the section 999(a) report in respect of the activities of that corporation. However, if two or more United States shareholders of a foreign corporation are included in the same consolidated return, only one report need be filed with respect to all United States shareholders included in the return.

A-5. Q: How will the reporting requirements under section 999(a), "International Boycott Reports by Taxpayers", be satisfied?

A: A taxpayer required to file an international boycott report under section 999(a) will fulfill this requirement by filing a new IRS Form 5713, "International Boycott Report", and all applicable supporting schedules and forms contained in the taxpayer's income tax returns which indicate the amounts and computations of benefits denied under sections 908(a), 952(a)(3) and 995(b)(1)(F) of the Internal Revenue Code.

A-6. Q: What degree of confidentiality will the international boycott reports submitted by taxpayers receive?

A: The reports by taxpayers will be submitted as part of the income tax return and, therefore, will be accorded the same degree of confidential treatment under section 6103 as any other information contained in an income tax return.

A-7. Q: Where and how should the "International Boycott Report" be filed?

A: The "International Boycott Report", Form 5713, should be filed in duplicate by all reporting taxpayers. One copy of Form 5713 should be sent to the Internal Revenue Service, 11601 Roosevelt Blvd., Philadelphia, Pennsylvania, 19155, and the other copy of Form 5713 should be attached to the taxpayer's income tax return that is filed with the taxpayer's customary Internal Revenue Service Center.

A-8. Q: Do individuals as well as corporations use Form 5713, "International Boycott Report"?

A: Yes. All taxpayers required to file a report under section 999(a) will use IRS Form 5713. However, some parts of the form apply to corporations only; individual taxpayers can ignore these parts and complete only the questions relevant to individuals. While all taxpayers reporting under section 999(a) are required to file Form 5713, the filing of Form 5713 does not necessarily fulfill all of the reporting requirements under section 999(a). (See Answer A-5.)

A-9. Q: Section 999(b)(4) permits a person to agree to comply with certain laws without being treated as having agreed to participate in or cooperate with an international boycott. In the course of its operations in or related to a boycotting country, a person agrees to comply with a prohibition on importation and exportation that is described in section 999(b)(4)(B) and section 999(b)(4)(C). Is that person required to report the operations on Form 5713, the "International Boycott Report"?

A: Yes, although agreements described in section 999(b)(4)(B) and (C) do not constitute participation in or cooperation with an

international boycott, the operations in or related to a boycotting country must be reported on Form 5713.

A-10. Q: Section 999(b)(4)(A) permits a person to meet requirements imposed by a foreign country with respect to an international boycott if United States law or regulations, or an Executive Order, sanctions participation in or cooperation with that international boycott. If a person's operations fall within this exception, is the person required to report such operations?

A: No. The reporting requirements with respect to operations under such international boycott agreements are waived.

A-11. Q: Company C sells goods or services to a person other than a boycotting country, or the government, a company, or a national of a boycotting country (or does other business with that person) outside a boycotting country. Company C knows or has reason to know that that person in turn will either use the goods or services in a boycotting country or sell the goods or services for use in a boycotting country. Is Company C required to report its sale of goods or services to that person?

A: Although the sale of the goods or services by Company C constitutes an operation related to a boycotting country of Company C (see Answer B-1), the requirement that Company C report the sale is waived, provided that in connection with the operation Company C does not receive a request to participate in or cooperate with an international boycott (within the meaning of section 999(b)(3)), Company C does not participate in or cooperate with an international boycott, and Company C did not establish its relationship with that person to facilitate participation in or cooperation with an international boycott.

A-12. Q. Company A is a U. S. shareholder (within the meaning of section 951(b)) of Company C, a foreign corporation. Company A has a taxable year ending January 31, and Company C has a taxable year ending June 30. Both companies have operations in Country X, which is on the list maintained pursuant to section 999(a)(3). Who should file Form 5713 and for what period ?

A: As indicated in Answer A-1, Company C need not file Form 5713 unless it claims the benefit of the foreign tax credit under section 901 or owns stock of a DISC. Company A must file Form 5713 for its taxable year ending January 31, and must report operations of Company C during Company C's taxable year ending within the period covered by Company A's report.

A-13. Q: In the case of an International Boycott Report, Form 5713, filed by a member of a controlled group, what period of time should be reflected in the report, and when should the report to be filed?

A: Each person described in Answer A-1 ("reporting-ing person") is required to report all reportable operations, requests and participation or cooperation of each member of the controlled group for each member's taxable year that ends with or within the taxable year of the controlled group's common parent that ends with or within the taxable year of the reporting person.

In addition, each reporting person is required to report all reportable operations, requests and participation or cooperation of each foreign corporation that has a United States shareholder that is a member of the controlled group. Such operations, requests and

participation or cooperation of a foreign corporation are reported for the foreign corporation's taxable year that ends with or within the taxable year of the United States shareholder that ends with or within the taxable year of the common parent that ends with or within the taxable year of the reporting person.

In the event that no common parent exists, the members of the controlled group are to elect the taxable year of one of the members to serve as the common taxable year of the group. Procedures for making the taxable year election are specified in the instructions to the "International Boycott Report," Form 5713. The taxable year election is a binding election and is made only once. Approval of the Secretary of the Treasury or his delegate is required for any changes in the group taxable year.

Each reporting person will use its normal taxable year for making adjustments required under sections 908(a), 952(a)(3) and 995(b)(1)(F), and for all purposes other than reporting and computing the international boycott factor. For example, if the reporting person uses the international boycott factor, the international boycott factor will be applied to the reporting person's normal taxable year for determining the reporting person's adjustments under sections 908(a), 952(a)(3) and 995(b)(1)(F).

More details concerning the time period covered in the international boycott report are contained in the instructions to Form 5713. Details concerning the time period covered in the international boycott factor are contained in the instructions to Form 5713 and in

Temp. Regs. §7.999-1 and Proposed Regs. §1.999-1.

As stated in Answer A-7, the reporting person's "International Boycott Report," Form 5713, is filed at the time the reporting person files its income tax return.

A-14. Q: Company C is either a U. S. corporation or a foreign corporation and is required to report under section 999(a). Company C is also a subsidiary or a sister of a foreign corporation that is not required to report under section 999(a). Is Company C required to report the operations, requests and participation or cooperation of the foreign parent or sister corporation?

A: Generally, under section 999(a) and Answer A-1, a person required to report must report the operations, requests and participation or cooperation of all members of the controlled group of which it is a member. However, if the foreign parent or sister corporation is not otherwise required to report, the requirement that Company C report the operations, requests and participation or cooperation of the foreign parent or sister corporation will be waived if Company C--

1. is not entitled to any benefits of deferral, DISC, or the foreign tax credit, or
2. applies the international boycott factor, and forfeits all the benefits of deferral, DISC and the foreign tax credit to which it is entitled (i. e., applies an international boycott factor of one under sections 908(a), 952(a)(3), and 995(b)(1)(F)), or

3. identifies specifically attributable taxes and income, and forfeits all the benefits of deferral, DISC, and the foreign tax credit in respect of which it is unable to demonstrate that the foreign taxes paid and the income earned are attributable to specific operations in which there was no participation in or cooperation with an international boycott.

Although the requirement that Company C report the operations, requests and participation or cooperation of its foreign parent or sister corporations may be waived, Company C must report <u>all</u> operations, requests and participation or cooperation--

i) of itself, and

ii) of all domestic members of each controlled group of which Company C is a member, and

iii) if Company C is a United States company, of all foreign corporations of which Company C is a United States shareholder within the meaning of section 951(b), but only if Company C owns within the meaning of section 958(a) stock of the foreign corporation, or

iv) if Company C is a foreign company, of all foreign corporations more than 50 percent of the stock of which is owned, directly or indirectly, by Company C.

If Company C is required to report on behalf of a foreign corporation (including itself if Company C is a foreign corporation), it must report <u>all</u> operations, requests and participation or cooperation of the foreign corporation, even if conducted by or received by the foreign corporation in connection with operations that are not effectively connected with a

United States trade or business.

A-15. Q: Company C receives from Country X an unsolicited invitation to tender for a contract for the construction of an industrial plant in Country X. The tender documents contain a provision stating that Country X will not enter into the contract unless the successful tenderer makes an agreement described in section 999(b)(3). Company C does not respond to the unsolicited invitation. Is Company C required to report the invitation under section 999(a)(2) as a request to participate in or cooperate with an international boycott?

A: No. The section 999(a)(2) reporting requirement will be waived provided that Company C neither solicited the invitation to tender nor responded to the invitation.

A-16: Q: Before May 13, 1977, Company C received requests to comply with international boycotts. Company C preserved the requests that were evidenced in writing and preserved the notations it made concerning the details of oral requests. When Form 5713 was issued on May 13, 1977, it required more details concerning the requests made of Company C than were preserved, and many of those details can no longer be ascertained. Will Company C's report under section 999(a)(2) be deemed deficient?

A: On October 4, 1976, Company C was put on notice that it would be required to document boycott requests received after November 3, 1976. Form 5713 does not require any details that would not have been preserved by a prudent person having such notice. In addition, under Answer A-15, the reporting requirements of section

999(a)(2) have been waived for certain unsolicited boycott requests. If Company C does not supply the required information with respect to the remaining requests that were either solicited or responded to, its report will be deficient.

A-17. Q: A United States partnership consisting of 100 United States partners has operations in a boycotting country. Is each partner required to file Form 5713?

A: Generally, if a partnership has operations in a boycotting country, each partner is required to file Form 5713. However, if the partnership files Form 5713 with its information return and has no operations for the taxable year that constitute participation in or cooperation with an international boycott, then the requirement that each partner file Form 5713 will be waived for each partner that has no operations in or related to a boycotting country, or with the government, a company, or a national of a boycotting country other than operations that are reported on the Form 5713 filed by the partnership.

A-18. Q: Company A owns 10 percent or more of the outstanding stock of Company C, a foreign corporation that has operations in Country X, but Company A does not have effective control over Company C. Company C participates in or cooperates with an international boycott. Company A requests information from Company C in order to meet its reporting obligations under section 999(a). Company C refuses to provide (or is prohibited by local law, regulation, or practice from providing) that information. Will Company A be subject to the section 999(f) penalites for willful failure to report the activities of Company C?

A: Company A must report on the basis of that information that is reasonably available to it. For example, in most cases Company A will be aware that Company C has operations in Country X, even though Company A is not aware of the operational details. Company A must report on Form 5713 that Company C has operations in Country X. Company A should also describe in a statement attached to Form 5713 the good faith efforts that it has made to obtain all the information required under section 999(a). Although each case must be resolved on the basis of the particular facts and circumstances, Company A will not be subject to the section 999(f) penalties for willful failure to provide information if it can demonstrate that it made good faith efforts to obtain the information but was denied the information by Company C.

A-19. Q: The facts are the same as in A-18 above except that Company A owns less than 50 percent of the stock of Company C, and Company C is not a controlled foreign corporation. What are the tax sanctions to which Company A will be subject?

A: Since Company C is neither a controlled foreign corporation nor a DISC, the sanctions of section 952(a)(3) and 995(b)(1)(F) are not relevant. However, Company A will be subject to the sanctions of section 908(a). Thus, if Company A applies an international boycott factor, that factor is applied to Company A's foreign tax credit in accordance with Answers F-5, N-1 and N-2. If Company A identifies specifically attributable taxes and income under section 999(c)(2), Company A will lose its section 902 indirect foreign tax credit for the taxes paid by Company C that Company A cannot demonstrate are

attributable to specific operations in which there was no boycott participa tion or cooperation. (To determine whether Company A will lose its section 901 direct foreign tax credit for income tax withheld by Country X on dividends paid by Company C to Company A, see Answer N-3.)

A-20. Q: Individual G is a national of Country X, which is on the list maintained by the Secretary. G engages in an operation with Company C. For example, if Company C were a bank, the operation might involve a deposit by G, or, if Company C were an automobile dealer, the operation might involve the purchase of a car, or, if Company C were a stockbroker, the operation might involve the purchase or sale of a security, or if Company C were a hotel, the operation might involve the letting of a room. Irrespective of the specific nature of the operation, the agreement under which the operation is consummated is the same agreement that Company C requires of all other customers. Company C is aware of G's nationality, but partici-pation in or cooperation with an international boycott is neither contemplated nor required as a condition of G's willingness to enter into the operation with Company C. Under section 999(a), what are the reporting obligations of Company C with respect to these operations?

A: In many business operations, there will be incidental contacts between the nationals or business enterprises of boycotting countries and persons from other countries. Company C's obligation to report these incidental contacts under section 999(a) will be waived provided that the contacts satisfy the following criteria:

1. all aspects of the operation contemplated by the parties are carried on outside a boycotting country; and
2. the operation does not contemplate any agreement which would constitute participation in or cooperation with an international boycott; and
3. no request for such an agreement is actually made or received by any party to the operation; and
4. there is no such agreement in connection with the operation; and
5. a. the operation does not involve the importation of property, funds or services from or produced in a boycotting country and Country C does not know or have reason to know that the property, funds or services will be used, consumed or disposed of in a boycotting country, or

   b. the value of the property, funds or services furnished or obtained in the operation does not exceed $5,000.

The answer to the question would be the same if Company C were an individual or if G were a corporation.

A-21. Q: Individual G, a U.S. citizen, owns 15 percent of the stock of Company A. Company A has operations in Country X. Is Individual G required to report the operations of Company A?

A: An individual generally is not required to report the operations of a domestic corporation of which the individual is a shareholder. However, if Individual G controls (within the meaning of section 304(c)) Company A and if Individual G is required to report under section 999(a), then under section 999(e) Individual G must report whether Company A participated in or cooperated with an international boycott.

A-22. Q: Companies A, B and C are all U.S. corporations reporting on a calendar year basis. Companies A, B and C each had operations in Country X during the calendar year. From January 1 to June 1, Company A owned more than 50 percent of the stock of Company B. On June 1, Company C acquired more than 50 percent of the stock of Company B. What operations must be reflected in the Forms 5713 filed by Companies A, B and C for the calendar year?

A: The Form 5713 filed by Company A must reflect the operations of Company A for the entire calendar year and the operations of Company B for the period January 1-May 31. The Form 5713 filed by Company C must reflect the operations of Company C for the entire calendar year and the operations of Company B for the period June 1-December 31. The Form 5713 filed by Company B must reflect the operations of Company B for the entire calendar year, the operations of Company A for the period January 1-May 31 and the operations of Company C for the period June 1-December 31. If the sale of stock had occurred during the first 30 days of the calendar year, the requirement that Company A report the operations of Company B and that Company B report the operations of Company A for the period of 30 days or less

would be waived unless under Reg. §1.1502-76(b)(5) Company B is included in the consolidated return filed by Company A for that period. The requirement that Company B report the operations of Company C, and that Company C report the operations of Company B, for that period of 30 days or less, would also be waived unless under Reg. §1.1502-76(b)(5) Company B is included in the consolidated return filed by Company C for that period. Similarly, if the sale of stock had occurred during the last 30 days of the calendar year, the requirement that Company A report the operations of Company B and that Company B report the operations of Company A for the period of 30 days or less would be waived unless under Reg. §1.1502-76(b)(5) Company B is included in the consolidated return filed by Company A for that period, and the requirement that Company B report the operations of Company C and that Company C report the operations of Company B for the period of 30 days or less would be waived unless under Reg. §1.1502-76(b)(5) Company B is included in the consolidated return filed by Company C for that period.

A-23. Q: In 1977, Company A owns more than 50 percent of the stock of Company C, a foreign corporation that has operations in Country X that constitute participation in or cooperation with an international boycott. Companies A and C both report on a calendar year basis. Company C pays no dividend in 1977, but pays a dividend in 1978, a year in which neither Company A nor Company C has operations in any boycotting country. Company A claims a foreign tax credit under section 902 in 1978 in respect of the taxes paid by Company C. For which year, 1977 or 1978, must Company A report the operations of Company C;

for which year are Company C's operations reflected in Company A's international boycott factor; and for which year is the sanction of section 908(a) applicable?

A: Company C's operations are reported by Company A and are reflected in Company A's international boycott factor for 1977. The operations of Company C during 1977 will not be reflected in Company A's Form 5713 or international boycott factor for 1978. However, if in 1978 Company A chooses to determine its loss of tax benefits using the specifically attributable taxes and income method described in section 999(c)(2), in 1978 Company A will lose that portion of the section 902 foreign tax credit specifically attributable to Company C's 1977 boycott operations. In this case, even though in 1978 Company A and Company C have no operations that are required to be reported by Company A on Form 5713, Company A must nevertheless file Form 5713 in 1978 (which will show no operations) and complete Schedules B and C to Form 5713, on which Company A will show the loss of the section 902 foreign tax credit attributable to Company C's boycott operations for 1977.

B. Definition of "Operations".

B-1. Q: Under what circumstances does a person have operations in, or related to, a boycotting country (or with the government, a company, or a national of that country)?

A: A person has operations in, or related to, a boycotting country (or with the government, a company, or a national of that country) if the operation in which it engages:

1. is carried on in whole or part in a boycotting country ("in a country");
2. is carried on outside a boycotting country either for or with the government, a company, or a national of a boycotting country ("with the government, a company, or a national of a country"); or
3. is carried on outside a boycotting country for the government, a company, or a national of a non-boycotting country if the person having the operation knows or has reason to know that the specific goods, services or funds produced by the operation are intended for use in a boycotting country or for the government, a company, or a national of a boycotting country ("related to a country").

The term "operation" encompasses all forms of business or commercial activites whether or not productive of income, including, but not limited to, selling; purchasing; leasing; licensing; banking, financing and similar activities; extracting; processing; manufacturing; producing; constructing; transporting; performing activities ancillary to the foregoing (e.g., contract

negotiating, advertising, site selecting, etc.); and performing services, whether or not ancillary to the foregoing.

Operations described in principles 2 and 3 are illustrated in the following two examples:

(a) Company C engages in a joint venture manufacturing operation in a non-boycotting country with Company D, a company incorporated under the laws of Country X. Company C has operations "with" a company of a boycotting country.

(b) D, a national of a non-boycotting country has a contract to construct a dam in Country X. D subcontracts to Company C for the manufacture of a generator for the dam. The contract between D and Company C and the generator specifications indicate that the generator is for use in Country X. The contract specifies delivery of the generator to D f.o.b. New York. Company C has operations "related to" a boycotting country.

B-2. Q: Individual G is a U.S. citizen living in Country X. G is retired. G receives social security payments and a pension, but has no business activities. Does G have "operations" in, or related to, Country X?

A: No. G is not engaged in any business or commercial activities.

B-3. Q: Individual H is a U.S. citizen living in Country X and working there as an employee. H earns a salary and has passive investment income, but has no business income. Does H have "operations" in or related to Country X?

A: No. The performance of personal services as an employee does not constitute an "operation."

C. Definition of "Reason To Know" Requirement of Boycott Participation.

C-1. Q: Under what circumstances, in the absence of a Treasury listing of a country under section 999(a)(3), will it be deemed under section 999 (a)(1)(B) that a person knows or has reason to know that participation in or cooperation with an international boycott is required as a condition of doing business within such country or with the government, a company, or a national of such country?

A: A person will be deemed to know or have reason to know that a country requires participation in or cooperation with an international boycott as a condition of doing business within a country or with the government, a company, or a national of a country, if that person receives what could be interpreted as an official request of that country to participate in or cooperate with an international boycott or if that person knows that others have received such requests. Whether a request could be interpreted as an official request of a country depends on an analysis of the facts and circumstances surrounding the request. However, the request need not be made directly by a government official or representative in order to be interpreted as an official request. Thus, for example, assume that Company C has a contract with the government of a boycotting country to build a dam in that country and is required under the contract to require its subcontractors to agree to participate in or cooperate with the boycott. Assume further that Company C requires Subcontractor D to make such an agreement as a condition of receiving the subcontract to build a generator for the dam. Subcontractor D will be deemed to have reason to know that participation in or cooperation with an international boycott is a condition of doing business within

the boycotting country or with the government, a company, or a national of such country.

D. Definition of "Clearly Separate and Identifiable Operations".

D-1. Q: If a person or a member of a controlled group (within the meaning of section 993(a)(3)) enters into an agreement that constitutes participation in or cooperation with an international boycott (within the meaning of section 999(b)(3)), what operations of that person or group will be considered to be operations in connection with which such participation or cooperation occurred?

A: All operations of that person or any member of that group in

(a) the country in connection with which the agreement is made; and

(b) any other country that requires participation in or cooperation with the boycott with respect to which the agreement is made

will be presumed to be operations in connection with which there was participation in or cooperation with an international boycott. (See, however, Answer D-4 for an exception to the presumption in the case of agreements that are unintentional and unauthorized and that relate to a minor aspect of an operation.)

This presumption may be rebutted, however, if the person (or, if applicable, the U.S. shareholder of a foreign corporation) or member of the group clearly demonstrates that a particular operation is a clearly separate and identifiable operation from the operation in connection with which the agreement was made, and that no agreement constituting participation in or cooperation with an international boycott was made in connection with such separate and identifiable operation.

The presumption of participation in or cooperation with the boycott will not apply with respect to operations outside the countries described in (a) and (b) above, but such operations will be considered to be operations in connection with which there was participation in or cooperation with an international boycott if so warranted by the facts.

D-2. Q: Who has the burden of proof of clearly demonstrating that a particular operation is a "clearly separate and identifiable operation" and that there was no participation in or cooperation with an international boycott in connection with that operation?

A: If a person or a member of a controlled group has participated in or cooperated with an international boycott in connection with one or more of its operations, that person (or, if applicable, the U.S. shareholder of a foreign corporation) or that group bears the burden of proof of clearly demonstrating that any other operation is clearly separate and identifiable from the operation in connection with which such participation or cooperation occurred and that no such participation or cooperation occurred in connection with the separate and identifiable operation.

D-3. Q: How can a taxpayer determine what constitutes a "clearly separate and identifiable operation"?

A: The determination whether an operation constitutes a clearly separate and identifiable operation must be based on an examination of all the facts and circumstances. The following factors are among those that may be considered in determining whether an operation is clearly separate and identifiable from an operation in connection

with which participation in or cooperation with an international boycott occurred:

1. Were the two operations conducted by different corporations, partnerships, or other business entities?

2. Were the operations, whether conducted by separate entities or not, supervised by different management personnel?

3. Did the operations involve distinctly different products or services?

4. Were the operations undertaken pursuant to separate and distinct contracts?

5. If business operations in the countries conducting the international boycott in question were not continuous over time, was each transaction separately negotiated and performed?

The factors listed above are not intended to represent all the factors that will be considered in determining whether an operation is a clearly separate and identifiable operation. Additional factors will be considered if so warranted by the facts. No relative weight is assigned to any specific factor; instead, the weight to be given to any factor will depend on the facts and circumstances of each individual case. In addition, a positive answer to all the listed factors will not necessarily result in a determination that an operation is a clearly separate and identifiable operation if other facts and circumstances

suggest that the operation is not clearly separate and identifiable.

D-4 Q: Company C has operations in or related to Country X. In connection with a minor aspect of that operation, an employee of Company C enters into an unintentional and unauthorized boycott agreement. For example, a clerk of Company C signs an invoice for office supplies. On the reverse side of the invoice, a boycott clause is printed in fine print or in a foreign language. Will that agreement give rise to the presumption that all the operations of Company C in or related to a boycotting country are operations in connection with which there is participation in or cooperation with an international boycott?

A: No. An agreement to participate in or cooperate with an international boycott made in connection with a minor aspect of an operation will not taint the operations of Company C in or related to a boycotting country if the agreement was unintentional, Company C has not authorized the employee to agree to participate in or cooperate with the international boycott and Company C does not comply with the terms of the unauthorized boycott clause.

E. Effective Date Provisions.

E-1. Q: What are the effective dates of the reporting requirements and sanctions of the international boycott provisions?

A: Generally, the reporting requirements and the sanctions of the international boycott provisions apply to agreements to participate in or cooperate with an international boycott made after November 3, 1976, and to agreements made on or before November 3, 1976, that continue in effect thereafter. However, there are two exceptions to this general rule. First, the reporting requirements of section 999(a) apply to operations referred to in section 999(a)(1) or (2) after November 3, 1976, whether or not there has been an agreement to participate in or cooperate with an international boycott, and whether or not the operations are carried out in accordance with the terms of a binding contract entered into before September 2, 1976. Operations on or before November 3, 1976, are reportable if there has been participation in or cooperation with the boycott during the taxable year after November 3, 1976 (see Answer E-2). Second, in the case of operations carried out in accordance with the terms of a binding contract entered into before September 2, 1976, the sanctions of the international boycott provisions apply only to agreements to participate in or cooperate with an international boycott made on or after September 2, 1976, and to agreements made before that date that continue in effect after December 31, 1977. More details concerning reporting requirements and the application of sanctions for years affected by the effective date of the international boycott provisions are contained in the instructions to Form 5713, in Temp. Regs. §7.999-1 and in Proposed Regs. §1.999-1.

E-2. Q: If a person who reports tax liability on a calendar year basis makes an agreement on November 20, 1976, to participate in or cooperate with an international boycott, which of that person's operations conducted during the taxable year are reportable, which operations are included in the international boycott factor calculations, and how are the sanctions applied?

A: All operations of the person during the entire 1976 taxable year (including pre-November 20, 1976, operations) in or related to a boycotting country or with the government, a company, or a national of such country must be reported under section 999(a) and will be considered in calculating the international boycott factor (or the amount of taxes or income specifically attributable to operations in which there was participation in or cooperation with an international boycott) for the taxable year. However, under section 999(c)(1), operations for which the presumption of participation in or cooperation with the boycott has been rebutted need not be reflected in the numerator of the international boycott factor (or under section 999(c)(2), the tax benefits specifically attributable to specific operations for which that presumption has been rebutted will not be denied). See also Temp. Regs. §7.999-1 and Proposed Regs. §1.999-1.

The sanctions are applied to the year 1976 on a pro rata basis. If a person uses the international boycott factor for 1976, the factor is applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) after it has been multiplied by the fraction 58/366, representing the number of days after the November 3, 1976 effective date remaining during the calendar year. If a person identifies specifically attributable taxes

and income, the tax benefits denied under sections 908(a), 952(a)(3), and 995(b)(1)(F) are computed by first ascertaining the tax benefits of the foreign tax credit, deferral, and DISC, respectively, for the taxable year attributable to operations for which the presumption of boycott participation has not been rebutted, and then multiplying those amounts by 58/366.

E-3. Q: If a person having a July 1-June 30 taxable year carries out operations in accordance with the terms of a binding contract entered into before September 2, 1976, and, in furtherance of that contract, makes an agreement on February 15, 1978, to participate in or cooperate with an international boycott, which of the person's operations conducted during the taxable year July 1, 1977-June 30, 1978 are reportable, which operations are included in the international boycott factor calculations, and how are the sanctions applied?

A: All operations of the person during the entire July 1, 1977-June 30, 1978 taxable year (including pre-February 15, 1978 operations) in or related to a boycotting country or with the government, a company, or a national of such country, must be reported under section 999(a) and will be considered in calculating the international boycott factor (or the amount of taxes or income specifically attributable to operations in which there was participation in or cooperation with an international boycott) for the taxable year. However, under section 999(c)(1), operations for which the presumption of participation in or cooperation with the boycott has been rebutted need not be reflected in the numerator of the international boycott factor, and, under section 999(c)(2), the tax benefits specifically attributable to specific operations for which that presumption has been rebutted will not be denied.

The sanctions are applied to the July 1, 1977-June 30, 1978 taxable year on a pro rata basis. If a person uses the international boycott factor for the taxable year, the factor is applied under sections 908(a), 952(a)(3), and 995(b)(1)(F) after it has been multiplied by the fraction 181/365, representing the number of days after the December 31, 1977 effective date remaining during the taxpayer's taxable year. (See also Temp. Regs. §7.999-1 and Proposed Regs. §1.999-1.) If a person identifies specifically attributable taxes and income, the benefits to be denied under section 908(a), 952(a)(3), and 995(b)(1)(F) are computed by first ascertaining the tax benefits of the foreign tax credit, deferral, and DISC, respectively, for the taxable year attributable to operations for which the presumption of boycott participation has not been rebutted and then multiplying those amounts by 181/365.

E-4. Q: What is a binding contract for purposes of the binding contract rule?

A: A binding contract with respect to a person, a member of a controlled group that includes that person, or a foreign corporation of which that person is a United States shareholder is a contract that was, on September 1, 1976, and is at all times thereafter, binding on that person, foreign corporation or member, and under which all material terms are fixed or are ascertainable with reference to an objectively determinable standard.

E-5. Q: If, under a binding contract existing before September 2, 1976, a person made an agreement described in section 999(b)(3), will operations under the contract be subject to the international boycott provisions in years after 1977?

A: Yes, unless the person establishes that, before December 31, 1977, the agreement to participate in or cooperate with the boycott was renounced, the renunciation was communicated to the government or person with which the agreement was made, and the agreement was not reaffirmed after 1977.

E-6. Q: If, under a contract made in 1979, a person who reports tax liability on a calendar year basis makes an agreement described in section 999(b)(3), but does not comply with the agreement after 1980, will operations under the contract be subject to the international boycott provisions in years after 1980?

A: Yes, unless the person establishes that, before December 30, 1980, the agreement to participate in or cooperate with the boycott was renounced, the renunciation was communicated to the government or person with which the agreement was made, and the agreement was not reaffirmed after 1980.

E-7. Q: If, under a contract made after January 1, 1977, a person makes an agreement described in section 999(b)(3), and later renounces the agreement and communicates such renunciation to the government or person with which the agreement was made, which operations of such person during the taxable year of the renunciation are reportable, which operations are included in the international boycott factor calculations, and how are the sanctions to be applied?

A: All operations of the person during the entire taxable year within which the agreement was renounced (including post-renunciation operations) in or related to a boycotting country or with the government, a company, or a national of such country must be reported

under section 999(a) and will be considered in calculating the international boycott factor (or the amount of taxes or income specifically attributable to operations in which there was participation in or cooperation with an international boycott) for the taxable year. However, under section 999(c)(1), operations for which the presumption of participation in or cooperation with the boycott has been rebutted need not be reflected in the numerator of the international boycott factor, and the tax benefits specifically attributable to specific operations for which such presumption has been rebutted will not be denied. There is no proration between the pre-renunciation and post-renunciation portions of the taxable year of either the boycott factor or the specifically attributable taxes and income.

E-8. Q: Before September 2, 1976, Company A entered into a binding contract that did not contain an agreement to boycott or by itself support an inference of the existence of an agreement to boycott. However, Company A's course of conduct in carrying out operations in accordance with the terms of the contract evidences that there is an implied agreement that constitutes participation in or cooperation with an international boycott. Will the sanctions of sections 908(a), 952(a)(3), and 995(b)(1)(F) be applied to such participation or cooperation that takes place prior to January 1, 1978 (see section 1066(a) of the Tax Reform Act of 1976)?

A: If the course of conduct from which the existence of the implied agreement was inferred took place before September 2, 1976, then the sanctions of sections 908(a), 952(a)(3), and 995(b)(1)(F) will not be applied to such participation in or cooperation with an international

boycott that takes place prior to January 1, 1978. However, if the inference of the existence of the implied agreement would depend on conduct on or after September 2, 1976, then those sanctions will be applied to participation in or cooperation with the international boycott after November 3, 1976 (see section 1066(a)(1) of the Tax Reform Act of 1976).

E-9. Q: Company C entered into a binding contract prior to September 2, 1976 to manufacture and deliver equipment to a customer located in Country X. The contract requires Company C to use no components that are manufactured by blacklisted United States companies. The contract also requires that the vessel on which the equipment is shipped not be blacklisted. On January 15, 1977, Company C is able to have the contract amended to eliminate the requirement regarding components, but is unable to secure any change regarding vessels. Will the amendment regarding components remove the binding contract protection otherwise afforded until December 31, 1977 that Company C has regarding vessels?

A: No. Since Company C could have waited to abrogate or renegotiate its contract until the end of 1977 and since it is in accord with the legislative purpose for Company C to accelerate elimination of the provision regarding components, it will remain protected until December 31, 1977 from the consequences of its continuing to refrain from shipping the goods on blacklisted vessels.

E-10. Q: If before December 31, 1977 a person carries out several different operations in boycotting countries and the only operation of that person that constitutes participation in or cooperation with

an international boycott is carried out in accordance with the terms of a binding contract entered into before September 2, 1976, will the existence of that one boycotting operation trigger the section 999(b)(1) presumption that the other operations of that person in boycotting countries are also operations in connection with which boycott participation or cooperation occurred?

A: No. Operations carried out before December 31, 1977, in accordance with the terms of a binding contract entered into before September 2, 1976, will not trigger the section 999(b)(1) presumption.

E-11. Q: Are operations of a person that constitute participation in or cooperation with an international boycott factor reflected in the numerator of a person's international boycott factor before December 31, 1977 if those operations are carried out in accordance with the terms of a binding contract entered into before September 2, 1976?

A: No. Boycotting operations carried out before December 31, 1977 in accordance with the terms of a binding contract entered into before September 2, 1976 are not reflected in the numerator of the international boycott factor. They are reflected in the denominator, however. See Temp. Regs. §7.999-1 and Proposed Regs. §1.999-1.

E-12. Q: On June 30, 1976, Company A, a domestic corporation that reports its operations on a calendar basis, disposed of all of its stock in Company C, a foreign corporation. Will Company A be required to report any operations, requests or participation or cooperation of

Company C for calendar year 1976? Will the operations of Company C be included in Company A's international boycott factor for 1976?

A: No. Since Company A did not own any stock of Company C after the effective date of the boycott provisions, Company A is not required to report any operations, requests or participation or cooperation of Company C in 1976 and will exclude Company C's operations from its international boycott factor computations.

E-13. Q: Are operations, requests or participation in or cooperation with an international boycott of a person for that person's taxable year that ends before November 4, 1976 required to be reported, either by that person or by any other person?

A: No, operations, requests and participation in or cooperation with an international boycott of a person for that person's taxable year that ends before November 4, 1976 need not be reported by any person. However, as stated in Answers E-1 and E-2, operations, requests and participation in or cooperation with an international boycott occurring or received before November 4, 1976 during a taxable year that ends on or after that date are reportable if there has been participation in or cooperation with an international boycott during that taxable year but on or after that date.

F. International Boycott Factor.

F-1. Q: How is the international boycott factor computed?

A: Section 999(c)(1) provides that the international boycott factor is determined under regulations prescribed by the Secretary. The international boycott factor is a fraction, the numerator of which reflects the boycotting operations of a person (or group) in or related to countries associated in carrying out the international boycott and the denominator of which reflects the person's (or group's) worldwide foreign operations. Temporary and proposed regulations setting forth the method of determining the international boycott factor were issued in February, 1977. See Temp. Regs. §7.999-1 and Proposed Regs. §1.999-1.

F-2. Q: In the case of a controlled group (within the meaning of section 993(a)(3)) is a single international boycott factor computed for the entire group?

A: Yes. All members of a controlled group share a single, common international boycott factor which reflects the operations of all members of the controlled group.

F-3. Q: Once an international boycott factor has been computed for a controlled group (within the meaning of section 993(a)(3)), how is the factor applied to individual members of the group?

A: The international boycott factor of a controlled group is applied separately under sections 908(a), 952(a)(3), and 995(b)(1)(F) to each individual member of the controlled group.

F-4. Q: If a person applies the international boycott factor to some operations during the taxable year, must the factor be applied to all operations of that person for the taxable year?

A: Yes. If a person applies the international boycott factor to one operation during the taxable year, the factor must be applied to all operations during the taxable year under each of sections 908(a), 952(a)(3), and 995(b)(1)(F). If a person identifies specifically attributable taxes and income under section 999(c)(2), that method must be applied to all operations during the taxable year and must be applied under each of sections 908(a), 952(a)(3), and 995(b)(1)(F).

F-5. Q: In the case of a controlled group (within the meaning of section 993(a)(3)), may one member use the international boycott factor under section 999(c)(1) and another member identify specifically attributable taxes and income under section 999(c)(2)?

A: Yes. Each member may independently choose either to apply the international boycott factor under section 999(c)(1) or to identify specifically attributable taxes and income under section 999 (c)(2). The method chosen by each member for determining the loss of tax benefits must be applied consistently to determine all loss of tax benefits of that member. For example, if one member of a controlled group, Company A, chooses to use the international boycott factor, then it must apply the international boycott factor to determine its loss of the section 902 indirect foreign tax credit in respect of a dividend paid to it by another member of the controlled group, Company C, even if Company C determines its loss of tax benefits by identifying specifically attributable taxes and income. Company A would also determine the amount deemed distributed to it under sections 995(b) (1)(F) and 952(a)(3) by applying its international boycott factor to the otherwise deferrable earnings of its DISCs or controlled foreign

corporations. In addition, if an affiliated group of corporations files a consolidated return, then the affiliated group must determine its loss of tax benefits either by applying the international boycott factor to the consolidated return, or by having each member determine its loss of tax benefits by identifying specifically attributable taxes and income.

F-6. Q: If a person chooses to determine its loss of tax benefits by applying the specifically attributable taxes and income method set forth in section 999(c)(2), may it demonstrate the amount of foreign taxes paid and income earned attributable to the specific operations by applying an overall effective rate of foreign taxes and an overall profit margin to each operation?

A: No. A person must clearly demonstrate foreign taxes paid and income earned attributable to specific operations by performing an in-depth analysis of the profit and loss data of each separate and identifiable operation. The principles of Regs. §1.861-8 are applicable in determining income and taxes attributable to specific operations.

F-7. Q: A United States partnership has operations in a boycotting country. Is the international boycott factor computed at the partnership level?

A: No. The international boycott factor is computed separately by each partner based on information submitted by the partnership and on other activities of that partner. Of course, if the partner can meet the conditions of section 999(c)(2) of the Code, he need not use the international boycott factor.

F-8. Q: A person desires to determine its loss of tax benefits by applying the specifically attributable taxes and income method set forth in section 999(c)(2). That person is able to clearly demonstrate that a specified portion of its operations in or related to a boycotting country constitute clearly separate and identifiable operations in connection with which there was no participation in or cooperation with an international boycott. That person is also able to clearly demonstrate the taxes and income attributable to those operations. With respect to the remainder of its operations in or related to a boycotting country, that person is either unable to clearly demonstrate clearly separate and identifiable operations in connection with which there was no participation in or cooperation with an international boycott or to identify taxes and income specifically attributable to operations in connection with which there was such participation or cooperation. Under these facts, will that person be required to determine its loss of tax benefits by applying the international boycott factor?

A: No. That person may compute its loss of tax benefits by applying the specifically attributable taxes and income method if it forfeits the benefits of deferral, DISC and the foreign tax credit attributable to:

1. the portion of its operations for which it can determine taxes and income specifically attributable to separate and identifiable operations in connection with which there was participation in or cooperation with an international boycott, and

2. the remaining portion of its operations for which it cannot demonstrate that the taxes and income are specifically attributable to separate and identifiable operations in connection with which there was no participation in or cooperation with an international boycott.

F-9. Q: If a person choses to compute its loss of tax benefits in one year by applying the international boycott factor, may that person compute its loss of tax benefits in another year using the specifically attributable taxes and income method?

A: Yes. The election to use the international boycott factor or the specifically attributable taxes and income method is an annual election. The election is made by completing the appropriate Schedule A or B to Form 5713.

F-10. Q: In 1978 a person computes its loss of tax benefits using the international boycott factor. On audit, it is determined that adjustments are to be made to the international boycott factor. May that person then recompute its loss of tax benefits for 1978 using the specifically attributable taxes and income method?

A: Yes. A person may change its method of computing loss of tax benefits under the international boycott provisions at any time for any open taxable year.

G. Determinations.

G-1. Q: What degree of confidentiality will determinations, and requests for determinations, under section 999(d) receive?

A: A determination under section 999(d) will be treated as a "written determination" within the meaning of section 6110(b)(1). Therefore the determination and any background file document related thereto will be subject to public inspection in accordance with the rules set forth in section 6110, and subject to the deletions set forth in section 6110(c).

G-2. Q: What procedures are applicable to requests for, and the issuance of, determinations under section 999(d)?

A: The procedures applicable to requests for, and the issuance of, determinations under section 999(d) are set forth in Revenue Procedure 77-9, 1977-10 IRB 12.

H. Definition of an Agreement to Participate in or Cooperate with a Boycott (section 999(b)(3)).

H-1. Q: Company C, a trading company, signs a contract with Country X to export goods to Country X. The contract contains a clause requiring Company C not to obtain any of the goods from any person blacklisted by Country X. Does Company C's entering into the contract constitute an agreement according to section 999(b)(3)?

A: Generally, entering into a written or oral agreement that includes a provision requiring a person to refrain from doing business with a person blacklisted by Country X (or by a group of countries associated with Country X in carrying out an international boycott directed against Country Y) constitutes participation in or cooperation with an international boycott within the meaning of section 999(b)(3). Blacklists are normally maintained to provide a convenient list of persons that engage in business with Country Y or engage in other activities that are inconsistent with the boycott. Thus, reference in an agreement to a "blacklist" can normally be assumed to be to such a list.

However, entering into the agreement does not constitute participation in or cooperation with an international boycott if it is established that the blacklist is maintained for reasons other than furtherance of the boycott or if it is established that no person on the blacklist is either (1) blacklisted because it is the government, a company or a national of Country Y or because its ownership, management or directors is made up of individuals of a particular nationality, race or religion or (2) a U. S. person blacklisted because it is engaged in trade with Country Y or with the government, a company or a national of Country Y.

H-2. Q: During the course of negotiations concerning a contract for the export of goods to Country X, Company C, a trading company, and Country X agree orally that Company C will not purchase any of the goods from any company included on a blacklist shown to Company C's representatives. They also agree that this agreement will not be reflected in the written contract for the export of the goods or in any other writing. Does the oral understanding between Company C and Country X constitute an agreement according to section 999(b)(3)?

A: Generally, yes. See Answer H-1.

H-3. Q: Company C signs a contract with Country X to construct an industrial plant in Country X. The contract states that the laws, regulations, requirements or administrative practices of Country X will apply to Company C's performance of the contract in Country X. The laws, regulations, requirements or administrative practices of Country X prohibit the importation into Country X of goods manufactured by any company engaged in trade in Country Y or with the government, companies or nationals of Country Y. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: No. The existence of an agreement will not be inferred solely from the inclusion in a contract of a provision stating that the laws, regulations, requirements or administrative practices will apply to the performance of the contract in that country. However, a course of conduct of complying with such laws, regulations, requirements or administrative practices may evidence such an agreement.

H-4. Q: The facts are the same as those in Question H-3, except that the contract states that Company C will comply with the laws, regulations, requirements or administrative practices of Country X in its performance of the contract in Country X. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: Yes. Entering into a contract that requires compliance with the laws, regulations, requirements or administrative practices of Country X constitutes an agreement according to section 999(b)(3), if some of those laws prohibit the importation into Country X of goods manufactured by any company engaged in trade in Country Y or with the government, companies or nationals of Country Y.

H-5. Q: Company C, a trading company, signs a contract with Country X to export goods to Country X. The contract contains no clause concerning a boycott, nor does it require Company C to comply with the laws, regulations, requirements or administrative practices of Country X, which, among other things, prohibit the importation into Country X of goods manufactured by persons engaged in trade in Country Y. Company C does not purchase any goods with which to fulfill its obligations under the contract from any U.S. company engaged in trade in Country Y or with the government, companies or nationals of Country Y. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: Where there is no express agreement, the existence of an agreement will not be inferred solely from the fact that Company C has not, consistent with the laws, regulations, requirements or administrative practices of Country X, purchased goods with which to

fulfill its obligations under the contract from any U. S. company engaged in trade in Country Y or with the government, companies or nationals of Country Y. However, the fact that Company C has not purchased goods manufactured by persons engaged in trade in Country Y suggests that Company C has entered into such an agreement. Thus, Company C's course of conduct pursuant to its contract with Country X is evidence that, together with other evidence, could be sufficient to establish an implied agreement unless Company A could show to the contrary. An example of other sufficient evidence is proof that Company C had in the past purchased goods from persons engaged in trade in Country Y but such purchases were reduced in volume or brought to a halt following the execution of the contract. An example of proof to the contrary is proof that the reduction in purchases from persons engaged in trade in Country Y was attributable to valid business reasons apart from the boycott.

H-6. Q: Questions and Answers H-1, H-2, H-4, and H-5 all involve contracts for the export of goods by Company C to Country X and either an explicit agreement, or an inferred agreement, by Company C to refrain from doing business with companies that are blacklisted by Country X. The issue of whether an agreement exists for purposes of section 999(b)(3) would be resolved in the same way as in each of the answers above were the contract for (a) the supply of services to Country X or (b) a construction project in Country X.

H-7. Q: (a) Company C incorporates a subsidiary in Country X. In the documents submitted by Company A relating to the incorporation of the subsidiary there is a general acknowledgement that the

subsidiary is subject to the laws, regulations, requirements and administrative practices of Country X.

(b) Company C establishes a branch in Country X. In the documents relating to its registration of the branch there is a general acknowledgement that the laws, regulations, requirements and administrative practices of Country X apply to the branch.

Included in the laws, regulations, requirements or administrative practices of Country X is a requirement that companies incorporated in Country X and branches registered in Country X refrain from doing business with any person engaged in trade in Country Y. Does either the acknowledgement of the subsidiary or the undertaking of the branch constitute an agreement by Company C for purposes of section 999(b)(3)?

A: The mere acknowledgement in incorporation or registration documents of the general applicability of the laws of a boycotting country will not support the inference of the existence of an agreement under section 999(b)(3). However, a course of conduct of complying with such laws, regulations, requirements or administrative practices may evidence such an agreement. In addition, if the incorporation or registration documents state that the subsidiary or branch will comply with the laws, rules, regulations, requirements or administrative practices, there is an agreement according to section 999(b)(3).

H-8. Q: Company C, a trading company, signs a contract with Country X to export goods to Country X. The contract contains no clause concerning a boycott, nor does it require the contract to be carried out in accordance with the laws, regulations, requirements

or administrative practices of Country X, which prohibit the importation into Country X of goods manufactured by persons engaged in trade with Country Y. Payment is made by means of a letter of credit that requires, as a condition of payment, that Company C provide Bank D with a certificate that the goods were not manufactured by a person blacklisted by Country X. Company C provides the required certificate to Bank D. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: Generally, yes. See Answer H-1. The terms of the letter of credit are part of the agreement entered into by Company C.

H-9. Q: Company C signs a contract with Country X to carry out a construction project in Country X. The contract says nothing about the nationality, race or religion of the individuals who are to be employed to carry out the contract within Country X. However, Company C is aware that the laws, regulations, requirements or administrative practices of Country X may prohibit the issuance of visas by Country X to individuals of religion R to work on projects in that country. Company C excludes from consideration for employment individuals of that religion to work on the project in Country X. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: In the absence of an express agreement, the existence of an agreement normally will not be inferred solely from the fact that a person's action is apparently consistent with the boycott requirements of Country X, although such action may evidence the existence of an agreement. However, since Company C's action in excluding from

employment consideration individuals of religion R violates other statutes and since it is highly unlikely that there are valid business reasons for such action, an agreement under section 999(b)(3) will be inferred unless Company C can establish that such action was not related to the boycott requirements. It would be unusual if Company C were able to establish that such action were not related to the boycott requirements.

H-10. Q: Company C signs a contract for a construction project with Country X. The contract says nothing about the nationality, race or religion of the individuals who are to be employed to carry out the contract within Country X. However, Company C is aware that the laws, regulations, requirements or administrative practices of Country X may prohibit the issuance of visas to individuals of religion R. Company C, in recruiting people for the project, informs all applicants that if they cannot obtain a visa to enter Country X, their employment will be terminated. It employs several individuals of religion R who are unsuccessful in obtaining visas and whose employment is subsequently terminated. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: No. Company C has not refrained from employing individuals of religion R for the project. The existence of an agreement to refrain from employing individuals of religion R will not be inferred from Company C's action.

H-11. Q: The facts are the same as those in Question H-10, except that Company C makes its employment contracts with all individuals for work on the project subject to the condition that they obtain

visas from Country X that will permit them to work in Country X. Few, if any, individuals of religion R to whom Company C offers employment in Country X are successful in obtaining visas. Does such action by Company C constitute an agreement according to section 999(b)(3)?

A: No. Company C has offered employment to all individuals who are able to obtain visas. If an individual is unable to obtain a visa, it is due to the requirements of Country X. The existence of an agreement by Company C will not be inferred from Company C's action.

H-12. Q: The facts are the same as those in Question H-10, except that no individuals of religion R are willing to accept employment on the terms offered by Company C. Does such action by Company C constitute an agreement according to section 999(b)(3)?

A: No, for the reasons given in Answer H-10.

H-13. Q: Company C signs a contract with Country X to carry out a construction project in Country X. The contract says nothing about who may or may not be a subcontractor to do certain work in Country X other than that Country X has the right to prior approval of any subcontractors. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: The contract provision giving the project owner a right of prior approval does not itself constitute an agreement according to section 999(b)(3). However, the provision may be evidence which, together with other evidence, could be sufficient to establish the existence of an implied agreement, unless Company C could show to the contrary. There may be valid business reasons for the provision apart from the boycott.

On the other hand, the provision may be merely a subterfuge for Company C's cooperation in the exclusion of subcontractors that are engaged in trade in Country Y.

H-14. Q: Company C signs a contract with Country X to carry out a construction project in Country X. The contract specifies a number of permissible subcontractors. All the subcontractors, in the view of Company C, are capable of carrying out the work, but none of them appears on a list of companies that are blacklisted by Country X. Company C has previously done business with each of the specified companies, but it has also done business with certain of the blacklisted companies with which it has had satisfactory relations. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: By entering into a contract that on its face indicates a pattern of exclusion of certain companies, including companies with which Company C has no particular reason not to do business, it would appear that Company C has agreed to refrain from doing business with the boycotted companies, unless Company C is able to show that the boycotted companies were not included on the list for reasons not related to the boycott. See Answer H-1.

H-15. Q: Company C signs a contract with Country X to carry out a construction project in Country X. The contract provides that Country X is to engage all the subcontractors that are to be engaged from outside Country X but that are to perform all or part of their services in Country X. Company C, however, is given the right to disapprove any company that Country X proposes to engage for a subcontract. While the contract is being carried out, none of the

companies that Country X proposes to prequalify or invite to bid are included on a list of companies blacklisted by Country X. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: Under the language of the contract, Company C has not agreed to refrain from doing business with companies that are on the blacklist. The contract moreover does not give Company C the right to select subcontractors other than those nominated by Country X. Therefore, Company C's action does not constitute an agreement according to section 999(b)(3). Nevertheless, an agreement may be inferred if Company C cooperates in the exclusion of blacklisted sub-contractors. See Answer H-13.

H-16. Q: Company C signs a contract for a construction project with Country X. The contract states that any disputes arising under the contract will be resolved in accordance with Country X's laws. The laws of Country X contain boycott provisions. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: No. The provision that disputes will be resolved in accordance with Country X's laws does not constitute Company C's agreement to comply with Country X's boycott laws with respect to the carrying out of the contract.

H-17. Q: Company C receives an inquiry from Country X about certain goods that Company C manufactures. The inquiry also requests Company C to furnish information about the following matters: whether it does business with Country Y and whether it does business with any United States person engaged in trade in Country Y. Company

C furnishes the requested information to Country X. Later Company C signs a contract with Country X to export goods to Country X. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: By furnishing such information Company C has not agreed to take any action, as a condition of doing business with Country X, that is described in section 999(b)(3). Nevertheless, the furnishing of such information is suspect and, when combined with a course of conduct that is consistent with an agreement to participate in or cooperate with an international boycott, will support an inference that such an agreement exists.

H-18. Q: Company C, a trading company, signs a contract with Country X to export goods to Country X. The contract contains a clause requiring Company C not to obtain any of the goods from any company blacklisted by Country X. Company C, however, purchases some of the goods from one of the listed companies. Does Company C's entering into this contract constitute an agreement according to section 999(b)(3)?

A: Generally, entering into a written contract that includes a provision requiring Company C to refrain from doing business with a person blacklisted by Country X constitutes participation in or cooperation with an international boycott within the meaning of section 999(b)(3), even if Company C, fully or partially, does not abide by the boycott provisions. See Answer H-1.

H-19. Q: Company C signs a contract with Country X to export goods to Country X. Included in the contract is a provision that Company

C will refrain from doing business with Country Y. Company C has done considerable business with Country Y in the past, but soon after it concludes that contract with Country X its distributor in Country Y, learning of the contract with Country X, refuses to continue to handle Company C's products and Company C tries but is unable to conclude any other satisfactory distribution arrangement in Country Y. Does Company C's entering into this contract constitute an agreement according to section 999(b)(3)?

A: Yes. Entering into an agreement to refrain from doing business with a boycotted country constitutes participation in or cooperation with an international boycott within the meaning of section 999(b)(3)(A)(i), even if Company C does not abide by, or intend to abide by, the terms of the agreement.

H-20. Q: Company C has been unable to do business with Country X because Company C has been on a blacklist of companies maintained by an organization of countries to which Country X belongs. Company A agrees, as a condition of being removed from the list, to refrain from doing business with Country Y. Does Company C's agreement constitute an agreement according to section 999(b)(3)?

A: Yes. Even though Company C has not yet entered into a contract to do business with any boycotting country, it has agreed, as a condition for being in a position to do business with one or more of the countries maintaining the blacklist, to refrain from doing business with Country Y. This action constitutes an agreement according to section 999(b)(3)(A)(i).

H-21. Q: The facts are the same as those in Question H-20, except that Company C does several different types of business with Country Y. It is requested to, and agrees to, refrain from doing only one of those types of business with Country Y, and in fact continues to do the other types of business with Country Y. Does Company C's agreement constitute an agreement according to section 999(b)(3)?

A: Yes. An agreement to refrain from some, but not all, business with a boycotted country constitutes an agreement according to section 999(b)(3)(A)(i). Answer H-20 is also relevant to this context.

H-22. Q: Company C is doing business in Country X. It contracts with Company D, which is not related to Company C, for Company D to build an office building for Company C's use in Country X. In the course of constructing the building, Company D participates in or cooperates with an international boycott imposed by Country X. Does Company C's actions constitute an agreement according to section 999(b)(3)?

A: Unless Company C directs or requires Company D to take action that constitutes participation in or cooperation with the boycott by Company D, or unless Company C's relationship with Company D is established to facilitate participation in or cooperation with the boycott, Company D's action will not be attributable to Company C under section 999(b)(3), and Company C will not be deemed to be participating in or cooperating with an international boycott.

H-23. Q: Company C signs a contract with Country X for the export of goods to Country X. The contract does not contain any provisions as to which ships should be [illegible] shipping the goods to Country X or

which insurance companies should be used. The laws, regulations, requirements, or administrative practices of Country X do not permit the importation of goods carried on a ship owned by, or insured by, companies that trade in Country Y. Company C is aware of this requirement and ships the goods on the ships of a company, and insures the goods with a company, that does not trade in Country Y. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: As indicated by Answer H-5, the existence of an agreement will not be inferred solely from the fact that Company C ships its goods on ships of, or insures the goods with, a company that does not trade in Country Y. However, those facts, together with additional facts, may be sufficient to establish that such an agreement exists.

H-24. Q: Company C is competing for an industrial plant construction contract for which Country X is inviting international tenders. The tender documents contain a provision to the effect that Country X will not enter into the contract unless the successful tenderer certifies that in carrying out the contract it will refrain from doing business with companies blacklisted by Country X. Company C does not win the tendering, but in its tender it has indicated that it will sign a contract, in the form indicated in the tender documents, and has given Country X a tender bond to that effect. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: Since its offer was not accepted, Company C has not entered into any agreement to refrain from doing business with the blacklisted companies that would constitute participation in or

cooperation with an international boycott. Nevertheless, Company C's stated willingness to cooperate with Country X's boycott will be contributing factor in establishing a course of conduct from which to infer the existence of an agreement in other transactions between Company C and Country X.

H-25. Q: Company C successfully prequalifies to tender for a contract for the construction of an industrial plant that will be owned by Country X. At the time it attempts to prequalify, Company C is required to state that it understands that the successful tenderer for the contract will have to agree not to do business in connection with the project with any company blacklisted by Country X or with the government, companies or nationals of Country Y. After it prequalifies, Company C decides not to tender for the contract. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: Since Company C did not tender, it did not enter into an agreement to refrain from doing business with the blacklisted companies. Thus, there was no agreement that would constitute participation in or cooperation with an international boycott. Nevertheless, Company C's stated willingness to cooperate with Country X's boycott will be a contributing factor in establishing a course of conduct from which to infer the existence of an agreement in other transactions between Company C and Country X.

H-26. Q: Company C competes for an industrial plant construction contract for which Country X is inviting international tenders. The tender documents contain a provision to the effect that Country X will not enter into a contract unless the successful tenderer certifies that

in carrying out the contract it will refrain from doing business with any company blacklisted by Country X. Company C wins the tender and successfully convinces Country X that the boycott clause should be deleted from the final contract. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: No. Company C's success in deleting the boycott clause from the final contract refutes the provision of the tender documents that would have required Company C to agree to participate in or cooperate with an international boycott according to section 999(b)(3). However, if the deletion of the boycott clause is not accomplished in good faith or is a subterfuge to mask an unstated understanding to participate in or cooperate with an international boycott, the existence of an agreement will be inferred.

H-27. Q: Company A charters a vessel to Company C to be used by Company C in carrying its goods to Country X. Company C, at the request of Company A, agrees in the charter agreement not to take any action with respect to, or issue any orders to, the vessel that would result in limiting the vessel's ability to call at ports in Country X or subject the vessel to arrest or confiscation in Country X. Does the action of Company C constitute participation in or cooperation with an international boycott according to section 999(b)(3)?

A: No. In the agreement, Company C has not agreed to refrain from taking any of the actions enumerated in section 999(b)(3) as a condition of doing business directly or indirectly within a boycotting country or with the government, a company, or a national of a boycotting country.

H-28. Q: Company A charters a vessel to Company C to be used by Company C in carrying its goods to or from specifically named ports, or a range of ports within a specified geographical area. Company A and Company C agree on a charter agreement which would, in effect, preclude that vessel from calling at a number of countries, including Country Y. Does the action of Company C constitute participation in or cooperation with an international boycott under section 999(b)(3)?

A: No. In the agreement, Company C has not agreed to refrain from taking any of the actions enumerated in section 999(b)(3) as a condition of doing business directly or indirectly within a boycotting country or with the government, a company or a national of a boycotting country.

H-29. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract provides that Company A will not trade in Country Y, and that payment will be made by means of a letter of credit confirmed by Bank C in the United States. The letter of credit requires Company A to provide to Bank C a certificate that it has not engaged in trade with Country Y before it can be paid by Bank C. Bank C confirms the letter of credit and later makes payment to Company A after determining that all documents, including the boycott certificate, are in order. Does Bank C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)?

A: Yes. Bank C's action constitutes an agreement by it to refrain from doing business with a United States person (Company A) engaged in trade with Country Y. Therefore Bank C's action constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii). (Company A's action constitutes participation in or cooperation with an international boycott by Company A according to section 999(b) (3)(A)(i).)

H-30. Q: Company C signs a contract with Country X for the supply of goods. The contract provides that Company C will not trade with Country Y, and that payment will be made by means of a letter of credit confirmed by Bank D in the United States provided that Bank D certifies to Country X that it will not confirm letters of credit relating to the export of goods to Country Y. Bank D confirms the letter of credit, after issuing the requested certificate. Does Bank D's action constitute participation in or cooperation with an international boycott under section 999(b)(3)?

A: Yes. Bank D has agreed to refrain from doing business with or in Country Y, or with the government, companies or nationals of Country Y, and with U.S. persons engaged in trade in Country Y or with the government, companies or nationals of Country Y. This action constitutes participation in or cooperation with an international boycott according to section 999(b) (3)(A)(i) and (ii).

H-31. Q: Company C signs a contract with Country X for the export of goods to Country X. The contract, consistent with the laws of Country X, provides that the goods may not be produced in whole or in part in Country Y or contain any parts, raw materials or labor originating in Country Y. The contract also provides that payment will be made by means of a letter of credit confirmed by Bank D. The letter of credit requires Company C to provide to Bank D a certificate that the goods were not produced in whole or in part in Country Y and contain no parts, raw materials or labor originating in Country Y before it can be paid by Bank D. Bank D confirms the letter of credit and later makes payment to Company C after determining that all documents, including the certificate, are in order. Does Bank D's action constitute a participation in or cooperation with an international boycott under section 999(b)(3)?

A: No. Bank D's action constitutes an agreement to comply with a prohibition on the importation of goods produced in whole or in part in a country that is the object of an international boycott. Therefore Bank D's action, according to section 999(b)(4)(B), does not constitute participation in or cooperation with an international boycott. (Similarly, Company C's action does not constitute participation in or cooperation with an international boycott. See Answer I-1.)

H-32. Q: Company C, a trading company, signs a contract with Country X to export goods to Country X. The contract contains no clause concerning a boycott, nor does it require the contract to be carried out in accordance with the laws, regulations, requirements or administrative prac[illegible] Country X, which prohibit the

importation into Country X of goods manufactured by persons engaged in trade with Country Y and which require import licenses. In order to obtain an import license, Company C provides a certificate indicating that the goods were not manufactured by a person engaged in trade in Country Y or with the government, companies or nationals of Country Y. Does Company C's action constitute an agreement according to section 999(b)(3)?

A: No. The signing (at the time of import) of a certification as to content, which is required to obtain an import license, does not by itself constitute an agreement. However, a course of conduct of providing such certificates may, along with other factors, be evidence of the existence of an agreement according to section 999(b)(3)(A)(ii).

I. Refraining from Doing Business with or in a Boycotted Country (section 999(b)(3)(A)(i)).

I-1. Q: Company C signs a contract with Country X for the export of certain goods to Country X. In that contract, consistent with the laws of Country X, there is a provision that none of the goods to be provided thereunder shall be produced in whole or in part in Country Y or contain any parts, raw materials or labor from Country Y. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: No. Company C in entering into such a contract is complying with the prohibition by Country X on the importation of goods produced in whole or in part in any country which is the object of an international boycott. Such action, according to section 999(b)(4)(B), does not constitute participation in or cooperation with an international boycott.

I-2. Q: Company C owns a number of ships. It understands that if one of its ships visits Country Y, that ship will thereafter be unable to visit Country X. Company C has some ships which visit Country Y but not Country X and other ships which visit Country X but not Country Y. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: No. Company C has not agreed to refrain from doing business with Country Y. Therefore Company C's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(i).

I-3. Q: Company C signs a contract with Country X, licensing a company in Country X to use certain of its patents and trademarks in Country X. The contract provides that Company C will not enter into an agreement with any national of Country Y with respect to the use in Country Y of patents and trademarks. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: Yes. Company C has agreed to refrain from doing business with any national of Country Y and such action constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(i).

I-4. Q: The facts are the same as in Question I-3, except that Company C has a number of other licensing agreements with Country Y and enters into still more such agreements after it signs the contract with Country X. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: Yes, for the same reasons as stated in Answer I-3 above. Answer H-18 is relevant in this context.

I-5. Q: Company C signs a contract with Country X to export some products from Country X. The contract, consistent with the laws of Country X, requires Company C to certify that the goods will not be sent to Country Y. Company A so certifies. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: No. Company C's compliance with Country X's prohibition on the exportation of products of Country X to Country Y does

not constitute participation in or cooperation with an international boycott, according to section 999(b)(4)(C).

I-6. Q: Company C signs a contract with Country X for the export of goods to Country X. In the contract there is a provision that no capital of Country Y origin will be used in the production or manufacturing of the goods. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: Yes. Under the terms of the agreement Company C has agreed to refrain from doing business with the government, a company or a national of Country Y.

I-7. Q: Company C enters into a contract with Country X for the manufacture and sale of goods and the provision of customer support services. The contract provides that Company C may assign its rights and obligations under the contract. The contract further provides that the rights and obligations cannot be assigned to a company incorporated under the laws of Country Y without the express approval of Country X. There is no similar requirement with respect to companies incorporated under the laws of other countries. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(i)?

A: The contract provision requiring Company C to obtain the approval of Country X prior to an assignment of the rights and obligations to a company incorporated under the laws of Country Y does not itself constitute an agreement under section 999(b)(3)(A)(i).

However, the provision is strong evidence that, and is sufficient to create a presumption that, Company C has an implied agreement to refrain from doing business with a company of Country Y. Company C may overcome this presumption by establishing the existence of valid business reasons for this provision apart from the boycott or by establishing that Country X approves, as a matter of course, assignments of rights and obligations under the contract to companies in Country Y.

J. Refraining from Doing Business with any United States Person Engaged in Trade in a Boycotted Country (section 999(b)(3)(A)(ii)).

J-1. Q: Company C signs a contract with Country X for the turn-key construction of an industrial plant. The contract provides that Company C will not use as subcontractors a number of named U. S. firms whose past performance on contracts in Country X has been unsatisfactory, according to Country X, for reasons unrelated to the boycott. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. The exclusion of subcontractors based on their performance is not covered by section 999(b)(3).

J-2. Q: Company C enters into a contract with Country X to export certain goods to Country X. The contract provides that Company C shall not use any goods manufactured by Company A in performing the contract since Company A is blacklisted by Country X even though Company A does not engage in any kind of trade in a country which is the object of the boycott or with the government, companies, or nationals of that country. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: Generally, entering into a written or oral agreement that includes a provision requiring a person to refrain from doing business with a person blacklisted by Country X (or by a group of countries associated with Country X in carrying out an international boycott directed against Country Y) constitutes participation in or cooperation with an

international boycott within the meaning of section 999(b)(3). If Company C can establish that Company A is not engaged in trade in Country Y or with the government, companies or nationals of Country Y, Company C's agreement to refrain from doing business with Company A does not come within the scope of section 999(b)(3)(A)(ii). However, Company C's action may constitute an agreement under section 999(b)(3)(A)(iii) unless Company C can establish that Company A is not blacklisted because of the nationality, race or religion of its owners, management or directors. Answer H-1 is relevant in this context.

J-3. Q: Company C competes for an industrial plant construction contract for which Company P of Country W is inviting international tenders. The contract is to be financed by Country X, which maintains a blacklist of companies. Country X requires contracts which it finances to state that the contractor is required to refrain from making any purchases for the project from any of the blacklisted companies. Country W does not boycott those companies. Company C wins the tender and signs the contract with Company P with the blacklist provision. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: Generally, yes. See Answer H-1. Although the boycott is not implemented by Country W, but by Country X, and the project is being carried out in Country W, Company C may have agreed not to do business with blacklisted U.S. companies as a condition of doing business indirectly with Country X.

J-4. Q: Company C signs a contract with Country X to export certain goods to Country X. The contract provides that Company C will not do business with any company blacklisted by Country X. Company C establishes that although a number of the blacklisted companies are foreign subsidiaries of U. S. companies, no U. S. companies are on the list. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. According to section 999(b)(3)(A)(ii), refraining from doing business with any United States person engaged in trade in a boycotted country constitutes participation in or cooperation with an international boycott. For purposes of this particular section "United States person" does not include foreign subsidiaries of a United States person. However, Company C's action may constitute an agreement under section 999(b)(3)(A)(i) or (iii). Answer H-1 is relevant in this context.

J-5. Q: Bank C advises Country X on its investments in the United States. Country X instructs Bank C not to recommend for investment any shares of certain companies that are blacklisted by Country X. Bank C follows these instructions. Does Bank C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: No. The recommendation of shares of certain companies by Bank C does not constitute "doing business" with those companies. Therefore Bank C's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii). Nor does Bank C's action constitute an agreement under section 999(b)(3)(A)(i) or (iii).

J-6A. Q: Bank C manages Country X's investment portfolio in the United States. Bank C has been given certain powers to act for Country X, pursuant to instructions that, among other things, require Bank C not to invest Country X's funds in stocks and bonds issued by certain blacklisted United States companies. Bank C is authorized by Country X to purchase and sell stocks and bonds only through recognized exchanges. Does Bank C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: No. Since purchasing stocks or bonds issued by a company, through recognized exchanges, does not constitute "doing business" with that company, an agreement to refrain from purchasing stocks or bonds issued by a company does not constitute an agreement to refrain from doing business with that company. Accordingly, Bank C's action does not constitute participation in or cooperation with an international boycott, according to section 999(b)(3)(A)(ii). Nor does Bank C's action constitute an agreement under section 999(b)(3)(A)(i) or (iii).

J-6B. Q: The facts are the same as in Question J-6A, except that Bank C is also authorized to purchase original issues of stocks and bonds directly from the issuing company. Does Bank C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii)?

A: Generally, yes. An agreement not to purchase original issues of stocks or bonds from a company blacklisted by Country X may

constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(ii). In addition, the agreement may constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(i) and (iii). Answer H-1 is relevant in this context.

J-7. Q: Company C signs a contract with Country X to construct an industrial plant in Country X. The laws, regulations, requirements or administrative practices of Country X prohibit the entry into Country X of goods produced by blacklisted companies. The contract states that the laws and regulations of Country X will apply to Company C's performance of the contract in Country X. In carrying out the project, Company C invites bids to furnish all goods and equipment on a delivered-in-Country X basis. No company on the blacklist maintained by Country X bids. Does Company C's action, as described in this question, constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. By the terms of the agreement Company C has not agreed to refrain from doing business with any of the blacklisted companies. The fact that blacklisted companies are unable to meet the conditions that Company C establishes is not due to any agreement by Company C with Country X, but is due to Country X's laws, regulations, requirements or administrative practices.

J-8. Q: The facts are the same as those in Question J-7, except that Company C's purchase contracts require vendors to reimburse Company C for the purchase price and transportation costs, plus interest, of any goods that Company C cannot import into Country

X because of Country X's import restrictions. In this case, does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No, for the reasons given in Answer J-7.

J-9. Q: Company C signs a contract with Country X to produce goods in Country X for export. The contract requires Company C to certify that, consistent with the laws of Country X, the goods will not be sent to Country Y and that Company C will require any purchaser of the products to certify that the goods will not be sent to Country Y if they are substantially unaltered at the time of the resale by the purchaser. Company C thereafter sells these goods to Company A, requiring the certification. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(ii)?

A: No. Company C's agreement to refrain, and to require Company A in the resale to refrain, from sending Country X's unaltered products to Country Y, according to section 999(b)(4)(C), does not constitute participation in or cooperation with an international boycott.

J-10. Q: Company C, a trading company, signs a contract with Country X for the export of goods to Country X. The contract requires that the goods be produced by Company A and that a certain component in the goods be produced by Company B. The laws, regulations, requirements or administrative practices of Country X prohibit the importation into Country X of goods manufactured by any company blacklisted by Country X. Company A and Company B are not blacklisted by Country X. Does Company C's action constitute an agreement, according to section 999(b)(3)(A)(ii)?

A: No. The existence of an agreement to refrain from doing business with a person blacklisted by Country X will not be inferred solely from the inclusion of a requirement in a contract that the goods or components be produced by a specific company that does not in fact appear on the blacklist. Accordingly, Company C's action does not constitute an agreement under section 999(b)(3)(A)(i), (ii) or (iii).

K. Refraining from Doing Business with any Company Whose Ownership or Management is Made up, in Whole or in Part, of Individuals of a Particular Nationality, Race or Religion (section 999(b)(3)(A)(iii)).

K-1. Q: Company C signs a contract with Country X for the export of certain goods to Country X. In the contract it is provided that the goods shall not bear any mark symbolizing Country Y or religion R. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iii)?

A: No. Section 999(b)(3)(A)(iii) prohibits agreements to refrain from doing business on the basis of the nationality, race or religion of the owners or management of the organization and to refrain from selecting (or to remove) directors of a particular nationality, race or religion. It does not prohibit agreements not to import goods bearing certain marks into a country. No part of section 999(b)(3) concerns refusals to purchase goods bearing marks symbolizing a certain country or religion.

K-2. Q: As a condition of doing business in Country X, Company C's subsidiary in Country X agrees that the board of directors of the subsidiary must consist of a specified number of nationals of Country X. Does such action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iii)?

A: No. Such action will not be deemed to constitute an agreement to participate in or cooperate with an international boycott according to section 999(b)(3)(A)(iii).

K-3. Q: Company C is the leader of a syndicate of U.S. and foreign banks that is underwriting a public bond issue of Country X.

Company D is a member of that syndicate. During the loan negotiations, Country X indicates that Company E, which is not a U. S. company, should be excluded from the syndicate because of the religion of some of its directors. Company C and Company D did not contemplate that Company E would be a member of the syndicate in any event and they agree to comply with the request of Country X. Does the action of Company C and Company D constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iii)?

A: Yes. The action of Company C and Company D is an agreement to refrain from doing business with a company whose management are individuals of a particular religion. According to section 999(b)(3)(A)(iii) this constitutes participation in or cooperation with an international boycott.

K-4. Q: The facts are the same as in Question K-3, except that Country X indicates that Company E may be included only if it removes several of its directors who are of nationality Y. Does the action of Company C and Company D constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iii)?

A: Yes. The action of Company C and Company D is an agreement to obtain the removal of corporate directors of a particular nationality as a condition of including Company E. This constitutes an agreement under section 999(b)(3)(A)(iii).

L. Refraining from Employing Individuals of a Particular Nationality, Race or Religion (section 999(b)(3)(A)(iv)).

L-1. Q: Company C signs a construction contract with Country X that provides that Company C is not to employ individuals of religion R to work on the project in Country X. Does such action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iv)?

A: Yes. Company C has clearly agreed to refrain from employing individuals of religion R. Section 999(b)(3)(A)(iv) defines an agreement, made as a condition of doing business with the government of a country, to refrain from employing individuals of a particular religion, as participation in or cooperation with an international boycott.

L-2. Q: Company C signs a contract with Country X for a construction project in Country X. The contract specifies that only individuals who are nationals of the United States or Country X will be allowed to work on the project. Does Company C's action constitute participation in or cooperation with an international boycott under section 999(b)(3)(A)(iv)?

A: No. There is no evidence of an attempt to specifically exclude persons of a particular nationality. Persons of a number of different nationalities, including those from both friendly and unfriendly countries, have been evenhandedly excluded.

L-3. Q: As a condition of doing business in Country X, Company C agrees to employ a specified percentage of nationals of Country X or to employ increasing numbers of nationals of Country X. Does such action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv)?

A: No. Such action does not constitute an agreement to participate in or cooperate with an international boycott under section 999(b)(3)(A)(iv).

L-4. Q: Company C, incorporated under the laws of Country Z, signs a contract with Country X for the engineering and construction of an industrial plant in Country X. The contract excludes from working in Country X nationals of Country Z who are also nationals of Country Y or who were formerly nationals of Country Y. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv)?

A: Yes. Any agreement to differentiate among citizens of Country Z on the basis of dual nationality or national origin for employment on a project constitutes participation in or cooperation with an international boycott, according to section 999(b)(3)(A)(iv).

L-5. Q: Company C signs a contract with Country X for the engineering and construction of an industrial plant in Country X. The contract provides that Company C is not to employ in its home office any individuals who are nationals of Country Y to work on the design of the plant. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv)?

A: Yes. Company C has agreed to refrain from employing individuals who are nationals of Country Y, and such agreement constitutes participation in or cooperation with an international boycott according to section 999(b)(3)(A)(iv).

M. <u>As a Condition of the Sale of a Product, Refraining from Shipping or Insuring That Product on a Carrier Owned, Leased, or Operated by a Person Who Does Not Participate In or Cooperate with an International Boycott (section 999(b)(3)(B)).</u>

M-1. Q: Company C enters into a c.i.f. contract for the export of goods to Country X. The contract states that the goods are not to be shipped on a ship blacklisted by Country X. The blacklist contains the names of vessels that have called at ports in Country Y, vessels that are owned, leased or operated by the government, a company or a national of Country Y, and vessels that are owned, leased or operated by persons who engage in activities that are inconsistent with the boycott. Does Company C's action constitute an agreement described in section 999(b)(3)?

A: Yes. Company C has entered into an agreement described in section 999(b)(3)(A)(i), (ii) and (iii) and section 999(b)(3)(B).

M-2. Q: Company C enters into a f.a.s. Port of New York contract with Country X for the sale of goods to Country X. While no overseas shipping or insurance provisions are contained in the contract, Company C has reason to believe that arrangements will be made by Country X to see that the goods are not shipped on a carrier owned, leased, or operated by a person who does not participate in or cooperate with Country X's boycott of Country Y. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: No. Company C has not agreed as a condition of sale to refrain from shipping on a carrier owned, leased or operated

by a person who does not participate in or cooperate with an international boycott. It has not agreed to any shipping or insurance arrangements. Its action thus does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B).

M-3. Q: Company C, having its place of business in Country Z, is requested by Country X to enter into a c.i.f. contract for the export of goods to Country X. However, to avoid participating in or cooperating with a international boycott, Company C successfully convinces Country X that the contract should specify shipment f.a.s. port of Country Z. The remainder of the circumstances are as described in Question M-2 above. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: No, for the reasons given in Answer M-2.

M-4. Q: Company C, a freight forwarding company having its place of business in Country Z, has a contract with Country X to make, as an agent of Country X, shipping and insurance arrangements for goods which Country X purchases in Country Z on a f.a.s. port of Country Z basis. The contract provides that no shipments will be made on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott. Company C then makes shipping and insurance arrangements on that basis. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: Company C's agreement not to make shipping arrangements on a carrier of a person who does not participate in Country X's

boycott of Country Y is not made as a condition of the sale of a product that is to be shipped to Country X. Therefore, Company C's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B). However, Company C's agreement would constitute participation in or cooperation with an international boycott pursuant to section 999(b)(3)(A)(i), (ii) or (iii).

M-5. Q: Company C enters into a contract with Country X for the export of goods to Country X. As a precaution to protect against war risk or confiscation, the contract requires Company C not to ship the goods on a Country Y flag vessel or on a ship which during the voyage calls at Country & enroute to Country X. Does Company C's action constitute participation in or cooperation with an international boycott?

A: No. The requirement in the contract is not a restrictive boycott practice. Rather, the requirement arises from the need to protect goods from damage or loss.

M-6. Q: Company C enters into a contract with Country X for the export of goods to Country X. The contract requires Company C to ship the goods only on a ship registered in Country X. Does Company C's action constitute participation in or cooperation with an international boycott, according to section 999(b)(3)(B)?

A: No. An agreement to ship the goods only on a ship registered in Country X does not constitute an agreement to refrain from shipping or insuring those goods on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott. Therefore, Company C's action does not constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B).

M-7. Q: Company A signs a contract with Country X for the export of goods to Country X. The contract provides that the goods may not be shipped on a vessel that has been blacklisted by Country X because it has called at Country Y in the past. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: Yes. The reason for those vessels being blacklisted was that at some time in the past the owner, lessor or operator of the vessel did not comply with the requirement of Country X that the vessel not call at Country Y. Therefore, Company C's signing the contract constitutes participation in or cooperation with an international boycott, according to section 999(b)(3)(B).

M-8. Q: Company C signs a contract with Country X for the export of goods to Country X. The contract contains no requirement that the seller refrain from shipping the goods on a vessel that has been blacklisted by Country X. Company C does not ship the goods on a blacklisted vessel. Does Company C's action constitute participation in or cooperation with an international boycott according to section 999(b)(3)(B)?

A: Nc, an agreement to participate in or cooperate with an international boycott, according to section 999(b)(3)(B), will not be inferred from Company C's action.

M-9. Q: Company C signs a c.i.f. contract with Country X for the export of goods to Country X to be paid for by means of a letter of credit. The letter of credit for this transaction requires, as a condition of payment, Company C to certify as to the identity of the vessel and the identity of the insurer. Company C provides such a certificate to the paying bank. Does Company C's action constitute participation in or cooperation with an international boycott?

A: The existence of an agreement to participate in or cooperate with an international boycott will not be inferred solely on the basis of Company C's certification. However, repetitive certification by Company C identifying vessels and insurers that are not blacklisted by Country X may suggest that Company C chooses its shippers and insurers on the basis of Country X's blacklist (in anticipation of Country X's certification request). Such a course of conduct may be a sufficient basis from which to infer the existence of an agreement.

N. Reduction of Foreign Tax Credit.

N-1. Q: How is the reduction of the foreign tax credit for participation in or cooperation with an international boycott computed under section 908(a)?

A: The method of computation of the reduction of the foreign tax credit under section 908(a) differs depending on whether the person applying section 908(a) applies the international boycott factor under section 999(c)(1) or identifies specifically attributable taxes and income under section 999(c)(2).

If the person chooses to identify specifically attributable taxes and income, the person reduces the amount of foreign taxes paid (before the determination of the section 904 limitation) by the sum of the foreign taxes paid that the person has not clearly demonstrated are attributable to specific operations in which there has been no participation in or cooperation with an international boycott.

If the person applies the international boycott factor, the reduction of the foreign tax credit under section 908(a) is computed by first determining the foreign tax credit that would be allowed under section 901 for the taxable year if section 908(a) had not been enacted. The amount of credit allowed under 901 would, of course, reflect the credits allowable under sections 902 and 960, and would also reflect the limitations of both sections 904 and 907. The credit allowed under section 901 would then be reduced by the product of the section 901 credit (before the application of the section 908(a) reduction) multiplied by the international boycott factor.

N-2. Q: After the reduction of credit has been determined in accordance with the process described in Answer N-1, the taxes denied creditability may be deductible under section 908(b). If the taxes are deducted, is a new section 904 limitation, a new section 901 amount and a new section 908(a) reduction of credit computed based on the income reduced by the taxes deducted?

A: No. The process described in Answer N-1 is applied only once and the reduction of credit is determined as a result of that single application. If the taxes denied creditability are deducted, no further adjustment is made under sections 904, 901 or 908(a) as a result of the deduction.

N-3. Q: Company A owns 20 percent of the stock of Company C, a corporation organized under the laws of Country Z, a foreign country. Company C participates in an international boycott in connection with all its operations. Company C pays a dividend to Company A and Country Z withholds income tax on the dividend paid to Company A. Company A computes its loss of tax benefits by identifying specifically attributable taxes and income under section 999(c)(2). Will Company A be denied its section 901 direct foreign tax credit in respect of the income tax withheld by Country Z on the dividend paid by Company C?

A: If Company A can clearly demonstrate that its investment in Company C is a clearly separate and identifiable operation in connection with which Company A did not participate in or cooperate with an international boycott, Company A will not be denied its section 901 direct foreign tax credit in respect of the withholding tax on the dividend paid by Company C. On the other hand, even if Company C does not participate

in an international boycott, if Company A agreed to participate in or cooperate with an international boycott in connection with its investment in Company C, Company A will lose its foreign tax credit in respect of the withholding tax on the dividend. Thus, whether Company C participates in an international boycott is not relevant to the determination of Company A's loss of foreign tax credit under the facts of this question. (To determine the denial of the section 902 indirect foreign tax credit for foreign income taxes paid by Company C, see Answer A-19.)

N-4. Q: As a result of participation in or cooperation with an international boycott and the application of section 908(a), Company A loses a portion of its foreign tax credit under both sections 901 and 902. Are the foreign taxes denied creditability under both sections 901 and 902 deductible under section 908(b)?

A: The section 901 taxes denied creditability by reason of section 908(a) are deductible, but the section 902 taxes are not. Section 908(b) merely renders sections 275(a)(4) and 78 inapplicable to taxes denied creditability under section 908(a). Since section 902 taxes are not otherwise deductible under the Code, and since no section 78 gross-up is required in respect of section 902 taxes denied creditability, no deduction is allowed for those section 902 taxes.

N-5. Q: Company A has foreign tax credits under both sections 901 and 902. Company A applies the international boycott factor to determine its loss of foreign tax credits under section 908(a). What portion of the taxes denied creditability will be deductible under section 908(b)?

A: Since the section 901 taxes denied creditability under section 908(a) are deductible but the section 902 taxes are not, Company A may deduct that portion of the total taxes denied creditability under section 908(a) that the total section 901 taxes (before application of section 908(a)) bear to the total section 901 and 902 taxes (before application of section 908(a)).

O. Subpart F Income

O-1. Q: In determining the amount of subpart F income included in gross income by reason of section 952(a)(3), may any deductions be taken into account?

A: Yes. In computing subpart F income included in gross income under section 952(a)(3), a reasonable allowance may be made for deductions properly allocable to that income.

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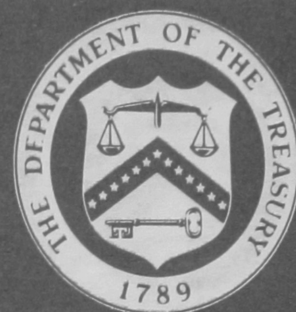

Contact: Robert E. Nipp
202/566-5328

FOR IMMEDIATE RELEASE January 23, 1978

TEXT OF STATEMENTS BY MINISTER OF ECONOMY GOSTA BOHMAN OF SWEDEN, IN HIS CAPACITY AS CHAIRMAN OF THE GROUP OF TEN, RELEASED IN STOCKHOLM, AND THE U.S. UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS, ANTHONY M. SOLOMON ON G-10 GOLD ARRANGEMENTS

Minister Bohman:

"The transitional arrangements on gold agreed upon on August 31, 1975, by the countries of the Group of Ten and Switzerland, and to which Portugal has also adhered, will be expiring on January 31, 1978. The participants having completed the review called for in these arrangements agreed that, in view of the impending amendment to the IMF Articles of Agreement, there is no need to extend the transitional arrangements."

Under Secretary Solomon:

"The United States supports this statement. We believe that the G-10 gold arrangements have served a useful role. However, in light of the experience of the past two years -- including the absence of actions to peg the price of gold or otherwise increase the monetary role of gold -- and in the expectation that this situation will continue, the U.S. has concluded that these transitional arrangements need not be formally extended. If this situation were to change, however, and we saw a need for resumption of these, or similar arrangements, the U.S. would not hesitate to seek them."

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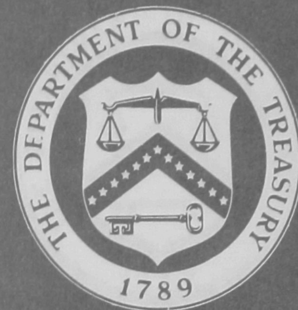

Contact: Alvin M. Hattal
202/566-8381

FOR IMMEDIATE RELEASE January 23, 1978

TREASURY ANNOUNCES FINAL COUNTERVAILING DUTY DETERMINATION ON IMPORTS OF CHAINS FROM SPAIN

The Treasury Department announced today its final determination that the Government of Spain subsidizes exports of chains and parts thereof. However, the Government of Spain recently provided new information about the case. After analyzing this information, the Treasury may revise its finding.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional Customs duty that equals the size of a "bounty or grant" (subsidy) bestowed on imported merchandise.

The countervailing duty on Spanish chains has been set at 12.5 percent of the value but may be revised based on additional information about the Spanish indirect tax rebate program, known as the "descravacion fiscal". Technically, Spanish chain imports are subject to "suspension of liquidation" for 30 days, meaning that Customs officers will collect the estimated 12.5 percent duty until a final determination of the amount of the duty is made.

Imports of Spanish chains and parts thereof, of iron or steel, during the first nine months of 1977 were valued at approximately $400,000.

The decision will take effect with the publication of the determination in the Federal Register on January 24, 1978.

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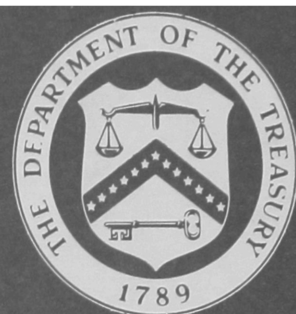

Contact: Alvin Hattal
202/566-8381

FOR IMMEDIATE RELEASE

January 24, 1978

TREASURY ANNOUNCES COUNTERVAILING DUTY INVESTIGATION ON OPTIC-LIQUID LEVEL-SENSING SYSTEMS FROM CANADA

The Treasury Department has started an investigation into whether Canada is subsidizing exports of optic-liquid level-sensing systems to the United States. The investigation is being initiated pursuant to a petition filed on behalf of a domestic manufacturer.

The countervailing Duty Law requires the Secretary of the Treasury to collect an additional duty that equals the size of a "bounty or grant" (subsidy) paid on the manufacture or exportation of merchandise.

Optic-liquid level-sensing systems are designed to prevent the overfilling of tank trucks and distribution tanks in the petroleum industry.

Notice of this investigation will be published in the Federal Register of January 25, 1978.

No statistics are yet available regarding the value or quantity of imports of this product into the United States from Canada.

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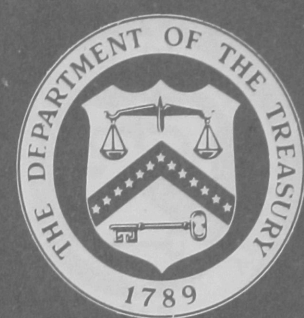
Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041



Contact: Alvin M. Hattal
202/566-8381

FOR IMMEDIATE RELEASE

January 24, 1978

TREASURY ANNOUNCES START OF
ANTIDUMPING INVESTIGATION ON NYLON YARN
FROM FRANCE

The Treasury Department said today it will begin an antidumping investigation on nylon texturing feed yarn from France.

Treasury's announcement followed a summary investigation by the U.S. Customs Service after receipt of a petition filed by E.I. du Pont de Nemours & Co. alleging that nylon yarn from France is being dumped in the United States.

Information contained in the petition indicates that French nylon yarn in the United States is priced under the same merchandise in the home market. The petition also includes information that the U.S. industry is being injured by the alleged "less than fair value" imports. If sales at less than fair value are determined by Treasury, the U.S. International Trade Commission will subsequently decide the injury question. Both "sales at less than fair value" and injury must be determined before a dumping finding is reached.

For purposes of this investigation, the term "nylon yarn" means nylon yarn and grouped nylon filaments, not textured. The subject merchandise must first be textured before being used in the production of knit apparel, athletic wear, socks, sweaters, etc.

Notice of the start of this investigation will appear in the Federal Register of January 25, 1978.

Imports of this merchandise from France were valued at approximately $1.3 million during the first six months of 1977.

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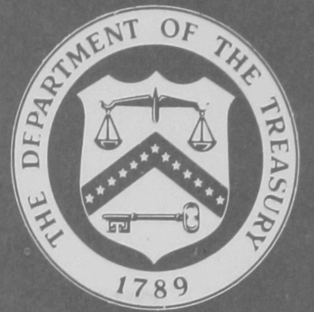

FOR RELEASE AT 4:00 P.M. January 24, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,900 million, to be issued February 2, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,901 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $2,400 million, representing an additional amount of bills dated November 3, 1977, and to mature May 4, 1978 (CUSIP No. 912793 Q2 5), originally issued in the amount of $3,402 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,500 million to be dated February 2, 1978, and to mature August 3, 1978 (CUSIP No. 912793 S5 6).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing February 2, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,201 million of the maturing bills. These accounts may exchange bills they hold for the bills now being offered at the weighted average prices of accepted competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Except for definitive bills in the $100,000 denomination, which will be available only to investors who are able to show that they are required by law or regulation to hold securities in physical form, both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, January 30, 1978. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

B-658

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 in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, or for bills issued in bearer form, where authorized. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action 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 weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, and bills issued in bearer form must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on February 2, 1978, in cash or other immediately available funds or in Treasury bills maturing February 2, 1978. Cash adjustments will be made for differences between the par value of the 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 these bills 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 these bills (other than life insurance companies) must include in his or her 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 Circulars, No. 418 (current revision), Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

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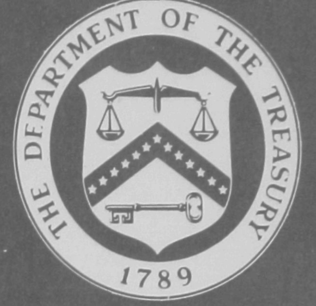

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE January 25, 1978

TREASURY FEBRUARY QUARTERLY FINANCING

The Treasury will raise about $1,700 million of new cash and refund $5,031 million of securities maturing February 15, 1978, by issuing $2,500 million of 3-1/4-year notes, $3,000 million of 7-year notes, and $1,250 million of 27-1/4-year bonds. The bonds represent an addition to bonds which are currently outstanding.

The $5,031 million of maturing securities to be refunded in the general offering are those held by the public. Government accounts and Federal Reserve Banks, for their own accounts, hold $3,358 million of maturing securities that may be refunded by issuing additional amounts of new securities. Additional amounts of the notes and the bonds may also be issued, for new cash only, to Federal Reserve Banks as agents for foreign and international monetary authorities.

Details about each of the new securities are given in the attached "highlights" of the offering and in the official offering circulars.

In a separate release today the Treasury announced its regular 52-week bill offering in the amount of $3,105 million to refund maturing bills in a like amount.

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Attachment

B-659

HIGHLIGHTS OF TREASURY
OFFERINGS TO THE PUBLIC
FEBRUARY 1978 FINANCING
TO BE ISSUED FEBRUARY 15, 1978

January 25, 1978

Amount Offered:			
To the public	$2,500 million	$3,000 million	$1,250 million
Description of Security:			
Term and type of security	3-1/4-year notes	7-year notes	27-1/4-year bonds
Series and CUSIP designation	Series M-1981 (CUSIP No. 912827 HK 1)	Series 8% A-1985 (CUSIP No. 912827 HL 9)	8-1/4% Bonds of 2000-2005 (CUSIP No. 912810 BU 1)
Maturity date	May 15, 1981	February 15, 1985	May 15, 2005
Call date	No provision	No provision	May 15, 2000
Interest coupon rate	To be determined based on the average of accepted bids	8%	8-1/4%
Investment yield	To be determined at auction	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction	To be determined after auction
Interest payment dates	November 15 and May 15 (first payment on November 15, 1978)	August 15 and February 15	May 15 and November 15 (first payment on May 15, 1978)
Minimum denomination available	$5,000	$1,000	$1,000
Terms of Sale:			
Method of sale	Yield Auction	Price Auction	Price Auction
Accrued interest payable by investor	None	None	$20.96685 per $1,000
Preferred allotment	Noncompetitive bid for $1,000,000 or less	Noncompetitive bid for $1,000,000 or less	Noncompetitive bid for $1,000,000 or less
Deposit requirement	5% of face amount	5% of face amount	5% of face amount
Deposit guarantee by designated institutions	Acceptable	Acceptable	Acceptable
Key Dates:			
Deadline for receipt of tenders	Tuesday, January 31, 1978, by 1:30 p.m., EST	Wednesday, February 1, 1978, by 1:30 p.m., EST	Thursday, February 2, 1978, by 1:30 p.m., EST
Settlement date (final payment due)			
a) cash or Federal funds	Wednesday, February 15, 1978	Wednesday, February 15, 1978	Wednesday, February 15, 1978
b) check drawn on bank within FRB district where submitted	Friday, February 10, 1978	Friday, February 10, 1978	Friday, February 10, 1978
c) check drawn on bank outside FRB district where submitted	Thursday, February 9, 1978	Thursday, February 9, 1978	Thursday, February 9, 1978
Delivery date for coupon securities	Wednesday, February 15, 1978	Wednesday, February 15, 1978	Wednesday, February 15, 1978

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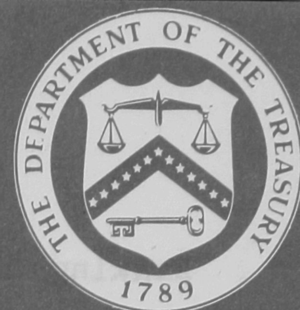

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE January 25, 1978

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for $3,105 million, or thereabouts, of 364-day Treasury bills to be dated February 7, 1978, and to mature February 6, 1979 (CUSIP No. 912793 V4 5). The bills, with a limited exception, will be available in book-entry form only, and will be issued for cash and in exchange for Treasury bills maturing February 7, 1978.

This issue will not provide new money for the Treasury as the maturing issue is outstanding in the amount of $3,105 million, of which $1,914 million is held by the public and $1,191 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 par amount will be payable without interest. Except for definitive bills in the $100,000 denomination, which will be available only to investors who are able to show that they are required by law or regulation to hold securities in physical form, this series of bills will be issued entirely in book-entry form on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 12:30 p.m., Eastern Standard time, Wednesday, February 1, 1978. Form PD 4632-1 should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

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.

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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.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities, for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, or for definitive bills, where authorized. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

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 for bills to be maintained on the records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on February 7, 1978, in cash or other immediately available funds or in Treasury bills maturing February 7, 1978; provided, however, that settlement for tenders submitted to the New Orleans Federal Reserve Branch must be completed at that branch by February 8, 1978. If settlement is made on February 8, 1978, with other than Treasury bills maturing February 7, 1978, payment must include one day's accrued interest. If settlement is completed on or before February 6, 1978, there will not be a charge for accrued interest. 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 a 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 Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

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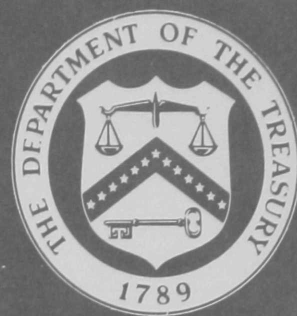

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
JANUARY 26, 1978

TESTIMONY OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
OF THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

Mr. Chairman and Members of this distinguished Committee:

I am pleased to present the Administration's position on S. 1010, a bill to create a Consumer Cooperative Bank. As you know, I testified before the Subcommittee on Financial Institutions of the House Banking Committee last April on a similar bill that had been introduced by Representative St Germain. At that time, I described the Administration's interest in helping consumer cooperatives, but I also emphasized our need to know more about the extent of cooperative economic activity in the United States, the availability of existing government programs for which cooperatives are eligible and the possible gaps in the group of financing alternatives available to cooperatives.

Following that testimony, the Administration undertook to learn more about consumer cooperatives. I should emphasize at the outset that this was in no sense a comprehensive "survey" or a technical study. Rather, we thought that the best way to understand the needs of cooperatives and their contributions to American society was to talk to the people who started them and who run them. They are a dedicated and impressive group.

Mr. Chairman, I do not now claim that we have found the "answer" to what the cooperatives really need. There are too many variations for me to make a blanket assertion today that "x" amount of money and "y" amount of technical assistance, made available to certain types of cooperatives through a certain type of mechanism, will inevitably meet the justifiable needs of consumer cooperatives in this country. There is no quantitative answer.

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Nevertheless, I am pleased to say that while many questions remain unanswered, the Administration now has a better appreciation for the needs of consumer cooperatives than we did last April. Members of my staff met with representatives of some 41 consumer cooperatives and cooperative organizations in 12 different states. These meetings were arranged with the help of the Cooperative League of the United States, and we are most grateful to the League for all the help they have given us. We also met with government agencies to try to determine the programs for which consumer cooperatives might be now eligible and whether those agencies believe consumer cooperatives might contribute to the success of their programs.

I would like to summarize for you the lessons we drew from our visits to cooperatives around the country.

First, the cooperative idea is sound. At its best, it produces an admirable blend of community action and commercial enterprise.

Second, it is hard to start a cooperative because the community organizing skills and experience required are significant and difficult to come by, and because -- like any new business -- the availability of bank financing at this stage is limited or nonexistent.

Third, more established cooperatives have been able to obtain some financing, but with difficulty. We have talked to some bankers who have both extended and refused loans to cooperatives; they report that the reason for refusal is more often their credit analysis than a lack of comfort in dealing with non-profit making entities.

Fourth, there is wide agreement among coops and concerned government agencies on advantages of providing government-sponsored technical assistance to consumer cooperatives.

Fifth, the program of governmental aid for cooperatives is, at present, fundamentally deficient. With the exception of housing cooperatives, most cooperatives are small businesses. Yet cooperatives are not eligible for the basic program by aid to small business, that administered by the SBA under its business loan program. This is a serious gap that can be filled in such a way not to pose unfair burdens on small businesses.

On the basis of these visits, our conversations with others, the hearings in the House and our analysis of the issues and the fiscal and organizational goals set by this Administration, I am pleased to present to the Senate a revised Administration response to the needs of consumer cooperatives.

In brief, the proposal includes

-- a single, independent Consumer Cooperative Bank.

-- an authorization for the Federal government to invest in the Bank's preferred stock $100 million in fiscal 1979 and up to $100 million in each of the two succeeding fiscal years.

-- authority granted to the Bank to borrow, without a Federal guarantee, on a basis of 3 to 5 times its paid-in capital and surplus.

-- an arrangement for redemption of the Federal government's preferred stock like that contemplated by H.R. 2777 as passed by the House.

-- an authorization of $25 million in fiscal 1979 to a Self-Help Development Fund administered by the Bank and up to $25 million in each of the next two succeeding fiscal years.

-- a technical assistance facility to be administered by the Bank.

This proposal represents a revision of the Administration's position as presented to the House during the hearings on H.R. 2777. The position which we are presenting today reflects the substantial review that we have undertaken during this past year of this issue. As I have already stated, Mr. Chairman, members of my staff have visited a sizeable number of cooperatives around the country, and we have examined exhaustively the tools presently available to deal with their financing difficulties. As a consequence, we have concluded that a program of loans and technical assistance is desirable and that such a program would be most effectively administered by an independent Bank. In our judgment, the existence of a separate staff, supervised by a Board of Directors and concerned only with cooperatives, will be a strong force for the building of a carefully administered and forceful program.

Size of the Program

Our proposal is somewhat smaller than that embodied in the House-passed bill. On the other hand, our approach calls for substantial financing assistance and will enable us to provide major help to consumer cooperatives.

We regard the financial needs of most cooperatives as not unlike those of small businesses. The average loan made or guaranteed by the SBA under its business loan program is about $104,000, with a $500,000 maximum. We believe, based on our discussions with cooperatives, that these limits would cover the needs of most consumer cooperatives. Accordingly the funding levels of our program will permit assistance to be extended to a wide range of cooperatives.

This approach will also give both the Administration and Congress an opportunity to gauge the program in its early stages. Prudent management of any organization, particularly the Federal government, requires that major new programs be carefully tested. For this reason, we are recommending a smaller program than that embodied in H.R.2777, as passed by the House.

Self-Help Development Fund

Our recommendation includes a Self-Help Development Fund for lower income and other cooperatives with special capital problems. Our visits to cooperatives around the country demonstrated that many need more permanent capital than hard loans. This fund is aimed at meeting a portion of those capital needs.

In particular, consumer cooperatives in blighted urban and underdeveloped rural areas may offer one of the best prospects for economic development or redevelopment there. Again, particularly in urban areas, the self-help approach should be fostered. Yet, many cooperatives in those areas need more access to equity or quasi-equity and they should benefit from this Self-Help Fund.

At the same time, the Fund will deal with the riskier end of the credit spectrum. On this basis, the rate of loss -- and thus the ultimate cost of the program -- is very hard to predict. Accordingly, we have recommended a more modest approach than that of H.R. 2777, until we have more experience with this program.

Technical Assistance

Many of the people whom we consulted expressed the view that providing technical assistance to emerging and existing consumer cooperatives is more important than hard financial aid. Such assistance would include various ways in which cooperatives can be structured, and the fundamentals of bookkeeping, contracting with suppliers, and related problems. In addition, many felt the need for continuing help to meet the problems inherent in running specific types of business.

We believe that there is an important role for the Federal government to play in this area. In the Executive Branch there are a number of agencies which have provided services of this kind on a continuing basis: the Farmers Cooperative Service, the Office of Minority Business Enterprise, and the Small Business Administration, to name but a few.

We have elected to put both the technical assistance program and the Self-Help Development Fund in the Bank rather than an existing agency within the Executive Branch for a number of reasons. First, there is not a sharp line between those cooperatives that will borrow from the Bank and those that will turn to the Fund. That decision can be most effectively made if both lending facilities are under one roof. This approach will avoid the spectre of a needy cooperative shuttling from one group to another.

Second, the knowledge gained in one lending program will be useful to those administering the other. And the use of experience gained in the lending program should be put to work in the technical assistance program -- and vice versa.

Finally, this is an integrated arrangement for improving the financial position of cooperatives. It will be most effective if the responsibility for its success is lodged in a single place.

Eligibility

We have given much thought to the question of which cooperatives will be eligible for consumer cooperative loans. This is a difficult issue becuase this program, unlike most federal credit programs, is oriented to entities whose common theme is their form of organization. In contrast, most financing programs are aimed at types of economic activity -- housing, agriculture, etc. -- not types of organizations. The Consumer Cooperative Bank proposed in S. 1010 and H.R. 2777, then, would provide assistance to many programmatic areas in which the Congress has already authorized extensive financial aid or other action. For that reason, we have concluded that only certain classes of cooperatives should be eligible for loans.

First, borrowers should be consumer cooperatives rather than producer cooperatives. In some cases, such as farm producer cooperatives, there already exists a lending facility to help meet financial needs. More importantly, our goal is to aid coop members as consumers to create an organization which allows them to participate in their community. Producer cooperatives serve quite different social goals -- usually in allowing existing small producers of goods to take advantage of certain economies of production or distribution through cooperatives.

Second, we would include only cooperatives for which there does not exist another major government effort directed toward stimulating this type of service. For example, health maintenance organizations, credit unions and rural electric coops should be ineligible. This result would hold even if the cooperative were refused a loan or other aid from the other program. In short, if the area is one which has been dealt with by the Federal government in a systematic way, then the decisions made there ought not to be circumvented simply because the cooperative form has been chosen.

The one exception to this policy is housing. The cooperative form has historically played such a special role in housing that the Administration supports the participation of housing cooperatives in this program, up to 30% of the total.

We have concluded, after much deliberation, that it would not be wise for eligible borrowers to be restricted to those who cannot obtain credit from private financial institutions. Although that is a common pattern in government loan programs, it would have the effect of eliminating all loans to the more creditworthy part of the cooperative spectrum. Such a "credit elsewhere" test would make it hard -- if not impossible -- for the Bank to be economically self-sufficient. The better credit of the established cooperatives is required to offset the more uncertain credit status of other borrowers. Self-sufficiency is important, for it is the foundation of the Bank's ability to redeem the preferred stock to be purchased by the Government. It may be advisable, in addition, for this Committee to add language to the Bill requiring that the Bank be assured a reasonable prospect of repayment before making its hard loans.

Assistance to Distressed Areas

We are considering, Mr. Chairman, that whether a portion of this Bank's total financing assistance should be directed to distressed areas. These are areas where the self-help, community development concept is needed most. They also are the areas where financing for cooperatives is most difficult to obtain, even though we realize that it is generally difficult everywhere.

The Administration is committed to improving the federal and local incentives for urban and rural economic development. We have spent the past nine or ten months working assiduously on these policies. We have learned among other things, that financing is almost totally unavailable for fledgling enterprises in distressed urban areas, and certainly hard to obtain in underdeveloped rural areas. The proponents of S. 1010 stress that inner City cooperatives would be particular beneficiaries of this Bank, and we are considering whether the provisions of this legislation should assure this.

A way of accomplishing this, of course, would be to establish an index of economic distress -- such as the one used in our Anti-recession fiscal assistance program -- and direct a specific percentage of the Bank's lending assistance each year to economically distressed areas which qualify under this index. We would like to study this further, together with the Committee, over the immediate future.

Examinations and Other Technical Considerations

Until the preferred stock held by the Government has been fully redeemed, the Bank will be examined by an agency designated by the President, as in H.R. 2777.

I have omitted any reference to a variety of technical matters concerning the capital structure of the Bank, its borrowing program and other matters. We would be pleased to discuss these matters with the Committee after the conclusion of these hearings.

* * * * * * * * * * * * *

In closing, Mr. Chairman, I wish to reaffirm the President's interest in helping consumer cooperatives. I have outlined an approach to the problems expressed to us by consumer cooperatives. We believe that this approach will best serve the needs of consumer cooperatives and the American taxpayer.

Thank you

* * *

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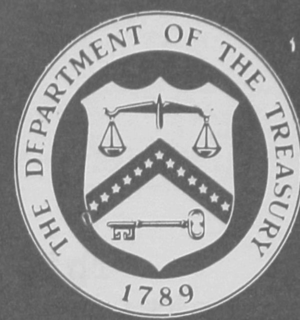

RELEASE FOR FRIDAY AMs
January 27, 1978

REMARKS BY THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
AT THE
MANHATTAN COLLEGE DINNER HONORING THOMAS A. MURPHY
WALDORF ASTORIA HOTEL
NEW YORK CITY
JANUARY 26, 1978

It's a pleasure to help honor the achievements of Tom Murphy, among so many of his friends. Manhattan College has chosen well in recognizing this man.

Over the years I have had the privilege of working closely with Tom on a number of endeavors - as a business colleague, on community projects in Michigan, and most recently in our respective roles as business leader and government official. I can attest from personal experience to the tremendous contribution which Tom Murphy has made in all endeavors.

He is truly a modern business leader with a breadth of vision that transcends the concerns of any one company. He understands the importance of the role which private enterprise and business leadership must play, and he knows the interrelationship between the concerns of business and those of the wider community. His active role in community affairs, in education, and in the cultural life of our nation -- as well as his farsighted leadership on business and economic matters -- are a model for others to emulate.

Without men and women of Tom Murphy's talents and dedication, America could not have built today's $2 trillion economy.

An economy of that unprecedented size is in no small part the sum of hard work and planning by the leadership of America's private economic enterprises.

As Henry Luce said, "Business more than any other occupation is a continual dealing with the future; it is a continual calculation, an instinctive exercise in foresight."

The chief goal of this Administration is to establish an environment in which business leaders can plan intelligently and confidently for the future.

This goal is spelled out in all of the messages the President has issued this past week: in the State of the Union Address, the Economic Report, the Budget Message and the Tax Message. Together, they lay out the President's assessment of the economy, his goals for the future, and how he intends to reach them.

Throughout these messages, there is a consistency of purpose, a consistency of philosophy, a consistency of implementation. The program is fashioned around certain basic understandings of how our economy functions, and how it functions best.

We begin with the understanding that our economic health is basically good and headed in the right direction. We are not prescribing for an economy that is approaching cyclical senility or plagued by incurable structural ailments. Our patient is healthy, vigorous and shows every sign of a bright future.

Our economy demonstrated that in the first year of this Administration by real growth of 5-3/4 percent; by adding 4 million new jobs, an annual record; and by reducing the rate of unemployment by almost 1-1/2 percentage points. These are unmistakable signs of fundamental health and economic balance.

We want to keep it healthy. There should be no confusion about our goals. We believe that the economy is growing at about the right rate -- fast enough to reduce gradually a too high unemployment rate, but not so fast as to accelerate a too high rate of inflation.

We judge that a real growth rate between 4-1/2 and 5 percent would steer us safely between these shoals. So it should be clear that we are not trying to stimulate a slumping economy. Instead, our objective is to maintain a pace of economic advance that the rest of the industrialized world regards with admiration.

There are forces in prospect which could pull the economy down from this growth path. The most important of these are large increases in social security taxes, income tax increases as inflation pushes taxpayers into higher brackets, the winding down of stimulus programs which the Administration put in place last year, a continuing trade deficit, and sizeable budget surpluses in the state and local sector. We have designed a fiscal program that will largely offset these forces and permit continued, balanced growth.

The emphasis in the fiscal program is on releasing resources for the private economy. We are not planning to offset fiscal or other drags by piling on more Federal spending.

On the expenditure side, President Carter's first full budget is one of the most frugal in recent memory. The increase in proposed outlays for fiscal year 1979, after adjusting for inflation, is only slightly more than 1 percent. Federal spending will be a smaller share of GNP next year than this -- 22 percent of GNP, instead of 22.6 percent -- and will continue to decline in the years ahead.

Instead of relying on "more government spending" as the way to keep the economy moving, we are turning to the private sector. That is the core of the President's economic strategy. In particular, it is the rationale for his tax program. The reductions in taxes we are proposing would return almost $25 billion to the private spending stream.

The question naturally arises: Is the tax cut large enough? Or is it too much? The answer is that it is just about right.

We did not start our deliberations on the Administration's fiscal policies for 1979 by picking a tax cut number and wrapping reform and expenditures around that. We started with a careful examination of the economy's strengths and weaknesses, current and prospective. Then we designed a program to maximize strengths and correct for weaknesses, taking into account the basic vigor of the economy, and considering both the expenditure and the revenue sides of government activities.

We have tested the adequacy of the fiscal program from a number of perspectives. Does it adequately offset contractionary forces? Does it support economic expansion at a reasonable rate? Does it zero in on structural problems?

The program meets these tests. One indicator is the share of income absorbed by Federal taxes. The proposed reduction in individual income taxes, combined with the reductions enacted last year, will substantially offset the increased bite of employee social security taxes and the impact of inflation on the effective tax rate.

Our program ensures that the combined drain of income and social security taxes, relative to personal income, will be no larger in fiscal year 1979 than it was last year. The figure will remain at about 14 percent. Similarly, our proposed reduction in corporate taxes means that a smaller share of profits will be absorbed by taxes in fiscal year 1979 than in fiscal year 1977.

In addition to making macroeconomic sense, our program directly confronts the most important structural problems in the economy.

The budget addresses, for example, the knotty dilemma of structural unemployment. The gains in employment and the reduction in unemployment last year were impressive. But they were not shared equally by everyone in our work force. In particular, unemployment among minorities and youth declined far less than it did for adults and whites.

The budget provides significant initiatives to employ the disadvantaged. We will be retargeting over 700,000 CETA job slots so as to benefit the truly disadvantaged. Over a billion dollars is provided for youth unemployment.

Perhaps most important, there is a new $400 million initiative to increase the involvement of the business community in local employment and training programs. The Administration recognizes that, for the long run, private sector job creation is the right answer. We welcome, and need, strong business participation in this cooperative attack on a major social problem.

Another very important structural, as well as cyclical problem, is the slow pace of capital formation. To provide the tools of production for a growing labor force, to restore our productivity, we must invest far more of our output in new productive capital than has been the case in recent years. We should be allocating more than 12 percent of our annual output to meet our long-term capital requirements. So far in the 1970's, we have been allocating barely 10 percent of output to investment.

As our factories and equipment continue to age, without modernization or replacement -- as our production capacity remains below what we need for our long-term future -- as productivity growth continues to decline, we come dangerously closer to risking long term economic stagnation and a resurgence of inflationary pressures.

I know that for most of you this persistent lag in new investment is the chief worry about the long-term prospects of our economy. It is our chief worry, as well, and the President is committed to a straightforward, long-term solution for it.

The shortfall in investment can be traced directly to the inadequate rate of return business has been earning on its capital outlays. If reported profits are corrected for the inflation in the cost of the capital and inventories used up in production, the true return on capital has been very low. During the three years 1974-76, profits after tax, adjusted for inflation, averaged only a shade over 3 percent of GNP, the lowest such ratio for any three years since World War II.

The answer is to make business investment more attractive. The tax program we have proposed will do that.

The individual income tax cuts we are proposing will provide the markets for the goods produced in new factories. The reduction in corporate income tax rates will raise the prospective after-tax return on contemplated investment.

Making permanent the investment tax credit should enable the business community to plan ahead with confidence that the tax rules of the game will not suddenly change. The extension of the investment credit to structures will correct the bias in current provisions toward equipment, at the expense of construction of new plants. Finally, the proposal to offset investment credits against a larger share of corporate income will broaden the range of enterprises able to take advantage of this incentive.

These proposed changes in the level and structure of business taxes will, I am confident, bring forth a significant rise in business capital spending.

Our basic strategy is to give private investment the lead in sustaining our economic expansion. That is the sure way to create lasting jobs, long run price stability, and improved competitiveness in world markets.

In developing the tax program, we consulted widely and intensively with a broad range of business interests. The proposals that emerged reflect their advice.

Because of our substantial tax cut, the 1979 budget deficit will be almost as large as this year's -- about $60 billion. Without the tax cut, the deficit would be sharply lower -- about $40 to $50 billion.

There will be pressures to enlarge the tax cut, and thus to run an even larger deficit in 1979. We intend to resist those pressures. We would like to bring that deficit down each year, and we mean to start on that project immediately, with this first full budget. A $60 billion deficit is big enough.

Some of you may think that it is too big, that it risks added inflation or sharply increased pressure on interest rates. With the private economy improving constantly, shouldn't the deficit fall at a quicker rate?

I welcome concerns of that kind. It is not healthy to take big budget deficits for granted. I can assure you that none of us is allowed to take them for granted. Red ink makes this president see red.

But the $60 billion deficit projected for 1979 does not in fact threaten serious upward pressures on wages, prices, or interest rates. We are not, after all, running a deficit in an overheated economy. With unemployment at 6.4 percent and capacity utilization at about 83 percent, a deficit is still needed to sustain expansion of the private economy.

Similarly, the budget deficits will not result in "crowding out" private borrowers. This fear was raised several years ago, and has yet to materialize -- largely because our financial markets have been capable of meeting both private and public borrowing needs.

The federal deficit, also, must be seen in perspective. The total government deficit will be substantially less than $60 billion. While the Federal government is running large deficits, state and local governmental entities are running large surpluses. Our fiscal perception of state and local governments has been somewhat obscured by the plight of some major urban centers. But overall, state and local governments are running very large surpluses -- on the order of $25 to $30 billion.

In fact, a significant share of the Federal deficit can be attributed to Federal grants to these other levels of government. About one quarter of state and local spending comes from Federal funds, up from about 15 percent during the 1960's. Taking this into account, the magnitude of the Federal deficit becomes somewhat less alarming.

Looking at the longer term, we have not abandoned our goal to balance the budget as circumstances improve. The budget for 1979 very carefully avoids commitments that could mushroom uncontrollably and prevent early achievement of a balanced budget.

We should note that over one-sixth of proposed budget outlays in fiscal year 1979 represents spending committed by prior year contracts and obligations. Another 50 percent of outlays are virtually uncontrollable, since they reflect open-end programs and fixed costs, such as social insurance payments, farm price supports, and the like -- reducing these costs would require changing the laws that authorized these programs.

That leaves us with roughly a quarter of the budget amenable to control. And here the most intensive honing of budget requests has taken place. As a result of many hours of close Presidential attention, these controllable outlays will be rising much less rapidly in 1979 than the rest of the budget.

Just how rapidly we move toward a balanced budget will depend on the strength of the private sector's response to our fiscal initiatives, particularly to our tax reduction program.

It will not escape your attention that our new economic program conforms very closely to the advice you have given to us over the past six months.

-- We have sharply focused our legislative agenda and set clear priorities.

-- We have been very tight on spending.

-- We have moved toward a smaller deficit.

-- We have avoided overstimulating aggregate demand.

-- We have relied on tax reductions -- moving resources to the private sector -- as the centerpiece of our economic strategy.

-- We have designed tax reductions that give a prominent place to deep, permanent, simple cuts for businesses.

-- We have ruled out wage-price controls and have adopted a cooperative posture with the private sector in fighting inflation.

-- We are moving to prune away overly costly regulation.

-- We are fighting unemployment through focused, structural programs.

The overriding purpose of this comprehensive program is to establish a long-run economic climate of confidence and certainty. This is what is needed to move the recovery into a new phase, where robust private investment can carry the economy safely into the 1980's.

It is now largely up to the private sector whether this strategy succeeds. This program reflects your advice. It now needs, and deserves, your strong support. There will be no climate of confidence and certainty unless the business community stands up for the central themes of this economic program. At your urging, we have established a firm foundation for a partnership with business and labor -- a partnership for steady, balanced economic progress led by the private sector. It is essential now that you join that partnership.

You asked us to listen and respond. We did so, in the national interest. In the same national interest, we now ask for your help.

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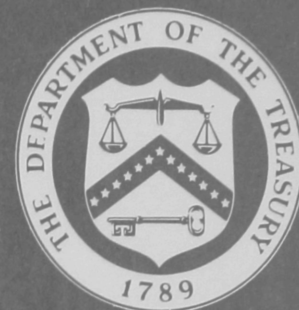

FOR RELEASE ON DELIVERY

STATEMENT OF THE HONORABLE RICHARD J. DAVIS
ASSISTANT SECRETARY OF THE TREASURY
FOR ENFORCEMENT AND OPERATIONS
BEFORE THE
SUBCOMMITTEE ON ALCOHOLISM AND DRUG ABUSE
SENATE COMMITTEE ON HUMAN RESOURCES
JANUARY 31, 1978, 10:30 a.m.

Mr. Chairman and Members of the Committee:

I appreciate being able to appear before you today, and I welcome the opportunity to provide you with information on the issue of warning labels for alcoholic beverages particularly relating to the Fetal Alcohol Syndrome. Accompanying me today are Rex D. Davis, Director of ATF, Stephen Higgins, Assistant Director, Marvin Dessler, Chief Counsel of ATF, and Catherine Milton, my special assistant.

First, I would like to describe my role in relation to the Bureau of Alcohol, Tobacco and Firearms. The Secretary of Treasury has all powers and responsibilities for all Treasury employees including ATF. However, by Treasury Order 221, the Secretary delegated to the Director of the Bureau of Alcohol, Tobacco and Firearms, the Secretary's authority under the Federal Alcohol Administration Act. This is the Act which establishes the responsibility for regulating the alcoholic beverage industry. Another Treasury Order, No. 190, however, gives me as Assistant Secretary of Treasury the responsibility to supervise and oversee the Bureau in all policy and operations.

The Federal Alcohol Administration Act (FAA Act) which was enacted into law in 1935 contains a section on labeling, Section 205(e). This Section prohibits

B-663

any alcohol to be sold or shipped in interstate commerce unless the alcoholic products are labeled properly according to regulations issued by the Secretary of Treasury.

While under this provision ATF has been given broad authority in the labeling area, some have suggested that because warnings for health purposes are not explicitly enumerated in the statute, that ATF cannot act in this area. It is clear, however, from the language of the Act and the legislative history that ATF has been given wide labeling authority aimed at protecting the consumer from a variety of evils. For example, one section forbids statements found to be likely to mislead the consumer; and another section states that labels should provide the "consumer with adequate information as to identity and quality of the products." Under these provisions numerous regulations relating to labeling have been issued by the Secretary of the Treasury. Nevertheless, prior to making a judgment on the statutory authority of ATF to require health warnings, we intend to await the presentation of all legal arguments which may be made in connection with the rulemaking proceedings discussed below.

Fetal Alcohol Syndrome Warning Proposal

As for the specific proposal for a health label to be placed on alcoholic beverages warning women about the consumption of alcohol during pregnancy, ATF has issued an Advance Notice of Proposed Rulemaking which was published January 16, 1978 in the Federal Register. This notice followed a November 15, 1977, letter from Dr. Donald Kennedy, Commissioner of the Food and Drug Administration requesting the Bureau to initiate action for the placement of warning labels on containers of alcoholic beverages because of the potential health hazard to the fetus if a woman consumes too much alcohol while pregnant. After holding discussions with FDA and reviewing their materials and consulting with the Office of Science and Technology Policy, we decided to issue an Advance Notice of Proposed Rulemaking. We felt that this course would enable us to get the maximum amount of information in the most efficient manner so that the best judgment can be made as to the appropriate course of action. ATF drafted the advance notice and it was published on January 16, 1978. The notice allows a 60-day comment period. A copy is attached to my testimony. Rather than describe in detail the substance of that notice, I will describe two important points.

First, the scientific evidence presented thus far has suggested that damage to the fetus can occur at early stages of prenatal development, even before the woman is aware she is pregnant. Second, some studies have indicated that consumption of 3 ounces of 100 percent alcohol (an equivalent of 6 drinks) produces a risk of damage to the fetus. Thus, a woman who one time engages in excessive drinking may endanger the fetus. If these two facts are true, then the problem is much broader than one of merely warning problem drinkers or alcoholics. It means that all women of child-bearing age must be made aware of the potential dangers. Any proposal must take these facts into consideration.

In reviewing the comments and deciding on the best course of action we intend to concentrate on a number of matters. First, we need to review all the available medical evidence. Then we need to consider whether labeling is the most effective way to warn women of the danger or whether other alternatives are better. For example, it has been suggested that doctors should be the ones to provide the necessary warning. Others have questioned whether this issue should be dealt with separately or as part of a broader program to warn women as to the variety of dangers they face when pregnant including such things as aspirin, alcohol and any other dangerous commodities. Finally, if we decide that a warning label is required, we will look to the comments to provide guidance on exactly what the label should say. It is our hope that the comments we receive will enable us to answer these and other questions.

We take the responsibility in addressing this problem most seriously. In order to assure, therefore, that the proper expertise is applied to this issue, I have asked ATF to consult in evaluating the comments it receives with FDA, the National Institute of Alcohol Abuse and Alcoholism, and the Office of Science and Technology Policy. These consultations would focus particularly, though not exclusively, on the medical comments. If the need arises, we are prepared to seek additional scientific and medical advice. In addition, we are determined to evaluate the comments as expeditiously as possible.

General Health Warning Proposal

You have also asked our views on the proposal to require a generalized warning label on certain alcoholic

beverages indicating that their consumption may be hazardous to health as well as habit forming. We are concerned that use of such generalized warnings may reduce the significance attached to warning labels generally. By reserving this remedy for more specific dangers, all warnings may have more meaningful impact on those who read them. We therefore doubt that a showing has been made that the proposed warning would be effective. We would be happy, of course, to re-evaluate this view if additional information is presented which would make that showing.

In closing, I would like to say that there has been, we know, publicity about disputes between ATF and FDA on various matters. It is my firm belief that in the future cooperation with FDA--with its obvious expertise--is important so that we both can assure that the best interests of the consumer are protected. While agreement between agencies may not always be possible, we plan on actively seeking FDA's advice and working together constructively.

At this point, I would suggest that Mr. Rex Davis make a brief statement describing the comments which ATF has already received as a result of the Advance Notice of Proposed Rulemaking, how he intends to review these comments, and some other background. We will then, of course, be happy to answer your questions.

Thank you.

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EPARTMENT OF THE TREASURY

reau of Alcohol, Tobacco, and Firearms

[27 CFR Parts 4, 5, and 7]

[Notice No. 316]

ARNING LABELS ON CONTAINERS OF ALCOHOLIC BEVERAGES

Proposed Rulemaking

NCY: Bureau of Alcohol, Tobacnd Firearms.

ION: Advance notice of proposed naking.

IMARY: The Bureau of Alcohol, icco, and Firearms is issuing this nce notice to obtain information ling it to decide whether the cur- regulations should be amended to ire a warning label on alcoholic rage containers, regarding the umption of alcohol by pregnant en. The Bureau is particularly in- ted in comments from consumers, stry, women's organizations and cal experts concerning the busi- impact and technical aspects, sci- ic and legal aspects, and the possi- overall value and benefits of the osal.

ES: Comments must be received r before March 17, 1978.

RESS: Comments must be sub- ed, in duplicate, to the Director, au of Alcohol, Tobacco, and Fire- , Washington, D.C. 20226, Attn.: ilations and Procedures Division.

FURTHER INFORMATION TACT:

berta K. Kulina, Research and gulations Branch, Bureau of Alcohol, Tobacco, and Firearms, Washington, D.C. 20226, 202-566-7626.

SUPPLEMENTARY INFORMATION: ATF has decided to invite interested parties to participate early in the rulemaking process. This early participation will enable ATF to decide whether a notice of proposed rulemaking should be issued. An advance notice of proposed rulemaking is issued when it is felt that the resources of ATF do not provide sufficient information to identify the best course of action, or where it would be helpful to receive public participation in identifying the best course of action. Following is a discussion of the medical research conducted concerning fetal alcohol syndrome and a list of specific questions regarding the proposal.

BACKGROUND

Medical research on the impact on human infants of maternal alcohol consumption during pregnancy has demonstrated that fetal alcohol syndrome (FAS) is clinically observable. This condition is most often characterized by: (1) Prenatal growth deficiency in length and postnatal growth deficiency in both length and weight; (2) microcephaly (the condition of having an abnormally small head); (3) small palpebral fissures (the space between the margins of the eyelids); and (4) mental retardation. Along with these characteristics, however, other patterns of dysmorphism, deficient motor functions, and impaired neurological development have also been identified. Damage to the fetus can occur at the early stages of prenatal development, even before the woman is aware she is pregnant. In this respect, all women of child-bearing age should be aware of the possibility of FAS in potential offspring. Often times, the FAS pattern is identified first, and the maternal alcohol intake is documented later.

Much of the research conducted suggests that a high blood alcohol level during critical periods of embryonic development is probably a prerequisite for producing FAS. The average alcohol consumption may not be as important as the maximum concentration obtained during "binge drinking," or one-time heavy drinking during critical periods. Evidence from both animal and human studies indicates that consumption of 3 ounces of 100 percent alcohol or above (an equivalent of six drinks) produces a risk to fetal outcome. As to the risk for consumption of lower quantities of alcohol, the National Institute on Alcohol Abuse and Alcoholism has determined that further animal and human studies are needed.

Other research has been conducted linking alcoholism with FAS. In studies comparing alcoholic couples to couples where only the wife was alcoholic, maternal alcoholism was considered to be essential to produce adverse consequences to the fetus. It is important to note that heavy drinking can often be associated with heavy nicotine and caffeine ingestion; however, in clinical observations the effects produced by maternal alcoholism appeared even without nicotine and caffeine ingestion. Studies show that smoking one pack of cigarettes a day by a pregnant woman reduces her baby's birth weight. However, no malformations have been observed. No human malformations have been attributed to caffeine intake either. Malnutrition is another factor often associated with impairment to fetal growth and development. However, the fetal alcohol syndrome, as described, is characterized by a greater deficiency in prenatal growth, with an even greater deficiency in length than weight. In studies conducted of non-alcoholic malnourished women, neither this pattern of growth deficiency nor the pattern of malformation described was observed.

In summary, the research on the impact of maternal alcohol consumption on human infants has clearly identified the morphological characteristics of fetal alcohol syndrome. Over 58 published cases reported from 16 different medical centers have confirmed the existence of this syndrome. Currently three major studies on maternal alcohol consumption and infant outcome are being funded by the National Institute on Alcohol Abuse and Alcoholism and are taking place in three major U.S. cities. Early findings of these studies have already confirmed the presence of morphological characteristics of FAS in some of the infants. There are of course instances where only part of the syndrome is found. These may be cases of single malformations, retarded growth and development, or behavioral patterns such as jitteriness. Observations of alcohol intake affecting physiological and metabolic development clearly indicate that alcohol exposure to the placenta may impair nervous system development, specifically morphological and neurological fetal development.

QUESTIONS

To assist ATF in identifying the best course of action, written comments and supporting data are specifically requested on the following topics:

1. What type of specific warning label, if any, should be placed on containers of alcoholic beverages?

2. What would be the impact on consumers, primarily women, as a result of such a warning?

(a) Would the warning be effective in preventing pregnant women from consuming alcohol in amounts that might prove detrimental to their unborn infants?

3. What other possible alternatives are available to disseminate informa-

tion to the public on possible health hazards resulting from alcoholic intake?

(a) Should these alternatives be in place of or in addition to a warning label?

4. What other medical research is available documenting or refuting the existence of fetal alcohol syndrome?

DRAFTING INFORMATION

The principal author of this document is Roberta K. Kulina of the Research and Regulations Branch, Bureau of Alcohol, Tobacco, and Firearms. However, personnel from other offices of the Bureau and from the Treasury Department participated in developing the document, both on matters of substance and style.

AUTHORITY

This advance notice of proposed rulemaking is issued under the authority contained in section 5 of the Federal Alcohol Administration Act (49 Stat. 981 as amended; 27 U.S.C. 205).

Signed: December 23, 1977.

MILES N. KEATHLEY,
Acting Director.

Approved: January 3, 1978.

BETTE. B. ANDERSON,
Under Secretary of the Treasury.

[FR Doc. 78-1042 Filed 1-13-78; 8:45 am]

Department of the TREASURY NEWS
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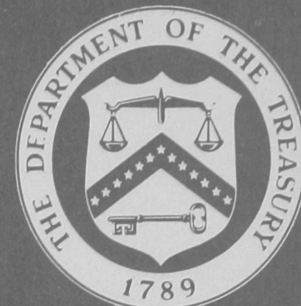

FOR IMMEDIATE RELEASE
January 27, 1978

REMARKS BY UNDER SECRETARY BETTE B. ANDERSON
TO THE
BANK PRESIDENT'S SEMINAR
CALIFORNIA BANKERS ASSOCIATION
ANAHEIM, CALIFORNIA
JANUARY 27, 1978

It's a pleasure to have this chance to discuss the Carter Administration's economic program.

1978 is being called "the year of the economy," and that certainly was the intended theme of President Carter's State of the Union Address, his Economic Report, and his Budget and Tax messages.

These messages covered a lot of ground in the past few days. But the goals are clear: We will continue to pursue policies to move our economy to higher ground -- real growth of 4-1/2 to 5 percent this year, further reductions in unemployment, and further moderation in the rate of inflation -- and we will rely on the private sector for that growth.

To meet these goals, we will be building on the successes of the past year, with a major tax program and some other new policies to meet the changing nature of our economic problems.

Before I go into this program, however, we should recall where we started a year ago and where we stand today.

When President Carter took office a year ago, he inherited an economy that had come to a virtual standstill.

Following the worst recession and inflation since World War II, the recovery was nearly halted. Real growth at the end of 1976 was at an annual rate of 1 percent, with unemployment at 8 percent. There was talk that another recession was just around the corner.

By the end of 1977, it was obvious that something quite different had happened.

We ended the year with real economic growth of 5-3/4 percent, with our expansion well into its third year.

We reduced unemployment by about 1-1/2 percentage points, closing the year with a rate of 6.4 percent, the lowest in over three years. Even more remarkable, last year we added over 4 million jobs to our economy, and raised the percentage of Americans working to a record level of 58 percent.

Moreover, we ended the year without any real imbalances that could signal an end to our expansion. Consumer and business financial positions are not strained. Inventories were at a low level, indicating that production should pick up soon to replace stocks depleted by strong consumer demand.

In short, last year was a good year for an economy that three years ago was deep in the worst recession since the 1930's -- and the prospects for the next several months are very good.

Partly, this is because our economic policies helped provide favorable conditions to sustain the expansion. We strove for a balanced, prudent set of policies to get our economy moving again along the right course.

But the real progress was made when customers returned to stores with money to spend, when order books began to fill up again, when new construction got underway, when new production expanded the base of jobs for Americans -- in other words, when the countless number of decisions and transactions in our private market economy added up to renewed growth.

Looking at 1978, I know we can continue that growth at the same time we turn toward some of the serious problems that remain -- an unemployment level that is still too high, especially for minorities and youths, a stubbornly high inflation rate, a worrisome trade deficit, and a lagging rate of business investment.

This last problem -- business investment -- is a special concern of this Administration, both for 1978 and the longer term.

Because of various factors, our capital stock has not been growing enough. Capacity growth in manufacturing has declined from a rate of 4.6 percent from 1948 to 1968, to 4 percent in the four years after that, and to 3 percent from 1973 to 1976. Moreover, the latest Commerce Department survey of business plans predicts a decrease in plant and equipment spending growth from last year -- only a 10.1 percent increase, down from last year's 13.7 percent increase.

A major cause of lagging investment, of course, has been lower returns on investment in recent years. Reported profits often don't reflect higher inventory and capital replacement cost increases due to inflation. As a result of that and other

factors, return on investment has averaged about 5 percent from 1974 to 1976, compared to almost 13 percent from the mid-1950's to the mid-1960's.

These and other economic problems cannot be minimized. But we should not look upon them as insurmountable, either. The fact is that we can make progress against inflation, unemployment and our balance of payments deficit while sustaining a broad economic expansion.

And the economic program we are putting in place this year can accomplish just that. I won't attempt to detail the entire program, but I would like to describe what I consider its two most important parts -- the tax proposal and the anti-inflation program.

The centerpiece of this year's economic policy clearly will be the President's proposals to cut taxes by about $25 billion and to enact important tax reforms to make our tax system simipler and fairer.

Some two-thirds of the cuts would go to individuals, primarily through lower rates for each bracket and the substitution of a credit of $240 for each $750 personal exemption and $35 credit in the taxpayer's family. Individuals would also benefit from elimination of the Federal excise tax on telephone bills.

The other third of the tax cuts would go to businesses, along these general lines:

-- The corporate tax rate would be reduced by 3 percentage points starting October 1, 1978 and by another point off the top bracket in 1980, with 2 percentage points off the lower brackets.

-- The 10 percent investment tax credit, due to revert to 7 percent in three years, would be made permanent.

-- The investment tax credit would also be extended to industrial and utility structures as well as equipment, and would be allowed for up to 90 percent of taxes, instead of the current limitation of 50 percent of taxes.

There are significant reforms in the proposals, such as limiting deductions for business entertainment, tightening tax shelters and preferences, phasing out DISC and foreign tax deferral, and eliminating some of the personal itemized deductions.

We need these reforms to correct inequities and to get rid of unnecessary complexity. It is a manageable reform package that Congress can readily consider and enact in 1978.

We also need the economic boost that will come from tax reduction.

Without the tax cut, we could expect the economy to slow to an unacceptable growth rate by 1979 and stay there. One of the primary reasons for that slowdown would be the fiscal drag of higher income taxes, as inflation pushes taxpayers into higher brackets, and higher payroll taxes for workers and businesses.

Moreover, our current economic stimulus package, which relied heavily on public spending to create jobs, will reach its peak this year.

So even though our economy is basically healthy, these factors would exert a strong drag on the expansion. Rather than adding stimulus to an already accelerating economy, the tax cuts would go mostly to counteract expected negative forces, and to continue the momentum that would otherwise be lost.

There are two additional points that we should remember about this tax proposal.

First, not only is this a timely move, but it also represents a shift in emphasis from public to private spending to create permanent jobs for a growing labor force. New investment tax incentives and greater aggregate demand would help lay a base for future, long-term growth.

Second, and perhaps just as important, the tax proposals are an important structural change that go beyond the immediate task of sustaining the economic expansion.

The cuts in rates will be permanent, across-the-board cuts, not just temporary ones scheduled to expire later. Making the 10 percent investment tax credit permanent, for example, recognizes the necessity for greater business investment as a long-term need.

And it signals our determination to restrain the growth of Government spending as a share of GNP, and to counter inflation as it pushes people into higher tax brackets. The President reiterated his pledge to reduce the share of GNP committed to Federal spending from this year's 23 percent by 1981 to its historical share in the recent past -- about 21 percent. The tax reduction the President is proposing is an essential element of that overall effort.

Along with these tax proposals, we are putting in place an anti-inflation program that can gradually reduce the pressures now forcing up wages and prices. While we may have grown accustomed to our recent inflation, the fact remains that we cannot allow it to go on indefinitely without jeopardizing our long-term economic goals.

Inflation may be the most difficult challenge of the Carter Administration because of its complexity and pervasiveness. Certainly it resisted the efforts of the previous Administration, when policy-makers thought that we could stop inflation by allowing unemployment to rise. The only result of that was both high unemployment and high inflation.

So we're embarking on this anti-inflation program with full realization of its difficulty, and without making any easy promises. Instead, it will consist of these carefully-targeted efforts:

-- First, business tax cuts that increase productivity will prevent future bottlenecks and reduce costs. This will be especially important as we move closer to full capacity in key industries.

-- Second, we are cutting some taxes that have a direct effect on costs. Elimination of the telephone excise tax and reduction of unemployment insurance contributions by employers will further reduce cost pressures.

-- Third, we are establishing new procedures to restrain the inflationary effect of Federal regulations -- by assessing their overall impact and setting priorities among our regulatory objectives.

-- Fourth, we are helping to establish farmer-owned grain reserves to prevent shortages that could add to food prices. Food prices have been a wild card, causing unexpected surges in consumer prices, and we need this buffer against sudden changes in harvest conditions.

-- Fifth, and finally, we are developing what I believe will become the key to this diverse, but coordinated strategy. That is a voluntary business and labor effort to promote "deceleration" of wage and price increases.

The goal of this will be to ensure that price and wage increases in 1978 are less than in the past two years -- that 1979 increases are less than 1978 -- with lower increases in each succeeding year.

Rather than using an indiscriminate, across-the-board formula for everyone to follow, we will negotiate voluntary restraints with workers and management in major firms. We do not expect firms to depress profits, or workers to accept lower real incomes. Instead, we are seeking a standard of behavior that keeps our inflation goals in clear focus.

The voluntary emphasis of this program is probably the only really acceptable approach for government to restrain wages and

prices. From the beginning of this Administration, we have rejected wage and price controls, and we will continue to hold to that position.

Taken singly, none of these anti-inflation efforts could have much of an effect. But together, in a coordinated effort, they can gradually reduce the wage-price spiral now underway.

In addition to the tax and inflation programs, there are several other major elements of the President's economic strategy.

-- We are keeping up the effort to reduce structural unemployment, primarily with programs that directly produce jobs -- public service jobs, training and employment programs for youths, and new funds for private-sector initiatives to employ the disadvantaged. These are a necessity if we are to avoid establishing a class of permanently unemployed Americans, with no hope for the future.

-- We are continuing to work for passage of the President's energy program to reduce the burdensome cost of oil imports and to help increase domestic production. This effort is the best single move we can make to reduce our balance of payments deficit and stabilize the dollar.

-- We are also exercising strict discipline in Federal spending. The results of this are apparent, in the budget that the President has sent to Congress the budget for fiscal year 1979. Despite pressures from all sides to increase favored spending programs, the President in his first full budget cut requested increases to a close margin. The 1979 budget actually decreases the share of our GNP taken up by Federal spending -- from 22.6 percent this year, to 22 percent in 1979.

-- Finally, we are pursuing international economic policies that measure up to our role as a world leader. We have resisted protectionist pressures -- helping to maintain an open trading system that has contributed so greatly to worldwide economic growth. We will also step in when conditions in currency exchange markets become disorderly or threaten abrupt changes in the value of the dollar, and to work with other nations to prevent further disruptions.

That, briefly, is the shape of the Administration's economic program for 1978. And if you see that we are confronting a great number and diversity of economic problems, you also can see we are doing this through an integrated, balanced economic strategy.

The unifying theme of the strategy is reliance on the private sector -- to invest in the future, to create new, permanent jobs, and to work through the market mechanism to create lasting price stability.

Our experience in the 1970's -- when all of us learned some hard lessons -- has shown that neither government nor business has all the answers.

That's why we sought close consultations and cooperation with business leaders throughout last year in shaping the program we now put before the American people.

We know that solutions are almost certain to be more efficient and effective if the private sector is allowed to use our productive resources unhindered by unnecessary government intervention. Through this year and beyond, we intend to encourage and support the private sector to come up with those solutions.

In the meantime, we invite your participation in our policy-making -- to keep the momentum of cooperation going -- and to ensure that Administration policies reflect the real needs of the American business community and the public.

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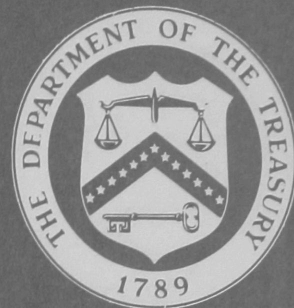

Contact: Alvin Hattal
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FOR IMMEDIATE RELEASE

January 27, 1978

TREASURY ANNOUNCES COUNTERVAILING DUTY INVESTIGATION ON IMPORTS OF TEXTILE MILL PRODUCTS AND MEN'S AND BOYS' APPAREL

The Treasury Department has started an investigation into whether textile mill products and men's and boys' apparel imports from Argentina, Brazil, Colombia, India, The Philippines, Republic of China, Republic of Korea, and Uruguay are being subsidized.

This action is being taken pursuant to petitions alleging that the textile and apparel industries in these countries receive benefits under several government programs that subsidize the manufacture/exportation of those products.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional customs duty that equals the size of a "bounty or grant" (subsidy) paid on the exportation of merchandise.

A preliminary determination in this case must be made on or before May 7, 1978, and a final determination no later than November 7, 1978.

Notice of this investigation will be published in the Federal Register of January 30, 1978.

The value of imports of textile mill products and men's and boys' apparel from these nations is not currently available.

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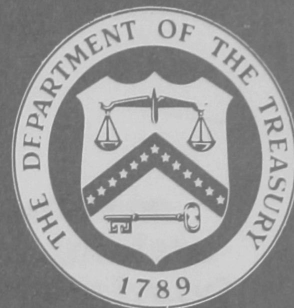

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FOR IMMEDIATE RELEASE January 27, 1978

STEEL "EXTRAS" TRIGGER PRICES ANNOUNCED

The Treasury Department today announced "extras" prices for 16 of the 17 imported steel mill products which had trigger prices assigned on January 3, 1978. Extras for hot rolled carbon bars will be announced later.

Trigger prices and "extras" for additional steel products including pipe and tube, small structural shapes, flat bars, concrete reinforcing bars, hot rolled round and square bars and bar size channels will be announced in about a week.

When steel that is being imported has been heat treated, sized, graded, smoothed, cut to special lengths and sizes, or has other extras, the trigger prices for those extras will be added to the base price.

The trigger prices for "extras" were calculated based on information supplied by the Japanese Ministry of International Trade and Industry and generally conform to U.S. charges.

All prices listed in the "extras" book have been rounded off to the nearest dollar and are based on metric tons (2,204.6 pounds) since imported steel is generally sold in metric tons. The January 3 announcement of prices was based on U.S. short (net) tons of 2,000 pounds. (Short ton -- 2,000 pounds prices can be converted to metric, by multiplying them by 1.10231.)

Also enclosed with today's announcement is a series of questions and answers on the trigger pricing program.

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GENERAL

QUESTION: What is the need for establishing a reference price system when the Secretary of the Treasury currently has authority to initiate dumping investigations and to withhold appraisement retroactively?

ANSWER: The trigger price mechanism (TPM) is seen as a means of organizing Treasury's resources so that it can exercise the authority to self-initiate investigations. The system is designed to gather the information necessary for Treasury to act. It will enable the Secretary of the Treasury to exercise his authority under the Antidumping Act, to initiate dumping investigations whenever he receives information that merchandise is being sold in the United States at less than its fair value and that an industry in the United States is being, or is likely to be, injured by reason of such sales. This authority has been sparingly used (and not at all in recent years) because the Secretary generally does not regularly have reliable, adequate data on which to initiate formal proceedings. It takes the significant allocation of resources contemplated for the steel TPM to enable the Secretary to be currently and adequately informed.

Use of the TPM also should speed up the investigative phase of the proceedings and allow expedited determinations of the existence of sales at less than fair value. The mechanism will thus allow withholding of appraisement at an earlier date than under normal procedures.

QUESTION: What advantage does this system offer relative to either vigorous enforcement of the Antidumping Act or the establishment of orderly marketing or voluntary restraint agreements which justify the additional administrative burden and expense?

ANSWER: It is not accurate to say that the proposed TPM will be more administratively burdensome or expensive than the establishment of orderly marketing or voluntary restraint agreements. Experience has shown that such arrangements impose significant administrative burdens in terms of monitoring and gathering information no less than the TPM. On the other hand, the clear advantages of the trigger price mechanism are that it deals with the problems of unfair trade practices, and at the same time permits competitive forces to continue to operate. In this respect it can be contrasted favorably with voluntary restraint agreements (VRA's) and orderly marketing agreements (OMA's), because it does not, as the VRA's and OMA's tend to do, divide up the world steel market among suppliers. Additionally, the mechanism is preferable to VRA's in that the United States ultimately retains effective control over its enforcement.

The system is not an alternative to vigorous enforcement of the Antidumping Act. Rather it should be viewed as a device specially tailored to the unique situation of steel which enhances vigorous enforcement of the Antidumping Act on an expedited basis.

CALCULATION OF TRIGGER PRICE

3. QUESTION: Is our understanding correct that reference prices will be based on full Japanese cost of production and that the Japanese are supplying us with aggregate cost of production figures? What effect will the choice of aggregate, rather than company by company data have on the reference price? How does Treasury intend to verify the cost of production data it receives?

ANSWER: The data are being supplied by groups of Japanese firms. The choice of group of firms is based upon the product lines in question. Therefore, the six large integrated producers are supplying information on flat rolled products while electric furnace producers are supplying information on small structural shapes. Given that each of these groups of firms is relatively homogeneous, the data should be a reasonable reflection of Japanese costs. These data are being verified by comparing them with published information on individual cost components in Japan, unpublished information on United States costs, a variety of independent studies of costs, and published financial statements.

QUESTION: Section 205(b) requires certain conditions to be met for the use of constructed value rather than home market value or the price to third countries, i.e., sales at less than the cost of production must be made over an extended period of time and in substantial quantities and at prices which do not permit recovery of cost in a reasonable period of time. On what do you base your assumption that these conditions are met for every steel category and will continue to be met to warrant constructed value as the basis for a presumption of dumping? In a case involving sales by a Japanese producer below the reference price, will the dumping margin be based upon the foreign market value, if one exists for the particular product, or on the constructed value used as the reference price?

ANSWER: The TPM does not involve any presumption of dumping, based upon a comparison of imported prices with their "constructed value." The TPM involves neither immunity from antidumping investigations for sales above the trigger price nor conclusive presumption of dumping when sales are below the trigger price. Rather, the trigger price will enable the Secretary of the Treasury to determine when it is appropriate for him to initiate an investigation of dumping. Should the Secretary decide to initiate an investigation of sales below the trigger price, the investigation will proceed without reference to the trigger price. Any margins which are found upon investigation will be based on the statutory criteria of foreign market value or, as appropriate, constructed value without regard to the trigger price. Of course, in circum-

stances where it is appropriate under the Antidumping Act to look to the cost of production in the foreign market, the information gathered in constructing the trigger price will be useful in making those determinations as to cost, as was demonstrated in our recent decision in the Gilmore case.

5. QUESTION: Are you assuming that the Japanese are the most efficient producers with respect to every type of steel product?

ANSWER: Yes. However, as information becomes available concerning costs of other efficient producers these costs may be used in the future.

6. QUESTION: We have been informed that it would be administratively impossible for Treasury to set a reference price for every steel product. Rather, reference prices will be set for a number of product categories, and only where there is significant trade in a particular grade within a product category will a separate reference price be created.

1) What are the product categories for which reference prices will be calculated, and are they based on TSUS categories or other criteria?

2) How frequently will data on trade within a product category be revised to determine if trade for a particular product in the category is becoming significant?

3) What constitutes "significant" trade?

ANSWER: The base prices are being established for the main types of steel mill products (as defined by the American Iron and Steel Institute) imported in significant quantities of which there will be from 30 to 50 different types. The "extras" can, of course, differentiate thousands of products actually imported. The prices are being established on a base-plus-extras basis for every product imported in significant quantities into the United States. All carbon and alloy steel mill products will receive coverage under this plan. Decisions on added product categories to be covered may be made at each quarterly revision date.

7. QUESTION: It is our understanding that in calculating the reference price, Treasury will use "normal" capacity utilization. What is "normal" capacity utilization? Will Treasury use current or historical utilization figures, and what effect will that choice have on the reference price?

ANSWER: "Normal" capacity utilization is defined as the everage utilization achieved by the Japanese steel industry through successive business cycles over the past 20 years. That rate is about 85 percent, which figure was used in establishing the trigger prices. Choice of a higher rate would lower prices somewhat; choice of a lower rate would raise prices somewhat.

8. QUESTION: a. Will the full cost of production of the most efficient producer, on which the reference price is based, reflect the same factors considered in obtaining a "constructed value", including a minimum of 8% for profit and 10% for general expense under the Antidumping Act?

b. If the same factors, including the profit and overhead minimums, are not used in determining the reference price, is the domestic industry receiving the same protection from unfair import practices as it would from vigorous enforcement of the antidumping laws?

ANSWER: a. Yes, although the profit factor, as such, has not been isolated but has been treated as a part of an overall return on invested capital to permit equalization of debt and equity invested and avoid the double counting of capital costs both as interest and as profit. General expenses in Japan tend to exceed 10% of cost of fabrication.

b. As indicated in the answer to question 2, the TPM is not an alternative to vigorous enforcement of the Antidumping Act.

9. QUESTION: Is our understanding correct that there will be a 5 percent flexibility band on either side of the reference price? Why is a band necessary and why is it 5 percent? Will Treasury initiate an antidumping investigation when sales are less than the reference price minus 5 percent or less than the reference price plus 5 percent?

ANSWER: There will not be a 5 percent flexibility band on either side of the trigger price applicable to determine whether the trigger price has been reached. As pointed out in Under Secretary Solomon's report to the President, at the time of each quarterly adjustment in the trigger price, the trigger price for each product will be set within 5 percent of that product's full cost of production. The flexibility in either direction will permit smoothing out sharp fluctuations in production costs that may only be temporary. Taking immediate account of all such fluctuations would be unnecessarily disruptive to both domestic and international patterns of trade.

Any imports priced below the trigger price will be promptly identified and the information immediately forwarded to the Treasury in Washington for further investigation. In Washington this information will be reviewed to determine whether the quantities involved and the amount by which the sale price is less than the trigger price warrant the initiation of a formal antidumping investigation. No quantified "margin of safety" will be used; whether to initiate will depend on such factors as the size of the shipment, its source, its relation to other shipments under the same contract or from the same supplier (or country) and the amount by which the contract price is below the trigger price.

ADMINISTRATION OF THE REFERENCE PRICE SYSTEM

QUESTION: Will Treasury set a specific time limit within which Customs must notify the Secretary of sales below the reference price? If so, what will the time limit be?

ANSWER: Yes, Treasury will set specific time limits for Customs to notify the Secretary of sales below the trigger price. The exact time limits will have to await the actual implementation of the system, but it is presently envisaged that such notice should be given within two weeks of the actual importation of the items in question.

QUESTION: What evidence of injury or likelihood of injury to the domestic industry will Treasury use in cases of sales below the reference price on which it initiates an investigation and how will it obtain the evidence? Will Treasury conduct a preliminary review on injury before it initiates the investigation? Will evidence of both dumping and injury be considered simultaneously in deciding whether to initiate an investigation, as provided under Article 5 of the International Anti-Dumping Code? If Treasury does not have sufficient evidence of injury, will the domestic industry be required to or have an opportunity to petition for an investigation and supply such information even though sales are below the reference price?

ANSWER: The TPM will involve the current monitoring of the condition of the steel industry with respect to the particular products which

the mechanism covers. With the assistance of the Commerce Department, the industry, and Customs attachés in foreign countries, the Treasury Department expects to collect on a current basis information covering both foreign and domestic production, sales, prices, profitability, unemployment and capital investment for the industry producing each of the concerned products. Information will also be collected regarding capacity utilization, the volume and value of all imports of merchandise, the market share of the imports, and the effect of the sales of the imported merchandise on the prices of domestically produced products.

Import prices and injury will be considered simultaneously in deciding whether to initiate an investigation, as provided under Article 5 of the International Anti-Dumping Code.

The industry will have an opportunity, and in some cases will be requested, to supply additional information which would be useful concerning injury even though sales are below the trigger price.

QUESTION: We understand that in the event of a sale below the reference price the exporter is given 2-3 weeks to prove that he is not selling below his own cost of production. Assuming that the exporter cooperates and supplies the data (which, in testimony before the Subcommittee, Treasury has stated to be extremely complex), how much time would Treasury require to evaluate the data?

ANSWER: It is not correct to say that an exporter will be given two to three weeks to prove that he is not selling below his own cost of production. It is contemplated that after an initial indication of a significant sale below the trigger price the importer (and exporter) will be asked to explain the reason. If no reason is given that can be accepted within two or three weeks (such as a claim that the exporter's costs are below the trigger), the formal investigation may be initiated. Under the TPM it is anticipated that the investigation could often be completed within 60 to 90 days of its initiation. During this period the exporter would be in a position to offer evidence to support his position that he is not selling below "fair value", including his costs, particularly if he will have been preparing data contemporaneously in the form in which we will be requesting it and is cooperative in permitting its verification.

13. QUESTION: How will the reference price system enable Treasury to make a tentative determination of sales at less than fair value within 5-8 weeks after initiating an investigation?

ANSWER: The continuous monitoring of information with regard to foreign prices and costs of production and the condition of the U.S. industry will enable the Treasury Department to expedite anti-dumping investigations triggered by sales below the trigger price. In these circumstances, and assuming no special complications, such investigations often should require no more than 60-90 days

14. QUESTION: Will withholding of appraisement commence simultaneously with an initiation of an investigation, or at the time of a tentative LTFV sales determination?

ANSWER: The withholding of appraisement will commence at the time of a tentative determination of sales at less than fair value. in accordance with the Secretary's authority under the Anti-dumping Act and the provisions of the International Anti-Dumping Code, the Secretary may, in appropriate circumstances, withhold appraisement retroactively.

15. QUESTION: Will retroactive withholding of appraisement occur in all cases or only in the event of flagrant violations? If the latter, what will be the criteria for determining flagrant violations?

ANSWER: Retroactive withholding of appraisement will occur only in appropriate circumstances, and not in all cases. It is not possible at this time to state the criteria for determining appropriate circumstances. However, the Secretary will look to the quantities involved and the amount by which sales are below the trigger price, as well as the criteria now expressed in the regulations concerning breaches of price assurances furnished in previously discontinued antidumping proceedings.

16. QUESTION: Is Treasury considering actual collection of potential dumping duties, which would be held in escrow pending a dumping finding, at the time of a tentative determination of LTFV sales? If so, what statutory basis exists for such action?

ANSWER: Even though there is statutory authority for such action, Treasury is not considering at this time the collection of potential dumping duties to be held in escrow pending a dumping finding. The use of bonds to secure the collection of dumping duties has existed for many years and has been adequate to secure the payment of dumping duties due.

QUESTION: When Treasury, rather than a private industry, initiates an antidumping investigation, how will the ITC obtain the information necessary to make an injury determination?

ANSWER: Treasury will make available to the ITC all of the information which it collects in connection with the monitoring of the condition of the industry. The ITC itself will be able to collect additional injury information as it normally does in cases initiated by industry. Treasury will cooperate as fully as possible with the ITC in this investigation.

QUESTION: What steps is Treasury taking to ensure that dumping duties will in fact be assessed in a timely fashion following a dumping finding on steel imports?

ANSWER: The Treasury Department is concerned about the delays in liquidating entries subject to dumping findings. Customs has set up a task force which hopes to have assessments current by the end of March 1978. The work of the task force will be reviewed to ascertain whether assessments can be kept up-to-date under current law and with current resources.

QUESTION: We understand that once a reference price has been established, Treasury will make available to the public the information on which the decision is based. Precisely what information will be made available? Will there be any type of hearing process by which interested parties can challenge the reference price before it goes into effect?

ANSWER: The Treasury announcement of December 28, 1977 which was published December 30, 1977 in 42 Fed Reg 65214, describes the entire TPM including the methodology used in calculating the trigger prices. However, the data actually used in making the calculations was furnished on a confidential basis to the Treasury and will not be available to the public. Comment by the public on the TPM, as such, and the methodology used to calculate the trigger prices was invited in each Federal Register Notice. No formal hearing process to challenge the calculations is contemplated. However, none should be needed, because they are intended solely as a guide to the Secretary in selecting shipments of steel for investigation for possible action under the Antidumping Act. If action is taken, all of the defenses under the Act will be available.

QUESTION: How much will it cost Treasury to develop and implement the reference price system? When will the system be implemented?

ANSWER: It is anticipated at this time that the TPM will cost $2 million annually. Treasury Department expects to implement the mechanism around February 15, 1978.

1. QUESTION: How much additional staffing will be required to administer the system? Where will you obtain personnel trained in the field? Will there be any transfer of personnel currently involved in the administration of the antidumping statute, and, if so, how will this affect pending or future antidumping cases?

ANSWER: It is expected that the TPM will require an additional staff of 83 persons, most of whom will be in the Customs Service. Treasury is planning to hire or transfer persons experienced in the type of information gathering required for the TPM. Transferred persons will be replaced by additional recruits. Assuming that implementation of the TPM will not require full scale pursuit of all the steel anti-dumping petitions and that significant numbers of new petitions are not filed, it is not anticipated that these transfers will affect the administration of the antidumping statute.

IMPACT OF THE TRIGGER PRICE SYSTEM

A. Impact on pending and future antidumping cases.

2. QUESTION: What effect will the reference price system have on pending and future steel antidumping cases?

(a) Will complaints with petitions pending be requested, informally, to withdraw their petition in order to permit the new system a chance to operate?

ANSWER: No agreements with any steel companies to withdraw their petitions have been sought or concluded. However, when the TPM has been implemented and if it works successfully, Treasury expects that antidumping petitions affecting steel will be withdrawn because the companies will determine that they are no longer being injured by foreign imports and that they do not need application of the specific remedies under the Act. The steel companies will realize that withdrawal of their complaints will allow Treasury to concentrate more of its limited resources to the operation of the TPM and thus render the TPM more effective.

(b) Will Treasury consider discontinuance of pending cases based on the belief that the new system will protect the domestic steel industry, or will cases be discontinued on the basis of other criteria, as occurred in the auto case?

ANSWER: Although Treasury expects, for the reasons previously indicated, that antidumping petitions affecting steel will be withdrawn, Treasury has the authority under its regulations to discontinue investigations in appropriate circumstances. In considering whether to exercise this authority Treasury will have to determine whether it is able to devote its resources to both the TPM and the full scale pursuit of ~~all current~~ pertinent petitions when the same products are affected.

23. QUESTION: If the reference price is based on the full cost of production (COP) of the most efficient producer (Japanese) then less efficient producers, e.g., the Europeans and the LDC's, could sell below their own COP but above the reference price. Since the reference price system would not "catch" this form of dumping, the domestic industry would still have to initiate an investigation by filing an antidumping petition in order to protect itself against dumping.

However, it is our understanding that if many dumping petitions are filed, Treasury will abandon the reference price system.

Is this true, and if so, why, given the absence of any alternative for dealing with dumping above the reference price?

ANSWER: It is critical to recall that "dumping" is the injurious sale of merchandise below its fair value. The TPM is being implemented in the belief that the U.S. industry can compete with steel priced at levels above the costs of the most efficient foreign steel producers (including their freight, normal customs duty and similar charges). It is expected, therefore, that sales above the trigger prices will not cause injury even if they may, technically, be in one or another case below that seller's "fair value."

24. QUESTION: What will be the relationship between cases initiated under the reference price system and any petitions under the countervailing duty law which involve government subsidies to the same steel producer which enable it to sell below the reference price or above the reference price but below its own cost of production?

ANSWER: Pending or future countervailing duty cases will not be directly affected by the implementation or operation of the TPM. At issue in a countervailing duty investigation is the existence of a bounty or grant bestowed by the foreign government or other persons on the foreign industry. If sales below trigger prices are investigated and reveal the existence of such bounties, appropriate action may be taken under either the Antidumping Act or the countervailing duty law.

B. Impact on Domestic Industry

25. QUESTION: Won't the establishment of a single reference price for a product category encourage exporters to shift production to the higher priced end of the product category where there is

a greater margin of profit? Won't this upgrading lead to a greater import penetration in these higher priced items than would occur under present conditions? Since these higher priced items are usually more labor intensive than those at the lower value end of the product category, isn't it possible that although less tonnage is imported, greater domestic unemployment will result?

ANSWER: No. The TPM embodies a full base-plus-extras approach covering all product categories so that the "upgrading" problem should be avoided.

QUESTION: What impact will the reference price system have on the domestic industry's ability to compete with steel imports? Will the reference price be set with the purpose of limiting imports to an "acceptable" level of import penetration? If so, what is that level?

ANSWER: The TPM responds to assertions by domestic firms that they can compete effectively and recapture a meaningful share of the market heretofore lost to imports if all importers sell at above the costs of the most efficient foreign producers (plus their importation costs). The trigger prices are the result of adding cost components and were not "set" at any pre-determined level related to the domestic industry's prices or market shares.

C. Impact on International Efforts to Resolve the Problems of the Steel Industry

QUESTION: How will the reference price program relate to efforts in the multilateral trade negotiations and in the OECD to develop longer-range international responses to problems of world steel trade competition? Will this program affect the U.S. position on the steel sector negotiations in these fora and, if so, how?

ANSWER: The TPM is entirely consistent with established U.S. positions in various international fora regarding world steel trade. We still believe that greater understanding is needed of the cyclical distortions in steel markets which prompted the substantial excess steel producing capacity in 1977 following the shortages experienced as recently as 1974. We will continue to pursue actively greater international cooperation in anticipating and dealing with these difficult, long-range problems. In the meantime, we feel that the distressed market conditions of today can best be remedied by attacking the unfair and injurious trade which has helped create them. The TPM will allow us to do this expeditiously.

An alternative approach preferred by some, namely, international marekt sharing, may not be effective as quickly because it would have to be negotiated among the buyers and sellers, and distortions in the market place might even be exacerbated during such negotiations. Also, the long-term world need for ample and efficiently producec steel would be frustrated by such an anti-competitive scheme. Therefore, Treasury -- like other agencies -- has opposed any cartelization of world steel.

3. QUESTION: Is the reference price different from minimum import price systems used by the European Community, and, if so, how? Do you anticipate any challenge as to the consistency of th reference price with the GATT, and what would be your response?

ANSWER: The TPM is clearly different from the minimum import price system used by the European Community in the past in connec tion with certain tomato and other vegetable products. The minimum import price system used by the European Community is not related in any way to the problem of sales below fair value and is not part of the Community's system for administering its antidumping law. Also, unlike the minimum import price system, the TPM allows the products of more efficient producers to enter the United States at lower prices and does not violate the most-favored-nation principle of the GATT.

Similarly, the TPM appears to differ from the steel import price system which the EC has recently announced it intends to negotiate bilaterally with its major suppliers.

Treasury officials plan to visit Brussels in mid-January to gain a clearer understanding of the community's steel program. However, from available reports, the TPM seems far less trade restrictive since it allows the produc of any producer to enter the United States at prices below the trigger price (if it can demonstrate its "fair value" is lower) and does not violate the most-favored-nation principle of the GATT.

If the TPM is understood for what it is, we do not anticipate any serious challenge in the GATT. Both the GAT and the International Anti-Dumping Code clearly anticipate that governmental authorities in appropriate circumstances may initiate dumping investigations provided that they have evidence of both LTFV and injury resulting therefrom.

QUESTION: Will the information you make public include the reference price itself? If not, won't the reference price level soon become known to foreign countries by sending shipments at various prices to determine what level triggers an investigation, from the first tentative determination that indicates the margin of dumping, and to the Japanese from the cost of production information they supply as a basis for the reference price? Won't the reference price lead to worldwide price fixing by steel producers and an international steel cartel?

ANSWER: Trigger prices will be made public up to 90 days in advance of the quarter in which they will apply to entries of steel. This should enable affected parties to consider them in concluding contracts for shipment in the quarter to which those trigger prices apply. Hopefully widespread public knowledge of the trigger prices will enhance their effectiveness.

We expect the TPM to discourage sales to the United States at below the cost of production of the most efficient group of producers. But setting such a price level is not anti-competitive in any normal sense of the word, and should not produce any restraint of trade not already present under the Antidumping Act. Additionally, any foreign producer can sell into the U.S. at below the trigger price as long as its prices are not at less than "fair value" as defined in the Act.

QUESTION: Would retroactive withholding of appraisement up to 120 days prior to the initiation of the investigation be consistent with the International Anti-Dumping Code and, if so, how?

ANSWER: Retroactive withholding of appraisement, under appropriate circumstances, up to 90 days prior to the tentative determination of dumping, would be consistent with the provisions of the International Anti-Dumping Code.

DEPARTMENT OF THE TREASURY

Steel Reference Price Handbook

January 1978

U.S. CUSTOMS SERVICE

OFFICE OF OPERATIONS

DUTY ASSESSMENT DIVISION

PREFACE

Please note that all prices given in the Steel Reference Price Handbook are in metric tons, the standard weight in international trade. Also, the numbering system consists of two parts: the AISI Category (e.g. Wire Rods - Commercial Quality AISI 1008 Category AISI 2) and sequential numbering of pages. As subsequent pages are published, they will be either new pages or replacements for the appropriate numbered page.

The terms "negotiable" or "subject to negotiation" refer to discussion of the price ranges which are appropriate to the practice in extras for steel products.

WIRE RODS - COMMERCIAL QUALITY - AISI 1008 5.5m/m

Category AISI 2

Tariff Schedule Number(s) 608.7000 - 0.1¢/lb. 608.7300 - 0.2¢/lb.
608.7100 - 0.25¢/lb. 608.7500 - 0.375¢/lb.

Base Price per Metric Ton $265

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$25	$ 3	$ 6
Gulf Coast	26	5	7
Atlantic Coast	31	4	8
Great Lakes	45	4	10

Insurance 1% of base price + extras + ocean freight

Extras

Heat Treatment

Regular Anneal - $40/M.T.

Spherodize Anneal - $60/M.T.

WIRE RODS - WELDING QUALITY - JIS G3503
SRWYLL equivalent 5.5m/m

Category AISI 2

Tariff Schedule Number(s) 608.7000 - 0.1¢/lb/ 608.7300 - 0.2¢/lb.
608.7100 - 0.25¢/lb. 608.7500 - 0.375¢/lb.

Base Price per Metric Ton $266

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$25	$ 3	$ 6
Gulf Coast	26	5	7
Atlantic Coast	31	4	8
Great Lakes	45	4	10

Insurance 1% of base price + extras + ocean freight

Extras

Heat Treatment

Regular Anneal - $40/M.T.

Spherodize Anneal - $60/M.T.

WIRE RODS - HIGH CARBON - AISI 1065 (SPECIFIC) 5.5m/m

Category AISI 2

Tariff Schedule Number(s) 608.7000-0.1¢/lb. 608.7300-0.2¢/lb. 608.7100-0.25¢/lb. 608.7500-0.375¢/lb.

Base Price per Metric Ton $309

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$25	$ 3	$ 7
Gulf Coast	26	5	9
Atlantic Coast	31	4	9
Great Lakes	45	4	11

Insurance 1% of base price + extras + ocean freight

Extras

Heat Treatment

Regular Anneal - $40/M.T.

Spherodize Anneal - $60/M.T.

WIDE FLANGE BEAMS - ASTM A36 12" x 12"

Category AISI 3

Tariff Schedule Number(s) 609.8015 0.1¢ per lb.

Base Price per Metric Ton $259

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$27	$ 3	$ 5
Gulf Coast	30	5	7
Atlantic Coast	34	4	7
Great Lakes	47	4	9

Insurance 1% of base price + extras + ocean freight

Extras

1. Size Extras
2. Grade Extras
3. Cut Length Extras
4. Splitting Extras

WIDE FLANGE BEAMS

(1) Size Extras

Series	Lbs./Foot	Extra-$/M.T.	Series	Lbs./Foot	Extra-$/M.T.
4 x 4	13	40	14 x 12	78,84	Nil
5 x 5	16-18.9	35	14 x 14½	87-136	Nil
6 x 4	8.5	51	14 x 16	142-426	Nil
6 x 4	12,16	40	14 x 16	455	72
6 x 6	15.5	26	14 x 16	500	76
6 x 6	20,25	18	14 x 16	550	77
8 x 4	10	42	14 x 16	605	78
8 x 4	13,15	30	14 x 16	665	80
8 x 5¼	17,20	21	14 x 16	730	83
8 x 6½	24,28	15	16 x 5½	26,31	13
8 x 8	31-64	11	16 x 7	36-50	6
10 x 4	11.5	36	16 x 8½	58-78	Nil
10 x 4	15-19	31	16 x 11½	88,96	Nil
10 x 5-3/4	21-29	18	18 x 6	35,40	14
10 x 8	33-45	11	18 x 7½	45-60	5
10 x 10	49-112	5	18 x 8-3/4	64-85	Nil
12 x 4	14	39	18 x 11-3/4	96-114	Nil
12 x 4	16.5-22	32	21 x 6½	44,49	9
12 x 6½	27-36	13	21 x 8¼	55-73	Nil
12 x 8	40-50	7	21 x 9	82,96	Nil
12 x 10	53,58	5	21 x 13	112-142	Nil
12 x 12	65-190	Nil	24 x 7	55,61	9
14 x 5	22,26	18	24 x 9	68-94	Nil
14 x 6-3/4	30-38	9	24 x 12	100-120	Nil
14 x 8	43-53	5	27 x 10	84-114	Nil
14 x 10	61-74	Nil	30 x 10½	99-132	Nil

(2) Grade Extras ($/M.T.)

ASTM Grade	Web Thickness In Inches Thru 1-7/8	Over 1-7/8 Thru 2-3/8	Over 2-3/8
A242	111	--	--
A588	111	122	122
A441	49	89	89
A572			
G42	42	85	85
G50	49	89	--
G60	66	--	--
A36	0	32	32
A690	77	--	--

WIDE FLANGE BEAMS

(3) Cut Length Extras	
Length	$/M.T.
From 10 Up to 20 Feet	10
From 20 Up to 30 Feet	7
From 30 Up to 40 Feet	5
40 Feet	Nil
Over 40 Up to 50 Feet	4
50 Feet	Nil
Over 50 Up to 60 Feet	5
60 Feet	Nil
Over 60 Thru 70 Feet	5

(4) Splitting Extras		
Lbs./Foot		
Over	Thru	$/M.T.
8	12	36
12	15	31
15	22	28
22	45	18
45	100	14
100	150	11

SHEET PILING - ASTM A328 ARCH WEB PDA-27

Category AISI 4

Tariff Schedule Number(s) 609.96 0.1¢ per lb.

Base Price per Metric Ton $292

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$27	$ 3	$ 6
Gulf Coast	30	5	7
Atlantic Coast	34	4	8
Great Lakes	47	4	10

Insurance 1% of base price + extras + ocean freight

Extras

1. Quality Extras
2. Shape Extras
3. Length Extras

EXTRA FOR SHEET PILING

USD PER MT

		USD PER MT
1. QUALITY	SY 30 (EQUIVALENT TO ASTM A-328)	BASE
	SY36	+ 10
	SY40	+ 20
	A690/MARINE TYPE	+ 85
2. SHAPE		
STRAIGHT WEB	F,FA	+ 10
ARCH WEB	1A,U5,5,5L,6L	+ 10
	OTHERS (EQUIVALENT TO PDA-27)	BASE
ZEE	Z14,Z25,Z32,Z38,Z45	+ 10
FABRICATED CONNECTIONS		SUBJECT TO NEGO-TIATION
H TYPE		+ 30
3. LENGTH	3M UNDER	SUBJECT TO NEGO-TIATION
	3M TO UNDER 6M	+ 10
	6M & OVER	BASE
4. SURFACE TREATMENT (PROTECTIVE COATING)		SUBJECT TO NEGO-TIATION
5. HANDLING HOLES		SUBJECT TO NEGO-TIATION
6. QUANTITY		NONE

STEEL PLATES - ASTM A-36 ½" x 80" x 240"

Category AISI 5

Tariff Schedule Number(s)		
	608.8410	7.5%
	608.8415	7.5%
	608.8720	8%

Base Price per Metric Ton $266

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$25	$ 3	$ 6
Gulf Coast	25	5	8
Atlantic Coast	31	4	8
Great Lakes	40	4	10

Insurance 1% of base price + extras + ocean freight

Extras

1. Width/Thickness Extra
2. Specification Extra
3. Other Extras

Killed	UST A435, AS78LI
Fine Grain	AS78L2
Charpy	Checker
Normalize	Pickled & Oiled
Quench & Temper	Cut Length Extra
Normalize & Temper	Others

STEEL PLATE

1- Width/Thickness Extras ($/M.T.)

Steel Plate

Thickness/ Width	Up to 1/4"	From ¼" up to 5/16"	From 5/16" up to 3/8"	From 3/8" up to ½"	From ½" up to 1"	From 1" up to 1-3/16"	From 1-3/16" up to 1-3/8"	From 1-3/8" up to 1½"	From 1½" up to 3"	From 3" up to 6"	From 6" up to 12"
From 36" up to 48"	27	22	16	12	9	12	14	18	38	40	42
From 48" up to 60"	23	17	13	8	6	8	10	14	32	35	38
From 60" up to 80"	21	14	11	5	Nil	4	6	10	23	27	29
From 80" up to 90"	24	15	9	6	2	6	9	13	23	27	29
From 90" up to 100"	29	20	13	10	5	10	13	16	26	29	31
" 100" up to 110"	34	20	18	14	9	14	17	20	27	30	33
" 110" up to 120"	44	28	23	18	14	17	21	23	30	34	37
" 120" up to 130"	54	38	27	22	17	20	25	29	35	38	40
" 130" up to 140"	64	48	37	28	24	25	29	33	42	44	46
" 140" up to 150"		58	47	35	29	29	33	37	48	51	53
" 150" up to 170"			103	96	84	84	84	84	76		
" 170" up to 180"				105	98	98	98	98			
" 180" up to 185"					103	103	103	103			
" 185" up to 200"					106	106	106	106			

2 - SPECIFICATION EXTRA _ p.1   STEEL PLATE

Specification	Thickness	$/M.T.
ASTM:		
A36	1½" or less	Nil
	over 1½"	20
A283	1½" or less	Nil
Gr. A,B,C,D	over 1½"	20
A285	1½" or less	17
Gr. A,B,C	over 1½"	20
A515	1½" or less	37
Gr.55,60,65,70	over 1½" up to 2"	40
Gr.55,60,65	over 2" up to 8"	41
Gr. 70	over 2" up to 8"	43
Gr. 55	over 8" up to 12"	41
A516		
Gr. 55, 60	½" or less	43
Gr. 65, 70	½" or less	45
Gr.55,60,65,70	over ½ up to 1½"	45
Gr.55,60,65,70	over 1½" up to 8"	49
Gr. 55	over 8"	49
A455, Type 1	--	25
, Type 2	--	45
A537, Class 1	5/16" or less	170
	over 5/16" up to ½"	157
	over ½" up to 1"	148
	over 1" up to 1½"	146
	over 1½" up to 3"	154
	over 3" up to 4"	152

Specification	Thickness	$/M.T.
ASTM:		
A537,Class 2	5/16" or less	231
	over 5/16" up to ½"	208
	over ½" up to 1"	200
	over 1" up to 1½"	198
	over 1½" up to 3"	206
	over 3" up to 4"	203
A612 (M128B)	3/4" or less	68
	over 3/4" up to 1"	73
A242	1½" or less	95
A588	1½" or less	95
	over 1½"	97
A441	1½" or less	48
	over 1½"	70
A440	1½" or less	48
	over 1½"	70
A572		
Gr. 42	1½" or less	24
	over 1½"	46
Gr. 45	1½" or less	34
	over 1½"	56
Gr. 50	1½" or less	38
	over 1½"	60
Gr. 55	1½" or less	42
Gr. 60	1½" or less	61
Gr. 65	1½" or less	71

2 - SPECIFICATION EXTRA - p.2

STEEL PLATE

Specification	Thickness	$/M.T.
ASTM:		
A633		
Gr. A	5/16" or less	157
	over 5/16" up to ½"	144
	over ½" up to 1"	135
	over 1" up to 1½"	133
	over 1½" up to 3"	135
	over 3" up to 8"	160
Gr. C	5/16" or less	174
	over 5/16" up to ½"	161
	over ½" up to 1"	152
	over 1" up to 1½"	150
	over 1½" up to 3"	152
	over 3" up to 8"	177
Gr. E	5/16" or less	193
	over 5/16" up to ½"	190
	over ½" up to 1"	171
	over 1" up to 1½"	169
	over 1½" up to 3"	171
	over 3" up to 8"	196
A.B.S.:		
A131		
Gr. A	½" or less	4
	over ½" up to 1½"	10
Gr. B	1" or less	10
Gr. CS(Normal-ized)	½" or less	110
	over ½" up to 2"	95
Gr. D (Normal ized)	½" or less	110
	over ½" up to 2"	100
Gr. E (Normal-ized)	½" or less	130
	over ½" up to 2"	120
Gr. DS (as rolled, Nor-malized)	1-3/8" up to 2"	95
	1-3/8" or less	40

Specification	Thickness	$/M.T
A.B.S.:		
A131 (cont'd)		
Gr. AH32	½" or less	36
	over ½" up to 1½"	56
	over 1½" up to 2"	58
Gr. AH36	½" or less	44
	over ½" up to 1½"	64
	over 1½" up to 2"	66
Gr. DH32(Killed	½" or less	130
Normalized)	over ½" up to 2"	120
Gr. DH36(Killed	½" or less	130
Normalized)	over ½" up to 2"	120
Gr. EH32(Killed	½" or less	150
Normalized)	over ½" up to 2"	130
Gr. EH36(Killed	½" or less	150
Normalized)	over ½" up to 2"	130
AR		62
AR300, 350 (Q&T extra included)		225
A202		
Gr. A	All Thickness	130
Gr. B	All Thickness	110
A203		
Gr. A	2" or less	205
	over 2" up to 4"	210
	over 4" up to 6"	200
Gr. B	2" or less	205
	over 2" up to 6"	200
Gr. D	4" or less	285
Gr. E	4" or less	280

2 - SPECIFICATION EXTRA - p.3

STEEL PLATE

Specification		Thickness	$/M.T.
ABS:			
A204			
	Gr. A	2" or less	135
		over 2" up to 6"	125
	Gr. B	1" or less	135
		over 1" up to 6"	125
	Gr. C	4" or less	125
A387			
	Gr. 2	All	165
	Gr. 11	All	200
	Gr. 12	All	170
	Gr. 21	All	375
	Gr. 22	All	345
A533			
	Gr. A	All	135
	Gr. B	All	170
	Gr. C	All	185
	Gr. D	All	155
A553			
	Type 1	All	740
A514			
(Q & T extra included)			
	Type B	5/16" or less	305
		over 5/16" up to ½"	270
		over ½" up to 1"	265
		over 1" up to 1¼"	260
	Type F	5/16" or less	415
		over 5/16" up to ½"	380
		over ½" up tp 1"	375
		over 1" up to 3"	370
		over 3" up to 4"	475

Specification		Thickness	$/M.T.
ABS:			
A514			
(Q & T extra included)			
	Type H	5/16" or less	350
		over 5/16" up to ½"	315
		over ½" up to 2"	305
A517			
(Q & T extra included)			
	Gr. B	5/16" or less	320
		over 5/16" up to ½"	290
		over ½" up to 1¼"	280
	Gr. F	5/16" or less	335
		over 5/16" up to ½"	400
		over ½" up to 1"	395
		over 1" up to 3"	390
		over 3" up tp 4"	395
		over 4" up to 8"	415
	Gr. H	5/16" or less	365
		over 5/16" up to ½"	335
		over ½" up to 1"	325
		over 1" up to 2"	320
A225			
	Gr. A, B	4" or less	115
A302			
	Gr. A	1" or less	140
		over 1" up to 4"	130
	Gr. B	1" or less	150
		over 1" up to 2"	135

2 - SPECIFICATION EXTRA - p - 4 STEEL PLATE

Specification	Thickness	$/M.T.
SAE:		
1345	--	70
4130	--	105
4140	--	110
4150	--	110
4340	--	215
5150	--	75
5160	--	75
6150	--	125
8615	--	150
8617	--	150
8620	--	135
9260	--	105
UST:		
A578L2	from ½" up to 3"	40
A435 & A578L1 9" or higher grid	from 3/4" up to 3"	15
Under 9" grid or 100% scanning	from 3/4" up to 3"	25

Specification	Thickness	$/M.T.

3- OTHER EXTRAS

Description	$/M.T.
Killed	20
Fine Grain	6
Charpy	
+40°F & up	
L	15
T	20
L&T	25
Under + 40°F	
L	20
T	25
L&T	30
Normalize	70
Quench & Temper	120
Normalize & Temper	120
Checker	20
Pickled & Oiled	
Up to 0.172" Thickness	20
Over 0.172" Thickness	13

STEEL PLATE

Description	$/M.T.
Cut Length Cup (up to 72" width)	
0.070" & Thinner	
from 24" up to 36" long	27
from 36" up to 48" long	21
from 48" thru 240" long	19
over 240" long	22
0.071" & Thicker	
from 24" up to 36" long	24
from 36" up to 48" long	17
from 48" thru 240" long	16
over 240" long	19

HOT ROLLED CARBON BARS: SPECIAL QUALITY - AISI 1045
40 mm round x 4 meters

Category AISI 10

Tariff Schedule Number(s) 608.45 - 7% 608.48 3%
608.46 - 7%

Base Price per Metric Ton $340

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$24	$ 3	$ 7
Gulf Coast	26	5	10
Atlantic Coast	29	4	10
Great Lakes	35	4	12

Insurance 1% of base price + extras + ocean freight

Extras

Size Extras

To be issued

BLACK PLATE - ASTM A625-76 0.0083" x 34" x COIL

Category AISI 22

Tariff Schedule Number(s)		
	608.81	9%
	608.82	8%

Base Price per Metric Ton $373

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$23	$ 3	$ 8
Gulf Coast	23	5	10
Atlantic Coast	27	4	11
Great Lakes	35	4	13

Insurance 1% of base price + extras + ocean freight

Extras

1. Width Extras
2. Thickness Extras
3. Length Extras

BLACK PLATE

WIDTH/THICKNESS EXTRAS (U.S. $/M.T.)

WIDTH/ THICKNESS LBS.		Over 20" Thru 23"	Over 23" Thru 27.5"	Over 27.5" Thru 29"	Over 29" Thru 30.5"	Over 30.5"
75	0.0083"	N	42	29	8	Base
80	0.0088"	N	33	20	0	- 7
85	0.0094"	N	23	11	- 7	- 15
90	0.0099"	N	16	5	-13	- 20
95	0.0105"	N	9	- 1	-18	- 25
100	0.0110"	N	4	- 6	-22	- 28
103	0.0113"	N	2	- 8	-23	- 29
107	0.0118"	N	- 1	-11	-26	- 31
112	0.0123"	N	- 5	-14	-29	- 34
118	0.0130"	N	- 9	-17	-31	- 36
123	0.0135"	N	-11	-20	-33	- 37
128	0.0141"	N	-14	-22	-34	- 39

LENGTH EXTRA = US$ 20/M.T.

OTHER EXTRAS = N

Key: N = Subject to negotiation
- (Minus sign) = Deduction from Base Price

ELECTROLYTIC TIN PLATE - SR-25/25 75L x 34" x C

Category AISI 23

Tariff Schedule Number(s) 608.9100 8%
608.9200 0.8¢ per lb.

Base Price per Metric Ton $477

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$26	$ 3	$10
Gulf Coast	27	5	13
Atlantic Coast	34	4	13
Great Lakes	37	4	16

Insurance 1% of base price + extras + ocean freight

Extras

A. Coating Extra
- (1) Single Reduced ETP
- (2) Double Reduced ETP

B. Cut Length Extra
- (1) Single Reduced ETP
- (2) Double Reduced ETP

C. Width Extra
- (1) Single Reduced ETP
- (2) Double Reduced ETP

D. Quality Extras-ETP
- (1) Type D Single Reduced and Double Reduced
- (2) Type K, A, or J Single Reduced and Double Reduced

EXTRAS for Electrolytic Tinplate & Tin Free Steel (U.S. $ per M/T)

A: Coating Extra & Base Weight Extra

(I) Single Reduced ETP

Coating / Base Weight	# 10	# 20	# 25	# 35	# 50	# 75	# 100	#50/25	#75/25	#100/25	#100/50	#135/25
70lbs	- 5	15	24	43	67	110	160	50	72	99	120	134
73lbs	- 18	0	9	27	51	91	139	34	55	81	101	115
75lbs	- 27	- 9	BASE	18	41	80	127	25	45	70	90	103
78lbs	- 34	- 17	- 8	9	31	69	114	16	35	59	78	91
80lbs	- 38	- 21	- 13	4	25	62	106	10	29	52	71	83
83lbs	- 44	- 28	- 20	- 4	17	43	94	2	20	43	61	73
85lbs	- 49	- 33	- 25	- 9	11	46	87	- 3	14	36	54	66
88lbs	- 54	- 39	- 31	- 16	3	37	77	- 10	7	28	45	56
90lbs	- 58	- 42	- 35	- 20	- 1	32	70	- 15	2	23	39	51
93lbs	- 62	- 47	- 40	- 26	- 7	25	62	- 20	- 4	16	32	43
95lbs	- 65	- 51	- 44	- 30	- 12	19	56	- 25	- 9	11	26	37
100lbs	- 70	- 57	- 50	- 37	- 20	10	45	- 32	- 17	2	17	27
103lbs	- 74	- 61	- 54	- 41	- 25	4	38	- 36	- 22	- 3	11	21
107lbs	- 77	- 64	- 58	- 46	- 30	- 2	30	- 41	- 27	- 9	5	14
112lbs	- 81	- 69	- 63	- 51	- 36	- 9	22	- 47	- 33	- 17	- 3	6
118lbs	- 86	- 75	- 69	- 58	- 43	- 18	11	- 54	- 41	- 25	- 12	- 4
123lbs	- 90	- 79	- 73	- 62	- 49	- 24	4	- 58	- 46	- 31	- 19	- 11
128lbs	- 92	- 81	- 76	- 66	- 52	- 29	- 2	- 62	- 50	- 35	- 24	- 16
135lbs	- 94	- 84	- 79	- 69	- 57	- 35	- 9	- 66	- 55	- 41	- 30	- 22

(2) Double Reduced ETP

Coating / Base Weight	# 10	# 20	# 25	# 35	# 50	# 75	# 100	# 50/25	# 75/25	# 100/25	# 100/50	# 135/25
50lbs	- 13	14	27	54	88	147	217	64	94	132	161	181
53lbs	- 28	- 3	9	35	67	123	188	44	72	108	136	154
55lbs	- 39	- 14	- 2	23	53	108	171	32	59	93	120	138
60lbs	- 52	- 29	- 18	5	33	82	140	13	38	69	94	111
65lbs	- 62	- 41	- 31	- 10	16	62	115	- 3	20	49	72	87
70lbs	- 71	- 51	- 42	- 23	1	44	94	- 16	6	33	54	68
75lbs	- 77	- 59	- 50	- 32	- 9	30	77	- 25	- 5	20	39	53
80lbs	- 82	- 65	- 57	- 40	- 19	18	62	- 34	- 15	8	27	39
85lbs	- 87	- 71	- 63	- 47	- 27	8	49	- 41	- 24	- 2	16	28
90lbs	- 91	- 75	- 68	- 53	- 34	- 1	37	- 48	- 31	- 10	6	18
95lbs	- 97	- 83	- 76	- 62	- 44	- 13	24	- 57	- 41	- 21	- 6	5
100lbs	- 100	- 87	- 80	- 67	- 50	- 20	15	- 62	- 47	- 28	- 13	- 3

(3) Single Reduced TFS

Base Weight	
70lbs	18
73lbs	7
75lbs	BASE
78lbs	- 6
80lbs	- 9
83lbs	- 14
85lbs	- 17
88lbs	- 21
90lbs	- 24
93lbs	- 28
95lbs	- 30
100lbs	- 34
103lbs	- 36
107lbs	- 39
112lbs	- 42
118lbs	- 45
123lbs	- 47
128lbs	- 49
135lbs	- 50

(4) Double Reduced TFS

Base Weight	
50lbs	18
53lbs	5
55lbs	- 3
60lbs	- 14
65lbs	- 22
70lbs	- 29
75lbs	- 33
80lbs	- 38
85lbs	- 41
90lbs	- 44
95lbs	- 49
100lbs	- 52

B: Cut Length Extra

(1) Single Reduced

Base Weight	ETP	TFS
70lbs	24	21
73lbs	23	20
75lbs	22	20
78lbs	21	19
80lbs	21	18
83lbs	20	18
85lbs	19	17
88lbs	19	17
90lbs	18	16
93lbs	18	16
95lbs	17	15
100lbs	16	14
103lbs	16	14
107lbs	15	14
112lbs	15	13
118lbs	14	12
123lbs	13	12
128lbs	13	11
135lbs	12	11

(2) Double Reduced

Base Weight	ETP	TFS
50lbs	33	29
53lbs	31	28
55lbs	30	27
60lbs	28	25
65lbs	25	23
70lbs	24	21
75lbs	22	20
80lbs	21	18
85lbs	19	17
90lbs	18	16
95lbs	17	15
100lbs	16	14

C: Width Extra

(1) Single Reduced

Base Weight	Under 26 inch		Over 26 inch thru. 27-1/2 inch		Over 27-1/2 inch thru. 29 inch		Over 29 inch thru. 30-1/2 inch		Over 30-1/2 inch	
	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS
70lbs	70	62	45	40	31	27	8	7		
73lbs	67	60	43	38	29	26	8	7		
75lbs	66	58	42	37	29	25	7	7		
78lbs	63	56	40	36	27	24	7	6		
80lbs	61	55	39	35	27	24	7	6	Base	Base
83lbs	59	53	38	33	26	23	7	6		
85lbs	58	51	37	33	25	22	7	6		
88lbs	56	50	36	32	24	22	6	6		
90lbs	55	49	35	31	24	21	6	5		
93lbs	53	47	34	30	23	20	6	5		
95lbs	52	46	33	29	22	20	6	5		
100lbs	49	44	31	28	21	19	5	5		
103lbs	48	42	30	27	21	18	5	5		
107lbs	46	41	29	26	20	18	5	4		
112lbs	44	39	28	25	19	17	5	4		
118lbs	42	37	26	23	18	16	5	4		
123lbs	40	35	25	22	17	15	4	4		
128lbs	38	34	24	22	17	15	4	4		
135lbs	36	32	23	20	16	14	4	3		

(2) Double Reduced

Base Weight	Under 26 inch		Over 26 inch thru. 27-1/2 inch		Over 27-1/2 inch thru. 29 inch		Over 29 inch thru. 30-1/2 inch		Over 30-1/2 inch	
	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS
50lbs	99	88	63	56	43	38	11	10	Base	Base
53lbs	93	83	59	53	41	36	11	9		
55lbs	90	80	57	51	39	35	10	9		
60lbs	82	73	52	47	36	32	9	8		
65lbs	76	67	48	43	33	29	9	8		
70lbs	70	62	45	40	31	27	8	7		
75lbs	66	58	42	37	29	25	7	7		
80lbs	61	55	39	35	27	24	7	6		
85lbs	58	51	37	33	25	22	7	6		
90lbs	55	49	35	31	24	21	6	5		
95lbs	52	46	33	29	22	20	6	5		
100lbs	49	44	31	28	21	19	5	5		

D : Quality Extras

(1) Type D

1) Single Reduced

Base Weight	ETP	TFS
70lbs	34	30
73lbs	32	29
75lbs	31	28
78lbs	30	27
80lbs	29	26
83lbs	28	25
85lbs	28	24
88lbs	27	24
90lbs	26	23
93lbs	25	22
95lbs	25	22
100lbs	23	21
103lbs	23	20
107lbs	22	19
112lbs	21	18
118lbs	20	17
123lbs	19	17
128lbs	18	16
135lbs	17	15

2) Double Reduced

Base Weight	ETP	TFS
50lbs	47	42
53lbs	44	39
55lbs	43	38
60lbs	39	35
65lbs	36	32
70lbs	34	30
75lbs	32	28
80lbs	30	26
85lbs	28	24
90lbs	26	23
95lbs	25	22
100lbs	23	21

(2) Type K, A or J

1) Single Reduced

Base Weight	ETP
70lbs	22
73lbs	21
75lbs	21
78lbs	20
80lbs	19
83lbs	19
85lbs	18
88lbs	18
90lbs	17
93lbs	17
95lbs	16
100lbs	15
103lbs	15
107lbs	14
112lbs	14
118lbs	13
123lbs	12
128lbs	12
135lbs	11

2) Double Reduced

Base Weight	ETP
50lbs	31
53lbs	29
55lbs	28
60lbs	26
65lbs	24
70lbs	22
75lbs	21
80lbs	19
85lbs	18
90lbs	17
95lbs	16
100lbs	15

HOT ROLLED STEEL SHEETS - ASTM A569 0.121" x 48" x C

Category AISI 25

Tariff Schedule Number(s) 608.8440 - 7.5%
608.8742 - 8%

Base Price per Metric Ton $231

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$23	$ 3	$ 5
Gulf Coast	23	5	7
Atlantic Coast	27	4	7
Great Lakes	35	4	9

Insurance 1% of base price + extras + ocean freight

Extras

A. Width Thickness Extra
B. P/O Extra on Pickled
C. Other Extras
   (1) Quality
   (2) Structural
   (3) Chemistry
   (4) High Strength Carbon Steel
   (5) High Strength Low Alloy Steel

A- WIDTH/THICKNESS EXTRA ($/M.T.)

Width/ Thickness (inches)	Over 12" Up to 24"	From 24" Thru 36"	Over 36" Thru 48"	Over 48" Thru 72"	Over 72" Thru 76"	Over 76" Thru 84"
Over 0.5		11 + N	11 + N	11 + N	11 + N	14 + N
From 0.312 thru 0.5	25	11	11	11	11	14
From 0.251 thru 0.3119	25	11	11	11	11	12
From 0.230 thru 0.2509	16	0	0	0	7	12
From 0.180 thru 0.2299	16	0	0	0	6	11
From 0.121 thru 0.1799	16	0	0	0	10	11 + N
From 0.081 thru 0.1209	16	12	7	0	10	
From 0.071 thru 0.0809	24	18	13	13	10 + N	
From 0.061 thru 0.0709	36	27	20	20		
From 0.0568 " 0.0609	39	30	29	20 + N		
From 0.0509 " 0.0567	39 + N	30 + N	29 + N	20 + N		

A- WIDTH/THICKNESS EXTRA ($/M.T.)

Width/ Thickness (inches)	Over 12" Up to 24"	From 24" Thru 36"	Over 36" Thru 48"	Over 48" Thru 72"	Over 72" Thru 76"	Over 76" Thru 84"
Over 0.5		11 + N	11 + N	11 + N	11 + N	14 + N
From 0.312 thru 0.5	25	11	11	11	11	14
From 0.251 thru 0.3119	25	11	11	11	11	12
From 0.230 thru 0.2509	16	0	0	0	7	12
From 0.180 thru 0.2299	16	0	0	0	6	11
From 0.121 thru 0.1799	16	0	0	0	10	11 + N
From 0.081 thru 0.1209	16	12	7	0	10	
From 0.071 thru 0.0809	24	18	13	13	10 + N	
From 0.061 thru 0.0709	36	27	20	20		
From 0.0568 " 0.0609	39	30	29	20 + N		
From 0.0509 " 0.0567	39 + N	30 + N	29 + N	20 + N		

B - P/O Extra on Pickled	
Thickness	$/M.T.
0.172" & up	20
under 0.172"	13

N = Subject to Negotiation

C - Other Extras	$/M.T.
1. Quality - Drawing Q-Rimmed	10
Killed	23
2. Structural - A570 D/E	15
3. Chemistry (Carbon Range)	
0.26% to 0.34%	23
0.35% & up	23 + N
4. High Strength Carbon Steel	
YP 45,000 to 50,000 P.S.I.	10
YP 50,000 P.S.I. & up	10 + N
5. High Strength Low Alloy Steel	
D - A607 - G45	23
50	26
55	40
D - COR-TEN A	60

ELECTRICAL STEEL SHEETS - GRAIN ORIENTED - M-4 0.012" x 33" x C

Category AISI 26

Tariff Schedule Number(s) 608.8845 - 10%

Base Price per Metric Ton $1,000

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$26	$ 3	$17
Gulf Coast	27	5	21
Atlantic Coast	33	4	22
Great Lakes	37	4	27

Insurance 1% of base price + extras + ocean freight

Extras

1. Grade Extra
2. Surface Insulation Extras
3. Packing Extra
4. Size Extra

EXTRA FOR ELECTRICAL STEEL

Grain Oriented Electrical Steel

(1) Grade Extra (M-4 = 100)

(Grade)	(Thickness)	(Grade Extra)
M-2H	(0.012")	103.0
M-3H	(0.012" and 0.014")	101.5
M-4H	(0.012" and 0.014")	100.0
M-4	(0.011")	100.0 (Base)
M-5	(0.012" and 0.014")	96.4
H-6	(0.014")	90.9

(2) Surface Insulation Extras

Coating Extras are included in a base price.

(3) Packing Extra

Nil

(4) Size Extra (Unit-US$/M.T.)

Width/ Grade	Over 1" Thru 2"	Over 2" Thru 6"	Over 6" Thru 17"	Over 17" Up to 31"	31", 33", or 34"
M-2H	74.97	52.26	48.73	60.20	Nil
M-3H	73.87	51.38	48.07	59.31	Nil
M-4H	72.77	50.72	47.41	58.43	Nil
M-4	72.77	50.72	47.41	58.43	Nil
M-5	70.56	49.61	46.31	57.33	Nil
M-6	67.25	48.51	45.20	56.23	Nil

ELECTRICAL STEEL SHEETS - NON-ORIENTED - M-45 0.018" x 36" x C

Category AISI 26

Tariff Schedule Number(s) 608.8845 - 10%

Base Price per Metric Ton $538

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$26	$ 3	$17
Gulf Coast	27	5	21
Atlantic Coast	33	4	22
Great Lakes	37	4	27

Insurance 1% of base price + extras + ocean freight

Extras

1. Grade Extra
2. Surface Insulation Extras
3. Packing Extra
4. Size Extra

NON-ORIENTED ELECTRICAL STEEL

(1) Grade Extra (M-45 = 100)

	Fully-Processed	Semi-Processed
M-47	-	94.7
M-45	100.0 (Base)	100.0
M-43	105.2	105.3
M-36	117.7	118.0
M-27	123.0	123.5
M-22	128.2	128.7
M-19	133.1	-
M-15	139.6	-

(2) Surface Insulation Extras

Coating Extras are included in a base price.

(3) Packing Extra

Nil

(4) Size Extra (Unit-US$/M.T.)

Width/ Gage# (Thickness)	Over 2" Thru 6"	Over 6" Thru 18"	Over 18" Thru 24"	Over 24" Thru 28"	Over 28" Thru 36"	Over 36" Thru 40"
22,23, & 24 (.0310"-.0250")	30.87	25.36	39.69	7.72	Nil	16.54
25 & 26 (0220"-.0185")	45.20	39.69	54.02	22.05	14.33	30.87
27 (.0170")	61.74	56.23	70.56	38.59	30.87	47.41

COLD ROLLED SHEETS - ASTM A366 1.0m/m x 48" x C

Category AISI 26

Tariff Schedule Number(s) 608.8744 8%

Base Price per Metric Ton $297

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$23	$ 3	$ 7
Gulf Coast	23	5	8
Atlantic Coast	27	4	9
Great Lakes	35	4	11

Insurance 1% of base price + extras + ocean freight

Extras

1. Width & Thickness
2. Cut Length
3. Coil Weight
4. Finish
5. Surface Treatment
6. Quality
7. Chemistry
8. Quantity Extra
9. Restricted Tolerance
10. Theoretical Minimum Weighing
11. Others

EXTRAS FOR COLD ROLLED STEEL SHEET

UNIT: US$ PER M/T

* WIDTH & THICKNESS

Thickness, Inches	Width, Inches				
	$24 \le W < 36$	$36 \le W < 45$	$45 \le W \le 60$	$60 < W \le 68$	$68 < W \le 72$
$0.097 \le T < 0.126$	24	18	10	18	24
$0.083 \le T < 0.097$	24	18	8	16	24
$0.064 \le T < 0.083$	20	18	4	12	20
$0.054 \le T < 0.064$	20	14	0	8	20
$0.028 \le T < 0.054$	22	14	0	14	26
$0.023 \le T < 0.028$	36	28	16	20	32
$0.019 \le T < 0.023$	52	47	39	45	47
$0.014 \le T < 0.019$	69	65	57	59	-

* Widths under 24", - Inquire

* CUT LENGTH

Thickness, Inches	Width, Inches	Length, Inches			
		$24 < L \le 42$	$42 < L \le 60$	$60 < L \le 144$	$144 < L$
$0.064 \le T$	$24 \le W \le 72$	22	21	19	21
$0.028 \le T < 0.064$	$24 \le W \le 72$	20	19	17	19
$T < 0.028$	$24 \le W \le 72$	23	22	20	22

* COIL WEIGHT

GROSS MAX 10,000 lbs & OVER .... NONE

GROSS MAX 10,000 lbs UNDER 2.00

* FINISH

DULL .... NONE

COMMERCIAL BRIGHT 14.00

EMBOSSED NON GEOMETRIC 35.00

GEOMETRIC 45.00

* SURFACE TREATMENT

GREASED EDGES 1.00

SPECIAL CLEANLINESS REQUIREMENT

Thickness, Inches	Width, Inches	
	W ≤ 36	36 < W
0.021 ≤ T	8	8
T < 0.020	-	8

* QUALITY

COMMERCIAL .... NONE

DRAWING 10.00

DEEP DRAWING 26.00

FULL HARD (ROCKWELL HARDNESS B-84 MIN) .... NONE

1/4 HARD 12.00

1/2 HARD 12.00

STRUCTURAL (PHYSICAL) - CARBON STEEL 15.00

TWO PRIME SIDES 15.00

CLASS II DISCOUNT (ONLY FOR THE USAGE OF UNEXPOSED AUTO PARTS) 9.00

* CHEMISTRY

COPPER BEARING 10.00

RESTRICTED CHEMISTRY .... N

* QUANTITY EXTRA

10 S/T ≤ Q < 20 S/T 7.00

* RESTRICTED TOLERANCE .... N

* THEORETICAL MINIMUM WEIGHING 10.00

* OTHERS .... N

N -- SUBJECT TO NEGOTIATION

ELECTRO GALVANIZED SHEETS - EGC-10g/M^2 1.0m/m x 48" x C

Category AISI 27

Tariff Schedule Number(s) 608.94 - 9%
608.95 - 0.1¢ per lb. + 8%

Base Price per Metric Ton $343

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$24	$ 3	$ 8
Gulf Coast	23	5	9
Atlantic Coast	27	4	10
Great Lakes	36	4	12

Insurance 1% of base price + extras + ocean freight

Extras

1. Thickness/Width
2. Length
3. Coating
4. Chemical Treatment
5. Quality
6. Packing
7. Others

EXTRAS FOR ELECTRO GALVANIZED SHEET

1. PRICE BASE

   QUALITY: COMMERCIAL

   SIZE : MSG 20 (.038" - .034") x 36" - 48" x COIL

   COATING: 0.06 OZ/FT^2 on each side

   Chemical Treatment: Phosphated

2. EXTRAS FOR OTHER THAN PRICE BASE PRODUCTS (UNIT: US$ PER M/T)

   (1) THICKNESS/WIDTH

THICKNESS INCHES	WIDTH (INCHES)			
	$28 \leq W < 30$	$30 \leq W < 36$	$36 \leq W \leq 48$	$48 < W \leq 60$
.057 and Thicker	4	0	- 4	3
.056 - .051	5	1	- 3	4
.050 - .045	6	2	- 2	5
.044 - .039	7	3	- 1	6
.038 - .034	8	4	Base	7
.033 - .031	12	8	4	10
.030 - 028	15	11	7	14
.027 - .025	18	14	10	18
.024 - .022	23	19	15	22
.021 - .019	28	24	20	
.018 - .017	38	34	30	
.016 - .015	43	39	35	

(2) LENGTH

60" ≤ L ≤ 168"	15
L < 60"	17

(3) COATING

0.06 OZ/FT^2 on each side	Base
0.03 "	- 4
0.01 "	- 6

(4) Chemical Treatment

Phosphated	Base
Chromated	- 2
Oiled	- 2

(5) Quality

Commercial	Base
Drawing	Subject to Negotiation
Drawing, Special Killed	"
Physical (TS, YP, HRB, etc.)	"

(6) Packing

Coil 4ST UNDER	Subject to Negotiation
Sheet 3ST UNDER	"

(7) Others — Subject to Negotiation

GALVANIZED SHEET - ASTM A525G90 0.8m/m x 48" x C

Category AISI 27

Tariff Schedule Number(s) 608.9430 - 9%
608.9530 - 0.1¢ per lb. + 8%

Base Price per Metric Ton $345

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$24	$ 3	$ 8
Gulf Coast	23	5	9
Atlantic Coast	27	4	10
Great Lakes	36	4	12

Insurance 1% of base price + extras + ocean freight

Extras

1. Thickness/Width/Coating
2. Length
3. Packing
4. Finish
5. Quality
6. Quantity
7. Others

EXTRAS FOR GALVANIZED STEEL SHEET

1. PRICE BASE

   SIZE GSG23(0.031" - 0.029") x OVER 42" THROUGH 48" x COIL

   COATING G90

   QUALITY COMMERCIAL

2. EXTRAS FOR OTHER THAN PRICE BASE PRODUCTS (UNIT: US$ PER M/T)

   (1) THICKNESS/WIDTH/COATING

THICKNESS Inches	WIDTH (Inches)					COATING	
	24≤W<30	30≤W<36	36≤W≤42	42<W≤48	48<W≤60	0.6OZ/FT²	G60
.130 and Thicker	- 67	- 67	- 67	- 67	-	-	- 2
.129 - .116	- 55	- 55	- 55	- 55	- 53	-	- 2
.115 - .101	- 52	- 52	- 52	- 52	- 50	-	- 2
.100 - .086	- 49	- 49	- 51	- 51	- 49	-	- 2
.085 - .075	- 37	- 37	- 39	- 39	- 37	-	- 3
.074 - .067	- 35	- 35	- 37	- 37	- 35	-	- 3
.066 - .061	- 33	- 33	- 35	- 35	- 33	-	- 4
.060 - .055	- 24	- 24	- 26	- 26	- 24	-	- 4
.054 - .049	- 22	- 22	- 24	- 24	- 22	- 10	- 5
.048 - .043	- 18	- 18	- 20	- 20	- 18	- 12	- 5
.042 - .038	- 14	- 14	- 16	- 16	- 14	- 15	- 6
.037 - .035	- 4	- 4	- 6	- 6	- 3	- 15	- 6
.034 - .032	- 1	- 1	- 3	- 3	0	- 16	- 7
.031 - .029	2	2	0	Base	4	- 16	- 7
.028 - .026	4	4	3	3	9	- 13	- 9
.025 - .023	16	16	15	18	25	- 18	- 9
.022 - .021	22	22	22	25	33	- 19	-12
.020 - .019	32	32	32	41	-	- 19	-12
.018 - .017	39	39	39	53	-	- 20	-14
.016	50	50	59	68	-	- 20	-14
.015	60	60	72	81	-	- 22	-16
.014	73	69	75	84	-	- 22	-16
.013	83	79	79	88	-	- 22	-16

WIDTH UNDER 24" .... Subject to negotiation

(2) LENGTH

THICKNESS Inches	LENGTH (Inches)			
	42≤L<60	60≤L≤168	168<L≤198	198<L
.029 and Thicker	10	7	11	14
.028 - .017	12	7	13	
.016 - .013	14	7	-	

(3) PACKING

	W<2.5ST	2.5ST≤W≤4ST	4ST<W
COIL	-	4	Base
SHEET	5	Base	-

(4) FINISH

REGULAR SPANGLE	Base
MINIMUM SPANGLE	None
EXTRA SMOOTH	
COIL	16
SHEET	32

(5) QUALITY

COMMERCIAL	Base
LOCK FORMING	None
DRAWING	10
DRAWING SPECIAL KILLED	26
STRACTUAL	
GRADE A	3
" B and C	5
" D and E	10

(6) QUANTITY

20ST $\leqq$ W	Base
15ST $\leqq$ W < 20ST	1
10ST $\leqq$ W < 15ST	3

(7) OTHERS .... SUBJECT TO NEGOTIATION

3. REMARKS

Above extra price shall be changed according to the fluctuation of zinc price.

TIN FREE STEEL SHEETS - SR 75L x 34" x C

Category AISI 32

Tariff Schedule Number(s) 609.1700 - 9.5%

Base Price per Metric Ton $413

Charges to CIF	Ocean Freight	Handling	Interest
West Coast	$26	$ 3	$ 9
Gulf Coast	27	5	12
Atlantic Coast	34	4	12
Great Lakes	37	4	15

Insurance 1% of base price + extras + ocean freight

Extras

A. Base Weight Extra
   (3) Single Reduced TFS
   (4) Double Reduced TFS
B. Cut Length Extra
   (1) Single Reduced TFS
   (2) Double Reduced TFS
C. Width Extra
   (1) Single Reduced TFS
   (2) Double Reduced TFS
D. Quality Extras - TFS
   (1) Type D - Single Reduced and Double Reduced

A: Coating Extra & Base Weight Extra

(1) Single Reduced ETP

Coating / Base Weight	# 10	# 20	# 25	# 35	# 50	# 75	# 100	#50/25	#75/25	#100/25	#100/50	#135/25
70lbs	- 5	15	24	43	67	110	160	50	72	99	120	134
73lbs	- 18	0	9	27	51	91	139	34	55	81	101	115
75lbs	- 27	- 9	BASE	18	41	80	127	25	45	70	90	103
78lbs	- 34	- 17	- 8	9	31	69	114	16	35	59	78	91
80lbs	- 38	- 21	- 13	4	25	62	106	10	29	52	71	83
83lbs	- 44	- 28	- 20	- 4	17	43	94	2	20	43	61	73
85lbs	- 49	- 33	- 25	- 9	11	46	87	- 3	14	36	54	66
88lbs	- 54	- 39	- 31	- 16	3	37	77	- 10	7	28	45	56
90lbs	- 58	- 42	- 35	- 20	- 1	32	70	- 15	2	23	39	51
93lbs	- 62	- 47	- 40	- 26	- 7	25	62	- 20	- 4	16	32	43
95lbs	- 65	- 51	- 44	- 30	- 12	19	56	- 25	- 9	11	26	37
100lbs	- 70	- 57	- 50	- 37	- 20	10	45	- 32	- 17	2	17	27
103lbs	- 74	- 61	- 54	- 41	- 25	4	38	- 36	- 22	- 3	11	21
107lbs	- 77	- 64	- 58	- 46	- 30	- 2	30	- 41	- 27	- 9	5	14
112lbs	- 81	- 69	- 63	- 51	- 36	- 9	22	- 47	- 33	- 17	- 3	6
118lbs	- 86	- 75	- 69	- 58	- 43	- 18	11	- 54	- 41	- 25	- 12	- 4
123lbs	- 90	- 79	- 73	- 62	- 49	- 24	4	- 58	- 46	- 31	- 19	- 11
128lbs	- 92	- 81	- 76	- 66	- 52	- 29	- 2	- 62	- 50	- 35	- 24	- 16
135lbs	- 94	- 84	- 79	- 69	- 57	- 35	- 9	- 66	- 55	- 41	- 30	- 22

(2) Double Reduced ETP

Coating / Base Weight	# 10	# 20	# 25	# 35	# 50	# 75	# 100	# 50/25	# 75/25	# 100/25	# 100/50	# 135/25
50lbs	- 13	14	27	54	88	147	217	64	94	132	161	181
53lbs	- 28	- 3	9	35	67	123	188	44	72	108	136	154
55lbs	- 39	- 14	- 2	23	53	108	171	32	59	93	120	138
60lbs	- 52	- 29	- 18	5	33	82	140	13	38	69	94	111
65lbs	- 62	- 41	- 31	- 10	16	62	115	- 3	20	49	72	87
70lbs	- 71	- 51	- 42	- 23	1	44	94	- 16	6	33	54	68
75lbs	- 77	- 59	- 50	- 32	- 9	30	77	- 25	- 5	20	39	53
80lbs	- 82	- 65	- 57	- 40	- 19	18	62	- 34	- 15	8	27	39
85lbs	- 87	- 71	- 63	- 47	- 27	8	49	- 41	- 24	- 2	16	28
90lbs	- 91	- 75	- 68	- 53	- 34	- 1	37	- 48	- 31	- 10	6	18
95lbs	- 97	- 83	- 76	- 62	- 44	- 13	24	- 57	- 41	- 21	- 6	5
100lbs	- 100	- 87	- 80	- 67	- 50	- 20	15	- 62	- 47	- 28	- 13	- 3

(3) Single Reduced TFS

Base Weight	
70lbs	18
73lbs	7
75lbs	BASE
78lbs	- 6
80lbs	- 9
83lbs	- 14
85lbs	- 17
88lbs	- 21
90lbs	- 24
93lbs	- 28
95lbs	- 30
100lbs	- 34
103lbs	- 36
107lbs	- 39
112lbs	- 42
118lbs	- 45
123lbs	- 47
128lbs	- 49
135lbs	- 50

(4) Double Reduced TFS

Base Weight	
50lbs	18
53lbs	5
55lbs	- 3
60lbs	- 14
65lbs	- 22
70lbs	- 29
75lbs	- 33
80lbs	- 38
85lbs	- 41
90lbs	- 44
95lbs	- 49
100lbs	- 52

B: Cut Length Extra

(1) Single Reduced

Base Weight	ETP	TFS
70lbs	24	21
73lbs	23	20
75lbs	22	20
78lbs	21	19
80lbs	21	18
83lbs	20	18
85lbs	19	17
88lbs	19	17
90lbs	18	16
93lbs	18	16
95lbs	17	15
100lbs	16	14
103lbs	16	14
107lbs	15	14
112lbs	15	13
118lbs	14	12
123lbs	13	12
128lbs	13	11
135lbs	12	11

(2) Double Reduced

Base Weight	ETP	TFS
50lbs	33	29
53lbs	31	28
55lbs	30	27
60lbs	28	25
65lbs	25	23
70lbs	24	21
75lbs	22	20
80lbs	21	18
85lbs	19	17
90lbs	18	16
95lbs	17	15
100lbs	16	14

C: Width Extra

(1) Single Reduced

Base Weight	Under 26 inch		Over 26 inch thru. 27-1/2 inch		Over 27-1/2 inch thru. 29 inch		Over 29 inch thru. 30-1/2 inch		Over 30-1/2 inch	
	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS
70lbs	70	62	45	40	31	27	8	7		
73lbs	67	60	43	38	29	26	8	7		
75lbs	66	58	42	37	29	25	7	7		
78lbs	63	56	40	36	27	24	7	6		
80lbs	61	55	39	35	27	24	7	6	Base	Base
83lbs	59	53	38	33	26	23	7	6		
85lbs	58	51	37	33	25	22	7	6		
88lbs	56	50	36	32	24	22	6	6		
90lbs	55	49	35	31	24	21	6	5		
93lbs	53	47	34	30	23	20	6	5		
95lbs	52	46	33	29	22	20	6	5		
100lbs	49	44	31	28	21	19	5	5		
103lbs	48	42	30	27	21	18	5	5		
107lbs	46	41	29	26	20	18	5	4		
112lbs	44	39	28	25	19	17	5	4		
118lbs	42	37	26	23	18	16	5	4		
123lbs	40	35	25	22	17	15	4	4		
128lbs	38	34	24	22	17	15	4	4		
135lbs	36	32	23	20	16	14	4	3		

(2) Double Reduced

Base Weight	Under 26 inch		Over 26 inch thru. 27-1/2 inch		Over 27-1/2 inch thru. 29 inch		Over 29 inch thru. 30-1/2 inch		Over 30-1/2 inch	
	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS	ETP	TFS
50lbs	99	88	63	56	43	38	11	10	Base	Base
53lbs	93	83	59	53	41	36	11	9		
55lbs	90	80	57	51	39	35	10	9		
60lbs	82	73	52	47	36	32	9	8		
65lbs	76	67	48	43	33	29	9	8		
70lbs	70	62	45	40	31	27	8	7		
75lbs	66	58	42	37	29	25	7	7		
80lbs	61	55	39	35	27	24	7	6		
85lbs	58	51	37	33	25	22	7	6		
90lbs	55	49	35	31	24	21	6	5		
95lbs	52	46	33	29	22	20	6	5		
100lbs	49	44	31	28	21	19	5	5		

D : Quality Extras

(1) Type D

1) Single Reduced

Base Weight	ETP	TFS
70lbs	34	30
73lbs	32	29
75lbs	31	28
78lbs	30	27
80lbs	29	26
83lbs	28	25
85lbs	28	24
88lbs	27	24
90lbs	26	23
93lbs	25	22
95lbs	25	22
100lbs	23	21
103lbs	23	20
107lbs	22	19
112lbs	21	18
118lbs	20	17
123lbs	19	17
128lbs	18	16
135lbs	17	15

2) Double Reduced

Base Weight	ETP	TFS
50lbs	47	42
53lbs	44	39
55lbs	43	38
60lbs	39	35
65lbs	36	32
70lbs	34	30
75lbs	32	28
80lbs	30	26
85lbs	28	24
90lbs	26	23
95lbs	25	22
100lbs	23	21

(2) Type K, A or J

1) Single Reduced

Base Weight	ETP
70lbs	22
73lbs	21
75lbs	21
78lbs	20
80lbs	19
83lbs	19
85lbs	18
88lbs	18
90lbs	17
93lbs	17
95lbs	16
100lbs	15
103lbs	15
107lbs	14
112lbs	14
118lbs	13
123lbs	12
128lbs	12
135lbs	11

2) Double Reduced

Base Weight	ETP
50lbs	31
53lbs	29
55lbs	28
60lbs	26
65lbs	24
70lbs	22
75lbs	21
80lbs	19
85lbs	18
90lbs	17
95lbs	16
100lbs	15

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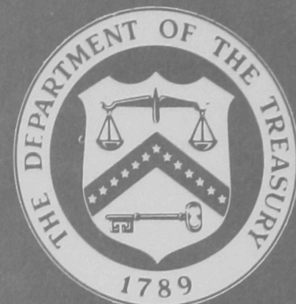

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
January 30, 1978

TESTIMONY OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

Mr. Chairman and Distinguished Members of this Committee:

I am glad to have this opportunity to appear before you to discuss the Federal Financing Bank. I particularly want to clarify the role of the FFB as lender to foreign governments under the Foreign Military Sales program.

The Federal Financing Bank

Let me begin by outlining briefly the goals and responsibilities of the FFB. As you know, the Bank was established under legislation enacted in December 1973 to centralize and better coordinate the timing and terms of Federal financing, and to lower related borrowing costs.

Before the FFB's inception, some form of Federally-backed financing was entering the securities markets around three days a week. Large numbers of small market issues were congesting those markets and increasing the borrowing costs of all Federal borrowers.

Many of these direct and guaranteed issues were selling at yields considerably higher than the yields on Treasury securities themselves, even though the credit risks were equal. The two major reasons for this were that investors were unfamiliar with the Federal entities issuing those securities, and that the securities did not provide the liquidity of a direct Treasury issue.

Congress created the Treasury-supervised FFB with the power to purchase obligations issued or guaranteed by Federal agencies in order to centralize the financing of loans and to lower borrowing costs. Amounts which would otherwise be financed in the securities markets now are financed through the Treasury, which borrows itself to finance them. This means that one large Federal issuer has been substituted for many small ones, and finances those overall needs at lower costs. Those savings, in turn, are passed through to borrowers by the FFB. At the end of December, Mr. Chairman, FFB holdings of agency debt totaled $38.6 billion. Table 1 attached to my statement provides a breakdown of these securities.

The FFB is not a Program Agency

I want to emphasize that the FFB is a conduit for financing Federal programs and is not a program agency. It neither increase or decreases total Federal credit assistance programs, nor does it allocate credit among programs. In particular, the Bank is not authorized to make any judgments with respect to the relative merits of Federal agency programs. Its function is only to finance efficiently the credit assistance programs which are authorized by the Congress.

FFB policy is to treat all borrowers on equal footing unless otherwise directed by statute. The FFB is not required to purchase guaranteed obligations of any issuer. In fact to date, the Bank has purchased only obligations that are fully guaranteed as to principal and interest even though partially-guaranteed obligations technically are eligible for FFB purchase. We firmly believe that providing equal treatment for all of its borrowers is the most effective way to reflect the equivalent credit risk involved -- that all loans are fully guaranteed. It also is the best way to assure that the FFB remains neutral regarding agency program decisions.

FMS Financing Before FFB

The Department of Defense has guaranteed loans for foreign military sales since 1965. The process of marketing of these loans has passed through three distinct phases. The first, between 1965 and 1968, involved financing all FMS guaranteed loans through the Export-Import Bank. The second phase spanned 1968 through 1974, when the loans were sold strictly in the private market. In the latest period, which began early in 1975, all loans guaranteed under the FMS program have been sold to the FFB.

Export-Import Bank purchases of guaranteed FMS loans ended in 1968, when Congress enacted the Foreign Military Sales Act. This legislation prohibited sales of FMS guaranteed loans to a Federal agency. On that basis, foreign governments turned to private financial sources in the U.S. -- mostly commercial banks -- to finance a major share of their purchases. Each country was required to locate a lender, negotiate financing arrangements and then obtain a DOD guarantee.

Private negotiation of loan terms was later determined to be unsatisfactory. This judgment reflected the high private returns which lenders were receiving in relation to both their minimal risk on those guaranteed obligations and in relation to interest rates on other guaranteed obligations. A further criticism was that many banks were interested in guaranteed FMS loans to particular countries but were not able to participate in those financings.

The private negotiation process was replaced then by a process of loan auctions conducted by the Treasury Department. While auctions of FMS loans quieted charges that potential lenders were excluded from an opportunity to participate, they failed to attract wide participation and still resulted in relatively high returns to lenders.

FFB Financing of FMS Loans

At the time of FFB's inception, Mr. Chairman, the Treasury was well aware of the problems which FMS guaranteed loans were causing in the private markets. The legislative history of the FFB Act made clear that Congress envisioned a broad financing role, and Treasury believed that FMS loans were eligible for financing under Section 6(a) of the FFB Act. That section reads in part:

> Any Federal agency which is authorized to issue, sell or guarantee any obligation is authorized to issue or sell such obligations directly to the Bank.

Internally, FFB counsel was of the opinion that this authorization was sufficient and that the FFB could purchase guaranteed FMS loans. Nevertheless, the then Administration determined that it was appropriate to seek Congressional confirmation of the FFB's authority concerning FMS guarantees. At that time, the Administration supported an amendment to the FMS Act, enacted in December 1974, which expressly authorized the Defense Department to guarantee loans purchased by FFB.

The FFB began making loans to guaranteed FMS borrowers in February 1975, and held $2.9 billion of outstanding loans of 33 countries at the end of December 1977. Loans to Israel account for about half of all those FMS loans, as shown in Table 2.

Let me emphasize, however, that the overwhelming proportion of foreign military sales are for cash and that credit sales are relatively small. I think that Table 3, attached here, underscores this. In fiscal year 1977, for example, the amount of new loan commitments provided by the FFB for this purpose was only about 12 percent of the value of new DOD sales agreements.

Treasury Role as Financial Advisor

As you can see, the Treasury has long been the financial advisor to this program. This involvement is directed by statute and under Executive Order and parallels the Department's historical responsibility as the focal point of financial expertise in the Executive Branch. The Secretary of the Treasury applies a statutory formula to determine the interest rate to be charged by the Department of Defense on its direct FMS loans.

Furthermore, Treasury participates in the interagency review process when the annual security assistance programs are developed. It also provides financial and economic advice almost daily to State and Defense in connection with specific proposals to provide financing for FMS.

Let me stress, Mr. Chairman, that the total of FMS guaranteed loans is not affected by the source of financing, whether it is the private markets or the FFB. Congress sets a ceiling on the amount of Federally-assisted credit, and appropriates funds to DOD both for direct loans and for a reserve fund to back the guaranteed loans. FFB purchases have no effect on the Government's contingent liability in this program because loans are fully guaranteed by DOD before FFB purchases them. In fact, since interest rates on FFB loans are lower than private market rates, the total amount of interest which DOD must guarantee is reduced.

Financing Charges on FMS Loans

I would like to turn now to the question of appropriate interest rates to be charged on FMS loans. As you know, the FFB has followed a policy as supported by its legislative history, of dealing with all borrowers on an equal basis. FFB buys only

securities which are either issued or guaranteed by a Federal agency. The FFB does not differentiate among its borrowers with regard to interest rates or fees.

Each FFB loan carries an interest rate based on the Treasury borrowing rates for the same maturities. The FFB then adds a standard 1/8 percentage point administrative fee.

Let me say, however, that Treasury recently has recommended a slight revision in financing charges for FMS guaranteed loans. FFB interest rates for FMS loans are slightly lower -- by a few basis points -- than rates charged by the Export-Import Bank on commercial exports. Treasury believes that it is inconsistent to finance arms exports more cheaply than commercial exports financed by Export-Import Bank.

For this reason, we have recommended to the National Security Council that interest rates and fees charged on FMS loans be at least as high as Export-Import Bank rates, including commitment fees. The National Security Council has recommended that this matter be reviewed by the Arms Export Control Board, and we assume it will be resolved shortly.

Conclusion

In closing, Mr. Chairman, let me reiterate our strong belief that the FFB should continue to purchase FMS loans rather than returning them to the private market. It is not appropriate for final agreement on matters that affect U.S. foreign policy and national security to hinge on the outcome of private negotiations over which the U.S. Government has no control regarding interest rates, repayment schedules, compensating balances and other loan terms. Furthermore, the inordinately high interest rates, potential for capital market congestion and other problems which originally were involved in marketing these obligations to private investors would simply return if these loans were again financed in the securities markets.

I will be glad to answer your questions.

Table 1

Summary of Federal Financing Bank holdings, beginning fiscal year 1974
(In millions of dollars)*

Obligation	Holdings end of period					
	Fiscal 1974	Fiscal 1975	Fiscal 1976	T.Q.	Fiscal 1977	December 31, 1977
On-budget agency debt:						
Export-Import Bank /1	.....	4,049.4	4,984.6	4,768.1	5,923.5	5,833.5
Tennessee Valley Authority	.....	1,435.0	2,180.0	2,735.0	3,880.0	4,190.0
Off-budget agency debt:						
U.S. Postal Service	500.0	1,500.0	2,748.0	3,248.0	2,181.0	2,181.0
U.S. Railway Association	.....	33.9	85.3	96.8	310.4	336.3
Agency assets:						
Farmers Home Administration	.....	5,000.0	8,800.0	9,650.0	14,615.0	16,095.0
Health, Education and Welfare health maintenance organization	.....	....	....	....	29.8	29.8
Health, Education and Welfare medical facilities loan program	2.0	62.1	118.5	125.5	152.2	163.3
Overseas Private Investment Corporation	.....	5.5	5.5	5.5	44.5	42.3
Rural Electrification Administration	.....	....	166.4	353.6	353.6	353.6
Secretary of the Treasury (N.Y.)	.....	....	....	1,082.1	1,157.2	1,885.8
Small Business Administration	.....	....	166.4	159.6	133.1	127.5
Government-guaranteed loans:						
Chicago, Rock Island & Pacific Railroad	.....	....	....	5.6	15.0	16.9
Defense foreign military sales	.....	111.7	898.9	1,106.5	2,515.7	2,893.5
General Services Administration	.....	45.1	68.8	75.0	142.1	179.5
Guam	.....	....	....	....	36.0	36.0
Housing and Urban Development New Communities Administration	.....	21.0	27.5	37.5	42.5	38.5
Missouri, Kansas, Texas Railroad	.....	....	....	....	4.4	7.3
National Railroad Passenger Corporation (Amtrak)	.....	317.5	567.5	602.4	558.5	532.1
Rural Electrification Administration	.....	254.8	948.0	1,159.9	2,382.4	2,646.7
Small business investment companies	.....	47.5	70.7	90.9	176.0	187.3
Student Loan Marketing Association	100.0	240.0	400.0	405.0	510.0	515.0
Virgin Islands	.....	....	....	....	22.0	21.8
Washington Metropolitan Area Transit Authority	.....	177.0	177.0	177.0	177.0	177.0
Western Union Space Communications	.....	....	....	....	56.5	90.1
Total	602.0	13,300.4	22,413.2	25,884.3	35,418.4	38,579.8

/1 Restored to on-budget status on October 1, 1976.
* Totals may not add due to rounding.

Table 2

SUMMARY OF FFB LOANS FOR FOREIGN MILITARY SALES
December 31, 1977

(in millions of dollars*)

Country	Commitment	Disbursed	Repayments	Outstanding Debt	Undisbursed Commitments
Argentina	$ 64.0	$ 45.9	$ 7.7	$ 38.2	$ 18.1
Bolivia	9.0	9.0	.7	8.3	-0-
Brazil	76.5	74.5	7.6	67.0	2.0
China	188.0	151.9	33.2	118.7	36.1
Colombia	19.6	12.2	2.9	9.3	7.4
Costa Rica	5.0	-0-	-0-	-0-	5.0
Dom. Rep.	2.0	1.0	.3	.7	1.0
Ecuador	25.0	8.8	1.5	7.3	16.2
Gabon	2.0	1.8	-0-	1.8	.2
Greece	341.0	341.0	8.3	332.7	-0-
Guatemala	1.5	1.4	-0-	1.4	.1
Haiti	.5	-0-	-0-	-0-	.5
Honduras	5.0	2.5	-0-	2.5	2.5
Indonesia	51.2	20.7	6.1	14.7	30.5
Israel	1,550.0	1,499.3	23.5	1,475.8	50.7
Jordan	187.5	81.6	1.8	79.8	105.9
Kenya	65.0	50.0	.3	49.8	15.0
Korea	471.5	325.3	42.5	282.8	146.2
Lebanon	25.0	25.0	-0-	25.0	-0-
Liberia	2.2	1.7	-0-	1.7	.5
Malaysia	57.7	19.6	3.4	16.2	38.1
Morocco	74.0	56.9	4.8	52.1	17.1
Nicaragua	8.0	5.0	1.4	3.6	3.0
Panama	3.0	1.7	-0-	1.7	1.3
Paraguay	.5	.4	.1	.3	.1

Table 2
SUMMARY OF FFB LOANS FOR FOREIGN MILITARY SALES
December 31, 1977

(in millions of dollars*)

Country	Commitment	Disbursed	Repayments	Outstanding Debt	Undisbursed Commitments
Peru	$ 50.5	$ 32.2	$ 1.7	$ 30.5	$ 18.3
Philippines	51.4	36.3	6.4	29.9	15.1
Spain	120.0	-0-	-0-	-0-	120.0
Senegal	8.0	2.4	-0-	2.4	5.6
Thailand	74.7	28.2	1.9	26.2	46.5
Tunisia	55.0	21.1	2.8	18.8	33.9
Turkey	378.7	193.9	6.6	187.4	184.8
Uruguay	10.0	7.5	.6	6.9	2.5
Totals	$3,983.0	$3,058.8	$165.9	$2,893.5	$924.2

*totals may not add due to rounding.

Table 3

FOREIGN MILITARY SALES
AND FMS CREDIT

FY 1975-77
(billions of $)

US FY	Military Sales by DOD[1/]	FFB Credit Commitments/2	Direct Credit	Commercial Credit
1975	12.31	.59	.23	.02
1976 and TQ	13.17	1.90	.89	-
1977	11.19	1.38	.53	-
Total	36.67	3.87	1.65	.02

1/ Reflects commitments rather than actual deliveries. Source: DSAA Foreign Military Sales and Military Assistance Facts.

2/ Source: Bureau of Government Financial Operations, Treasury.

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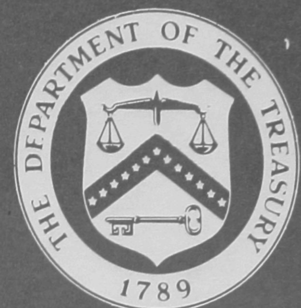

FOR IMMEDIATE RELEASE January 30, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,401 million of 13-week Treasury bills and for $3,502 million of 26-week Treasury bills, both series to be issued on February 2, 1978, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing May 4, 1978			26-week bills maturing August 3, 1978		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.379	6.413%	6.61%	96.609	6.707%	7.04%
Low	98.371	6.444%	6.64%	96.603	6.719%	7.05%
Average	98.372	6.440%	6.64%	96.605	6.715%	7.05%

Tenders at the low price for the 13-week bills were allotted 30%.
Tenders at the low price for the 26-week bills were allotted 58%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS AND TREASURY:

Location	Received	Accepted	Received	Accepted
Boston	$ 41,145,000	$ 22,495,000	$ 41,755,000	$ 11,755,000
New York	3,933,715,000	2,072,930,000	5,589,815,000	3,139,840,000
Philadelphia	35,235,000	32,785,000	7,395,000	7,395,000
Cleveland	48,420,000	28,420,000	114,900,000	38,500,000
Richmond	45,135,000	27,265,000	36,700,000	30,860,000
Atlanta	40,395,000	37,395,000	16,965,000	13,805,000
Chicago	215,375,000	32,875,000	334,840,000	81,920,000
St. Louis	41,580,000	18,170,000	37,315,000	12,115,000
Minneapolis	30,455,000	6,455,000	38,150,000	8,630,000
Kansas City	40,405,000	35,305,000	21,340,000	18,840,000
Dallas	21,385,000	21,385,000	11,390,000	11,140,000
San Francisco	226,565,000	55,065,000	388,730,000	123,330,000
Treasury	10,275,000	10,275,000	4,330,000	4,330,000
TOTALS	$4,730,085,000	$2,400,820,000a/	$6,643,625,000	$3,502,460,000b/

/ Includes $402,745,000 noncompetitive tenders from the public.
/ Includes $164,000,000 noncompetitive tenders from the public.
/ Equivalent coupon-issue yield.

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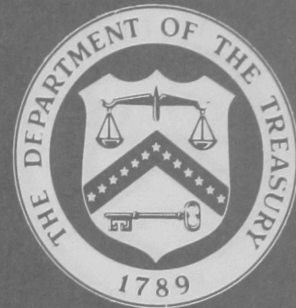

January 31, 1978

BIOGRAPHICAL SKETCH

John R. Karlik

John R. Karlik has served as Deputy Assistant Secretary of the Treasury for International Economic Analysis since December 1977. In this capacity he is responsible for the international economic and financial research programs carried on within the Treasury. He is also responsible within the Treasury for the development of long range plans in the international economic area.

Prior to joining Treasury, Dr. Karlik served for nine years as senior international economist for the Joint Economic Committee, bearing responsibility to the Committee members for all phases of U.S. external economic relations, including balance of payments, international monetary reform, commercial trade, and policy toward the oil-producing and developing countries.

Dr. Karlik was born in White Plains, New York, on December 2, 1938. He received an A.B. in Mathematics from Middlebury College and Ph.D. in Economics from Columbia University. He served as an economist with the Federal Reserve Bank of New York from 1963 to 1966. In 1967 and 1968 he was a member of the professional staff of Hudson Institute. Dr. Karlik has taught undergraduate international economics at the University of Maryland and at the graduate level at American University. He is the author of numerous articles and reports.

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FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
FEBRUARY 1, 1978

TESTIMONY OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE APPROPRIATIONS COMMITTEE

Mr. Chairman and members of this distinguished Committee:

It is my privilege this morning to initiate the discussions with you of the President's economic program for 1979. There is a lot of ground to cover. While the program is simple in design, it is comprehensive in scope. It builds on the great strengths of our private economy, at the same time that it addresses the need for important structural changes in the economic process. Most importantly, it is designed to continue the good performance achieved by our economy last year.

For 1977 -- the first year of this Administration -- was indeed a good year. It was a year of balanced, sustainable growth, free of most of the strains and stresses which have in the past marked the third year of many previous recoveries. Real GNP growth of 5-3/4 percent was close to the target set by the President in his Budget message last February, and the reduction in unemployment -- to a rate of 6.4 percent in December -- more than met expectations.

Overall, an extraordinarily large number of jobs was created -- 4.1 million between December 1976 and December of last year. The number of unemployed was reduced by 1.2 million.

While progress was not even throughout the year, the year ended on a strong note, as the lull of the summer gave

way in the fall to renewed vigor of consumer and business spending. The strength of the economy at year-end is underscored by a few statistics:

-- Retail sales increased by 11-1/2 percent, in real terms, between the third and fourth quarters of 1977.

-- Orders placed with manufacturers of durable goods -- responding to the good performance of retail sales -- advanced at a very high rate, in real terms, in the fourth quarter and were 11 percent above levels of a year earlier.

-- Total employment jumped 1-1/2 million during the final three months of the year.

-- Starts of new housing units were at a 2.3 million annual rate at year-end, the best since the 1972-73 housing boom, and 21 percent above a year earlier.

The economic program proposed by the President is designed to sustain this good economic performance. Let me stress the verb "sustain", for there is some misunderstanding as to the objectives of the program.

We start with the premise that a growth rate of about 4-1/2 to 5 percent in real gross national product is about the right pace for our economy at this stage of recovery. Such a rate of growth will permit steady improvement in the utilization of labor and capital resources -- that is, a steady reduction in unemployment and a steady increase in industrial plant utilization -- without fueling a resurgence in inflation.

Our economy is, today, progressing along such a growth track. We intend to keep it on this path. The risks in stimulating the economy to an even faster growth track are great; we still suffer from a much too-high rate of inflation to afford actions which could push the advance in prices even higher.

But we also recognize that there are many forces that could pull us down from our safe track. Potential hazards include:

-- The sharp increases recently legislated in taxes for social security.

-- The impact of inflation on effective tax rates.

-- The impact of inflationary expectation on consumer and business spending plans.

-- The inequities in the current distribution of the total tax burden.

-- The levelling off in the thrust provided by the economic stimulus program enacted last year.

-- The large drain on our economy of payments for imported fuels.

-- The inadequate rate of business capital formation.

-- The inadequate employment opportunities for important segments of our society, particularly minorities and youth.

-- The slowing in our rate of technological innovation, which threatens the technical supremacy of the American industrial system.

Our basic strategy in overcoming these potential road-blocks rests on three fundamental principles:

-- The enormous strength and vitality of our private sector must be freed from the burden of excessive taxation and unnecessary regulation. As the President stated in his Economic Report, "We should rely principally on the private sector to lead the economic expansion and to create new jobs for a growing labor force."

-- The rise in government spending must be restrained. The more our nation's resources are usurped by government, the less is available for the private economy.

-- Within this restraint, total government spending must be redirected to focus on the major social and economic problems of our society.

The proposed implementation of this strategy is spelled out in the various messages the President has transmitted to the Congress in recent weeks. Central in this strategy is the proposed tax program, which will offset an imminent rise in the burden of taxation and assure a more equitable sharing of the burden.

Prompt tax relief is particularly necessary in light of the recent changes that have been made in social security taxation. To restore the financial integrity of the social security system, which was battered by the severe recession and severe inflation of recent years, and to insure social security benefits for future generations, large infusions of revenues are needed. But the taxes enacted to provide these revenues will represent a significant drain on the current purchasing power of American workers. To sustain an adequate rate of economic growth, the drain of higher social security taxes must be offset by income tax reductions.

In addition to the rise in social security taxes, inflation has been levying a growing but hidden tax. Under our progressive income tax system, inflation pushes individual incomes up the tax rate schedule and into higher tax brackets, resulting in a higher tax toll even though real purchasing power of incomes may remain constant.

The income tax reductions proposed in the President's tax program will offset both the rising social security tax burden <u>and</u> the effects of inflation on effective tax rates. We estimate that for the consumer sector of the economy, the combined drain of social security and incomes taxes -- which together absorb about 14 percent of personal income -- will be about the same in 1979 as it was in 1977. Without the proposed tax cut, the tax drain would rise by about one percentage point.

Most of the proposed income tax relief is directed toward low- and middle-income families. The President is committed to the principle that the net tax reductions should be focused on those individuals who need tax relief the most -- low- and middle-income Americans. Through a combination of substantial tax cuts and needed tax reforms, the Administration's tax program lessens the burden significantly on those individuals who now shoulder a disproportionately large share of the burden of public support while providing lesser relief -- or, in some cases, raising the tax liability --

for those persons who now make use of unjustified tax preferences to escape paying their fair share of taxes. Over 94 percent of the proposed tax relief is provided to families making less than $30,000.

By offsetting the fiscal drags that threaten to reduce consumer purchasing power, the tax program promotes continuation of strong markets for the goods and services produced by American business. In addition, the tax program provides specific encouragement for the business investment that will enable our industrial society to meet expanding demands and provide the tools of production for a growing labor force.

Over the past decade, the growth of our productive capital stock has not kept pace with the expansion of the economy or of its labor supply. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the fourth quarter of 1977 was still 3 percent below its previous peak, reached in the first quarter of 1974.

We are simply not allocating enough of current output to provide the capacity for future growth. Several years ago, a study by the U.S. Department of Commerce concluded that in order to build a capital structure adequate to support a full employment economy by the end of the decade, we would have to allocate at least 12 percent of national output to business fixed investment. In recent years, we have been allocating less than 10 percent of output to investment. The lagging rate of capital growth has impaired our productivity, threatens capacity bottlenecks and price pressures in the years ahead, and fails to provide adequate job opportunities for our growing labor force.

Many factors have combined to restrain the rate of business investment. One of the most important has been the low rate of return on capital. Reported profits do not accurately measure the true return on capital, for conventional accounting practice does not adequately take into account the costs of replacing the capital equipment and inventories used up in production. If the reported figures are corrected for the inflation in these costs, it will be seen that the return on capital has been very depressed in recent years, and is still at levels well below that of the mid 1960's.

The tax program we are proposing addresses directly the urgent need to provide more adequate incentives for investment. The key element is the proposed reduction in the tax rate on corporate incomes -- a reduction of 3 percentage points to become effective on October 1 of this year, and an additional reduction of 1 percentage point on January 1, 1980. Intensive discussions with business leaders from many industries affirm that this form of tax relief will be very beneficial as an incentive for long-term productive investment.

In addition to the reductions in corporate tax rates, we are proposing several modifications of the investment tax credit. By making the present 10 percent rate permanent, rather than reverting to the 7 percent level that is now scheduled to apply after 1980, businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

Further, it is proposed to extend the investment credit to utility and industrial structures. The current ineligibility of structures results in an unbalanced industrial expansion. It should be noted that the extension of the credit is not only for new structures, but also applies to the rehabilitation of existing buildings, to avoid the possibility of an anti-urban bias.

In addition, the eligibility for the full 10 percent investment tax credit would be extended to all pollution control facilities. Also, the ceiling on the extent to which investment credits can generally be used to offset tax liabilities would be raised, from the present ceiling of 50 percent to a new 90 percent of tax liabilities. The extension of the tax liability ceiling should greatly broaden the range of business which can benefit from the investment credit and encourage a broader base for industrial expansion. Finally, a number of specific measures of tax relief for smaller businesses are proposed. Together, this package of proposed tax reductions will provide powerful incentives for business investment, enabling American industry to put into application the latest and most efficient technologies.

Some have argued that the amount of the proposed tax reduction will not be large enough to meet our national

objectives, particularly in reducing unemployment. But the Administration's program does not rely solely on aggregate fiscal policy to address the unemployment problem, which has strong structural characteristics. In particular, unemployment among youth and minorities remains unacceptably high despite the improvement that has occurred in the overall economic environment.

The Budget before you requests funds for specific programs targetted on these major pockets of structural unemployment. These include extension of the public service employment program, more sharply focussed on the long-term unemployed and the disadvantaged, and expansion of programs directed at youth. Importantly, a new initiative is being launched to encourage the involvement of the business sector in local employment and training programs. The Administration recognizes that, for the long-run, private sector job creation is the right answer to our unemployment problems.

Countering the concerns of those who fear the tax reduction program might prove inadequate are the concerns of those who fear that with the economy advancing at a vigorous pace, a $25 billion tax reduction would over-stimulate demand and accelerate inflation. This is often coupled with the concern that financing the resultant deficit will impact financial markets adversely, with a resultant rise in interest rates that could negate the stimulus from tax reductions.

Such fears are understandable, but not warranted. The proposed tax reductions have been gauged so that, in aggregate, they offset the scheduled rise in social security taxes and the drag on purchasing power from the inflation impact on effective tax rates. The intent is to maintain the satisfactory growth rate of the economy, not to accelerate activity to an unsustainable pace.

Moreover, the effects of the proposed tax reductions must be evaluated in the context of the entire fiscal program submitted by the President. On the expenditure side of the Budget, the President proposes an increase, in real terms, of only a little over 1 percent, the smallest rise in five years and a third less than the average annual increase in spending in the 1969 to 1976 period. The Federal government's demands on the nation's resources will decline; the ratio of

Federal outlays to GNP will drop from 22.6 percent this year to 22 percent in FY 1979, and decline further in the years ahead.

With this restraint on spending, the $60 billion deficit projected for 1979 does not threaten serious upward pressures on wages, prices or interest rates. We would not, after all, be running a deficit in an overheated economy. With slack still remaining in labor markets, and a substantial margin of industrial capacity still available, a deficit of this order of magnitude in FY 1979 would reflect appropriate tax and expenditure policies.

Financing a deficit of this size should not present serious problems for financial markets. Treasury financing requirements -- in the order of $65 to $70 billion in FY 1978 and FY 1979 -- will represent a smaller share of total credit market flows than in 1975 or 1976, and not much higher than in 1977. It must be remembered that the volume of savings flows grows along with the rise in economic activity -- personal savings alone is expected to rise by almost $20 billion this year -- and we expect that our financial markets will prove attractive to foreign investors. As we gauge the prospective flows of credit demand and supply, we see no basis for concern over the possibility that Treasury financing needs will "crowd out" private sector financing. And the Administration's tight control over Federal spending, along with the initiatives we are taking to reduce the rate of inflation, will alleviate some of the burden on monetary policy.

One very important element of the President's economic program is the effort we are mounting to reduce the rate of inflation. The prudence evident in the President's spending plans is assurance that the government's demands on the nation's resources will not be a source of inflationary pressures. The tax program's strong incentives for investment in new production facilities will reduce the possibilities of shortages or bottlenecks as the economy reaches higher levels of resource utilization. Similarly, the jobs-training and employment opportunity programs proposed in the Budget will develop a reservoir of skills we will need as demand for workers continues to grow.

The President's tax program also includes proposals to reduce excise and unemployment insurance taxes, modest steps but ones that will contribute directly to reducing costs and prices. The development of larger grain reserves will also

contribute to price stability, by providing a buffer against food price changes in the event of bad weather. Legislation has already been submitted to limit the rate of increase in hospital care costs.

A vigorous program is being launched to reduce the burden of government regulations which add unnecessarily to costs and prices. Steps taken this past year have already reduced the number of regulations, and the paperwork burden involved in complying with regulations. The program is being expanded through the development of procedures that encourage regulatory agencies to apply the most cost-effective solutions in accomplishing their regulatory objectives, and by a careful review of the economic justification of major new regulatory proposals. An interagency committee has been established to review the adequacy of the economic analyses underlying such regulations, and to assure that all alternatives have been explored in the search for the least costly means of achieving the objectives. We are also undertaking an assessment of the impact of regulation on the economy as a whole, to find ways of setting priorities among regulatory objectives.

A major element in the Administration's efforts in restraining inflation is a cooperative program with business and labor to lower the rate of wage and price increases. Because this program is voluntary, rather than mandatory or coercive, and because it does not rely on a single standard of wage and price behavior, it has been dismissed by some as ineffective.

Such premature judgments appear based on a lack of understanding of the inflation process, a process in which wages have been vainly chasing prices which have been vainly chasing wages, in an escalating cycle with no one the victor for long. We believe it is possible to reduce the rate of escalation in almost every market, and we intend to work closely with business and labor leaders in every major industry to achieve this.

If we can all cool off in concert, everyone will benefit. Reduction in the rate of inflation will encourage business and consumer spending plans, stabilize financial markets, and improve our ability to compete in international markets. The price deceleration program we are initiating, which

involves a collaboration of government, business and labor, will substitute *ex ante* consultation for *ex post* confrontation, and we are confident it will achieve a significant degree of success.

The success of our efforts to promote domestic growth, reduce unemployment and curb inflation depend importantly on maintenance of an open, prosperous, world economy. The continuation of large imbalances in international payments is, however, placing a strain on the international monetary system which threatens a further slowdown in the world economy and resort to trade restrictions.

All nations must cooperate to reduce these payments imbalances, and to increase the world's ability to cope with them. Strong domestic economic growth in major industrial societies is a prerequisite to achieving better international balance. The Administration's economic program will assure that the U.S. remains a source of strength in the world economy. It is important that other strong nations join us in comparable efforts, if we are to sustain economic recovery throughout the industrial world.

The persistence of large international payments imbalances has become a source of disturbance in international exchange markets. Toward the end of 1977, the foreign exchange market became increasingly volatile, and the United States has intervened more forcefully to counter increased market disorder.

Our objective is the limited one of checking speculation and re-establishing orderly conditions. I believe we are making progress in calming the situation.

The measures that have been taken are designed to deal with a particular market situation. They are not a substitute for action to correct the root causes of international trade problems.

For the United States, the trade deficit is not the result of an overheated domestic economy that must be restrained through sharply higher interest rates. It primarily reflects two factors: excessive U.S. dependence on imported oil, and slow growth abroad. The solution lies in implementing a strong U.S. energy policy and in the

Administration considers it essential that this particular portion of our request be made available to the development banks this year.

Let me summarize, Mr. Chairman, by noting that the economic program proposed by the President will make possible solid progress towards achieving our goals of steady growth, reduction in unemployment, fuller utilization of industrial capacity, and strengthened international confidence in the U.S. economy. Our projections indicate that, with this program, there will be five million additional persons employed by the fourth quarter of 1979. Moreover, about 700 thousand fewer persons will be faced with the frustrating experience of being unable to find meaningful work; the overall unemployment rate will drop to about 5-3/4 percent. Real gross national product will be almost 10 percent above fourth quarter 1977 levels, and real disposable personal income per capita will be about 8 percent higher.

By emphasizing expenditure restraint, and relying on tax reductions to promote growth, the share of GNP absorbed by government would decline. This would permit an increase in the share of our national output to be devoted to the private sector's decisions, and particularly to fixed investment--the basis for increased productivity and expanded future consumption. This can be accomplished without accelerating inflationary pressures.

I trust you will agree that the Administration's program represents a balanced, effective response to the nation's major social and economic needs. I will be happy to respond to any questions you may have.

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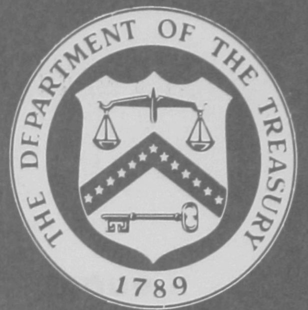

FOR RELEASE AT 4:00 P.M. January 31, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,800 million, to be issued February 9, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,811 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $2,300 million, representing an additional amount of bills dated November 10, 1977, and to mature May 11, 1978 (CUSIP No. 912793 Q3 3), originally issued in the amount of $3,407 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,500 million to be dated February 9, 1978, and to mature August 10, 1978 (CUSIP No. 912793 S6 4).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing February 9, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,492 million of the maturing bills. These accounts may exchange bills they hold for the bills now being offered at the weighted average prices of accepted competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Except for definitive bills in the $100,000 denomination, which will be available only to investors who are able to show that they are required by law or regulation to hold securities in physical form, both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, February 6, 1978. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

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 in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, or for bills issued in bearer form, where authorized. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action 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 weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, and bills issued in bearer form must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on February 9, 1978, in cash or other immediately available funds or in Treasury bills maturing February 9, 1978. Cash adjustments will be made for differences between the par value of the 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 these bills 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 these bills (other than life insurance companies) must include in his or her 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 Circulars, No. 418 (current revision), Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

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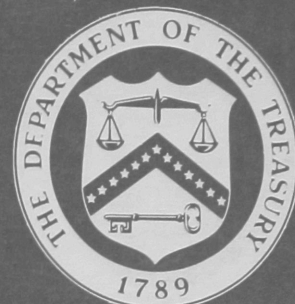

FOR IMMEDIATE RELEASE January 31, 1978

RESULTS OF AUCTION OF 3-1/4-YEAR NOTES

The Department of the Treasury has accepted $2,504 million of $5,088 million of tenders received from the public for the 3-1/4-year notes, Series M-1981, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	7.50%
Highest yield	7.55%
Average yield	7.53%

The interest rate on the notes will be 7-1/2%. At the 7-1/2% rate, the above yields result in the following prices:

Low-yield price	99.936
High-yield price	99.794
Average-yield price	99.850

The $2,504 million of accepted tenders includes $1,194 million of noncompetitive tenders and $1,301 million of competitive tenders (including 10% of the amount of notes bid for at the high yield) from private investors. It also includes $ 10 million of tenders at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities in exchange for maturing securities.

In addition, $1,320 million of tenders were accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for securities maturing February 15, 1978, ($1,000 million) and from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash ($320 million).

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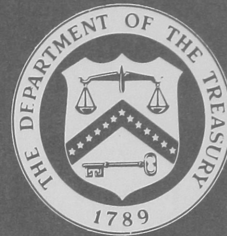

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
FEBRUARY 2, 1978

TESTIMONY OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
BEFORE THE
SENATE BUDGET COMMITTEE

Mr. Chairman and members of this distinguished Committee:

It is my pleasure this morning to continue the Administration's discussion with you on the President's economic program for 1979, and the implications of this program for Federal outlays and revenues.

The President's program is comprehensive in scope. It addresses both the need to support and sustain the economic recovery we are now enjoying, as well as the need to undertake the major structural changes that will assure adequate and balanced growth in the years ahead and more equitable distribution of the benefits of growth.

In 1977, the economy regained its recovery path, after faltering in 1976. The year turned out to be one of balanced, sustainable growth, free of most of the strains and stresses which have in the past marked the third year of many previous recoveries. Real GNP growth of 5-3/4 percent was close to the target set by the President in his Budget message last February, and the reduction in unemployment -- to a rate of 6.4 percent in December -- more than met expectations.

Overall, an extraordinarily large number of jobs was created -- 4.1 million between December 1976 and December of last year. The number of unemployed was reduced by 1.2 million.

While progress was not even throughout the year, the year ended on a strong note, as the lull of the summer gave

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way in the fall to renewed vigor of consumer and business spending. The strength of the economy at year-end is underscored by a few statistics:

-- Retail sales increased by 11-1/2 percent, in real terms, between the third and fourth quarters of 1977.

-- Orders placed with manufacturers of durable goods -- responding to the good performance of retail sales -- advanced at a very high rate, in real terms, in the fourth quarter and were 11 percent above levels of a year earlier.

-- Total employment jumped 1-1/2 million during the final three months of the year.

-- Starts of new housing units were at a 2.3 million annual rate at year-end, the best since the 1972-73 housing boom, and 21 percent above a year earlier.

The economic program proposed by the President is designed to sustain this good economic performance. Let me stress the verb "sustain", for there is some misunderstanding as to the objectives of the program.

We start with the premise that a growth rate of about 4-1/2 to 5 percent in real gross national product is about the right pace for our economy at this stage of recovery. Such a rate of growth will permit steady improvement in the utilization of labor and capital resources -- that is a steady reduction in unemployment and a steady increase in industrial plant utilization -- without fueling a resurgence in inflation.

Our economy is, today, progressing along such a growth track. We intend to keep it on this path. The risks in stimulating the economy to an even faster growth track are great; we still suffer from a much too-high rate of inflation to afford actions which could push the advance in prices even higher.

But we also recognize that there are many forces that could pull us down from our safe track. Potential hazards include:

-- The sharp increases recently legislated in taxes for social security.

-- The impact of inflation on effective tax rates.

-- The impact of inflationary expectation on consumer and business spending plans.

-- The inequities in the current distribution of the total tax burden.

-- The levelling off in the thrust provided by the economic stimulus program enacted last year.

-- The large drain on our economy of payments for imported fuels.

-- The inadequate rate of business capital formation.

-- The inadequate employment opportunities for important segments of our society, particularly minorities and youth.

-- The slowing in our rate of technological innovation, which threatens the technical supremacy of the American industrial system.

Our basic strategy in overcoming these potential roadblocks rests on three fundamental principles:

-- The enormous strength and vitality of our private sector must be freed from the burden of excessive taxation and unnecessary regulation. As the President stated in his Economic Report, "We should rely principally on the private sector to lead the economic expansion and to create new jobs for a growing labor force."

-- The rise in government spending must be restrained. The more our nation's resources are usurped by government, the less is available for the private economy.

-- Within this restraint, total government spending must be redirected to focus on the major social and economic problems of our society.

The proposed implementation of this strategy is spelled out in the various messages the President has transmitted to the Congress in recent weeks. Central in this strategy is the proposed tax program, which will offset an imminent rise in the burden of taxation and assure a more equitable sharing of the burden.

Prompt tax relief is particularly necessary in light of the recent changes that have been made in social security taxation. To restore the financial integrity of the social security system, which was battered by the severe recession and severe inflation of recent years, and to insure social security benefits for future generations, large infusions of revenues are needed. But the taxes enacted to provide these revenues will represent a significant drain on the current purchasing power of American workers. To sustain an adequate rate of economic growth, the drain of higher social security taxes must be offset by income tax reductions.

In addition to the rise in social security taxes, inflation has been levying a growing but hidden tax. Under our progressive income tax system, inflation pushes individual incomes up the tax rate schedule and into higher tax brackets, resulting in a higher tax toll even though real purchasing power of incomes may remain constant.

The income tax reductions proposed in the President's tax program will offset both the rising social security tax burden and the effects of inflation on effective tax rates. We estimate that for the consumer sector of the economy, the combined drain of social security and incomes taxes -- which together absorb about 14 percent of personal income -- will be about the same in 1979 as it was in 1977. Without the proposed tax cut, the tax drain would rise by about one percentage point.

Most of the proposed income tax relief is directed toward low- and middle-income families. The President is committed to the principle that the net tax reductions should be focused on those individuals who need tax relief the most -- low- and middle-income Americans. Through a combination of substantial tax cuts and needed tax reforms, the Administration's tax program lessens the burden significantly on those individuals who now shoulder a disproportionately large share of the burden of public support while providing lesser relief -- or, in some cases, raising the tax liability --

for those persons who now make use of unjustified tax preferences to escape paying their fair share of taxes. Over 94 percent of the proposed tax relief is provided to families making less than $30,000.

By offsetting the fiscal drags that threaten to reduce consumer purchasing power, the tax program promotes continuation of strong markets for the goods and services produced by American business. In addition, the tax program provides specific encouragement for the business investment that will enable our industrial society to meet expanding demands and provide the tools of production for a growing labor force.

Over the past decade, the growth of our productive capital stock has not kept pace with the expansion of the economy or of its labor supply. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the fourth quarter of 1977 was still 3 percent below its previous peak, reached in the first quarter of 1974.

We are simply not allocating enough of current output to provide the capacity for future growth. Several years ago, a study by the U.S. Department of Commerce concluded that in order to build a capital structure adequate to support a full employment economy by the end of the decade, we would have to allocate at least 12 percent of national output to business fixed investment. In recent years, we have been allocating less than 10 percent of output to investment. The lagging rate of capital growth has impaired our productivity, threatens capacity bottlenecks and price pressures in the years ahead, and fails to provide adequate job opportunities for our growing labor force.

Many factors have combined to restrain the rate of business investment. One of the most important has been the low rate of return on capital. Reported profits do not accurately measure the true return on capital, for conventional accounting practice does not adequately take into account the costs of replacing the capital equipment and inventories used up in production. If the reported figures are corrected for the inflation in these costs, it will be seen that the return on capital has been very depressed in recent years, and is still at levels well below that of the mid 1960's.

The tax program we are proposing addresses directly the urgent need to provide more adequate incentives for investment. The key element is the proposed reduction in the tax rate on corporate incomes -- a reduction of 3 percentage points to become effective on October 1 of this year, and an additional reduction of 1 percentage point on January 1, 1980. Intensive discussions with business leaders from many industries affirm that this form of tax relief will be very beneficial as an incentive for long-term productive investment.

In addition to the reductions in corporate tax rates, we are proposing several modifications of the investment tax credit. By making the present 10 percent rate permanent, rather than reverting to the 7 percent level that is now scheduled to apply after 1980, businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

Further, it is proposed to extend the investment credit to utility and industrial structures. The current ineligibility of structures results in an unbalanced industrial expansion. It should be noted that the extension of the credit is not only for new structures, but also applies to the rehabilitation of existing buildings, to avoid the possibility of an anti-urban bias.

In addition, the eligibility for the full 10 percent investment tax credit would be extended to all pollution control facilities. Also, the ceiling on the extent to which investment credits can generally be used to offset tax liabilities would be raised, from the present ceiling of 50 percent to a new 90 percent of tax liabilities. The extension of the tax liability ceiling should greatly broaden the range of business which can benefit from the investment credit and encourage a broader base for industrial expansion. Finally, a number of specific measures of tax relief for smaller businesses are proposed. Together, this package of proposed tax reductions will provide powerful incentives for business investment, enabling American industry to put into application the latest and most efficient technologies.

Some have argued that the amount of the proposed tax reduction will not be large enough to meet our national

objectives, particularly in reducing unemployment. But the Administration's program does not rely solely on aggregate fiscal policy to address the unemployment problem, which has strong structural characteristics. In particular, unemployment among youth and minorities remains unacceptably high despite the improvement that has occurred in the overall economic environment.

The Budget before you requests funds for specific programs targetted on these major pockets of structural unemployment. These include extension of the public service employment program, more sharply focussed on the long-term unemployed and the disadvantaged, and expansion of programs directed at youth. Importantly, a new initiative is being launched to encourage the involvement of the business sector in local employment and training programs. The Administration recognizes that, for the long-run, private sector job creation is the right answer to our unemployment problems.

Overall, budget requests for employment and training programs total almost $12 billion, 18 percent higher than in 1978, and almost double those of 1977. Thus, a substantial share of our bugetary resources are being focussed on meeting the employment needs of our society.

Countering the concerns of those who fear the tax reduction program might prove inadequate are the concerns of those who fear that with the economy advancing at a vigorous pace, a $25 billion tax reduction would over-stimulate demand and accelerate inflation. This is often coupled with the concern that financing the resultant deficit will impact financial markets adversely, with a resultant rise in interest rates that could negate the stimulus from tax reductions.

Such fears are understandable, but not warranted. The proposed tax reductions have been gauged so that, in aggregate, they offset the scheduled rise in social security taxes and the drag on purchasing power from the inflation impact on effective tax rates. The intent is to maintain the satisfactory growth rate of the economy, not to accelerate activity to an unsustainable pace.

Moreover, the effects of the proposed tax reductions must be evaluated in the context of the entire fiscal program submitted by the President. On the expenditure side of the Budget, the President proposes an increase, in real terms, of only a little over 1 percent, the smallest rise in five years and a third less than the average annual increase in spending in the 1969 to 1976 period. The Federal government's demands on the nation's resources will decline; the ratio of

Federal outlays to GNP will drop from 22.6 percent this year to 22 percent in FY 1979, and decline further in the years ahead.

With this restraint on spending, the $60 billion deficit projected for 1979 does not threaten serious upward pressures on wages, prices or interest rates. We would not, after all, be running a deficit in an overheated economy. With slack still remaining in labor markets, and a substantial margin of industrial capacity still available, a deficit of this order of magnitude in FY 1979 would reflect appropriate tax and expenditure policies.

Financing a deficit of this size should not present serious problems for financial markets. Treasury financing requirements -- in the order of $65 to $70 billion in FY 1978 and FY 1979 -- will represent a smaller share of total credit market flows than in 1975 or 1976, and not much higher than in 1977. It must be remembered that the volume of savings flows grows along with the rise in economic activity -- personal savings alone is expected to rise by almost $20 billion this year -- and we expect that our financial markets will prove attractive to foreign investors. As we gauge the prospective flows of credit demand and supply, we see no basis for concern over the possibility that Treasury financing needs will "crowd out" private sector financing. And the Administration's tight control over Federal spending, along with the initiatives we are taking to reduce the rate of inflation, will alleviate some of the burden on monetary policy.

One very important element of the President's economic program is the effort we are mounting to reduce the rate of inflation. The prudence evident in the President's spending plans is assurance that the government's demands on the nation's resources will not be a source of inflationary pressures. The tax program's strong incentives for investment in new production facilities will reduce the possibilities of shortages or bottlenecks as the economy reaches higher levels of resource utilization. Similarly, the jobs-training and employment opportunity programs proposed in the Budget will develop a reservoir of skills we will need as demand for workers continues to grow.

The President's tax program also includes proposals to reduce excise and unemployment insurance taxes, modest steps but ones that will contribute directly to reducing costs and prices. The development of larger grain reserves will also

contribute to price stability, by providing a buffer against food price changes in the event of bad weather. Legislation has already been submitted to limit the rate of increase in hospital care costs.

A vigorous program is being launched to reduce the burden of government regulations which add unnecessarily to costs and prices. Steps taken this past year have already reduced the number of regulations, and the paperwork burden involved in complying with regulations. The program is being expanded through the development of procedures that encourage regulatory agencies to apply the most cost-effective solutions in accomplishing their regulatory objectives, and by a careful review of the economic justification of major new regulatory proposals. An interagency committee has been established to review the adequacy of the economic analyses underlying such regulations, and to assure that all alternatives have been explored in the search for the least costly means of achieving the objectives. We are also undertaking an assessment of the impact of regulation on the economy as a whole, to find ways of setting priorities among regulatory objectives.

A major element in the Administration's efforts in restraining inflation is a cooperative program with business and labor to lower the rate of wage and price increases. Because this program is voluntary, rather than mandatory or coercive, and because it does not rely on a single standard of wage and price behavior, it has been dismissed by some as ineffective.

Such premature judgments appear based on a lack of understanding of the inflation process, a process in which wages have been vainly chasing prices which have been vainly chasing wages, in an escalating cycle with no one the victor for long. We believe it is possible to reduce the rate of escalation in almost every market, and we intend to work closely with business and labor leaders in every major industry to achieve this.

If we can all cool off in concert, everyone will benefit. Reduction in the rate of inflation will encourage business and consumer spending plans, stabilize financial markets, and improve our ability to compete in international markets. The price deceleration program we are initiating, which

involves a collaboration of government, business and labor, will substitute _ex ante_ consultation for _ex post_ confrontation, and we are confident it will achieve a significant degree of success.

The success of our efforts to promote domestic growth, reduce unemployment and curb inflation depend importantly on maintenance of an open, prosperous, world economy. The continuation of large imbalances in international payments is, however, placing a strain on the international monetary system which threatens a further slowdown in the world economy and resort to trade restrictions.

All nations must cooperate to reduce these payments imbalances, and to increase the world's ability to cope with them. Strong domestic economic growth in major industrial societies is a prerequisite to achieving better international balance. The Administration's economic program will assure that the U.S. remains a source of strength in the world economy. It is important that other strong nations join us in comparable efforts, if we are to sustain economic recovery throughout the industrial world.

The persistence of large international payments imbalances has become a source of disturbance in international exchange markets. Toward the end of 1977, the foreign exchange market became increasingly volatile, and the United States has intervened more forcefully to counter increased market disorder.

Our objective is the limited one of checking speculation and re-establishing orderly conditions. I believe we are making progress in calming the situation.

The measures that have been taken are designed to deal with a particular market situation. They are not a substitute for action to correct the root causes of international trade problems.

For the United States, the trade deficit is not the result of an overheated domestic economy that must be restrained through sharply higher interest rates. It primarily reflects two factors: excessive U.S. dependence on imported oil, and slow growth abroad. The solution lies in implementing a strong U.S. energy policy and in the

restoration of maximum sustainable non-inflationary growth in other countries. World economic recovery and confidence in the dollar will be better served by a dynamic rather than a stagnant U.S. economy.

The Administration's fiscal program will support dynamic growth. But, concomitantly, we must intensify our efforts at reducing the drain on our domestic economy of much-too-high a bill for imported fuels. Prompt enactment of an effective energy policy, one that will enable us to limit our fuel imports as we substitute more abundant, more reliable domestic sources of energy, is undoubtedly the single most important step we can take to reduce our international payments deficit and to assure, for the longer-run, domestic economic growth.

Adjustment of the world's international payments to a better balance cannot be an instantaneous process. In the interim, it is important to ensure that financing facilities are in place to permit orderly adjustment.

Last year agreement was reached--with strong support from the United States--on a major improvement in the world's ability to cope with payments imbalances, through establishment of a $10 billion Supplementary Financing Facility in the IMF. By assuring that adequate official financing is available if needed, this Facility will enable and encourage countries to correct their imbalances in an internationally responsible manner. In promoting a more sustainable international financial system, the Facility will also provide the confidence needed to foster expansionary economic policies in the stronger countries, to spur the business investment essential for sustained growth, and to avoid trade restrictions.

Legislation to provide for U.S. participation is now before Congress. Our share of approximately $1.7 billion represents an appropriate and needed investment in a sound, open world economy. Prompt action by the United States is required to bring the facility into operation, to reduce present uncertainties that are unsettling to markets and to preserve the important U.S. leadership role in the international financial area.

We are consulting closely with the Congress as to the appropriate budgetary treatment of U.S. participation in the

new Facility. We recommend that the Congress authorize budget authority and budget outlays only to the extent of possible exchange losses arising from changes in the dollar value of the SDR because of exchange rate fluctuations. Accordingly, the President's proposed FY 1978 Supplemental Budget request provides for a $200 million contingency reserve to meet such losses.

There is one other Budget item, of critical importance to the international position of the U.S. economy, on which I would like to comment.

In the international area, one of the Administration's highest priorities is the request for funds for the international development banks. These banks represent an extremely effective channel for U.S. assistance to the poorer countries, which are of growing importance to us in both political and economic terms. They assure full burden-sharing by other donor countries, who now contribute $3 for every $1 contributed by the United States. They represent an extremely effective instrument for improving overall North-South relations, because they engender true partnership among the developed and developing countries. They support basic human needs around the world, promote international respect for human rights and increase world production of food and energy.

We are asking for $3.5 billion for the banks in FY 1979. However, nearly $1.4 billion of our request is for callable capital. Unlike paid-in capital, which entails a budgetary outlay, callable capital does not; it serves simply as backing for the borrowing operations of the banks, whose loans are financed through their own borrowings from the private capital markets. Our capital would be called only if needed to cover a default by one of the banks on a bond issue, which has never happened in the past and is extremely unlikely to happen in the future.

In addition, $835 million of our request represents past unfunded appropriations of amounts previously authorized by the Congress. Our failure to make good on these pledges has reduced the level of funds available to the developing countries, forced other donor countries to assume higher shares in the banks than they had accepted in good faith negotiations and, most importantly, jeopardized the overall international credibility of the United States. The

Administration considers it essential that this particular portion of our request be made available to the development banks this year.

Let me summarize, Mr. Chairman, by noting that the economic program proposed by the President will make possible solid progress towards achieving our goals of steady growth, reduction in unemployment, fuller utilization of industrial capacity, and strengthened international confidence in the U.S. economy. Our projections indicate that, with this program, there will be five million additional persons employed by the fourth quarter of 1979. Moreover, about 700 thousand fewer persons will be faced with the frustrating experience of being unable to find meaningful work; the overall unemployment rate will drop to about 5-3/4 percent. Real gross national product will be almost 10 percent above fourth quarter 1977 levels, and real disposable personal income per capita will be about 8 percent higher.

By emphasizing expenditure restraint, and relying on tax reductions to promote growth, the Budget puts us on a path that will permit a balanced budget in the future, as we achieve a high-employment economy. Under this Budget, the share of GNP absorbed by the Federal government would decline. This will permit an increase in the share of our national output to be devoted to the private sector's decisions, and particularly to fixed investment--the basis for increased productivity and expanded future consumption. This can be accomplished without accelerating inflationary pressures.

I trust you will agree that the Administration's program represents a balanced, effective response to the nation's major social and economic needs. I will be happy to respond to any questions you may have.

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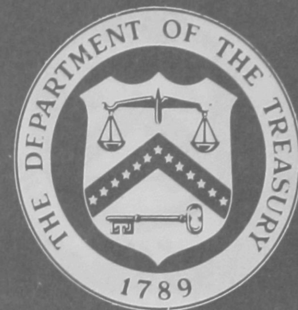

FOR IMMEDIATE RELEASE February 1, 1978

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,106 million of 52-week Treasury bills to be dated February 7, 1978, and to mature February 6, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS: (Excepting 1 tender of $2,000,000)

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	93.125	6.799%	7.27%
Low -	93.097	6.827%	7.30%
Average -	93.110	6.814%	7.29%

Tenders at the low price were allotted 62%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS AND TREASURY:

Location	Received	Accepted
Boston	$ 86,345,000	$ 61,345,000
New York	4,404,685,000	2,285,385,000
Philadelphia	31,020,000	31,020,000
Cleveland	120,535,000	104,535,000
Richmond	29,560,000	27,560,000
Atlanta	18,615,000	15,615,000
Chicago	320,725,000	204,225,000
St. Louis	33,945,000	6,445,000
Minneapolis	61,610,000	56,610,000
Kansas City	11,680,000	10,680,000
Dallas	5,220,000	4,220,000
San Francisco	391,550,000	296,550,000
Treasury	1,330,000	1,330,000
TOTAL	$5,516,820,000	$3,105,520,000

The $3,106 million of accepted tenders includes $ 78 million of noncompetitive tenders from the public and $755 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 $143 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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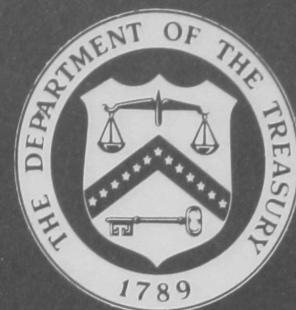

FOR IMMEDIATE RELEASE February 1, 1978

RESULTS OF AUCTION OF 7-YEAR 8% NOTES

The Department of the Treasury has accepted $3,000 million of the $4,856 million of tenders received from the public for the 7-year 8% notes, Series A-1985, auctioned today. The range of accepted competitive bids was as follows:

		Price	Approximate Yield
High	-	100.80 1/	7.85%
Low	-	100.58	7.89%
Average	-	100.65	7.88%

The $3,000 million of accepted tenders includes $1,126 million of noncompetitive tenders and $1,874 million of competitive tenders (including 40 % of the amount of notes bid for at the low price) from private investors.

In addition, $1,200 million of tenders were accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for securities maturing February 15, 1978.

1/ Excepting 1 tender of $10,000

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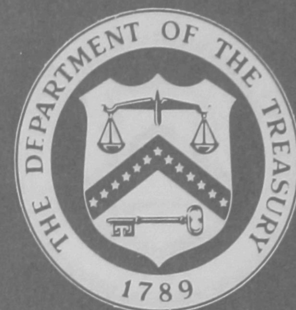

FOR IMMEDIATE RELEASE February 2, 1978

RESULTS OF AUCTION OF 27-1/4-YEAR TREASURY BONDS
AND SUMMARY RESULTS OF FEBRUARY FINANCING

The Department of the Treasury has accepted $1,250 million of the $3,377 million of tenders received from the public for the 27-1/4-year 8-1/4% Bonds of 2000-2005, auctioned today. The range of accepted competitive bids was as follows:

	Price	Approximate Yield To First Callable Date	Approximate Yield To Maturity
High -	100.73	8.17%	8.18%
Low -	100.01	8.24%	8.25%
Average -	100.13	8.23%	8.23%

The $1,250 million of accepted tenders includes $ 159 million of noncompetitive tenders and $1,091 million of competitive tenders (including 76% of the amount of bonds bid for at the low price) from private investors.

In addition, $ 771 million of tenders were accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for securities maturing February 15, 1978.

SUMMARY RESULTS OF FEBRUARY FINANCING

Through the sale of the three issues offered in the February financing, the Treasury raised approximately $2.0 billion of new money and refunded $8.4 billion of securities maturing February 15, 1978. The following table summarizes the results:

	New Issues						
	7-1/2% Notes 5-15-81	8% Notes 2-15-85	8-1/4% Bonds 5-15-00-2005	Nonmar-ketable Special Issues	Total	Maturing Securities Held	Net New Money Raised
Public	$2.5	$3.0	$1.3	$ -	$ 6.8	$ 5.0	$ 1.7
Government Accounts and Federal Reserve Banks	1.0	1.2	0.8	0.4	3.4	3.4	-
Foreign Accounts for Cash	.3	-	-	-	0.3	-	0.3
TOTAL	$3.8	$4.2	$2.0	$ 0.4	$10.4	$ 8.4	$ 2.0

Details may not add to total due to rounding.

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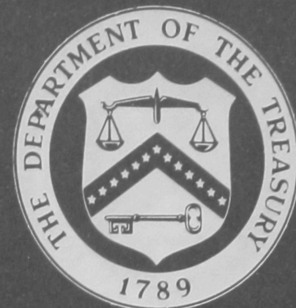

FOR IMMEDIATE RELEASE February 2, 1978

H. DAVID ROSENBLOOM APPOINTED
INTERNATIONAL TAX COUNSEL

Secretary of the Treasury W. Michael Blumenthal today announced the appointment of H. David Rosenbloom as International Tax Counsel and Director of the Office of International Tax Affairs.

Mr. Rosenbloom, 36, has been Special Assistant to the Deputy Assistant Secretary for Tax Policy since July 1977. Prior to joining Treasury, Mr. Rosenbloom had been a partner in the Washington law firm of Caplin & Drysdale since 1972 and an Associate with the firm since 1968. From 1967 to 1968, he was law clerk to Justice Abe Fortas and from 1966 to 1967, he was special assistant to U. S. Ambassador to the United Nations Arthur J. Goldberg.

As International Tax Counsel, Mr. Rosenbloom will be the principal legal advisor to the Assistant Secretary for Tax Policy in the formulation of policy, legislation, and regulations on international tax matters, including the taxation of foreign source income of U. S. taxpayers, the taxation of foreigners receiving income from U. S. sources, and the prevention of international tax evasion. The Office of International Tax Counsel is one of four major units under the Assistant Secretary for Tax Policy. The other units are the Office of Tax Legislative Counsel, which has similar responsibilities for domestic tax matters; the Office of Tax Analysis; and the Office of Industrial Economics.

As Director of the Office of International Tax Affairs, Mr. Rosenbloom will be responsible for the Treasury Department's income and estate tax treaty program and for the participation of the Treasury Department in the activities of the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD). The Office of International Tax Affairs was established in March 1976 to provide a focal point for the handling of international tax matters. Personnel for the Office consist of lawyers in the Office of International Tax Counsel and international economists in the Office of Tax Analysis.

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A native of New York City, Mr. Rosenbloom received the A.B. degree Summa Cum Laude from Princeton University in 1962, having spent his junior year at the Sorbonne in Paris. He attended the University of Florence on a Fulbright scholarship in 1962-63. In 1966, Mr. Rosenbloom graduated from Harvard Law School, receiving the J.D. degree Magna Cum Laude and serving as president of the Harvard Law Review.

Mr. Rosenbloom was consultant to the Ford Foundation in 1971 on a project involving corporate social responsibility, and was co-author with Bevis Longstreth of a report, "Corporate Social Responsibility and the Institutional Investor," which was published in 1973.

Mr. Rosenbloom is married to the former Carla L. Peterson, of Amherst, Massachusetts. They have a daughter, Sarah Alix, and reside in Washington, D. C.

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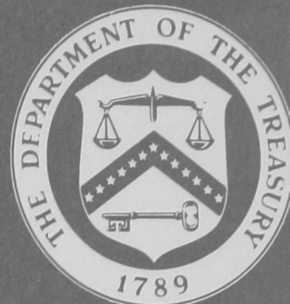

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
February 6, 1978

TESTIMONY OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to assist you in your consideration of the public debt limit. The present temporary debt limit of $752 billion will expire on March 31, 1978, and the debt limit will then revert to the permanent ceiling of $400 billion. Legislative action by March 31 will be necessary, therefore, to permit the Treasury to borrow to refund securities maturing after March 31 and to raise new cash to finance the estimated deficits in the budget, as submitted to Congress by the President last month.

In addition, to permit the Treasury to continue borrowing in the long-term market, it will be necessary to increase the $27 billion limit on the amount of bonds which we may issue without regard to the 4-1/4 percent interest rate ceiling on Treasury bond issues.

Finally, we are repeating our earlier request for authority to permit the Secretary of the Treasury, with the approval of the President, to change the interest rate on U.S. Savings Bonds if that should become necessary to assure a fair rate of return to savings bond investors.

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Debt Limit

Turning first to the debt limit, our estimates of the amounts of debt subject to limit at the end of each month through the fiscal years 1978 and 1979 are shown in the attached table. The table indicates that the debt subject to limit will increase to $778 billion on September 30, 1978, and to $868 billion on September 30, 1979, assuming a $12 billion cash balance on those dates. These are the debt estimates and cash balances assumptions included in the President's January budget proposals. The usual $3 billion margin for contingencies would raise these amounts to $781 billion on September 30, 1978, and $871 billion on September 30, 1979. Thus the present debt limit of $752 billion would need to be increased by $29 billion to meet our financing requirements through the remainder of fiscal 1978 and by an additional $90 billion to meet the requirements in fiscal 1979.

Our $781 billion estimate of the debt subject to limit on September 30, 1978 (which includes the $3 billion margin for contingencies) is $6 billion higher than the $775 billion approved in the second concurrent resolution on the Federal budget for fiscal year 1978, which was adopted by Congress on September 15, 1977.

The $90 billion increase in FY 1979 reflects the Administration's current estimates of a fiscal 1979 unified budget deficit of $60.6 billion, a trust fund surplus of $13.9 billion, and a net financing requirement for off-budget entities of $12.5 billion. The trust fund surplus must be reflected in the debt requirement because the surplus is invested in Treasury securities which are subject to the debt limit.

The relevant debt of off-budget entities consists largely of obligations which are issued, sold or guaranteed by Federal agencies and financed through the Federal Financing Bank. Since the Federal Financing Bank borrows from the Treasury, we are required to increase our borrowing in the market by a corresponding amount. This, of course,

adds to the debt subject to limit.

Bond Authority

I would like to turn now to our fiscal 1979 need for an increase in the Treasury's authority to issue long-term securities in the market without regard to the 4-1/4 percent statutory ceiling on the rate of interest which may be paid on such issues. To meet our requirements next year, the Treasury's authority to issue bonds (securities with maturities over 10 years) should be increased by $10 billion from the current ceiling of $27 billion to $37 billion.

The 4-1/4 percent ceiling predates World War II but did not become a serious obstacle to Treasury issues of new bonds until the mid-1960's. At that time, market rates of interest rose above 4-1/4 percent, and the Treasury was precluded from issuing new bonds.

In 1971, Congress authorized the Treasury to issue up to $10 billion of bonds without regard to the 4-1/4 percent ceiling. This limit has since been increased a number of times, and in the debt limit act of October 4, 1977, it was increased from $17 billion to the current level of $27 billion.

The Treasury to date has used almost $20 billion of the $27 billion authority, including the $1-1/4 billion bond auctioned last week, which leaves the amount of unused authority at about $7 billion. While the timing and amounts of future bond issues will depend on prevailing market conditions, a $10 billion increase in the bond authority would permit the Treasury to continue its recent pattern of bond issues throughout fiscal year 1979. Thus, the Treasury would be able to make further progress toward achieving a better balance in the maturity structure of the debt and re-establishing the market for long-term Treasury securities. We believe that such flexibility is essential to efficient management of the public debt.

Savings Bonds

In recent years, Treasury has recommended frequently that Congress repeal the 6 percent ceiling on the rate of interest that the Treasury may pay on U.S. Savings Bonds. Prior to 1970 the ceiling had been increased many times, but the current 6 percent statutory ceiling was enacted by Congress in 1970. As market rates of interest rose, it became clear that an increase in the savings bond interest rate was necessary to provide investors in savings bonds with a fair rate of return.

Mr. Chairman, we do not feel that an increase in the interest rate on savings bonds is necessary today. Yet, we are concerned that the present requirement for legislation to cover each increase in the rate does not provide sufficient flexibility to adjust the rate in response to changing market conditions. The delays encountered in the legislative process could result in inequities to savings bond purchasers and holders as market interest rates rise on competing forms of savings.

Furthermore, Treasury relies on the savings bond program as an important and relatively stable source of long-term funds. On that basis, we are concerned that participants in the payroll savings plans and other savings bond purchasers might drop out of the program if the interest rate were not maintained at a level reasonably competitive with comparable forms of savings.

Any increase in the savings bond interest rate by the Treasury would continue to be subject to the provision in existing law which requires approval of the President. Also, the Treasury would, of course, give very careful consideration to the effect of any increase in the savings bond interest rate on the flow of savings to banks and thrift institutions.

Debt Limit Procedure

Mr. Chairman, I would also like take this opportunity to suggest that your Committee consider a more effective procedure for controlling the size of the public debt.

We do not think that the present statutory debt limit is an effective way for Congress to control the debt. In fact, the debt limit may actually divert public attention from the real issue -- control over the Federal budget. The increase in the debt each year is simply the result of earlier decisions by the Congress on the amounts of Federal spending and taxation. Consequently, the only way to control the debt is through firm control over the Federal budget. In this regard, the Congressional Budget Act of 1974 greatly improved Congressional budget procedures and provided a more effective means of controlling the debt. That Act requires Congressional concurrent resolutions on the appropriate levels of budget outlays, receipts, and public debt. This new budget process thus assures that Congress will face up each year to the public debt consequences of its decisions on taxes and expenditures.

Moreover, the statutory limitation on the public debt occasionally has interfered with the efficient financing of the Federal Government and has actually resulted in increased costs to the taxpayer. For example, when the temporary debt limit expired on September 30, 1977, and new legislation was not enacted on the new debt limit until October 4, Treasury was required, in the interim to suspend the sale of savings bonds and other public debt securities. The suspension of savings bonds sales, in particular, resulted in considerable public confusion, and indignation, as well as additional costs to the Government. The cost of printing and distributing notifications to about 40,000 savings bonds issuing agents was $16,775. A much greater, but incalculable, cost is the loss of public confidence in the savings bond program and in the management of the government's finances.

Accordingly, we believe that the public debt would be more effectively controlled and more efficiently managed by tying the debt limit to the new Congressional budget process. We simply put this proposal on the table, Mr. Chairman, for you and the other members of the subcommittee to consider in the hope that we can work together to devise a more acceptable way to control the debt.

I will be happy to try to answer questions.

OoO

PUBLIC DEBT
SUBJECT TO LIMITATION
FISCAL YEAR 1978
Based on: Budget Receipts of $400 Billion,
Budget Outlays of $462 Billion,
Unified Budget Deficit of $62 Billion,
Off-Budget Outlays of $12 Billion

($ Billions)

	Operating Cash Balance	Public Debt Subject to Limit	With $3 Billion Margin for Contingencies
1977		-Actual-	
September 30	$19.1	$700.0	
October 31	7.7	698.5	
November 30	5.5	709.1	
December 31	12.3	720.1	
1978			
January 31	12.5	722.7	
		-Estimated-	
February 28	12	738	741
March 31	12	747	750
April 19	12	750	753
April 30	12	740	743
May 31	12	753	756
June 21	12	753	756
June 30	12	746	749
July 31	12	756	759
August 31	12	772	775
September 30	12	778	781

PUBLIC DEBT
SUBJECT TO LIMITATION
FISCAL YEAR 1979
Based on: Budget Receipts of $440 Billion,
Budget Outlays of $500 Billion,
Unified Budget Deficit of $61 Billion,
Off-Budget Outlays of $12 Billion

($ Billions)

	Operating Cash Balance	Public Debt Subject to Limit	With $3 Billion Margin for Contingencies
		-Estimated-	
1978			
September 30	$12	$778	$781
October 31	12	789	792
November 30	12	801	804
December 31	12	806	809
1979			
January 31	12	809	812
February 28	12	824	827
March 31	12	837	840
April 18	12	841	844
April 30	12	828	831
May 31	12	846	849
June 20	12	852	855
June 30	12	839	842
July 31	12	848	851
August 31	12	864	867
September 30	12	868	871

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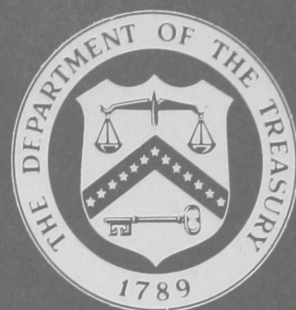

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STATEMENT OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
ON
THE PRESIDENT'S TAX PROGRAM
BEFORE THE COMMITTEE ON WAYS AND MEANS
WASHINGTON, D.C.

Mr. Chairman and members of this distinguished Committee:

I am pleased to appear before you today to discuss one of the President's highest legislative priorities for 1978--a significant revision of our Nation's tax laws. Last year, the Administration thoroughly studied the present tax system. The President himself had extensive personal involvement. This study reaffirmed our view that the tax system should be made more equitable and simpler for the average taxpayer.

In recent months, it has become apparent that tax reform should be combined with substantial tax reductions. The continued growth of the economy requires tax cuts to sustain the purchasing power of individuals. And businesses must have adequate incentives and resources to modernize facilities and to create permanent jobs for American workers.

Therefore, the President submitted to Congress on January 21 a tax package that will attain three overall goals: tax reduction for individuals, improvement of the tax structure, and increased incentives for business investment. The specific proposals to secure these objectives are closely interrelated: the gross tax cuts of $34 billion are partially financed by $9 billion in revenue-raising structural changes. Enactment of the tax reductions and incentives without the structural changes would result in an excessive drain on tax revenues and a serious distortion in the allocation of the tax burden. For this reason, the President offers his proposals in the form of a balanced tax program, and we urge Congress to consider these recommendations as an integrated package.

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The President's tax package consists of the following elements:

-- Net income tax reductions for individuals of $16.8 billion, comprising gross tax cuts of $23.5 billion and revenue-raising structural changes of $6.8 billion.

-- Net income tax reductions for businesses of $5.7 billion, reflecting gross business cuts of $8.3 billion combined with $2.6 billion of structural reform.

-- Excise and payroll tax reductions of $2.0 billion.

This program will achieve major structural reform, but we have not attempted to correct all the inequities nor to simplify all the complications in the Code. What we seek through the President's proposals is enactment of structural changes that are urgently needed, but will not disproportionately consume the time of the Committee. It is critical that a program of tax reform and reduction be passed in 1978, and we have devised a tax package that reflects the importance of expeditious action. Most of the reforms involve provisions with which this Committee is familiar; and, in fact, many of the Administration's recommendations have been approved by the Committee in recent Congressional sessions. We believe our tax package can be fully considered and adopted this year.

The remainder of my statement will outline the principal features of the package. A detailed technical explanation is being submitted for the convenience of the Committee and other witnesses. In addition, I have attached to this statement exhibits that contain revenue estimates and other statistical data.

THE IMPORTANCE TO THE ECONOMY OF A BALANCED PROGRAM OF TAX REDUCTIONS AND STRUCTURAL CHANGES

The economic importance of the tax program is emphasized after a review of our economy's recovery to date. When the President assumed office one year ago, our Nation's economy was making only a halting recovery from recession. The unemployment rate for December 1976 was 7.8 percent, with 7.5 million Americans out of work. In 1976, the economy operated at approximately $120 billion below its high employment potential.

After surveying the economic situation in January 1977, the President offered a two-year economic recovery package as one of his first official acts. Enactment of that stimulus program has had a favorable impact on economic conditions. The unemployment rate dropped almost 1-1/2 points during 1977 to a level of 6.4 percent as of the end of the year. Over four million more people are employed now than were employed one year ago, and a record 58 percent of the working age population now holds jobs. The real gross national product--the Nation's combined output of goods and services, adjusted for inflation--has grown at a rate of 5-3/4 percent from the fourth quarter of 1976 to the fourth quarter of 1977.

For the most part, the economic performance for 1977 has been encouraging. Nevertheless, an unemployment rate of 6.4 percent is still too high. This Administration will not be satisfied as long as millions of Americans are jobless and billions of dollars of productive capacity of the business sector remain idle. It is imperative that steady economic recovery be sustained.

However, there are impending forces that threaten the recovery. In 1979, social security tax liabilities will be increased over 1977 levels by $4 billion due to previously scheduled rate increases and by an additional $7 billion due to changes enacted in 1977. Many individuals also face the prospect of bearing an "automatic" income tax increase, as inflation pushes taxpayers into higher rate brackets even though real purchasing power of incomes may remain constant. A combination of these and other tax increases would cause Federal receipts to assume an unacceptably large share of our Nation's gross national product. The result would be a significant slowdown in economic growth toward the end of this year, with the rate of real growth falling to about 3-1/2 percent in 1979. Unemployment would remain above 6 percent and, by the end of 1979, would be moving upward.

These developments must be averted by sound fiscal policy. The President has submitted a budget for fiscal year 1979 that will reduce the ratio of Federal spending to the gross national product from 22.6 percent to 22 percent. This Administration is determined to release sufficient resources through income tax reductions to enable the private sector to take the lead in sustaining a strong economic recovery.

Therefore, a carefully fashioned, net tax reduction of $25 billion is the centerpiece of the Administration's economic program. These tax cuts will maintain consumer purchasing power by offsetting both the scheduled social security tax increases and the impact of inflation on effective tax rates. The ratio of personal taxes and employee and self-employed social security taxes to personal income in 1979 will be brought down to the 1977 level, 14 percent. Without the proposed tax cut, the ratio would rise at least 1 full percentage point. At the same time, business tax reductions will provide incentives for investment to meet expanding demand and to furnish the tools of production for a growing labor force.

Together with the programs outlined in the President's Budget Message, this tax package should assure that our economy will grow at a 4-1/2 to 5 percent pace through 1979, with unemployment declining to about 5-3/4 percent by the end of 1979. Five million new jobs will be created--about one million more than would be created in the absence of a tax cut.

Yet, in fashioning a tax program that ensures steady and sustainable economic growth, we have been wary of providing excessive "stimulus." Enlarging the net reduction substantially beyond the $25 billion level would put at serious risk the balanced, steady character of our economic recovery. The average recovery in the postwar period has lasted four years and has typically been destroyed by the appearance of rapid inflation or radical imbalances between the various sectors or elements in the economy. We are now in the third year of this recovery; and, as I have indicated, it is proceeding in a remarkably smooth and balanced fashion. We have experienced solid economic growth. There has been a steady reduction in the rate of unemployment. The inflation rate, while far too high, is not accelerating.

If the recommended net tax cut were significantly increased, an appropriate economic balance might well be upset. Private sector confidence in our ability to manage the Federal budget would be eroded, for we could make no progress in reducing the deficit. Financial markets would tighten, thereby blunting the effects of our proposed tax incentives for job-creating investments and injuring the housing sector. Finally, we would damage our chances of getting better control over inflation. A $25 billion tax cut is required to maintain the momentum of economic recovery, but the risks associated with a larger net tax reduction are simply not worth taking.

PROPOSALS TO PROVIDE A TAX SYSTEM THAT IS MORE EQUITABLE, SIMPLER, AND LESS BURDENSOME FOR INDIVIDUALS

Although the tax program is a central element of this Administration's economic policy for the years ahead, it should not be assessed solely in macroeconomic terms. In devising the program--both reductions and structural changes--we have kept in sharp focus the tax system's impact on individual taxpayers. That system directly involves 130 million Americans annually in a process that has an important bearing not only upon their financial well being, but also upon their perception of the quality of the Federal government.

Unlike some systems in which a government determines the amount of tax due and sends the taxpayer a bill, the first formal determination of income tax liability occurs when an individual files his tax return. The withholding system and IRS auditing procedures assist the tax collection process. But in the end, the tax structure relies upon the honesty, trust, and diligence of individual citizens who are asked to calculate their share of the burden of public support.

In many ways, the tax system reflects our highest national ideals. It represents the active participation of Americans in the affairs of their government. And it reflects a mutual trust between that government and its citizens.

However, if our system of self-assessment is to remain successful, it is essential that the tax structure be considered fair by taxpayers and that average Americans understand how their tax liability is computed. Accordingly, our tax program has been structured to address the important needs of individual taxpayers:

-- The tax system should not claim too large a share of personal incomes; incentives to work and invest must not be impeded by an onerous tax burden.

-- The income tax burden should be allocated fairly among taxpayers. Individuals with similar levels of income should have similar tax liabilities, and the proportionate tax burden should vary among income classes in accordance with ability to pay.

-- Tax calculations and return preparation should be comprehensible for average taxpayers.

I. REDUCING THE TAX BURDEN FOR INDIVIDUALS

The President recommends a gross tax reduction for individuals of $23.5 billion, with offsetting structural reforms of $6.8 billion. When both the reductions and reforms are considered, the typical family of four at the $20,000 income level will save $270, a 12.4 percent reduction in income tax liability. Commencing October 1, 1978, that family's withholding rates will be reduced so that it will then experience an increase in take-home pay and purchasing power.

The recommended tax reduction is needed to maintain the standard of living of American taxpayers. Without an income tax cut, scheduled increases in the social security tax will reduce the take-home pay of workers. In 1979, the family of four with one earner at the $20,000 income level will bear an additional payroll tax liability of $261 due to the combination of social security tax increases enacted prior to this Congress and the financing package that was enacted last year. I commend the members of this Committee for facing up to the challenge of restoring the financial integrity of the social security system; large infusions of revenue were urgently needed to ensure social security benefits for future generations. Congress determined to accomplish that objective entirely through the payroll tax. Consequently, unless income taxes are reduced, payroll tax increases will drain purchasing power of American workers, stall the economic recovery, and impose a very onerous burden on low and middle-income families.

The President's tax program will provide the necessary tax relief. For most taxpayers, there will be a net reduction in combined income and payroll tax liability through 1979 even after the scheduled social security tax increases are considered. Tables 1 and 2 compare the combined income and FICA taxes under 1977 law and the proposed law for 1978 and 1979. Included in the calculations are the FICA tax increases resulting from legislation enacted prior to 1977 as well as the increases contained in the Social Security Amendments of 1977. The tables assume a four person, one-earner family with wage income at various levels. Our recommended income tax cuts will completely offset the increase in social security taxes for families with wage income up to $25,000 in 1978 and $20,000 in 1979. A substantial offset will result even above those levels. Only 16 percent of families have wage income of more than $25,000 a year and 23 percent have wage income of more than $20,000 a

year. Tables 3 and 4 present similar information for a four person, two-earner family, assuming that each spouse earns one-half of total family income; under these assumptions, the proposed income tax reductions for 1978 and 1979 will offset the social security tax increase up to $30,000 of total family income.

In proposing this substantial income tax relief, the Administration recommends a more equitable allocation of the tax burden. The President is committed to the principle that the net tax reductions should be focused on those individuals who need tax relief the most--low and middle-income Americans. Through a combination of substantial tax cuts and needed reforms, the Administration's program: provides sizable tax reductions for low and middle-income individuals who now shoulder a disproportionately large portion of the burden of public support; lowers taxes for most high-income taxpayers as well; and raises the tax liability of some persons who now use unjustified tax preferences to escape paying their fair share of taxes.

Over 94 percent of the income tax relief is provided to families making less than $30,000, but typical families in every income class through $100,000 will experience a tax cut. The net tax reductions are proportionately largest at the low end of the income scale. For example, families earning between $5,000 and $10,000 will have their taxes reduced by 22.6 percent. The percentage reduction is 9.7 percent for the $20,000 to $30,000 income class. In the income classes over $100,000, some persons will have a tax reduction while those now using tax preferences may have an increase; overall for this group, the tax program will result in a modest tax increase of 3.7 percent. Stated in dollar terms, the typical family earning $20,000 a year will save $270 in taxes; on the average, a family at the $100,000 income level will pay $590 more.

In short, the Administration's tax package will reduce the share of the total income tax burden for each income class through $30,000, thereby resulting in a decrease from 60.8 percent to 57.6 percent in the aggregate individual income tax liability that falls on those low and middle-income taxpayers. Under current law, the effective rates of tax range from 0.2 percent for individuals with incomes under $5,000 to 30.0 percent for persons making over $200,000 annually. The tax program will have the effect of reducing effective tax rates for all income classes through $100,000, with a new range of effective tax rates from -0.4 percent (reflecting the refundable earned income credit) to 31.7 percent.

Rate Cuts

The gross tax reduction for individuals will be accomplished primarily through a sizable cut in tax rates that will benefit every taxpayer. The proposed rate schedule for joint returns will range from a tax bracket of 12 percent for the first $1,000 of taxable income to a rate of 68 percent on taxable income exceeding $200,000. (These taxable income figures and all others I will discuss do not include the "zero bracket amount.") For single taxpayers, the 12 percent rate will apply to the first $500 of taxable income and the 68 percent rate to taxable income over $100,000. The present rate schedule covers a 14 percent to 70 percent span. A comparison of the old and new schedules is contained in Tables 5 and 6.

This new rate schedule will provide the largest rate cuts in the middle-income brackets. For example, the marginal rate for each taxable income bracket from $12,000 through $24,000 on a joint return will be reduced by 5 percentage points whereas the marginal rates in income brackets above $44,000 are generally reduced only 1 or 2 percentage points. Nevertheless, high-income taxpayers will also derive substantial benefits from these rate cuts--benefits that must be borne in mind when assessing the impact of the per capita credit proposal and the recommendations that will broaden the income base subject to taxation.

Per Capita Tax Credit

As a part of the substantial tax relief provided to low and middle-income families, we propose a new tax credit of $240 for each dependent. This credit will replace the current $750 exemption for each family member and the general tax credit, which is now equal to the greater of $35 per dependent or 2 percent of the first $9,000 of taxable income. The existing tax benefits for family members vary directly in proportion to income level. A family of four in the 50 percent tax bracket now enjoys a tax savings of $1,680 for dependents while a family earning $10,000 saves about one-third of that amount. By contrast, the $240 credit will provide a tax savings of $960 to a four-member family regardless of income level. Due in large part to the new credit, the tax-free level of income for a family of four will rise to $9,256 under the tax program as compared to $7,200 under current law.

Although the per capita credit is being proposed in combination with a restructuring of tax rates, it may be helpful for the Committee to know the credit's "break-even level" if presented as an isolated change. For a four-person family with less than $20,200 of income, the new $240 credit will provide greater tax savings than the existing personal exemption and general tax credit, assuming no changes were made in the tax rate schedule. At that level of income, the family is neither better off nor worse off. The tax would be $2,580 under either the $240 credit or under existing law.

	Current Law	Proposed Law (assuming current law rate schedule)
Adjusted gross income	$20,200	$20,200
Less personal exemptions	3,000	--
Taxable income*/	17,200	20,200
Tax before credits	2,760	3,540
General tax credit	180	--
Per capita credit	--	960
Tax after credits	$2,580	$2,580

I want to emphasize, however, that families above $20,200 of income are not going to be worse off under the Administration's proposal. The proposed rate schedules have been designed to offset the tax increases that would occur at high income levels if a $240 credit simply replaced the existing personal exemption and general tax credit. What we achieve with the $240 credit and the new rate schedule are:

*/ The example assumes the taxpayer has no itemized deductions in excess of the zero bracket amount. If the taxpayer had average itemized deductions equal to 23 percent of income, the break-even point would be $22,078 of income.

Equity--the credit for family members is worth the same regardless of the family's level of income; and

Simplification--one credit will replace the existing combination of a deduction and alternative credits.

And these improvements in the tax system are accomplished without providing tax increases for families above the so-called break-even level.

Adoption of the per capita credit will also facilitate additional tax reductions the President may recommend to adjust for Congressional action on the National Energy Plan. In April, the President proposed that Congress pass the crude oil equalization tax and rebate the proceeds to the American people on a per capita basis. This action is essential if we are to protect the real incomes of consumers. If the final energy bill includes the full rebate of the net proceeds of the crude oil tax, no further Presidential action will be required. However, if the final bill contains a rebate provision only for 1978--as provided in the House version--the President intends to recommend that the individual tax reductions proposed in his message to Congress be increased by the net proceeds of the crude oil tax.

II. TAX EQUITY AND SIMPLIFICATION FOR INDIVIDUALS

The rate cuts and the per capita credit I have described will help achieve a more equitable and simpler tax structure. But those tax changes cannot stand alone. The $23.5 billion of tax relief provided by these measures would have to be scaled down considerably in the absence of revenue-raising structural changes. Steady, noninflationary economic growth can be sustained only if we keep the net revenue loss of the entire package--including individual and business reductions--at approximately $25 billion.

The structural changes are focused in part on serious inequities in the tax laws. Without such changes, tax relief simply cannot be focused effectively on those persons who are now bearing a disproportionately heavy tax burden--especially middle-income taxpayers. A tax program that provides large-scale relief to taxpayers would be inequitable if the benefits were fully shared by those already avoiding payment of their fair share of tax liability.

The proposed tax cuts are also closely interrelated with the Administration's efforts to promote tax simplification. For many middle-income persons, the major source of complexity in the tax laws relates to itemized deductions. Average Americans are forced to assemble detailed records for tax purposes and to grapple with complicated tax forms and instructions in order to prepare a schedule for itemized deductions.

Changes in itemized deductions are essential if the tax system is to be simplified for middle-income taxpayers. We are recommending such changes. But we are also recommending substantial rate reductions in the middle-income classes--cuts ranging from 3 to 5 percentage points in each taxable income bracket from $8,000 through $44,000--that will more than offset the tax increases that would otherwise result from the proposed itemized deduction changes.

Changes in Itemized Deductions

The Administration's proposals continue the simplification efforts that began last year. In the Tax Reduction and Simplification Act of 1977, Congress worked with the Administration to enact changes in the standard deduction that have increased the percentage of nonitemizers from 69 percent to 77 percent. We now recommend additional steps that will increase the percentage of nonitemizers still further, to 84 percent of all individual taxpayers. The changes we propose will enable over 6 million Americans to switch to the simple, flat standard deduction that was recently enacted and thereby avoid vexing recordkeeping requirements.

These proposals can accomplish drastic tax simplification without creating significant controversy. The recommended changes curtail deductions that add complexity and inequity to the tax system without advancing major objectives of public policy.

(1) State and Local Taxes. The special deduction will be eliminated for general sales taxes, personal property taxes, gasoline taxes, and miscellaneous taxes but retained for State and local income and real property taxes. Most itemizers determine the amount of deductions for their State sales and gasoline taxes by reference to published tables that provide nearly uniform deductions and result in a relatively small tax benefit. Due to the fact that the tax benefit is so

slight for itemizers and the fact that there is no benefit at all for the 77 percent of individuals claiming the standard deduction, deductibility is not a major factor for State and local governments in determining the rate of tax to impose.

This Committee has already voted in connection with the energy bill to eliminate the deduction for gasoline taxes--a decision supported by the recognition that the deduction runs counter to our national goal to conserve energy. We propose that the Committee renew that decision and also terminate the deduction for general sales taxes, personal property taxes, and miscellaneous taxes.

(2) Political Contributions. We also recommend simplification of the present confusing scheme of deductions and credits for political contributions. Under current law, a taxpayer can elect to claim an itemized deduction for the first $200 of contributions. In lieu of the deduction, he may claim a credit for one-half of his political contributions, with a maximum credit of $50. We propose that the political contribution deduction be repealed while the credit is retained. As a result, whatever incentive a tax subsidy provides for political contributions will be equally available to itemizers and nonitemizers and will not rise with the income level of the taxpayer.

(3) Medical and Casualty Expenses. Twelve lines on Schedule A for Form 1040 are devoted to computation of the deduction for medical and dental expenses. The form reflects a tax provision that is unnecessarily complicated and that results in recordkeeping and record-searching burdens for millions of taxpayers. Currently, one-half of the first $300 of health insurance premiums is deductible outright for those who itemize. Other medical expenses are deductible to the extent they exceed 3 percent of adjusted gross income, with this latter category of deductibility including the remaining portion of health insurance premiums and medicines and drugs in excess of 1 percent of adjusted gross income.

Another six lines on Schedule A relate to a deduction for damage to property from a casualty, such as a theft or fire. A casualty loss may be deducted only if it exceeds $100 and is not reimbursed by insurance.

We propose that the deductions for medical and casualty expenses be combined in a new "hardship expense" deduction. This new deduction will apply only to medical and casualty expenses in excess of 10 percent of adjusted gross income. In the case of casualty losses, the excess over $100 per casualty will be included in the computation. Medical insurance premiums, drugs and medicines will be treated the same as other medical expenses. In this manner, tax return preparation will be simplified greatly, and the deduction will be available only to taxpayers whose ability to pay has been significantly affected by medical and casualty expenditures that can truly be considered "abnormal" in the light of the current relationship between medical and casualty costs and income.

Tax Shelters

The members of this Committee are familiar with the basic concept of a tax shelter. Although shelter devices can assume a wide variety of forms and include a great diversity of activities, they share a common characteristic: "paper" losses generated by shelters are used by high-income individuals to reduce taxable income from other sources. Typically, shelter investments are made not because of anticipated economic productivity, but in anticipation of the various tax preferences that are packaged together by shelter promoters to provide optimum tax writeoffs. This drain of investment dollars into shelter activities creates economic distortions and harms legitimate profit-seeking businesses.

Due in large part to tax shelter devices, there is now a wide disparity in effective tax rates among individuals with similar economic incomes. This phenomenon is especially prevalent in the upper income brackets. For example, some taxpayers with incomes exceeding $200,000 effectively pay only one or two cents in taxes for every dollar of income received; other individuals are taxed at effective rates of about 60 percent.

Data recently compiled by the IRS graphically illuminate the disturbing impact of tax shelters. Through the use of tax preferences, thousands of affluent Americans are reporting poverty-level income for tax purposes. In 1976, tax preference items were enjoyed by 16,000 taxpayers statistically classified as having "adjusted gross income" below $10,000. But these individuals are not members

of the low-income class; on the average, each of them claimed $35,000 of preference income. Our tax system needs significant improvement if it is to approach the objective of providing equal tax treatment for equals.

Congress is to be commended for its recognition of tax shelter abuses in 1976 and its innovative and forceful reform efforts in this area. The Tax Reform Act of 1976 contains important provisions designed to curtail shelter activities. The principal methods used in that legislation were revisions of the minimum tax on certain tax preference items and the adoption of an "at risk" rule that denies deductibility for certain paper losses that exceed an individual's cash investment and indebtedness for which he has personal liability.

Unfortunately, the 1976 amendments--significant as they are--have not ended shelter abuses. In fact, tax shelter activity may have increased during 1977. The National Association of Securities Dealers reports that over $1 billion of shelters were publicly offered by its members during the first 9 months of 1977--a 30 percent increase over offerings for a similar period in 1976. And there is some evidence that unreported shelter deals may have increased even more dramatically.

The explanation for this high level of post-1976 shelter activity is simple. Promoters have adapted their operations to provide shelters in forms that were not substantially affected by the 1976 Act. The Internal Revenue Service is waging a vigorous campaign against tax shelter gimmicks, but it must be given stronger weapons.

The Administration is not proposing any radically new approaches to this problem. Rather, in the light of experience, we are recommending that Congress build upon the efforts that led to reforms in 1969 and 1976. Flagrant tax shelter abuses must be curtailed.

In the Administration's program, we are proposing several different methods of continuing the attack on tax shelters.

(1) Elimination of Certain Tax Preferences. Some of our recommendations eliminate or limit directly a tax preference that makes shelter investments attractive. An example of this approach is our recommended reform of real estate depreciation. Shelter investments in such real estate projects as shopping centers and office buildings are attractive, in large part, due to the fact that depreciation may be claimed for tax purposes that far exceeds a realistic measurement of actual economic decline. Real estate shelters, in contrast to other major shelter investments, were left virtually untouched by the 1976 Act. As a result, they have become even more popular.

We propose elimination of accelerated depreciation for most real estate. The reform program will generally require taxpayers to base their depreciation for buildings on the straight-line method and to use the present average tax lives claimed by taxpayers for different classes of property.

Exceptions from the general rule will be granted until 1983 for new multi-family and used low-income housing, which will be permitted to use a 150 percent and 125 percent declining balance method, respectively. New low-income housing will remain eligible for a 200 percent declining balance method until 1983, and for 150 percent thereafter. In the interim period, the Administration intends to analyze tax and nontax subsidies for housing. Our objective is to determine the need for subsidizing particular segments of the housing market and the most efficient means of providing needed subsidies.

In addition to reform of real estate depreciation, the elimination of two other shelter preferences is proposed. The Administration recommends that the earnings of most deferred annuities, purchased for shelter purposes, be taxed currently to the purchaser. Also, we propose an extension of the 1976 Act's accrual accounting rule relating to large corporate farms; under our proposal, accrual accounting will be required for most farming syndicates and the current exemption for large "family owned" farm corporations (with gross receipts exceeding $1 million) will be eliminated.

(2) Extension of "at risk" Rule. Another Administration proposal is designed to deal with a common shelter financing technique--the use of nonrecourse loans to enable a shelter investor to obtain tax writeoffs greatly exceeding his own investment. "At risk" rules were enacted in 1976 to limit this abuse, but coverage was extended only to partnerships and certain specified activities of individuals. Action should be taken now to curtail the extensive shelter activities that have arisen in situations not expressly covered by the 1976 Act; recent shelter promotions project tax writeoffs as high as $170,000 for $25,000 cash investments in such items as books, television programs, and lithographic plates. We recommend that the "at risk" rule be extended to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons.

(3) Restricting Use of Limited Partnership as Shelter Vehicle. The attractiveness of the limited partnership as a shelter vehicle will be limited by the reform program. New limited partnerships with more than 15 limited partners will be treated as corporations for tax purposes so that shelter losses may not ordinarily be passed through the partnership to reduce the taxable income of the limited partners. An exception will be made for partnerships formed before 1983 to engage in the construction and operation of residential real estate, with the exception continuing after 1982 for new low-income housing as long as it remains eligible for accelerated depreciation. By 1983, the Administration will have made recommendations to Congress as to what form of subsidy is appropriate to our housing needs.

(4) Auditing Partnerships. We also propose that the Internal Revenue Service be authorized to implement tax audits of partnerships and to determine tax issues at the partnership level rather than being forced to proceed against each partner individually.

(5) Strengthening the Minimum Tax. Finally, the benefits available through excessive use of tax preferences will be restricted through a tightening of the minimum tax provision. In its current form, the minimum tax is imposed at a rate of 15 percent on the amount of certain tax preference items enjoyed by a taxpayer.

However, the total amount of tax preferences can now be reduced by the greater of $10,000 or one-half of an individual's regular tax liability before the minimum tax is applied.

We propose to eliminate the offset of one-half of regular tax liability so that the minimum tax will attack tax shelters more directly and effectively. High-income individuals will no longer be able to use their taxes on non-preferred income to avoid the minimum tax on excessive preference income. On the other hand, those individuals with modest preference income will still be totally exempted from the minimum tax by the $10,000 preference offset, and the minimum tax will not be applied to capital gain realized on the sale of a personal residence.

Termination of Alternative Tax for Capital Gains

The current deduction for the long-term capital gains of individuals generally has the effect of taxing such gains at a rate that is one-half of the rate for ordinary income. During our intensive study of the tax laws, this capital gains preference was carefully studied. The study also included such matters as the partial integration of corporate and shareholder taxes and drastic rate reductions for investment income.

These aspects of the tax system are both controversial and relatively unexplored. Full consideration of the issues raised would require extensive Congressional debate. Therefore, in order to expedite consideration of tax legislation this year, the program does not involve these matters.

We do propose in this tax package to eliminate what is left of the 25 percent alternative tax for capital gains. The effect of the current provision is to grant taxpayers in the highest income brackets an additional tax preference over and above the special capital gains deduction. Through the alternative tax, individuals above the 50 percent tax bracket can take advantage of a 25 percent tax ceiling on the first $50,000 of capital gains.

The alternative tax cannot be said to benefit the middle-class investor. Its benefits accrue exclusively to persons with taxable income exceeding $52,000 (if filing a joint return) or $38,000 (if filing a single return)--less than one percent of all taxpayers. And for those families

with taxable income in excess of $200,000, the benefit is greatest of all. Those wealthy investors can use the alternative tax to exclude nearly 65 percent of $50,000 of capital gains each year from taxation; by contrast, a family with income of $50,000 a year can exclude only one-half of capital gains, and most workers are taxed on every cent of their wages and salaries.

This Committee has voted on prior occasions to terminate this inequitable and complicating provision. I urge the Committee to repeat such action this session.

Unemployment Compensation

We recommend that the current tax exemption for unemployment compensation benefits be phased out as an individual's income rises above $20,000 for single persons or $25,000 for married couples. Under the Administration's proposal, 50 cents of unemployment compensation will be taxed for every dollar of total income (including unemployment compensation) received in excess of these income ceilings.

Dollars received as unemployment benefits are just as valuable as dollars received in any other form. Therefore, a continued exemption at middle and high-income levels violates the tax policy principle that persons should be taxed in accordance with ability to pay. In the 1976 Act, Congress repealed the sick pay exclusion for workers at higher income levels on the grounds that sick pay is a substitute for wages and should generally be taxed in the same manner. This rationale should now be extended to unemployment compensation.

Reforming the tax treatment of unemployment benefits is especially important in view of the serious abuses that can be caused by the preference. In many cases, the unemployment compensation system serves not to relieve hardship but to discourage work for taxable income. For example, an individual can receive a substantial income every year through stock dividends and the salary from his 9-month job, take a winter vacation and collect untaxed unemployment benefits. There is no reason we should continue to permit such persons to "beat the system" at the expense of their neighbors who work throughout the year for taxable wages.

Fringe Benefits Unavailable to Rank-and-File Workers

The major tenet of tax equity--that tax liability be based on ability to pay--should also be considered by this Committee as it examines certain employee fringe benefits. Application of the principle in its pure sense requires that compensation be taxed to an employee regardless of the form that compensation assumes. A worker who receives cash wages that he uses to provide benefits for his family should not ordinarily be taxed more heavily than the employee who receives those benefits directly from his employer.

Yet, the tax laws now contain numerous exceptions for various employee benefits. For example, if an employer establishes a medical insurance plan for his employees, the premium payments by the employer are deductible while neither the premiums nor the benefits are taxable to the employee. Favored tax treatment is also conferred upon certain pension plans, group life insurance plans, and employee death benefits.

Again, the Administration is not proposing a radical departure from the current treatment of fringe benefits. Instead, we recommend Congressional action to ensure that these tax preferences benefit rank-and-file workers as well as corporate management. Preferential tax treatment for these fringe benefits can be justified only as a means of ensuring that a wide range of employees are protected against such contingencies as sickness, disability, retirement, or death. We should move closer to fulfilling that objective.

Accordingly, the President recommends the following proposals:

(1) Medical, Disability, and Group Life Insurance Plans. The full tax exemption for employer-established medical, disability, and group life insurance plans will be denied if those plans discriminate in favor of officers, shareholders, and higher-paid employees. Preferential treatment is now available to pension plans and group legal plans only if nondiscrimination standards are met. The tax laws should require similar nondiscriminatory treatment for workers in the case of these other types of employee benefit plans.

(2) Integration of Social Security and Private Pension Benefits. Although there is now a nondiscrimination requirement for qualified retirement plans, such plans are permitted to cover only employees who earn amounts exceeding the social security wage base. When Congress established new nondiscrimination standards in the Employee Retirement Income Security Act of 1974 (ERISA), this issue of proper "integration" of social security and private pension plans was expressly left unresolved.

In view of the fact that the social security wage base will rise to $29,700 by 1981 under the recently enacted social security financing legislation, it is especially important that Congress act now to address this question left open by the 1974 ERISA legislation. It is unfair to grant tax preferences for private pension plans that exclude all low and middle-income employees. We recommend that a new integration formula be enacted so that no qualified pension plan can provide benefits beyond social security for highly compensated employees unless all workers receive substantial coverage under the plan.

(3) Employee Death Benefits. We propose the repeal of the current exclusion for the first $5,000 of payments made by an employer on account of the death of an employee. These death benefits typically represent deferred wages that would have been paid to a high-income employee, and they should not be given preferential tax treatment.

Entertainment and Other Expenditures for Personal Consumption

For many average taxpayers, the inequity of current tax law is demonstrated most vividly by the treatment of entertainment expenses that are claimed as business deductions. The deductibility of entertainment expenses is a significant revenue item; approximately $2.2 billion a year are lost to the Federal Treasury through the deductibility of expenditures for items such as theater and sports tickets, country club dues, yachts, hunting lodges, first class air fare, and business meals. However, the recapture of a large revenue loss is not the only consequence of reforms the President recommends in this area. Of greater significance will be the effect on the morale of average taxpayers, who are now forced to subsidize the untaxed personal consumption of some of the most affluent Americans.

Some persons have become accustomed to living luxuriously on tax-deductible dollars. One individual deducted 338 business lunches in one year, skipping Thanksgiving day but not the Friday, Saturday, or Sunday of Thanksgiving weekend. A surgeon deducted $14,000 a year for maintaining a yacht where he allegedly "talked shop" with other doctors. And, another wealthy professional claimed a deduction of $17,000 for the cost of entertaining associates at his home, at a country club, at sporting events, at restaurants, and at a rental cottage.

Yet, in spite of the disturbing impact on average Americans of such tax-deductible extravagance, some persons would have us believe there is really no tax preference involved--that reform in this area represents an anti-business attitude without a sound basis in tax policy. These persons argue that business bears part of the cost of deductible entertainment expenditures and that business can, and should, determine which expenditures are nonproductive. Under this line of reasoning, entertainment expenses are viewed as being analogous to business expenditures for advertising or research, and any attempt to limit deductibility is seen as an interference with business decision-making.

This argument is dead wrong. Entertainment expenditures, unlike expenditures for advertising and research, confer untaxed personal benefits to the participants. Preparing or reading an advertisement is not comparable to dining at an elegant restaurant, sailing on a yacht, or attending a Sunday football game. Entertainment is more closely analogous to wages; they both provide personal benefits to employees. However, the tax collector withholds a portion of wages before they can be spent for personal consumption while entertainment benefits are now received tax-free by employees.

Ideally, the preference for business meals and other entertainment expenditures would be eliminated by taxing the participants, but such an approach would obviously be very complex and disruptive. What we propose instead is to deny a deduction for entertainment expenditures to the extent they provide the participants with untaxed personal benefits. This is the approach Congress used in 1962 when business deductions for gifts were limited.

The President's recommendations are based on sound theories of tax law and public finance. Economists tell us that an employer's entertainment expenditures are wage substitutes. Tax lawyers tell us that the law should deny the employer a deduction where compensation, in whatever form, is untaxed to the employee. Internal Revenue Service agents describe problems in trying to enforce a law that often becomes a test for a taxpayer's imagination and ingenuity. And, as the Secretary of the Treasury, I am concerned about the loss of billions of dollars in Federal revenue.

However, this issue will not be decided on such academic grounds. Nor should it. The general public realizes there is something wrong here. For example, Mr. Fisher has sent me the results of a poll which canvassed 22,000 of his constituents. This question was posed: "Would you favor or oppose elimination of business expense deductions for items such as lunches, club and other membership fees, and the first class portion of air fares?" Over 72 percent said they would favor elimination of the deduction.

Public irritation will become increasingly evident as the "expense account" issue is debated in Congress. I doubt that Congress would appropriate direct Federal expenditures to subsidize elegant restaurants and the affluent individuals who dine there. There is no reason to permit these governmental subsidies to be provided indirectly through the tax system.

The President's proposals address this public concern. Let me describe them briefly.

(1) Tickets and Certain Other Entertainment Expenses. No deduction will be permitted for purchases of tickets to such events as theater performances and athletic contests. A deduction will also be denied for the expenses of maintaining facilities such as yachts, hunting lodges, and swimming pools, and for fees paid to social, athletic, or sporting clubs.

(2) Meals. Fifty percent of currently deductible business entertainment expenses for food and beverages will remain deductible, and 50 percent will be disallowed. A substantial portion of business meal expenses represents the cost of personal consumption that must be incurred regardless of the business connection. The 50 percent disallowance represents an approach that approximates the actual personal benefit involved and provides a reasonable, simple answer to the problem.

(3) Foreign Conventions. There will be a modification of the rules in the 1976 Act relating to the deductibility of foreign convention expenses. Current law now effectively permits taxpayers to deduct the expenses for two foreign vacations a year--as long as those vacations are packaged with the label of a "convention." We recommend that the two-convention rule be stricken. In its place will be a rule that denies deductibility for foreign convention expenses unless factors such as the purpose and membership of the sponsor make it reasonable to hold the convention outside the United States and possessions. This proposal will eliminate abuses while easing restrictions on conventions held in foreign countries for legitimate business reasons.

(4) First Class Air Fare. The 1976 Act denied a deduction for first class flights to foreign conventions. The President recommends that this rule be extended to tickets for domestic business travel. Although business travel constitutes a legitimate cost of producing income, the business purpose is served by purchasing a ticket at coach fare. Private extravagence should not be publicly supported through the deductibility of first class air fare.

MUNICIPAL FINANCING

Interest on debt obligations issued by State and local governments is exempt from Federal income tax. There is also a current tax exemption for certain "industrial development bonds" that are issued by State and local governments for the benefit of private borrowers. In order to qualify for tax-exempt status, industrial development bonds must be issued to provide financing for certain facilities such as pollution control equipment, sports arenas and convention halls, airports, industrial parks, and the facilities (such as hospitals) of private, nonprofit organizations. There is also a "small issue" exemption for certain industrial development bonds where the amount of the bonds sold does not exceed $1 million or the total capital expenses of the facility being financed do not exceed $5 million.

This current structure for State and local bonds creates two problems. First, the present system is a very inefficient means of providing a Federal subsidy to State and local governments; less than three-fourths of the revenue loss to the Federal Treasury actually accrues to

State and local governments through lower borrowing costs. Second, the exemption is a major source of tax avoidance by wealthy individuals and by commercial banks, which retain for themselves the portion of the Federal revenue loss not accruing to State and local governments.

In the Administration's tax program, we are recommending measures that will address both of these weaknesses in the current structure. A more efficient subsidy will be made available to State and local governments to reduce their borrowing costs below what a tax exemption alone can provide; and at the same time, the equity of the tax system will be improved. Yet, our program retains the autonomy of State and local governments over the financing of their projects and preserves the freedom of State and local governments to issue tax-exempt bonds in whatever amounts they choose. It does not restrict State and local discretion to determine the governmental purposes for which subsidized financing is used.

Taxable Bond Option

State and local governments will be given the option of continuing to issue tax-exempt bonds or of issuing taxable bonds which will receive a subsidy from the Treasury for a fixed percentage of the interest costs. The choice will be entirely a matter for State and local governments to decide. For bonds issued in 1979 and 1980, the subsidy will be equal to 35 percent of the interest costs, with the subsidy level rising to 40 percent for bonds issued after 1980.

This proposal is not intended to be a step toward elimination of the tax exemption, nor a movement to exert more Federal control over State and local decision-making. The taxable bond option is not an interim proposal, but a reasonable long-term solution to the problems of tax policy and public finance that have plagued the municipal bond area. A sizable tax-exempt market will remain; in fact, we project that 75 percent of State and local bonds will continue to be issued in tax-exempt form after an initial adjustment period, of perhaps 5 years, during which 40 to 50 percent of new issues might be taxable. It is our firm conviction that the addition of a taxable bond option to a tax-exempt market, which currently applies to a limited class of investors, will prove to be an enormous benefit for State and local governments. Borrowing costs on municipal debt will be reduced by about 15 percent whether bonds are issued in tax-exempt or taxable form.

Termination of Exemption for Pollution Control Bonds, Bonds for the Development of Industrial Parks, and Private Hospital Bonds

There will no longer be an exemption for interest on industrial development bonds for pollution control or for the development of industrial parks. The exemption will also be removed for bonds issued to finance construction of hospital facilities for private, nonprofit institutions unless there is a certification by the State that a new hospital is needed.

These activities are essentially for the benefit of private users. The tax exemption in such cases serves little or no governmental purpose, but increases the supply of bonds in the tax-exempt market. The cost of municipal financing is raised as a result.

Municipal financing is injured particularly by the abundance of pollution control bonds in the marketplace. I will describe later our proposal to liberalize the investment tax credit for pollution control facilities so that Federal assistance in bringing existing plants into compliance with environmental standards can be provided in a manner that is much more efficient and less disruptive of the tax-exempt market.

Small Issue Exemption for Economically Distressed Areas

The existing "small issue" exemptions will be retained only for economically distressed areas; and, with respect to those areas, the $5 million exemption will be raised to $10 million.

Option for Certain Industrial Development Bonds

Industrial development bonds that continue to enjoy tax-exempt status will be eligible for the taxable bond option with the same interest subsidy applicable to general obligation bonds of State and local governments.

REDUCTION AND REFORM OF BUSINESS TAXATION TO ENCOURAGE EFFICIENCY AND PRODUCTIVITY

The business portion of the tax program is designed to encourage the productive investments needed to satisfy consumer demand, to create permanent jobs and to move toward greater price stability. The President has recommended gross business tax reductions of $8.3 billion in 1979 in a

form that will provide efficient incentives for investment in productive facilities and will apply equitably to a wide spectrum of businesses, affecting every industry and benefitting both small and large firms. Tied integrally with these gross cuts are business tax reforms that will eliminate tax preferences that have proved to be wasteful and inequitable. As in the case of individual tax reductions, the business cuts have been combined with reforms in order to ensure that Federal tax revenues are focused where relief is needed-- both to make the tax system more equitable and to provide the maximum benefit to our economy.

I. BUSINESS TAX REDUCTIONS

Increased incentives for business investment are essential if we are to maintain a strong economic recovery. In recent years, the growth of our productive capital stock has not kept pace with the expansion of the economy or of its labor supply. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the fourth quarter of 1977 was still 3 percent below its previous peak reached in the first quarter of 1974.

The portion of our gross national product devoted to investment must be increased in the years ahead. As we look to the long-term needs of the economy, we must depend upon private businesses to provide permanent jobs for a growing labor force while meeting the goals of our national energy plan and providing a cleaner environment and safer workplaces. Vigorous business investment will also prevent capacity bottlenecks and price pressures that might otherwise occur as consumer demand increases.

The real income of workers can grow steadily over the years only if businesses increase productivity with investments in new machinery and more efficient plants. By providing substantial, permanent tax incentives for business expansion, the Administration's tax program will help to create an atmosphere that is conducive to a continued economic recovery led by the private sector.

Corporate Rate Cut

The President recommends a sizable rate cut for both small and large corporations. Effective October 1, 1978, the corporate tax rate will be reduced from 20 percent to 18 percent on the first $25,000 of income, from 22 percent to 20 percent on the next $25,000, and from 48 percent to 45 percent on income exceeding $50,000. The highest rate will be reduced an additional point, to 44 percent, on January 1, 1980. These rate reductions will reduce corporate taxes by $6 billion in 1979 and by $8.5 billion in 1980.

The corporate rate cut will provide an impetus to capital formation in a simple and straightforward manner. The cash flow of businesses will be increased significantly; for a business with $100,000 of taxable income, $2,500 more in after-tax earnings will be available in 1979 and an additional $3,000 in 1980 to provide internal financing for needed capital expenditures. The reduced tax rate will also increase the anticipated after-tax profits on investment projects and will thereby encourage businesses to increase capital spending. This increased after-tax return on corporate investments will stimulate external financing by making corporate stock more attractive to public investors.

Liberalization of the Investment Tax Credit

Needed business investments will also be encouraged by improvements in the investment tax credit. The President recommends that the credit be made available to a wider range of taxpayers and for a broader scope of investments. In addition, the present 10 percent rate will be made permanent--rather than reverting to the 7 percent level that is now scheduled to apply after 1980--so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

In addition to proposing that the 10 percent credit be made permanent, the President recommends the following extensions of the investment credit:

(1) Application to Industrial Structures. The investment credit should be extended to utility and industrial structures as well as machinery and equipment. The current ineligibility of structures is based in large part upon the investment patterns that existed when the credit was first introduced in 1962; at that time, investment in equipment was lagging behind the investment in nonresidential structures. Also, structures were then eligible for depreciation allowances that were even more favorable than those available today.

We are now confronted with a different set of circumstances. In contrast to the investment patterns in the early 1960's, a particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures; investment in structures reached its peak almost 4 years ago and is now 11 percent below that level. The tax preference for depreciation of structures has been reduced through the operation of the "recapture" rules and the minimum tax. In view of these developments, it is important that the investment credit be changed to remedy the existing tax bias against structures and to encourage balanced industrial expansion.

We recommend that the investment credit be available both for the construction of new utility and industrial structures and the rehabilitation of existing structures so that the proposal will have no anti-urban bias. Eligibility for the credit will provide five times more tax savings for investments in structures than does the current provision for accelerated depreciation. By combining our investment credit proposal with the repeal of accelerated depreciation for structures, we will provide a tax incentive that is stronger, more efficient, and much simpler.

The President recommends that this provision apply to construction costs incurred after December 31, 1977. In the case of new structures, there will be an additional requirement that the facility be placed in service after that date.

(2) Application to Pollution Control Facilities. Currently, only one-half of the full investment credit can be claimed by a taxpayer who elects special 5-year amortization for pollution control equipment installed in pre-1976 plants. This restriction should be removed.

We propose that pollution control equipment placed in service after December 31, 1977 be allowed to qualify for the full 10 percent credit even if rapid amortization is claimed under the provisions of existing law. As in the case of industrial structures, our recommendation will provide tax relief in a form that is more efficient and straight-forward than current government tax subsidies; this proposal will permit the tax exemption to be removed for pollution control bonds without increasing the costs of compliance with environmental standards.

(3) Increase in Tax Liability Ceiling. The investment credit will be made more fully available to businesses with relatively high investment needs and low taxable incomes. Currently, the investment credit claimed during any taxable year cannot generally exceed $25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a 3-year carryback and a 7-year carryforward). The President recommends that the tax liability ceiling be raised to 90 percent of all tax liability, with no firm being able to use investment credits to eliminate its entire tax liability.

Revision and Simplification of Regulations Under the Asset Depreciation Range (ADR) System

The asset depreciation range (ADR) system provides substantial tax benefits to businesses through generous depreciation allowances. However, certain complexities in the ADR regulations discourage most businesses from electing ADR and impose administrative burdens on those businesses that do use ADR.

The President proposes that legislation be enacted expressly to permit the Treasury Department to issue regulations that will simplify the ADR system. Included among the simplifications will be the termination of the annual reporting requirement.

Proposals Focused on Small Business

The President's tax cut proposals will provide significant relief for small businesses. Reductions in individual and corporate tax rates will increase the net earnings of small businesses whether conducted in the form of a sole proprietorship, a partnership, or a corporation. For example, a small corporation with profits of $50,000 will experience a tax reduction of about 10 percent in 1979 because 2 points of the 4-point corporate rate cut have been targeted to small businesses and made fully effective as of October 1, 1978. The resulting increase in cash flow will enable small firms to expand their facilities and compete more effectively.

In addition to these general tax reduction recommendations, the Administration's program contains three proposals designed specifically to aid small companies. First, the Subchapter S rules that treat certain small corporations as partnerships will be simplified and liberalized. Second, a

new, simple table for equipment depreciation, tantamount to a streamlined ADR system, will be authorized for small businesses. And third, risk-taking will be encouraged by doubling the amount of a small corporation's stock (from $500,000 to $1 million) that can qualify for special ordinary loss treatment and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

II. CURTAILMENT OF BUSINESS TAX PREFERENCES THAT ARE WASTEFUL AND UNFAIR

The business incentives I have discussed total $8.3 billion. Revenue-raising reforms (including those relating to entertainment expenditures) will offset that gross reduction by $2.6 billion. To understand the importance of the reforms, the President's tax proposals should be viewed in the context of a tight Federal budget for fiscal year 1979. This Presidential budget is the first that reflects the results of a zero-based review of all Federal expenditures; projected government spending for fiscal year 1979 has been held to $500 billion through a process that demands that Federal dollars be spent most productively and efficiently.

On the other side of the Federal ledger, the President's tax program reflects the same concern for an efficient allocation of resources. The $8.3 billion of increased incentives is desirable only in combination with reforms that eliminate inequitable and inefficient business tax preferences that contribute little to our efforts to sustain economic growth and create jobs for American workers. We must not leave the careful budgeting process half completed; the same scrutiny that is used in allocating Federal outlays must be used in examining tax expenditures.

Tax Treatment of Financial Institutions

Viewed in this light, it is imperative that the tax treatment of financial institutions be modified. Financial institutions do not pay income taxes on the same basis as other taxpayers. Commercial banks, savings and loan associations, and mutual savings banks can reduce taxable income by special bad debt deductions that do not reflect actual loss experience. Credit unions are provided an even greater preference; they are completely exempted from taxation.

The preferred tax status of financial institutions is based largely on outmoded concepts regarding the nature of these businesses. Commercial banks, mutual savings banks

and savings and loan associations were permitted to deduct artificially inflated reserves for bad debts supposedly to protect the banking system from catastrophic losses that were prevalent decades ago. However, since the 1930's, the Federal government has acted to protect commercial banks and thrift institutions and their depositors from financial crises. These protections include deposit insurance, regulatory restrictions on bank practices, and the availability of the Federal Reserve discount window. Also, financial institutions are eligible for special 10-year carryback and 5-year carryforward provisions so that large losses in any one year can be used to reduce taxable income over a broad span of years. The excess bad debt deductions seriously distort the measurement of a financial institution's income, and that distortion cannot be rationalized on the grounds that the preference is needed to protect the banking system.

Likewise, the exemption for credit unions is an anachronism. Credit unions were exempted from taxation in the days when these institutions were small entities with close bonds among the members and few powers to provide extensive financial services. Today, many have expanded to a point where they are functionally identical to and compete directly with savings and loan associations and commercial banks.

The Administration recommends changes that will recognize the contemporary practices of financial institutions and will bring the tax treatment of commercial banks, savings and loan associations and credit unions more in line with the taxation of other businesses.

(1) Commercial Banks. Commercial banks may now claim bad debt deductions that greatly exceed their actual losses. Under legislation enacted in 1969, this special bad debt deduction is scheduled for elimination after 1987. The Administration proposes that the effective date for repeal be accelerated so that beginning in 1979 banks, like other businesses, will base their bad debt reserves on their own experience in the current and 5 preceding years.

(2) Mutual Savings Banks and Savings and Loan Associations. Mutual savings banks and savings and loan associations are generally entitled to deduct 40 percent of their net income (this percentage is scheduled to apply in 1979) as a bad debt reserve. The tax program will reduce the percentage to 30 percent over a 5-year period.

(3) Credit Unions. We recommend that credit unions be made taxable on the same basis as mutual savings banks and savings and loan associations, with this change imposed gradually over a 5-year phase-in period.

Domestic International Sales Corporation (DISC)

The so-called "DISC" provision is another example of a wasteful tax expenditure that should be eliminated. In 1971, the Code was amended to add a special tax program to shield export income from taxation. This program grants tax benefits for exports channeled through a company's specially created subsidiary, usually a paper organization, known as a domestic international sales corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of eligible DISC income is deferred as long as these profits are invested in export-related assets.

When DISC was enacted, Congress wisely included a provision for an annual study by the Treasury Department to evaluate DISC's impact. Those studies have demonstrated that DISC is a very inefficient and wasteful export subsidy. The most recent Treasury study indicates that DISC may have contributed only $1 to $3 billion to U.S. exports in 1974--an increase of less than 3 percent in total exports--at a tax revenue cost of $1.2 billion. In the long run, even these increased exports are probably offset by rising imports that result from the operation of the flexible exchange rate system. DISC helps exporters with large profit margins and does nothing for, and may even disadvantage, our import sensitive industries. Independent experts believe that DISC may have had no lasting effect on our balance of payments.

If government support is to be provided for exports, tax dollars should be expended more efficiently. In this regard, it is significant to note that the President's budget for fiscal year 1979 provides for a $2.2 billion increase between 1977 and 1978 in authorizations for direct loans by the Export-Import Bank and for another $800 million increase in 1979. Likewise, the Export-Import Bank's guarantee and insurance authorizations are increased by $1.8 billion in 1978 and by $1.7 billion in 1979. The Bank will use these funds to provide financial support for exports, targeted on areas of greatest need for this assistance. By contrast, DISC tax benefits are claimed without regard to whether there is any need for them or whether any real export improvement occurs through them.

Congress recognized the wasteful nature of DISC in 1976 when the Tax Reform Act limited its applicability. However, DISC continues to cost U.S. taxpayers over $1 billion per year, with well over one-half of DISC benefits realized by only 2 percent of the DISC's. While the 1976 changes reduced the cost of this wasteful program, we seriously doubt that those changes made the program more cost-effective.

We recommend the elimination of one-third of DISC benefits in 1979, two-thirds in 1980, and all DISC benefits in 1981 and later years. However, our proposal will not affect past earnings; accumulated DISC income will remain tax deferred as long as it continues to be invested in export-related assets.

Foreign Tax Deferral

Domestic corporations now pay a U.S. tax on the earnings from operations that they conduct directly overseas, such as through a foreign branch. However, domestic corporations can avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. The U.S. tax is usually deferred until dividends are paid by a subsidiary to its domestic parent, and then U.S. tax liability is offset by a tax credit for foreign income taxes paid on those remitted earnings. The President recommends that this deferral privilege be phased out over a 3-year period. At least one-third of a foreign subsidiary's earnings will be taxed to the U.S. parent in 1979, at least two-thirds in 1980, and all the subsidiary's earnings after 1980.

The fundamental problem with current law is that it makes the tax consequences of foreign investment depend upon the form of an investment, rather than its substance. Deferral is an artificial concept that causes the taxation of U.S. taxpayers to depend upon whether a foreign corporate charter has been placed as a screen between the foreign income and the U.S. taxpayer. In 1969, Congress revised the corporate surtax exemption provisions so that a commonly owned business enterprise would be taxed at the same rate, whether it operated under a single corporate charter or under multiple charters and regardless of the business reason for the use of multiple charters. We propose that Congress act in a similar manner to prevent the interposition of foreign corporate charters from affecting the level of U.S. taxation.

You will undoubtedly hear some persons argue that the termination of deferral will cause U.S. multinationals to lose their competitive position in world markets. The vast majority of investment is made in response to real market forces rather than the lure of the deferral preference. And consequently, when deferral is terminated, these overseas investments will continue to be made--and to be competitive--because they are governed not by tax consequences but by basic investment factors such as large and growing markets overseas, high consumer incomes, and a substantial demand for U.S. products.

In some countries, our tax deferral, in combination with their low tax rates, may provide an artificial tax incentive for U.S. investment. Elimination of deferral may restrict that insignificant portion of U.S. investment overseas that is now tax induced. But in such instances, there is no reason to favor a distortion of normal market forces that may work to the detriment of overall U.S. investment.

In short, the primary impact of deferral is to grant a tax preference to firms doing what prudent business judgment would dictate in the absence of deferral--investing in profitable foreign markets. There is no sound reason to continue this preference. The substantial business incentives recommended by the President will help ensure that U.S. multinationals have ample after-tax funds available to make the productive investments necessary to remain competitive in world markets. Terminating deferral represents only a small offset to the gains that businesses will realize through other provisions in the tax package. The Administration has proposed a program of business taxation that is generous and fair and does not depend upon the formalistic structure of international business operations.

SPECIAL TAX REDUCTIONS PROPOSED TO REDUCE COSTS FOR CONSUMERS AND BUSINESSES

Finally, we propose two tax reduction measures--outside the income tax system--that will assist our efforts to attain price stability.

Repeal of Excise Tax on Telephone Services

The present 4 percent excise tax on amounts paid for telephone services is now being phased out at the rate of 1 percentage point a year, with full repeal scheduled as of

January 1, 1982. The Administration's program will completely repeal this tax as of October 1, 1978. This action will reduce the cost of living directly. It will also lower consumer prices indirectly through a reduction of the business cost associated with telephone services.

Federal Unemployment Insurance Tax

We also recommend a reduction in the Federal unemployment insurance tax to reduce the payroll costs of employers. On January 1, 1977, the unemployment insurance tax rate rose from 0.5 percent to 0.7 percent of an employer's taxable wage base. This tax increase was instituted in order to replenish general revenue funds that have been loaned to the unemployment insurance trust fund during recent periods of high unemployment. We remain committed to sound financing of unemployment compensation; a National Committee on Unemployment Compensation will soon be appointed to study the long-term financing issue. Pending that study, we believe that the proposed tax cut can make a significant contribution to our efforts to fight the immediate problem of inflation. The President's tax program will reduce the tax rate to the 0.5 percent level as of January 1, 1979.

CONCLUSION

The President's recommendations would effect important changes in our Nation's tax laws. These proposals are presented in the form of a balanced package of tax reductions and reforms that should be manageable in one Congressional session. Action this year is vital. The sustained growth of our economy requires tax reductions for individuals to maintain their purchasing power, and for businesses to encourage investment in new facilities.

Tax reforms, designed to promote equity and simplification, are carefully integrated with the proposed tax cuts. Reforms finance a major part of the gross tax reductions. In the absence of offsetting reforms, we must either reduce the cuts substantially or face a budget deficit for fiscal year 1979 that expands well beyond the fiscal year 1978 figure; neither of these alternatives is acceptable.

Moreover, the tax reforms enable us to target the net tax relief where it is needed most. Substantial reductions can be provided to individuals heavily burdened by current tax liability without passing along an unwarranted tax cut

to those persons already avoiding the payment of their fair share. Likewise, the merging of tax reform with the proposed business cuts produces investment incentives that are potent, efficient and equitable.

Our efforts in developing this package have been assisted greatly by the consultations we have had with members of this Committee. That relationship will become even more important in the weeks ahead as this Committee and the Administration work together to fashion tax legislation. The American people deserve prompt enactment of a tax reform and reduction program, and we must meet that challenge.

Table 1

1978

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax			1978 Proposed Tax			Change in Tax		
	Income tax 1/	FICA tax 2/	Total tax	Income tax 1/	FICA tax 3/	Total tax	Income tax	FICA tax	Total tax
(dollars)									
5,000	-300	292	-8	-300	303	3	0	11	11
10,000	446	585	1,031	192	605	797	-254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	965	3,145	2,042	1,071	3,113	-138	106	-32
25,000	3,150	965	4,115	3,025	1,071	4,096	-125	106	-19
30,000	4,232	965	5,197	4,150	1,071	5,221	-82	106	24
40,000	6,848	965	7,813	6,748	1,071	7,819	-100	106	6
50,000	9,950	965	10,915	9,855	1,071	10,926	-95	106	11
100,000	28,880	965	29,845	28,640	1,071	29,711	-240	106	-134

Office of the Secretary of the Treasury
Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Calculated under present law rate and base for 1978 (6.05 percent and $17,700), employees' share only.

Table 2

1979

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax: Income tax 1/	Present Law Tax: FICA tax 2/	Present Law Tax: Total tax	1979 Proposed Tax: Income tax 3/	1979 Proposed Tax: FICA tax 4/	1979 Proposed Tax: Total tax	Change in Tax: Income tax	Change in Tax: FICA tax	Change in Tax: Total tax
(dollars)									
5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	134	613	747	-312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	965	3,145	1,910	1,226	3,136	-270	261	-9
25,000	3,150	965	4,115	2,830	1,404	4,234	-320	439	119
30,000	4,232	965	5,197	3,910	1,404	5,314	-322	439	117
40,000	6,848	965	7,813	6,630	1,404	8,034	-218	439	221
50,000	9,950	965	10,915	9,870	1,404	11,274	-80	439	359
100,000	28,880	965	29,845	29,470	1,404	30,874	590	439	1,029

Office of the Secretary of the Treasury
Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Assumes deductible expenses equal to 20 percent of income under proposal.

4/ Calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 3

1978

Combined Income Tax and FICA Tax Burdens

Four Person, Two-earner Families 1/

Wage Income	Present Law Tax			1978 Proposed Tax			Change in Tax		
	Income tax 2/	FICA tax 3/	Total tax	Income tax 2/	FICA tax 4/	Total tax	Income tax	FICA tax	Total tax
(dollars)									
5,000	-300	292	-8	-300	303	3	0	11	11
10,000	446	585	1,031	192	605	797	-254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	1,170	3,350	2,042	1,210	3,252	-138	40	-98
25,000	3,150	1,463	4,613	3,025	1,513	4,538	-125	50	-75
30,000	4,232	1,755	5,987	4,150	1,815	5,965	-82	60	-22
40,000	6,848	1,931	8,779	6,748	2,142	8,890	-100	211	111
50,000	9,950	1,931	11,881	9,855	2,142	11,997	-95	211	116
100,000	28,880	1,931	30,811	28,640	2,142	30,782	-240	211	-29

Office of the Secretary of the Treasury
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January 23, 1978

1/ Assumes that each spouse earns 50 percent of total family income.

2/ Assumes deductible expenses equal to 23 percent of income.

3/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

4/ Calculated under present law rate and base for 1978 (6.05 percent and $17,700), employees' share only.

Table 4

1979

Combined Income Tax and FICA Tax Burdens

Four Person, Two-earner Families 1/

Wage Income	Present Law Tax: Income tax 2/	Present Law Tax: FICA tax 3/	Present Law Tax: Total tax	1979 Proposed Tax: Income tax 4/	1979 Proposed Tax: FICA tax 5/	1979 Proposed Tax: Total tax	Change in Tax: Income tax	Change in Tax: FICA tax	Change in Tax: Total tax
(................				dollars					................)
5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	134	613	747	-312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	1,170	3,350	1,910	1,226	3,136	-270	56	-214
25,000	3,150	1,463	4,613	2,830	1,533	4,363	-320	70	-250
30,000	4,232	1,755	5,987	3,910	1,839	5,749	-322	84	-238
40,000	6,848	1,931	8,779	6,630	2,452	9,082	-218	521	303
50,000	9,950	1,931	11,881	9,870	2,808	12,678	-80	877	797
100,000	28,880	1,931	30,811	29,470	2,808	32,278	590	877	1,467

Office of the Secretary of the Treasury
Office of Tax Analysis

January 23, 1978

1/ Assumes that each spouse earns 50 percent of total family income.

2/ Assumes deductible expenses equal to 23 percent of income under present law.

3/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

4/ Assumes deductible expenses equal to 20 percent of income under proposal.

5/ Calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 5

Individual Tax Rate Schedules For Joint Returns

Taxable Income Bracket 1/	Present Law: Tax At Low End of Bracket	Present Law: Tax Rate on Income In Bracket	Tax Proposal: Tax At Low End of Bracket	Tax Proposal: Tax Rate on Income In Bracket
0 - 500	0	14%	0	12%
500 - 1,000	70	14	60	12
1,000 - 2,000	140	15	120	14
2,000 - 3,000	290	16	260	16
3,000 - 4,000	450	17	420	17
4,000 - 8,000	620	19	590	18
8,000 - 12,000	1,380	22	1,310	19
12,000 - 16,000	2,260	25	2,070	20
16,000 - 20,000	3,260	28	2,870	23
20,000 - 24,000	4,380	32	3,790	27
24,000 - 28,000	5,660	36	4,870	32
28,000 - 32,000	7,100	39	6,150	36
32,000 - 36,000	8,660	42	7,590	39
36,000 - 40,000	10,340	45	9,150	42
40,000 - 44,000	12,140	48	10,830	44
44,000 - 48,000	14,060	50	12,590	48
48,000 - 52,000	16,060	50	14,510	48
52,000 - 54,000	18,060	53	16,430	51
54,000 - 62,000	19,120	53	17,450	51
62,000 - 64,000	23,360	53	21,530	51
64,000 - 76,000	24,420	55	22,550	54
76,000 - 88,000	31,020	58	29,030	57
88,000 - 90,000	37,980	60	35,870	57
90,000 -100,000	39,180	60	37,010	60
100,000 -110,000	45,180	62	43,010	60
110,000 -120,000	51,380	62	49,010	62
120,000 -130,000	57,580	64	55,210	62
130,000 -140,000	63,980	64	61,410	64
140,000 -150,000	70,380	66	67,810	64
150,000 -160,000	76,980	66	74,210	65
160,000 -175,000	83,580	68	80,710	65
175,000 -180,000	93,780	68	90,460	66
180,000 -200,000	97,180	69	93,760	66
200,000 and over	110,980	70	106,960	68

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1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $3,200.

Table 6

Individual Tax Rate Schedules For
Single Returns

Taxable Income Bracket 1/	Present Law: Tax At Low End of Bracket	Present Law: Tax Rate on Income In Bracket	Tax Proposal: Tax At Low End of Bracket	Tax Proposal: Tax Rate on Income In Bracket
0 - 500	0	14	0	12
500 - 1,000	70	15	60	13
1,000 - 1,500	145	16	125	15
1,500 - 2,000	225	17	200	15
2,000 - 3,000	310	19	275	18
3,000 - 4,000	500	19	455	19
4,000 - 6,000	690	21	645	20
6,000 - 8,000	1,110	24	1,045	20
8,000 -10,000	1,590	25	1,445	22
10,000 -12,000	2,090	27	1,885	23
12,000 -14,000	2,630	29	2,345	25
14,000 -16,000	3,210	31	2,845	25
16,000 -18,000	3,830	34	3,345	29
18,000 -20,000	4,510	36	3,925	29
20,000 -22,000	5,230	38	4,505	33
22,000 -24,000	5,990	40	5,165	33
24,000 -26,000	6,790	40	5,825	38
26,000 -28,000	7,590	45	6,585	38
28,000 -32,000	8,490	45	7,345	41
32,000 -36,000	10,290	50	8,985	46
36,000 -38,000	12,290	50	10,825	50
38,000 -40,000	13,290	55	11,825	50
40,000 -44,000	14,390	55	12,825	51
44,000 -48,000	16,590	60	14,865	57
48,000 -50,000	18,990	60	17,145	58
50,000 -52,000	20,190	62	18,305	58
52,000 -54,000	21,430	62	19,465	60
54,000 -60,000	22,670	62	20,665	60
60,000 -62,000	26,390	64	24,265	60
62,000 -64,000	27,670	64	25,465	63
64,000 -70,000	28,950	64	26,725	63
70,000 -76,000	32,790	66	30,505	63
76,000 -80,000	36,750	66	34,285	66
80,000 -88,000	39,390	68	36,925	66
88,000 -90,000	44,830	68	42,205	66
90,000 -100,000	46,190	69	43,525	67
100,000 and over	53,090	70	50,225	68

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1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $2,200.

Summary of Revenue Effects of Income Tax Reductions, Tax Reforms and Telephone Excise and Unemployment Insurance Tax Reductions

($billions)

	Fiscal Years				
	1979	1980	1981	1982	1983
Individual Income Tax:					
Tax reductions	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms	4.2	7.4	8.9	10.6	12.3
Net change	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation Income Tax:					
Tax reductions	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms	1.1	3.0	4.3	5.0	5.2
Net change	-5.1	-6.5	-6.8	-6.8	-7.6
Telephone excise and unemployment insurance tax reductions	-1.6	-2.0	-1.6	-1.2	-1.1
Total	**-25.0**	**-26.6**	**-28.6**	**-30.8**	**-34.9**

Table 8

The Effect of Tax Proposals on Calendar Year Tax Liability

($ millions)

	Full year 1976	Calendar Years					
		1978	1979	1980	1981	1982	1983
$240 credit and reduced tax rates	-17,305	-6,067	-23,538	-26,583	-30,272	-34,732	-40,110
Itemized deduction changes:							
Repeal gasoline tax deductions	582		862	983	1,121	1,277	1,456
Repeal sales tax deductions	1,672		2,477	2,824	3,219	3,670	4,184
Repeal miscellaneous tax deductions	384		569	649	739	843	961
Deduction for medical and casualty expenses	1,396		1,909	2,119	2,352	2,611	2,898
Repeal political contributions deduction	2		2	4	2	3	3
Repeal capital gains alternate tax	113		140	151	162	174	187
Individual real estate tax shelters	320		61	181	296	407	514
Taxation of unemployment benefits	275		212	207	204	204	214
Tax interest element of annuity contracts	320		12	26	40	57	80
Minimum tax change	229		284	306	329	353	380
Taxable bond option (individual)	255		197	592	1,080	1,666	2,218
Extend 10 percent investment tax credit to structures (indiv.)	-36	-47	-54	-65	-73	-79	-86
Limit individual tax credits to 90 percent of tax before credits	38		52	58	64	71	79
Tax qualified retirement plans and employee death benefits	30		32	32	33	33	34
Corporate real estate shelters	180		40	118	194	265	335
Corporate family farm accounting	30		40	25	10	5	7
Bad debt reserves:							
Commercial banks	196		227	232	232	23	--
Mutual savings banks and savings and loans	82		37	85	145	221	316
Credit unions	82		22	50	83	123	171
Entertainment expenses	1,125		1,476	1,633	1,771	1,932	2,107
Taxable bond option (corporations)	-24		-15	-47	-79	-113	-150
Phase-out DISC over 3 years	852	193	664	1,228	1,513	1,613	1,751
Phase-out deferral of tax on foreign source income	523		88	280	768	830	897
Corporate tax rate reduction	-5,718	-1,349	-5,965	-8,516	-9,228	-10,010	-10,764
At risk limitation (corporations)	10		14	10	8	5	6
Increase investment tax credit limit to 90 percent	-71		-882	-576	-114	-194	-205
Extend 10 percent investment tax credit to structures (corporations)	-1,055	-1,100	-1,389	-1,649	-1,869	-2,074	-2,268
Nondiscrimination rule for health and group term life plans	29		32	33	34	35	36
Full investment tax credit for pollution abatement facilities	-90	-142	-93	-107	-127	-115	-144
Total individual	-11,725	-6,114	-16,783	-18,516	-20,704	-23,442	-26,988
Total corporate	-3,849	-2,398	-5,704	-7,201	-6,659	-7,454	-7,905
Subtotal tax reform	-15,574	-8,512	-22,487	-25,717	-27,363	-30,896	-34,893
Repeal telephone excise tax	--	-355	-1,200	-900	-500	--	--
Reduce unemployment payroll tax rate	--	--	-850	-900	-950	-1,000	-1,050
Total	-15,574	-8,867	-24,537	-27,517	-28,813	-31,896	-35,943

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Table 9

The Effect of Tax Reform Proposals on Fiscal Years Receipts

($ millions)

Provisions	Full year 1976	Fiscal Year 1979	1980	1981	1982	1983
$240 credit and reduced tax rates	-17,305	-22,544	-25,669	-29,166	-33,394	-38,497
Itemized deduction changes:						
Repeal gasoline tax deductions	582	603	947	1,080	1,230	1,402
Repeal sales tax deductions	1,672	1,734	2,720	3,100	3,535	4,030
Repeal miscellaneous tax deductions	384	398	625	712	812	926
Deduction for medical and casualty expenses	1,396	1,336	2,056	2,282	2,533	2,812
Repeal political contributions deduction	2	1	3	3	3	3
Repeal capital gains alternate tax	113		140	151	162	174
Individual real estate tax shelters	320	9	93	228	361	448
Taxation of unemployment benefits	275	151	208	205	204	211
Tax interest element of annuity contracts	320		12	26	40	57
Extend 10 percent investment tax credit to structures (individual)	-36	-55	-61	-72	-81	-82
Minimum tax changes	229		284	306	329	353
Taxable bond option (individual) 1/	255	30	301	783	1,381	1,873
Limit individual tax credits to 90 percent of tax before credits	38	7	58	64	71	74
Tax qualified retirement plans and employee death benefits	30	5	34	35	35	33
Corporate real estate shelters	180	18	75	152	226	296
Corporate family farm accounting	30	18	33	18	8	6
Bad debt reserves:						
Commercial banks	196	102	229	232	138	13
Mutual savings banks and savings and loans	82	17	59	112	179	264
Credit unions	82	10	35	65	101	145
Entertainment expenses	1,125	664	1,547	1,695	1,843	2,011
Taxable bond option (corporations) 1/	-24	-7	-29	-61	-94	-130
Phase out DISC over 3 years	852	249	807	1,551	1,771	1,675
Elimination of deferral of tax on foreign source income	523	40	174	500	796	860
Corporate tax rate reduction	-5,718	-3,953	-7,078	-8,827	-9,570	-10,339
At risk limitation	10	2	14	10	8	5
Increase investment tax credit limit to 90 percent	-71	-397	-744	-368	-150	-199
Extend 10 percent investment tax credit to structures (corporations)	-1,055	-1,725	-1,506	-1,748	-1,961	-2,161
Nondiscrimination rule for health and group term life plans	29	14	32	33	34	35
Full investment tax credit for pollution abatement facilities	-90	-184	-99	-116	-122	-128
Total individual	-11,725	-18,325	-18,249	-20,263	-22,779	-26,183
Total corporate	-3,849	-5,132	-6,451	-6,752	-6,793	-7,647
Subtotal, tax reform	-15,574	-23,457	-24,700	-27,015	-29,572	-33,830
Repeal telephone excise tax	--	-955	-1,050	-700	-250	--
Reduce unemployment payroll tax rate	--	-600	-900	-900	-1,000	-1,100
Total	-15,574	-25,012	-26,650	-28,615	-30,822	-34,930

Office of the Secretary of the Treasury, Office of Tax Analysis — January 27, 1978

1/ Outlays associated with the proposal are $99 million in 1979, $495 million in 1980 increasing to $222 million in 1983.

Table 10

Expanded Income and Tax Liability Under Present Law
And Tax Proposals (Personal Only)

(1976 Levels of Income)

($ millions)

Expanded Income Class	Number of Returns (thousands)	Expanded Income	Present Law		Administration Proposal	
			Tax Liability	Effective Tax Rate	Tax Liability	Effective Tax Rate
($000)						
Less than 5	25,474	57,557	141	0.2%	-251	-0.4%
5 - 10	20,109	149,590	8,227	5.5%	6,368	4.3%
10 - 15	16,106	201,036	18,071	9.0%	15,361	7.6%
15 - 20	11,824	205,086	23,009	11.2%	20,148	9.8%
20 - 30	9,907	237,041	32,778	13.8%	29,593	12.5%
30 - 50	3,347	124,836	22,017	17.6%	20,971	16.8%
50 - 100	985	67,484	16,492	24.4%	16,344	24.2%
100 - 200	198	27,371	8,084	29.5%	8,261	30.2%
200 and over	49	21,573	6,476	30.0%	6,838	31.7%
Total	87,998	1,091,573	135,293	12.4%	123,633	11.3%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Note: Details may not add to totals due to rounding.

Table 11

Tax Reform Program: Effective Individual Tax Rates -- Taxes as a Percent of Expanded Income. 1976 Level of Income.

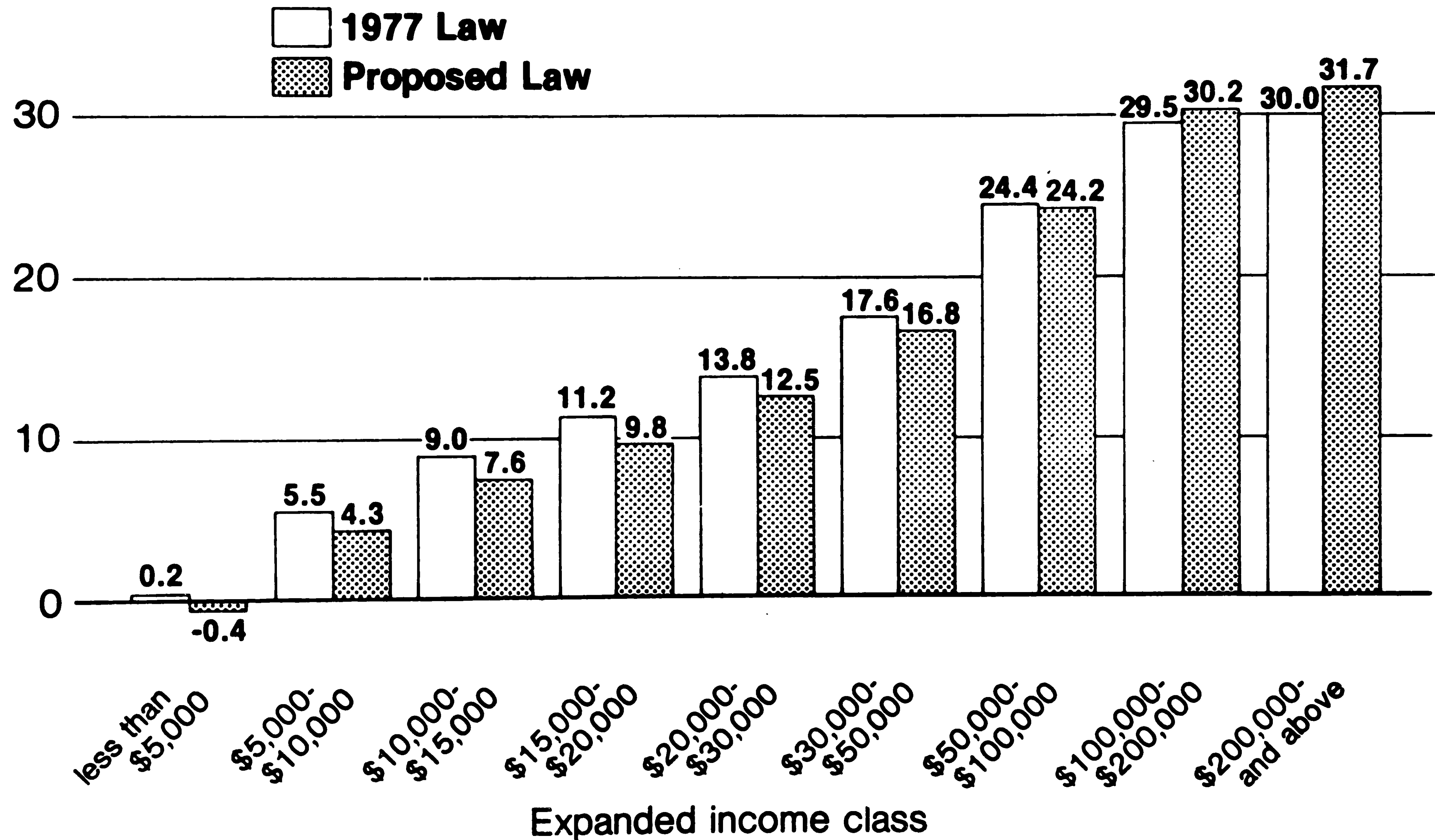

Table 12

Income Tax Liabilities: Present Law and Administration Proposal
(Personal Income Only)

(1976 Levels of Income)

Expanded Income Class	Present Law		Administration Proposal		Tax Change	
	Tax Liability	Percentage Distribution	Tax Liability	Percentage Distribution	Tax Liability	Change as Percent of Present Law Tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	(percent)
Less than 5	141	0.1%	-251	-0.2%	-392	-278.0%
5 - 10	8,227	6.1	6,368	5.2	-1,859	-22.6
10 - 15	18,071	13.4	15,361	12.4	-2,710	-15.0
15 - 20	23,009	17.0	20,148	16.3	-2,861	-12.4
20 - 30	32,778	24.2	29,593	23.9	-3,185	-9.7
30 - 50	22,017	16.3	20,971	17.0	-1,046	-4.8
50 - 100	16,492	12.2	16,344	13.2	-148	-0.9
100 - 200	8,084	6.0	8,261	6.7	177	2.2
200 and over	6,476	4.8	6,838	5.5	362	5.6
Total	$135,293	100.0%	$123,633	100.0%	$-11,660	-8.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Note: Details may not add to totals due to rounding.

Table 13

Burden Table

Single Returns

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(................. dollars		.................)	(.. percent ..)
Less than 10	217	181	-36	-16.4%
10 - 15	1,595	1,519	-76	-4.8
15 - 20	2,768	2,591	-177	-6.4
20 - 30	4,236	3,917	-319	-7.5
30 - 50	8,254	7,660	-594	-7.2
50 - 100	18,465	17,889	-576	-3.1
100 - 200	42,015	41,714	-301	-0.7
200 and over	161,723	167,760	6,037	3.7

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Table 14

Burden Table
Joint Returns
No Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..................	dollars	..................)	(.. percent ..)
Less than 10	168	95	-73	-43.6%
10 - 15	1,104	983	-121	-11.0
15 - 20	2,084	1,906	-178	-8.5
20 - 30	3,615	3,308	-307	-8.5
30 - 50	6,921	6,535	-386	-5.6
50 - 100	17,020	16,647	-373	-2.2
100 - 200	40,403	40,956	553	1.4
200 and over	132,121	137,140	5,020	3.8

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Table 15

Burden Table
Joint Returns
One Dependent

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	65	-38	-103	-157.8%
10 - 15	1,024	824	-200	-19.5
15 - 20	1,922	1,696	-226	-11.7
20 - 30	3.392	3,063	-329	-9.7
30 - 50	6,709	6,327	-382	-5.7
50 - 100	16,938	16,625	-313	-1.8
100 - 200	41,993	42,264	271	0.6
200 and over	121,583	125,202	3,620	3.0

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Table 16

Burden Table
Joint Returns
Two Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	9	-79	-88	-975.6%
10 - 15	867	589	-278	-32.1
15 - 20	1,739	1,461	-278	-16.0
20 - 30	3,117	2,780	-337	-10.8
30 - 50	6,287	5,979	-308	-4.9
50 - 100	16,336	16,088	-248	-1.5
100 - 200	40,885	41,087	202	0.5
200 and over	127,666	130,473	2,807	2.2

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Table 17

Burden Table
Joint Returns
Three Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..................	dollars	..................)	(.. percent ..)
Less than 10	-41	-81	-40	-97.7%
10 - 15	693	367	-326	-47.0
15 - 20	1,562	1,218	-344	-22.0
20 - 30	2,867	2,514	-353	-12.0
30 - 50	5,872	5,609	-263	-4.5
50 - 100	15,924	15,785	-139	-0.9
100 - 200	40,417	40,827	410	1.0
200 and over	126,915	130,397	3,483	2.7

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Table 18

Burden Table
Joint Returns
Four Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	..................)	(.. percent ..)
Less than 10	-64	-70	-6	-9.9%
10 - 15	526	177	-349	-66.3
15 - 20	1,375	985	-390	-28.3
20 - 30	2,590	2,248	-342	-13.2
30 - 50	5,720	5,521	-199	-3.5
50 - 100	16,529	16,593	64	0.4
100 - 200	42,090	42,707	617	1.5
200 and over	127,755	131,298	3,543	2.8

Office of the Secretary of the Treasury
Office of Tax Analysis

January 10, 1978

The President's 1978 Tax Program

DEPARTMENT OF THE TREASURY / Washington, D.C.

Embargoed for Release
at 12:00 noon, EST
Saturday, January 21, 1978

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EMBARGOED FOR SUNDAY AMs January 20, 1978

Office of the White House Press Secretary

THE WHITE HOUSE

TO THE CONGRESS OF THE UNITED STATES:

I recommend that Congress enact a series of proposals that will reform our tax system and provide $25 billion in net tax reductions for individuals and businesses.

Fundamental reform of our tax laws is essential and should begin now. Tax relief and the maintenance of a strong economy are essential as well. The enactment of these proposals will constitute a major step towards sustaining our economic recovery and making our tax system fairer and simpler.

The Need for Tax Reduction

I propose net tax reductions consisting of:

-- $17 billion in net income tax cuts for individuals, through across-the-board rate reductions and a new personal credit, focused primarily on low and middle-income taxpayers.

-- $6 billion in net income tax cuts for small and large corporations, through reductions in the corporate tax rates and extensions of the investment tax credit.

-- $2 billion for elimination of the excise tax on telephone calls and a reduction in the payroll tax for unemployment insurance.

These tax reductions are a central part of the Administration's overall economic strategy, which will rely principally upon growth in the private sector to create the new jobs we need to achieve our high-employment objective. The tax reductions will more than offset the recent increase in social security taxes and will provide the consumer purchasing power and business investment strength we need to keep our economy growing strongly and unemployment moving down.

Together with the programs that I will outline in my Budget Message, these tax cuts should assure that our economy will grow at a 4-1/2 to 5 percent pace through 1979, with unemployment declining to between 5-1/2 and 6 percent by the end of 1979. Without the tax cuts, economic growth would slow markedly toward the end of 1978 and fall to about 3-1/2 percent in 1979. Unemployment would be unlikely to fall below 6 percent and, by the end of 1979, might be moving upward.

This tax program will mean up to one million additional jobs for American workers. It should lead to a pattern of economic growth which is steady, sustainable, and non-inflationary.

In addition, I believe that our taxpayers, particularly those in the low and middle-income brackets, deserve significant tax relief -- I am determined to reduce Federal taxes and expenditures as a share of our Gross National Product.

The Need for Tax Reform

The $25 billion in tax reductions are net reductions, after taking account of $9 billion in revenue-raising reforms which I am also proposing. Indeed, the full cuts in personal and corporate tax rates which I recommend would not be desirable in the absence of significant reform.

But these reforms stand on their own merits and would be long overdue even if I were not proposing any net tax reductions to accompany them. They focus on simplification for the individual taxpayer and the elimination of some of the most glaring tax preferences and loopholes.

Guided by the need for tax simplification and tax equity, I propose that Congress adopt reforms that would:

- Sharply curtail tax shelters.
- Eliminate the deductions claimed by businesses for theater and sporting tickets, yachts, hunting lodges, club dues, and first-class airfare and limit the deduction for the cost of meals to 50 percent.
- Provide a taxable bond option for local governments and modify the tax treatment of industrial development bonds.
- Strengthen the minimum tax on items of preference income for individuals.
- Repeal the special alternative tax on capital gains, which only benefits individuals in the highest tax brackets.
- Replace the personal exemption and general tax credits with a $240 per person credit.
- Simplify return preparation and recordkeeping by:
  - eliminating the deductions for sales, personal property, gasoline, and miscellaneous taxes;
  - combining the separate medical and casualty deductions and allowing them only to the extent they exceed 10 percent of adjusted gross income;
  - repealing the deduction for political contributions but retaining the credit; and
  - liberalizing and modifying the Subchapter S and depreciation rules applicable to small businesses.
- Include unemployment compensation benefits in the taxable income of taxpayers above certain income levels.

-- Ensure that the tax preferences available for fringe benefits assist rank-and-file workers as well as executive officers.

-- Eliminate the special bad debt deduction for commercial banks, reduce the bad debt deduction available to savings and loan associations, and remove the tax exemption for credit unions.

-- Phase out the tax subsidies for Domestic International Sales Corporations (DISCs) and the deferral of tax on foreign profits.

These reforms will make our tax system both fairer and simpler. Many of them are targeted at tax preferences and subsidies for activities that do not deserve special treatment and that largely benefit those who have no need for financial assistance. The average working man and woman pay for the loopholes and the special provisions in our tax laws -- because when some do not pay their fair share, the majority must pay higher taxes to make up the difference.

Low and middle-income workers, struggling to make ends meet, are discouraged by tax laws that permit a few individuals to live extravagantly at the expense of government tax revenues. The privileged few are being subsidized by the rest of the taxpaying public when they routinely deduct the cost of country club dues, hunting lodges, elegant meals, theater and sports tickets, and night club shows. But the average worker's rare "night on the town" is paid for out of his own pocket with after-tax dollars.

Likewise, individuals who pay taxes on nearly every penny of earnings are treated unfairly compared to the few who are able to "shelter" their high incomes from taxes. Some persons with incomes exceeding $200,000 have little or no tax liability, while other high-income individuals return to the Federal government nearly 60 cents of every dollar received. There is no good reason for next-door neighbors, in the same economic circumstances, to have vastly different tax bills because one has found tax shelters and loopholes.

In addition to the preferences for expense account items and tax shelter activities, there are a number of equally inappropriate and inefficient corporate tax subsidies. For example, there is no justification for the DISC export subsidy under which we pay over $1 billion a year in foregone tax revenue (mostly to our largest corporations) to encourage our firms to do what they would do anyway -- export to profitable foreign markets. Nor can we rationalize proposals to reduce business taxes to increase investment at home while the deferral subsidy encourages multinational corporations to invest overseas by letting them pay lower taxes on their foreign profits than they pay on money earned in the United States.

I ask Congress to join with me to end these unwarranted subsidies and return the revenue to the vast majority of our taxpayers who want no more or less than to pay their fair share.

The tax reforms and tax reductions which I am proposing have been carefully balanced to coordinate with our overall economic and budgetary strategy. Large tax reductions are premised on substantial reforms.

I must, therefore, caution that fiscal prudence will require significantly reduced tax cuts for low and middle-income taxpayers if we cannot help finance the reductions I have proposed through enactment of these revenue-raising reforms. I am proposing a balanced tax program, and I urge Congress to consider these recommendations as an integrated package.

Tax Reduction and Simplification for Individuals

Under this tax program, virtually all Americans will receive substantial tax relief, principally through a simple, across-the-board reduction in personal tax rates. Lower withholding rates will be put into effect October 1, 1978, and taxpayers will experience an increase in take-home pay and purchasing power as of that date.

The typical taxpayer in all income classes up to $100,000 will pay lower taxes. But the bulk of relief has been targeted to low and middle-income taxpayers.

The $240 credit will be especially beneficial for low and middle-income families. It will remove millions of Americans at or near the poverty level from the income tax rolls. No longer will the tax savings for dependents be worth more to high income than low income families. Instead, the credit will be worth just as much to the moderate income blue-collar worker as to the wealthy executive.

Over 94 percent of the net individual tax relief will be provided to individuals and families earning less than $30,000 per year, and every income class up to $30,000 will bear a smaller share of the overall tax burden than it does now. (See Table 4.) Under my proposals, the typical family of four that earns $15,000 a year will save almost $260, a 19 percent tax reduction.

For most persons in the low and middle-income brackets, there will be a sizeable net reduction in combined income and payroll taxes even after the scheduled social security tax increases are taken into account. (See Table 10.) Without this cut in income taxes, the social security tax increases would cause a reduction in the take-home pay of American workers. With this tax program, we will have restored the integrity of the Social Security system -- returning that system to a sound financial basis and assuring the stability of future benefits for retired workers -- without increasing total taxes for most working people or causing a slowdown in our economic recovery.

We must also act to ease the burdens of tax return preparation and recordkeeping. We have a tax system that requires millions of individuals to compute their own tax liability. The government relies upon the good faith and conscientiousness of our taxpayers to an extent unparalleled in the rest of the world. But in order for our system to remain successful, it must be comprehensible to the average taxpayer.

Judged by this standard, the current tax structure is seriously defective. Millions of honest and intelligent Americans find themselves confused and frustrated by its complexity. The cost of this complexity is enormous in terms of hours and dollars spent.

Accordingly, tax simplification has been a goal of this Administration from the outset. The tax return individuals will file between now and April 15 has been simplified as a result of the Tax Reduction and Simplification Act which I proposed and Congress enacted last year. The short form 1040A has been reduced from 25 lines to 15 lines. Form 1040 has been restructured so that it can be completed more systematically. Tax tables have been revised to reduce arithmetic computations. The language of the tax forms and the instructions has been made more understandable.

The simplification efforts that were begun in 1977 will be continued and expanded in the tax program I am presenting today. The replacement of the existing personal exemption and general tax credits by the $240 personal credit will simplify return preparation for taxpayers and enable millions of individuals at or below the poverty level to file no tax return. Changes in itemized deductions (which will be more than offset by the rate cuts) will increase the number of nonitemizers to 84 percent of all taxpayers. Six million Americans will be able to switch to the standard deduction and avoid keeping detailed records for tax purposes. The preparation of returns by itemizers will be simplified, and the tax program will reduce recordkeeping burdens on small businesses.

Business and Anti-Inflation Tax Reductions

Our Nation's employment and anti-inflation goals cannot be met without a strengthening of private business investment. In recent years, capital spending in the United States has been inadequate. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948-1969, to 3.5 percent from 1969-1973, and to 3 percent from 1973-1976. Real business fixed investment in the third quarter of 1977 was 5 percent below its 1974 peak.

In order to encourage needed capital outlays in the period ahead, my tax program contains annual net business tax reductions of approximately $6 billion. The corporate tax rate will be reduced on October 1, 1978 from 20 percent to 18 percent on the first $25,000 of income and from 22 percent to 20 percent on the second $25,000 -- this will result in a 10 percent reduction in tax liability for most small corporations. The tax rate for large corporations will be cut from 48 percent to 45 percent on October 1, 1978 and to 44 percent on January 1, 1980.

I also recommend several important changes in the existing 10 percent investment tax credit: the 10 percent credit should be made permanent; liberalized to cover up to 90 percent of tax liability; made fully applicable to qualified pollution control facilities; and extended to investments in industrial and utility structures (including rehabilitation of existing structures). These changes should be particularly beneficial to developing businesses that are seeking to expand their productive facilities and should help to increase expenditures for the construction of new factories.

The corporate rate reductions and extensions of the investment tax credit which I am proposing will encourage capital formation by providing an immediate increase in cash flow to business and by enhancing the after-tax rewards of investment.

All small businesses will receive significant cuts in their tax rates under my program: reducing the bottom as well as the top corporate rates will be of special benefit to small corporations; small business proprietorships and partnerships will benefit from the individual rate cuts. In addition to these tax reductions, my program will simplify the depreciation rules applicable to small business and liberalize the provisions governing the deductions of losses on stock held in small companies.

Vigorous business investment will help ease inflationary pressure by averting capacity shortages that might otherwise occur as our economy continues to grow. The $2 billion reduction in telephone excise taxes and employer payroll taxes should provide additional relief from inflation by reducing costs and prices. These tax measures, applied in conjunction with other anti-inflation policies announced in my Economic Report, will support the objective of reducing and containing the rate of inflation.

The combination of these tax cuts and needed business tax reforms will result in a tax system that meets the needs of the broad spectrum of U.S. businesses more efficiently and equitably.

A detailed description of my program follows.

RECOMMENDATIONS TO REDUCE TAXES AND SIMPLIFY RETURNS FOR THE AVERAGE TAXPAYER

Tax Reductions for Individuals

Individual taxes will be reduced through across-the-board rate cuts and substitution of a single $240 personal credit for the existing personal exemption and alternative general credits. This tax relief will be reflected in decreased withholding rates for employees as of October 1, 1978.

The tax reductions I am now recommending do not include adjustments for Congressional action on the National Energy Plan. In April, I proposed that Congress pass the crude oil equalization tax and rebate the proceeds to the American people on a per capita basis. This course is essential if we are to protect the real incomes of consumers. If the final energy bill includes a full rebate of the net proceeds of the crude oil tax, no further action on my part will be required. However, if the final bill contains a rebate provision only for 1978 -- as provided in the House version -- I intend to send a supplemental message to Congress recommending that the individual tax reductions proposed in this Message be increased by the net proceeds of the crude oil tax.

(1) Rate Cuts. The proposed rate schedule will range from a lowest bracket of 12 percent to a top bracket of 68 percent, compared with the current 14 to 70 percent range. As under current law, the top rate bracket will apply with respect to income in excess of $200,000 for joint returns and $100,000 for single returns. The entire schedules are set forth in Tables 11 and 12. This new rate structure will, in and of itself, increase the overall progressivity of the individual income tax because the cuts are proportionately larger in the low and middle-income brackets.

(2) Per Capita Tax Credit. The tax benefits for dependents currently favor the wealthy over persons with modest incomes. A taxpayer is now entitled to a $750 exemption for each family member in addition to a general tax credit, which is equal to the greater of $35 per family member or 2 percent of the first $9,000 of taxable income. The net effect of the complicated series of exemptions and credits is this: a family of four in the 50 percent tax bracket enjoys a tax savings of $1,680 for dependents while families earning $10,000 save about one-third of that amount.

I propose that the existing exemption and general credits be replaced with a single credit of $240 per family member. Unlike the current structure, the new credit will provide the same benefit at all income levels; for a family with four members, the per capita credit will be worth $960 whether that family is middle class or wealthy. The $240 credit will ensure that most families at or near the poverty level will pay no taxes. Also, a single tax credit will simplify tax return preparation by eliminating the confusion caused by the existing combination of exemptions and alternative credits.

Changes in Itemized Deductions

The primary source of complexity in the tax laws for many middle-income individuals is itemized deductions. Average taxpayers have to maintain burdensome records in order to substantiate the deductions and are required to decipher complex tax rules to complete their tax returns. Restructuring of itemized deductions is essential if the tax laws are to be simplified for typical, middle-class individuals and families.

I am recommending changes in itemized deductions that will enable approximately 6 million taxpayers to switch to the simple standard deduction. The number of taxpayers who use the standard deduction will be increased from 77 percent to 84 percent. And the calculation of the deductions for itemizers will be simplified greatly.

The deductions that will be curtailed are ones that add complexity and inequity to the tax system without advancing significant objectives of public policy. We will have a simpler, more efficient tax system if we eliminate

these deductions and return the revenue directly to taxpayers through the rate cuts I propose.

(1) State and Local Taxes. The special deduction will be eliminated for general sales taxes, taxes on personal property (but not on residences or buildings), gasoline taxes, and miscellaneous taxes. These itemized deductions are claimed at nearly uniform rates by all itemizers and result in a relatively small tax benefit. For those taxpayers who do not use the published deduction tables, the record-keeping burden can be substantial.

Moreover, a deduction for these types of taxes cannot be defended on public policy grounds. A deduction for gasoline taxes runs counter to our national effort to conserve energy. And the present level of State sales taxes cannot be said to depend upon the fact that those State taxes are deductible for Federal income tax purposes.

(2) Political Contributions Deduction. Political contributions are now deductible as an itemized deduction in an amount not exceeding $200 for a joint return. Alternatively, a taxpayer may claim a credit against his tax for one-half of his political contributions, with a maximum credit of $50 on a joint return.

The reform program will repeal the political contribution deduction but retain the credit. The deduction is undesirable because it provides a larger subsidy to high-bracket contributors. Due to the present deduction, the wealthiest individuals can contribute $200 at an after-tax cost to them of only $60; middle-income Americans incur a cost of $150 for the same contribution. Elimination of the deduction will enhance tax equity and diminish the confusing complexity of the current scheme of deductions and credits.

(3) Medical and Casualty Deductions. The medical expense deduction is one of the most complicated items on the tax forms. Currently, one-half of the first $300 of health insurance premiums is deductible outright for those who itemize. Other medical expenses (including additional health insurance premiums) are deductible to the extent they are in excess of 3 percent of adjusted gross income. The latter category of deductibility also includes medicines and drugs to the extent they exceed 1 percent of adjusted gross income. And there is a separate deduction for damage to property from a casualty (such as theft or fire) if the loss exceeds $100 and is not reimbursed by insurance.

I recommend substantial simplification of these provisions. The deductions for medical and casualty expenses will be combined, and a new "extraordinary expense" deduction will be available for medical and casualty expenses in excess of 10 percent of adjusted gross income. In the case of casualty losses, the excess over $100 will be included in this computation. Medical insurance premiums and medicines will be treated the same as other medical expenses.

Medical and casualty expenditures should properly be deductible only when they are unusually large and have a significant impact on the taxpayer's ability to pay. The medical expense deduction originally met that standard.

But, as a result of the changing relationship between medical costs and income, that standard is no longer satisfied. Substantial recordkeeping burdens and administrative problems can be eliminated through the proposed simplification of the deduction and the redefinition of "extraordinary" in the light of current experience among taxpayers.

PROPOSALS TO CURTAIL INAPPROPRIATE SUBSIDIES, SPECIAL PRIVILEGES, INEQUITIES AND ABUSES OF THE TAX SYSTEM

Entertainment and Other Expenditures for Personal Consumption

One feature of the current tax system that is most disheartening to average taxpayers is the favorable tax treatment accorded extravagant entertainment expenses that are claimed to be business-related. Some individuals are able to deduct expenditures that provide personal enjoyment with little or no business benefit. And, even where entertainment expenditures may have some relationship to the production of income, they provide untaxed personal benefits to the participants. More than $2 billion of tax revenue is lost every year through these tax preferences.

For example, one person claimed a deduction of $17,000 for the cost of entertaining other members of his profession at his home, at a country club, at sporting events, at restaurants, and at a rental cottage. Another individual wrote off the cost of business lunches 338 days of the year at an average cost far exceeding $20 for each lunch. But there is no deduction in the tax laws for the factory worker's ticket to a football game or the secretary's lunch with fellow workers.

These special tax advantages for the privileged few undermine confidence in our Nation's tax system. The disparity must be eliminated by denying a deduction for expenditures to the extent they provide the participants with such untaxed personal enjoyment and benefits.

(1) Theater and Sporting Events. No deduction will be permitted for purchases of tickets to theater and sporting events. Present law, by allowing a deduction for the purchase of such tickets, provides a "two for the price of one" bargain to some taxpayers. As long as an individual is in the 50 percent tax bracket or above, he may be able to invite a business friend at no cost to himself by having the Federal government pay for at least one-half of the total ticket costs. The overwhelming majority of our citizens pay for their theater and sports tickets out of their own after-tax dollars. No taxpayer should be asked to help subsidize someone else's personal entertainment.

(2) Other Entertainment Expenses. The tax reform program will also deny deductibility of any expenses of maintaining facilities such as yachts, hunting lodges and swimming pools and for fees paid to social, athletic, or sporting clubs. During a recent tax year, one small corporation deducted $67,000 for yacht expenses incurred in entertaining customers and potential customers on cruises and fishing trips. Another small company deducts over $100,000 a year to maintain hunting and fishing lodges to entertain employees of customers. Asking taxpayers to subsidize these kinds of activities for a tiny minority of our citizens strikes at the fairness and integrity of the tax system.

(3) Business Meals. Fifty percent of currently deductible business entertainment expenses for food and beverages will remain deductible, and 50 percent will be disallowed. A substantial portion of business meal expenses represents the cost of personal consumption that must be incurred regardless of the business connection. The millions of Americans who work on farms, in factories and in offices should not be required to provide their tax dollars to support the high-priced lunches and dinners of a relatively small number of taxpayers. The 50 percent disallowance represents a reasonable and fair approach to compensate for the untaxed personal benefit involved.

(4) Foreign Conventions. Many professional, business, and trade organizations can furnish their members with tax-deductible foreign vacations. The method of conferring such tax-subsidized luxury is to sponsor a foreign convention or seminar. A brochure for one professional organization provides the appropriate atmosphere in promoting its foreign seminars:

> "Decide where you would like to go this year: Rome. The Alps. The Holy Land. Paris and London. The Orient. Cruise the Rhine River or the Mediterranean. Visit the islands in the Caribbean. Delight in the art treasures of Florence."

The Tax Reform Act of 1976 placed some limits on the deductibility of foreign convention expenses. But the rules still permit taxpayers to take two foreign vacations a year partially at public expense -- an exception that did not escape the attention of the organization whose 1977 brochure I have quoted.

I am proposing that the deductibility rules for foreign conventions be modified in a manner that will curb abuses while relaxing the current restrictions on conventions held in foreign countries for legitimate business purposes. The two convention rule will be stricken. In its place will be a rule that denies deductibility for foreign convention expenses unless factors such as the purpose and membership of the sponsor make it as reasonable to hold the convention outside the United States and possessions as within.

(5) First Class Air Fare. Another example of public support for private extravagance is the deductibility of first class air fare. Business travel constitutes a legitimate cost of producing income. However, the business purpose is served by purchasing a ticket at coach fare. The undue generosity of a deduction for first class air fare was recognized by Congress in 1976 when a deduction was denied for first class flights to foreign conventions. I propose that the rule be extended to tickets for domestic business travel.

Tax Shelters

Through tax shelters, persons can use "paper" losses to reduce taxes on high incomes from other sources. These shelter devices can slash the effective tax rate for many affluent individuals far below that of average income Americans. Moreover, such shelters attract investment

dollars away from profit-seeking businesses and into ventures designed only for tax write-offs; legitimate businesses suffer competitive disadvantages as a result.

In the Tax Reform Act of 1976, Congress enacted reforms intended to restrict tax shelter abuses. The principal methods used in that legislation were revisions of the minimum tax and the adoption of an "at risk" rule to limit the deductibility of certain tax shelter losses.

However, some promoters have now adapted their operations to provide shelters in forms that were not specifically covered by the 1976 Act. In fact, shelter activity in 1977 may have surpassed the level reached in 1976. Form letters, addressed to "All of Us Who Wish to Reduce Our Taxes," boldly promise tax write-offs several times larger than the amount invested, and persons are urged to pass the message along "to anyone you think may have interest in tax reduction." Tax shelter experts promote their services in large and expensive advertisements in the financial sections of our Sunday papers.

Such flagrant manipulation of the tax laws should not be tolerated. I recommend action that will build upon the 1976 reforms and further reduce tax shelter abuses.

(1) Strengthening of the Minimum Tax. The minimum tax has proved to be one of the most useful devices to limit the attractiveness of tax shelter schemes, and it should be made still more effective. In its current form, the minimum tax is imposed at a rate of 15 percent on the amount of certain tax preference items enjoyed by a taxpayer. But the total amount of tax preferences can be reduced by the greater of $10,000 or one-half of regular tax liability (in the case of individuals) before the minimum tax is applied.

I recommend that the minimum tax for individuals be strengthened by eliminating the offset of one-half of regular tax liability against preference income. This change will make the minimum tax more progressive and a more sharply focused deterrent to the use of tax shelters. Persons making excessive use of preferences will be taxed on their preference income without regard to regular tax liability. On the other hand, those individuals with modest preference income will still be totally exempted from the minimum tax by the $10,000 preference offset, and the minimum tax will not be applied to capital gain realized on the sale of a personal residence. Ninety-eight percent of the $284 million in revenue raised by this proposal will come from taxpayers with incomes exceeding $100,000 and more than 77 percent will come from the income class over $200,000.

(2) Extension of "at risk" Rule. One of the 1976 reforms that should be toughened is the "at risk" rule. That rule denies deductibility for a shelter investor's paper losses that exceed his cash investment and indebtedness for which he has personal liability. My tax reform plan will generally extend the "at risk" provisions to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons.

(3) Changes in Real Estate Depreciation. Reform of real estate depreciation practices is needed to reduce much of the wasteful tax shelter investment that has led to over-building of commercial real estate in such forms as shopping

centers and office buildings. Real estate shelters were left virtually untouched by the 1976 Act. Consequently, these shelters have continued to thrive.

It is time to move depreciation for tax purposes more closely into line with a measurement of actual economic decline. The reform program will generally require taxpayers to base their depreciation for buildings on the straight-line method, using the present average tax lives claimed by taxpayers for different classes of property. Exceptions from the general rule will be granted until 1983 for new multi-family housing, which will be permitted to use a 150 percent declining balance method; new low-income housing will remain eligible for a 200 percent declining balance method until 1983, and for 150 percent thereafter. Needed investment in industrial plants will be encouraged by an extension of the investment credit, as explained below. The investment credit is a more efficient and straight-forward means to provide a tax subsidy for such construction.

(4) Taxation of Deferred Annuities. Another flourishing tax shelter gimmick is the deferred annuity contract. Currently, a person can generally invest in an annuity contract and postpone taxation on the interest build-up until the annuity is actually received. Although originally designed primarily to provide a safe flow of retirement income, the deferred annuity contract is now used commonly as a convenient tax dodge for a wide range of investment opportunities. The shelter benefits are aptly described by the promotional literature:

> "HOW TO POSTPONE TAXES LEGALLY AND EARN INTEREST ON UNCLE SAM'S MONEY........With An Investment That Never Goes Down, Always Goes Up, And Is Guaranteed Against Loss."

I recommend that this tax abuse be eliminated. Under my proposal, the earnings of most deferred annuities will be taxed currently to the purchaser. However, in order that an individual may still use a deferred annuity with guaranteed interest as a means to provide retirement income, the proposal will allow each person to designate a single contract, contributions to which may not exceed $1,000 annually, as a contract that will remain eligible for tax deferral. Also unaffected will be the tax treatment of qualified employee annuities.

(5) Classification of Nominal Partnerships as Corporations for Tax Purposes. In many cases, tax shelter schemes can offer the desired tax benefits to investors only if the shelter vehicle is organized as a partnership rather than a corporation. At the same time, limited partnerships can now provide traditional non-tax attributes of a corporation, such as limited personal liability, centralized management, and transferability of interests without sacrificing partnership tax benefits.

Promoters should not obtain the non-tax attributes of a corporation for their shelters while using technicalities to avoid corporate tax treatment. I recommend that new limited partnerships with more than 15 limited partners be treated as corporations for tax purposes; however, partnerships engaged primarily in housing activities will be excepted from this classification rule.

(6) Tax Audit of Partnerships. Tax shelter partnerships are not themselves subject to the tax assessment mechanism of the Internal Revenue Service; therefore, each individual partner must be audited separately even though the same substantive determinations may be involved. I recommend that legislation be enacted to permit a partnership to be treated as an entity for the purpose of determining tax issues. Tax shelters based on illegitimate deductions should not be permitted to succeed merely because of the difficulties involved in conducting an IRS examination of their activities.

Termination of Alternative Tax for Capital Gains

The wages of most workers are fully subject to tax at the rates contained in the published tax tables. But persons whose income arises from the sale of assets such as stock or land generally receive preferred treatment; a deduction for long-term capital gains has the effect of taxing these gains at a rate that is one-half of the rate for ordinary income. This preference results in an annual revenue loss to the Treasury of $8 billion.

Taxpayers in the highest income brackets are granted an additional tax preference over and above the special capital gains deduction. Individuals above the 50 percent tax bracket can take advantage of a 25 percent tax ceiling on the first $50,000 of capital gains, a provision known as the "alternative tax." The benefits of this provision go exclusively to persons with taxable incomes exceeding $52,000 (if filing a joint return) or $38,000 (if filing a single return) -- less than one percent of all taxpayers.

Through the alternative tax, a wealthy investor can shield nearly 65 percent of his capital gains from taxation -- a benefit that is grossly inequitable when middle-class investors are taxed on one-half of such gains, and most workers are taxed on every cent of their wages and salaries. The alternative tax costs the Treasury over $100 million every year, almost 90 percent of which goes to taxpayers in income classes above $100,000. I propose the repeal of this unfair and complicated tax benefit.

Fringe Benefits Unavailable to Rank-and-File Workers

Our tax system generally operates under the principle that employees should be taxed on their compensation no matter what form that compensation assumes. A worker who receives cash wages that he uses to provide benefits for his family should not ordinarily be taxed more heavily than the employee who receives those benefits directly from his employer. There are now exceptions to this general rule for certain types of employee benefits. I urge Congress to act so that these tax preferences benefit rank-and-file workers as well as the executive officers.

(1) Non-discrimination Requirement for Health and Group Life Plans. An example of a tax-preferred employee benefit is a health or group life insurance plan. If an individual purchases medical insurance, the premiums are deductible only within the limits applicable to the medical expense deduction. However, if an employer establishes a medical insurance program for its employees, the premium payments by the employer are deductible while neither the premiums nor the benefits are taxable to the employee.

Although this tax preference was designed in theory to secure basic protections for a wide range of employees, it often serves instead to subsidize expenses of only the high-level corporate managers. It is now possible for a businessman, through his controlled corporation, to establish a health plan that covers only one employee -- himself -- and permits all of his medical and dental expenses to be deducted. Meanwhile, that corporation's other employees have to provide health care for their families with non-deductible expenditures.

To curb this abuse, I recommend denial of the tax exemption for employer-established medical, disability, and group life insurance plans if those plans discriminate in favor of officers, shareholders, and higher-paid employees. Preferential tax treatment is now available to pension plans only if non-discrimination standards are met. The tax law should require similar non-discriminatory treatment for workers in the case of medical, disability, and group life insurance plans.

(2) Employee Death Benefits. Current law provides an exclusion for the first $5,000 of payments made by an employer on account of the death of an employee. I recommend the repeal of this exclusion. Typically, these death benefits are in the nature of deferred wages that would have been paid to employees in high tax brackets. Adequate tax relief for an employee's heirs is provided through a complete tax exemption for insurance proceeds.

(3) Integration of Qualified Retirement Plans and Social Security. Certain employer-sponsored retirement plans have a preferred tax status. Employer contributions to a qualified plan are currently deductible while the employee can defer taxation until retirement benefits are received. Although qualification for this special treatment is generally dependent upon non-discriminatory coverage of employees, the tax laws now permit a qualified plan to cover only employees who earn amounts exceeding the social security wage base -- a base that will rise to $25,900 by 1980 under the recently enacted social security financing legislation.

It is unfair to grant tax preferences for private pension plans that bar all low and middle-income employees from participation. I propose that a new integration formula be enacted so that a qualified pension plan cannot provide benefits to supplement social security for highly compensated employees unless all employees receive some coverage under the plan.

Unemployment Compensation

Unemployment compensation is a substitute for wages that generally provides needed relief to persons in financial distress. But, in some cases, the unemployment compensation system discourages work for taxable income. Since unemployment benefits are tax-free, they are more valuable than an equivalent amount of wages. This means that if two individuals have the same total income, the one who remains idle several months and receives unemployment compensation will be better off financially than his colleague who works the whole year. There can be no justification for conferring this tax-free benefit upon middle and upper-income workers.

I propose that the current tax exemption for unemployment compensation benefits be phased out as an individual's income rises above $20,000 for single persons or $25,000 for married couples.

Taxable Bond Option and Industrial Development Bonds

Present law exempts from Federal taxation the interest on certain bonds issued by state and local governments. There are now two general categories of tax-exempt bonds: obligations issued for the benefit of the state and local government itself, and industrial development bonds issued by the government to provide facilities such as pollution control equipment, sports facilities, waste disposal facilities, industrial parks, and facilities (including hospitals) of private, non-profit organizations. Also, there is a "small issue" exemption for certain industrial development bonds with face amounts that do not exceed $1 million, or $5 million where the total cost of capital expenditures on the financed facility does not exceed the $5 million amount.

My tax program preserves the freedom of state and local governments to issue tax-exempt bonds. I am recommending reforms that will restrict the tax avoidance opportunities available to the wealthy in the tax-exempt market while, at the same time, increasing the ability of state and local governments to obtain low-cost financing. In particular, I propose the following:

(1) Option for Bonds Benefitting Governmental Units. State and local governments will be given the option of continuing to issue tax-exempt bonds or issuing fully taxable bonds, accompanied by a direct Federal interest subsidy to the governmental units. For bonds issued in 1979 and 1980, the subsidy will be equal to 35 percent of the interest cost; the subsidy will rise to 40 percent for bonds issued after 1980. The Federal government will exercise no control over the purposes for which state and local governments use subsidized financing. State and local governments will benefit under the taxable bond option regardless of whether they decide to issue taxable or tax-exempt bonds: those issuing taxable bonds will benefit directly from the interest subsidy, and those continuing to issue tax-exempt bonds will benefit because the reduced supply of such bonds will allow governments to sell them at lower interest rates.

(2) Pollution Control Bonds, Bonds for the Development of Industrial Parks, and Private Hospital Bonds. The tax exemption will be removed for interest on pollution control bonds and bonds for the development of industrial parks. Also, the exemption will be removed for bonds issued to finance construction of hospital facilities for private, non-profit institutions unless there is a certification by the state that a new hospital is needed. These activities are essentially for the benefit of private users, and the tax exemption for the bonds has the effect of undermining the financing of governmental functions. Moreover, the general exemption for hospital bonds encourages excessive expansion of unneeded hospital facilities and runs counter to the Administration's Hospital Cost Containment proposal.

(3) Small Issue Exemption. The existing "small issue" exemptions will be retained only for economically distressed areas; and, with respect to those areas, the $5 million exemption will be raised to $10 million.

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(4) Option for Certain Industrial Development Bonds. Industrial development bonds which continue to enjoy tax-exempt status (such as those to finance sports facilities, housing, airports and convention facilities and small issues for economically distressed areas) will be eligible for the taxable bond option on the same terms as obligations issued for the benefit of state and local governments.

Accrual Accounting for Large Corporate Farms

Most taxpayers that are in the business of selling products must use an accrual method of accounting so that income is reflected accurately for tax purposes. However, farmers have historically been permitted to use the simpler cash method on the grounds that they lack the accounting and bookkeeping expertise required by the accrual system.

Congress acted in 1976 to deny the cash accounting privilege to most large corporate farms (with annual gross receipts exceeding $1 million), but retained an exception for large corporations that are "family owned." This distinction between family and nonfamily corporations bears no relationship to the rationale of preserving simple bookkeeping methods for small farmers. It has resulted in severe competitive imbalances between large corporations now required to use accrual accounting and those that are equally large but happen to fall within the definition of a "family farm."

This inequitable exception should now be eliminated. Corporate farms with gross receipts exceeding $1 million cannot fairly claim that they lack the sophistication necessary to comply with accrual accounting standards. Nor can lack of financial sophistication be claimed by farm syndicates used as investment vehicles by nonfarmers. Therefore, I recommend that the accrual accounting requirement cover corporations with gross receipts greater than $1 million, regardless of their ownership, and all farm syndicates.

Tax Treatment of Financial Institutions

Financial institutions now have a favored tax status that is based largely on outmoded concepts regarding the nature of these businesses. Commercial banks, mutual savings banks and savings and loan associations were permitted to deduct artificially inflated reserves for bad debts in order to protect the banking system from catastrophic losses that were prevalent prior to the extensive banking legislation of the 1930's. Credit unions were exempted from taxation in the days when these institutions were small entities with close bonds among the members and few powers to provide extensive financial services. I am recommending changes that will recognize the contemporary practices of financial institutions and will bring the tax treatment of commercial banks, savings and loan associations and credit unions more in line with the taxation of other businesses. These reforms will raise $300 million per year in revenue.

(1) Commercial Banks. Commercial banks may now claim bad debt deductions that greatly exceed their actual losses. Under legislation enacted in 1969, this special bad debt

deduction is scheduled for elimination after 1987. I propose that the effective date for repeal be accelerated so that beginning in 1979 banks, like other businesses, will base their bad debt reserves on their own experience in the current and 5 preceding years.

(2) Mutual Savings Banks and Savings and Loan Associations. Mutual savings banks and savings and loan associations are also permitted a special bad debt deduction that bears no relationship to actual experience. These thrift institutions are generally entitled to deduct 40 percent of their net income (this percentage is scheduled to apply in 1979) as a bad debt reserve as long as a significant portion of their deposits is invested in real estate loans. My tax program will reduce the percentage to 30 percent over a 5-year period.

(3) Credit Unions. Credit unions are tax-exempt. Yet, their powers and functions are defined so broadly that the term "credit union" can include financial institutions that are functionally identical to a savings and loan association. The tax exemption provides them with an unfair financial advantage over their competitors. I propose that the percentage of exempt income be phased out over a 4-year period, and that credit unions be taxed in the same manner as mutual savings banks and savings and loan associations after 1982.

Domestic International Sales Corporation (DISC)

Business incentives form an integral part of my tax program. I am recommending measures that will encourage American businesses to invest in productive facilities and to create jobs. However, adoption of those incentives must be accompanied by the elimination of tax preferences that have proved to be wasteful. The so-called "DISC" provision is a prime example.

In 1971, Congress enacted a special tax program for exports. This program permitted tax benefits for exports channeled through a company's specially created subsidiary, usually a paper organization, known as a domestic international sales corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of eligible DISC income is deferred as long as these profits are invested in export related assets.

DISC has proved to be a very inefficient and wasteful export subsidy in the current international monetary system. A recent Treasury study indicates that DISC may have contributed only $1 to $3 billion to U.S. exports in 1974 -- an increase of less than 3 percent in total exports -- at a tax revenue cost of $1.2 billion. In the long run, even these increased exports are probably offset by rising imports that result from the operation of the flexible exchange rate system. DISC does nothing for, and may even disadvantage, our import sensitive industries and our exporters not using the DISC provision. Independent experts believe that DISC may have had no positive effect on our balance of payments.

Congress has recognized the wasteful nature of DISC and, in 1976, limited its applicability. However, DISC continues to cost U.S. taxpayers over $1 billion per year, with 65 percent of DISC benefits going to corporations with more than $250 million in assets.

I propose the elimination of one-third of DISC benefits in 1979, two-thirds in 1980, and all DISC benefits in 1981 and thereafter.

Foreign Tax Deferral

Domestic corporations can now avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. A U.S. tax is generally deferred until dividends are paid by the subsidiary to its domestic parent, and then U.S. tax liability is offset by a tax credit for foreign income taxes paid on those remitted earnings. Fifty percent of all the benefits of tax deferral is obtained by 30 large multinational corporations.

I recommend that this deferral privilege be phased out over a 3-year period. At least one-third of a foreign subsidiary's earnings will be taxed to the U.S. parent in 1979, at least two-thirds in 1980, and all the subsidiary's earnings after 1980. The tax reform program is designed to create incentives for investment in the United States and the creation of jobs for American workers. Tax deferral runs counter to these objectives. By providing a preference for foreign source income, the current deferral provision provides an incentive for investing abroad rather than in the United States, thereby having the effect of reducing job opportunities for Americans. Moreover, deferral can encourage multinational corporations to manipulate internal transfer prices in order to allocate income to low-tax countries.

There is no reason to defer the imposition of a U.S. tax just because business operations are conducted abroad rather than in the United States, regardless of the motivation for creating a foreign subsidiary. Congress eliminated in 1969 certain special tax preferences for businesses conducted in the United States through multi-layered corporations. I propose that Congress act in a similar manner to end the present preference for business operations conducted internationally through such multinational corporate structures.

The foreign tax credit will be retained in its present form. Therefore, elimination of deferral will not result in a double taxation of overseas earnings. And, in the event it appears to be in the national interest to permit tax deferral with respect to specific countries, such treatment can be provided selectively under negotiated tax treaties involving mutual concessions.

SPECIAL TAX REDUCTIONS PROPOSED TO REDUCE COSTS FOR CONSUMERS AND BUSINESSES

I propose two tax reduction measures -- outside the income tax system -- that will assist our efforts to attain price stability.

Repeal of Excise Tax on Telephone Services

The present 4 percent excise tax on amounts paid for telephone services is now being phased out at the rate of 1 percentage point a year, with full repeal scheduled as of January 1, 1982.

I recommend complete repeal of this tax as of October 1, 1978. This action will reduce the cost of living directly. It will also lower consumer prices indirectly through a reduction of the business cost associated with telephone services.

Federal Unemployment Insurance Tax

I recommend a reduction in the Federal unemployment insurance tax to reduce the payroll costs of employers. On January 1, 1978, the unemployment insurance tax rate rose from 0.5 percent to 0.7 percent of an employer's taxable wage base. This tax increase was instituted in order to replenish general revenue funds that have been loaned to the unemployment insurance trust fund during recent periods of high unemployment. But the issue of unemployment compensation financing requires a thorough reexamination to determine the best means of providing future benefits. To this end, I will soon appoint the National Commission on Unemployment Insurance which the Congress established to make this study and to offer recommendations. In the meantime, I am guided by my concerns about inflation. I propose that the tax rate be reduced to the 0.5 percent level as of January 1, 1979.

RECOMMENDED BUSINESS INCENTIVES TO FOSTER GROWTH OF THE ECONOMY

Corporate Rate Cut

I recommend a corporate rate cut that will reduce business taxes by $6 billion. Tax relief in this form is sizable, easily understood by taxpayers, and applicable across the board.

The corporate tax rate is now 20 percent on the first $25,000 of income, 22 percent on the next $25,000, and 48 percent on corporate income exceeding $50,000. Effective October 1, 1978, this program will reduce the first two rate brackets to 18 and 20 percent, respectively, and the rate to 45 percent on taxable income in excess of $50,000. The top rate will be reduced an additional point, to 44 percent, on January 1, 1980. Small as well as large corporations will benefit from these rate cuts.

A corporate rate reduction of this magnitude will increase capital formation and help to assure a sustained economic recovery. In recent years, the level of business fixed investment has been unsatisfactory. One of the primary causes of this inadequate investment performance has been the low rate of return businesses receive on their investments -- after tax liability is taken into consideration. The lower tax rates I recommend will enhance the anticipated after-tax profits on corporate investment projects and increase cash flow immediately. Businesses will thereby be encouraged to increase capital spending and to create jobs for American workers. Corporate rate cuts this large are made possible by, and depend upon, passage of the revenue-raising business tax reforms I have described earlier.

<u>Liberalization of Investment Tax Credit</u>

The investment tax credit has proven to be one of the most potent tax incentives for capital formation. It provides a direct reduction in tax liability generally equal to 10 percent of a business' qualifying investments. But there are now several limitations that restrict its effectiveness.

I recommend changes that will make the investment credit a stronger, more efficient, and more equitable incentive. These changes will reduce business taxes by approximately $2.5 billion per year.

(1) <u>Permanent 10 Percent Credit.</u> The present 10 percent investment credit is not a permanent feature of the Internal Revenue Code. On January 1, 1981, the credit level is scheduled to revert to 7 percent. I propose that the credit be extended permanently at a 10 percent rate so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

(2) <u>Increased Tax Liability Ceiling.</u> The investment credit claimed during any taxable year cannot generally exceed $25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a 3-year carryback and a 7-year carry-forward). My tax program will provide a ceiling of 90 percent of tax liability (including the first $25,000) and will thereby increase the incentive for those businesses with relatively high investment needs and low taxable incomes. Developing businesses and firms suffering from temporary business reversals will be helped to compete more effectively with their larger or more stable competitors.

(3) <u>Eligibility of Structures.</u> The investment credit now applies only to machinery and equipment. My tax program will extend eligibility for the credit to utility and industrial structures, where investments have been especially sluggish. Investment in these structures reached its peak over 4 years ago and is now 16 percent below that level. It is important that we act to remedy the existing tax bias against structures and encourage balanced industrial expansion. In order to ensure that this provision has no anti-urban bias, I propose that the investment credit be available for both new structures and the rehabilitation of existing structures.

I recommend that this provision apply to construction costs incurred after December 31, 1977. In the case of new structures, there will be an additional requirement that the facility be placed in service after that date.

(4) <u>Liberalized Credit for Pollution Control Facilities.</u> I propose that pollution abatement facilities placed in service after December 31, 1977, be allowed to qualify for a full 10 percent credit even if special 5-year amortization is claimed under the provisions of existing law. Currently, only a 5 percent credit may be combined with rapid amortization. This proposal will provide significant tax relief for industries that are forced to make pollution control expenditures in order to comply with environmental regulations.

Revision and Simplification of Regulations Under the Asset Depreciation Range System

The asset depreciation range (ADR) system provides substantial tax benefits to businesses. Under ADR, generous class lives are prescribed for categories of assets, and a taxpayer can select useful lives for depreciation purposes within a range that extends from 20 percent below to 20 percent above the designated class life. However, certain complexities in the ADR regulations discourage most businesses, especially small ones, from electing this depreciation system and impose administrative burdens on those businesses that do use ADR.

I recommend legislation expressly permitting the Treasury Department to issue regulations that will simplify the ADR system. Included among the changes will be a termination of the annual reporting requirement.

Proposals Focused on Small Business

The tax reductions I recommend will provide significant benefits for small businesses. For example, a small corporation with annual income of $50,000 will save $1,000 in taxes due to corporate rate reductions. For that corporation, tax liability will be reduced by nearly 10 percent. Moreover, those small businesses conducted in partnership or sole proprietorship form will benefit substantially from the rate cuts I have proposed for individuals.

But in addition to providing these general tax incentives, I recommend three proposals designed specifically to assist small businesses. First, my tax program will simplify and liberalize the rules (Subchapter S) that treat certain small corporations as partnerships; the number of permissible shareholders will generally be increased from 10 to 15, and the rules governing subchapter S elections will be made less stringent. Second, a simplified method of depreciation will be authorized for small businesses that will provide tax benefits similar to the current ADR system without complex recordkeeping requirements. And third, risk-taking will be encouraged by doubling the amount of a small corporation's stock (from $500,000 to $1 million) that can qualify for special ordinary loss treatment and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

CONCLUSION

Enactment of these recommendations will effect major reform of our tax laws, provide significant tax relief, and sustain our economic recovery.

This program will eliminate a number of the inequities that undermine the integrity of the tax system. It will make preparation of returns simpler and more understandable for millions of taxpayers. Prompt passage will strengthen the confidence of consumers and businesses in our growing economy and lead to the creation of up to one million new jobs for workers who need them.

I look forward to working in partnership with Congress to enact this program of tax reform and tax reduction.

JIMMY CARTER

THE WHITE HOUSE,

Table 1

Summary of Revenue Effects of Income Tax Reductions, Tax Reforms and Telephone Excise and Unemployment Insurance Tax Reductions

($billions)

	Fiscal Years				
	1979	1980	1981	1982	1983
Individual Income Tax:					
Tax reductions	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms	4.2	7.4	8.9	10.6	12.3
Net change	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation Income Tax:					
Tax reductions	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms	1.1	3.0	4.3	5.0	5.2
Net change	-5.1	-6.5	-6.8	-6.8	-7.6
Telephone excise and unemployment insurance tax reductions	-1.6	-2.0	-1.6	-1.2	-1.1

Table 2

The Effect of Tax Proposals on Calendar Year Tax Liability

($ millions)

	Full year 1976	Calendar Years 1978	1979	1980	1981	1982	1983
$240 credit and reduced tax rates	-17,305	-6,067	-23,538	-26,583	-30,272	-34,732	-40,110
Itemized deduction changes:							
Repeal gasoline tax deductions	582		862	983	1,121	1,277	1,456
Repeal sales tax deductions	1,672		2,477	2,824	3,219	3,670	4,184
Repeal miscellaneous tax deductions	384		569	649	739	843	961
Deduction for medical and casualty expenses	1,396		1,909	2,119	2,352	2,611	2,898
Repeal political contributions deduction	2		2	4	2	3	3
Repeal capital gains alternate tax	113		140	151	162	174	187
Individual real estate tax shelters	320		61	181	296	407	514
Taxation of unemployment benefits	275		212	207	204	204	214
Tax interest element of annuity contracts	320		12	26	40	57	80
Minimum tax change	229		284	306	329	353	380
Taxable bond option (individual)	255		197	592	1,080	1,666	2,218
Extend 10 percent investment tax credit to structures (indiv.)	-36	-47	-54	-65	-73	-79	-86
Limit individual tax credits to 90 percent of tax before credits	38		52	58	64	71	79
Tax qualified retirement plans and employee death benefits	30		32	32	33	33	34
Corporate real estate shelters	180		40	118	194	265	335
Corporate family farm accounting	30		40	25	10	5	7
Bad debt reserves:							
Commercial banks	196		227	232	232	23	--
Mutual savings banks and savings and loans	82		37	85	145	221	316
Credit unions	82		22	50	83	123	171
Entertainment expenses	1,125		1,476	1,633	1,771	1,932	2,107
Taxable bond option (corporations)	-24		-15	-47	-79	-113	-150
Phase-out DISC over 3 years	852	193	664	1,228	1,513	1,613	1,751
Phase-out deferral of tax on foreign source income	523		88	280	768	830	897
Corporate tax rate reduction	-5,718	-1,349	-5,965	-8,516	-9,228	-10,010	-10,764
At risk limitation (corporations)	10		14	10	8	5	6
Increase investment tax credit limit to 90 percent	-71		-882	-576	-114	-194	-205
Extend 10 percent investment tax credit to structures (corporations)	-1,055	-1,100	-1,389	-1,649	-1,869	-2,074	-2,268
Nondiscrimination rule for health and group term life plans	29		32	33	34	35	36
Full investment tax credit for pollution abatement facilities	-90	-142	-93	-107	-127	-115	-144
Total individual	-11,725	-6,114	-16,783	-18,516	-20,704	-23,442	-26,988
Total corporate	-3,849	-2,398	-5,704	-7,201	-6,659	-7,454	-7,905
Subtotal tax reform	-15,574	-8,512	-22,487	-25,717	-27,363	-30,896	-34,893
Repeal telephone excise tax	--	-355	-1,200	-900	-500	--	--
Reduce unemployment payroll tax rate	--	--	-850	-900	-950	-1,000	-1,050
Total	-15,574	-8,867	-24,537	-27,517	-28,813	-31,896	-35,943

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Table 3

Expanded Income and Tax Liability Under Present Law
And Tax Proposals (Personal Only)

(1976 Levels of Income)

($ millions)

Expanded Income Class ($000)	Number of Returns (thousands)	Expanded Income	Present Law: Tax Liability	Present Law: Effective Tax Rate	Administration Proposal: Tax Liability	Administration Proposal: Effective Tax Rate
Less than 5	25,474	57,557	141	0.2%	-251	-0.4%
5 - 10	20,109	149,590	8,227	5.5%	6,368	4.3%
10 - 15	16,106	201,036	18,071	9.0%	15,361	7.6%
15 - 20	11,824	205,086	23,009	11.2%	20,148	9.8%
20 - 30	9,907	237,041	32,778	13.8%	29,593	12.5%
30 - 50	3,347	124,836	22,017	17.6%	20,971	16.8%
50 - 100	985	67,484	16,492	24.4%	16,344	24.2%
100 - 200	198	27,371	8,084	29.5%	8,261	30.2%
200 and over	49	21,573	6,476	30.0%	6,838	31.7%
Total	87,998	1,091,573	135,293	12.4%	123,633	11.3%

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Table 4

Income Tax Liabilities: Present Law and Administration Proposal
(Personal Income Only)

(1976 Levels of Income)

Expanded Income Class	Present Law		Administration Proposal		Tax Change	
	Tax Liability	Percentage Distribution	Tax Liability	Percentage Distribution	Tax Liability	Change as Percent of Present Law Tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	(percent)
Less than 5	141	0.1%	-251	-0.2%	-392	-278.0%
5 - 10	8,227	6.1	6,368	5.2	-1,859	-22.6
10 - 15	18,071	13.4	15,361	12.4	-2,710	-15.0
15 - 20	23,009	17.0	20,148	16.3	-2,861	-12.4
20 - 30	32,778	24.2	29,593	23.9	-3,185	-9.7
30 - 50	22,017	16.3	20,971	17.0	-1,046	-4.8
50 - 100	16,492	12.2	16,344	13.2	-148	-0.9
100 - 200	8,084	6.0	8,261	6.7	177	2.2
200 and over	6,476	4.8	6,838	5.5	362	5.6
Total	$135,293	100.0%	$123,633	100.0%	$-11,660	-8.6%

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Note: Details may not add to totals due to rounding.

Table 5

Burden Table

Single Returns

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	..................)	(.. percent ..
Less than 10	217	181	-36	-16.4%
10 - 15	1,595	1,519	-76	-4.8
15 - 20	2,768	2,591	-177	-6.4
20 - 30	4,236	3,917	-319	-7.5
30 - 50	8,254	7,660	-594	-7.2
50 - 100	18,465	17,889	-576	-3.1
100 - 200	42,015	41,714	-301	-0.7
200 and over	161,723	167,760	6,037	3.7

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Table 6

Burden Table
Joint Returns
No Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	..................)	(.. percent ..)
Less than 10	168	95	-73	-43.6%
10 - 15	1,104	983	-121	-11.0
15 - 20	2,084	1,906	-178	-8.5
20 - 30	3,615	3,308	-307	-8.5
30 - 50	6,921	6,535	-386	-5.6
50 - 100	17,020	16,647	-373	-2.2
100 - 200	40,403	40,956	553	1.4
200 and over	132,121	137,140	5,020	3.8

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Table 7

Burden Table
Joint Returns
One Dependent

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..................	dollars	..................)	(.. percent ..
Less than 10	65	-38	-103	-157.8%
10 - 15	1,024	824	-200	-19.5
15 - 20	1,922	1,696	-226	-11.7
20 - 30	3.392	3,063	-329	-9.7
30 - 50	6,709	6,327	-382	-5.7
50 - 100	16,938	16,625	-313	-1.8
100 - 200	41,993	42,264	271	0.6
200 and over	121,583	125,202	3,620	3.0

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Table 8

Burden Table
Joint Returns
Two Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	9	-79	-88	-975.6%
10 - 15	867	589	-278	-32.1
15 - 20	1,739	1,461	-278	-16.0
20 - 30	3,117	2,780	-337	-10.8
30 - 50	6,287	5,979	-308	-4.9
50 - 100	16,336	16,088	-248	-1.5
100 - 200	40,885	41,087	202	0.5
200 and over	127,666	130,473	2,807	2.2

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Table 9

Burden Table
Joint Returns
Three Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..................	dollars	..................)	(.. percent ..
Less than 10	-41	-81	-40	-97.7%
10 - 15	693	367	-326	-47.0
15 - 20	1,562	1,218	-344	-22.0
20 - 30	2,867	2,514	-353	-12.0
30 - 50	5,872	5,609	-263	-4.5
50 - 100	15,924	15,785	-139	-0.9
100 - 200	40,417	40,827	410	1.0
200 and over	126,915	130,397	3,483	2.7

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Table 10

Income Tax and FICA Tax Changes
Four Person, One-earner Families

Wage Income	Income Tax [1]	FICA Tax [2]	Total Tax
$ 5,000	0	14	14
10,000	-312	28	-284
15,000	-258	42	-216
20,000	-270	120	-150
25,000	-320	298	-22
30,000	-322	298	-24
40,000	-218	298	80
50,000	-80	298	218
100,000	590	298	888

[1] Assumes deductible expenses equal to 23 percent of income under present law and 20 percent under the proposal.

[2] Change in FICA tax calculated assuming present law rate and base for 1979 (6.13 percent and $22,900), employees' share only and assuming prior law rate for 1977 (5.85 percent) and prior law estimated base for 1979 ($18,900).

Table 11

Individual Tax Rate Schedules For
Joint Returns

	Present Law		Tax Proposal	
Taxable Income Bracket 1/	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket
0 - 500	0	14%	0	12%
500 - 1,000	70	14	60	12
1,000 - 2,000	140	15	120	14
2,000 - 3,000	290	16	260	16
3,000 - 4,000	450	17	420	17
4,000 - 8,000	620	19	590	18
8,000 - 12,000	1,380	22	1,310	19
12,000 - 16,000	2,260	25	2,070	20
16,000 - 20,000	3,260	28	2,870	23
20,000 - 24,000	4,380	32	3,790	27
24,000 - 28,000	5,660	36	4,870	32
28,000 - 32,000	7,100	39	6,150	36
32,000 - 36,000	8,660	42	7,590	39
36,000 - 40,000	10,340	45	9,150	42
40,000 - 44,000	12,140	48	10,830	44
44,000 - 48,000	14,060	50	12,590	48
48,000 - 52,000	16,060	50	14,510	48
52,000 - 54,000	18,060	53	16,430	51
54,000 - 62,000	19,120	53	17,450	51
62,000 - 64,000	23,360	53	21,530	51
64,000 - 76,000	24,420	55	22,550	54
76,000 - 88,000	31,020	58	29,030	57
88,000 - 90,000	37,980	60	35,870	57
90,000 -100,000	39,180	60	37,010	60
100,000 -110,000	45,180	62	43,010	60
110,000 -120,000	51,380	62	49,010	62
120,000 -130,000	57,580	64	55,210	62
130,000 -140,000	63,980	64	61,410	64
140,000 -150,000	70,380	66	67,810	64
150,000 -160,000	76,980	66	74,210	65
160,000 -175,000	83,580	68	80,710	65
175,000 -180,000	98,780	68	90,460	66
180,000 -200,000	97,180	69	93,760	66
200,000 and over	110,980	70	106,960	68

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1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $3,200.

Table 12

Individual Tax Rate Schedules For Single Returns

Taxable Income Bracket 1/	Present Law: Tax At Low End of Bracket	Present Law: Tax Rate on Income In Bracket	Tax Proposal: Tax At Low End of Bracket	Tax Proposal: Tax Rate on Income In Bracket
0 - 500	0	14	0	12
500 - 1,000	70	15	60	13
1,000 - 1,500	145	16	125	15
1,500 - 2,000	225	17	200	15
2,000 - 3,000	310	19	275	18
3,000 - 4,000	500	19	455	19
4,000 - 6,000	690	21	645	20
6,000 - 8,000	1,110	24	1,045	20
8,000 -10,000	1,590	25	1,445	22
10,000 -12,000	2,090	27	1,885	23
12,000 -14,000	2,630	29	2,345	25
14,000 -16,000	3,210	31	2,845	25
16,000 -18,000	3,830	34	3,345	29
18,000 -20,000	4,510	36	3,925	29
20,000 -22,000	5,230	38	4,505	33
22,000 -24,000	5,990	40	5,165	33
24,000 -26,000	6,790	40	5,825	38
26,000 -28,000	7,590	45	6,585	38
28,000 -32,000	8,490	45	7,345	41
32,000 -36,000	10,290	50	8,985	46
36,000 -38,000	12,290	50	10,825	50
38,000 -40,000	13,290	55	11,825	50
40,000 -44,000	14,390	55	12,825	51
44,000 -48,000	16,590	60	14,865	57
48,000 -50,000	18,990	60	17,145	58
50,000 -52,000	20,190	62	18,305	58
52,000 -54,000	21,430	62	19,465	60
54,000 -60,000	22,670	62	20,665	60
60,000 -62,000	26,390	64	24,265	60
62,000 -64,000	27,670	64	25,465	63
64,000 -70,000	28,950	64	26,725	63
70,000 -76,000	32,790	66	30,505	63
76,000 -80,000	36,750	66	34,285	66
80,000 -88,000	39,390	68	36,925	66
88,000 -90,000	44,830	68	42,205	66
90,000 -100,000	46,190	69	43,525	67
100,000 and over	53,090	70	50,225	68

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1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $2,200.

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Fact Sheet 1

January 21, 1978

FACT SHEET

Overview of The Tax Reduction and Reform Act of 1978

The President's Proposal:

A major tax cut for individuals and business is combined with a major package of tax reforms.

Objectives

The proposal will:

° reduce taxes for most Americans, even after the recently legislated increase in social security taxes;

° help sustain the economic expansion and move the economy toward full employment;

° provide incentives for increased investment in productive facilities and for increased efficiency in the American economy;

° increase tax fairness by making the taxes actually paid more progressive and by reducing differences in taxes levied on taxpayers with like incomes;

° make the tax system simpler for individuals and business by making it easier for the average person to complete his or her tax return, making tax rules more understandable and removing special provisions.

Tax Cuts

For individuals, the President proposes cuts in individual tax rates and the adoption of a $240 per capita tax credit, in place of the existing $750 exemption and general tax credit, that will reduce taxes by $23.5 billion in calendar year 1979.

For business, the President proposes a tax cut of $8.4 billion in 1979 through reductions in the corporate tax rates and liberalization of the existing investment tax credit.

The President also proposes an additional $2 billion tax reduction for individuals and businesses by eliminating the excise tax on telephone service and reducing the Federal unemployment compensation payroll tax.

Thus, gross tax cuts are proposed which total $33.9 billion in 1979.

Tax Reform

These cuts are coupled with important reforms that will increase revenues in 1979 by $9.4 billion, and will make the tax system simpler and fairer. While the package of reforms is substantial, it is a practical size that will permit Congressional action in 1978.

Net Reduction

The tax cuts and reforms provide a net tax reduction in 1979 of $24.5 billion. This amount is considered optimal in the light of the prospects for the economy and the need to offset other tax increases. The full tax reductions recommended by the President would not be appropriate without the revenue raised by the proposed tax reforms.

Attached tables provide a summary of the revenue effect of the major elements of the program for 1979 and detailed data for the specific proposals for calendar years 1978 through 1983. Also attached is a summary statement of revenue effects for fiscal years 1979 through 1983.

Because of income growth, the net tax reduction will increase, after taking into account implementation of some reforms in stages, from $24.5 billion in 1979 to about $36 billion in 1983. The proposed tax cuts will reduce taxes for 1978 by $8.9 billion.

The investment credit changes will generally be effective as of January 1, 1978. The rate cuts will be effective beginning October 1, 1978. The tax reform proposals will generally take effect in 1979 and will not affect 1978 tax liabilities.

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Summary of Tax Proposals

Proposal	Revenue Effect 1979 ($billions)
• Reduce Individual Tax Rates and Adopt $240 Personal Credit	-23.5
• Limit Itemized Deductions	+5.8
• Restrict Tax Shelters and Other Opportunities to Receive Tax-Preferred Income	+1.0
• Restrict Deductions for Entertainment and Travel Expenses	+1.5
• Reduce Corporate Tax Rates	-6.0
• Liberalize Investment Tax Credit	-2.4
• Curtail Business Tax Preferences	+1.1
• Reduce Telephone Excise and Unemployment Taxes	-2.0
Total	**-24.5**

The Effect of Tax Proposals on Calendar Year Tax Liability

($ millions)

	Full year 1976	Calendar Years 1978	1979	1980	1981	1982	1983
$240 credit and reduced tax rates	-17,305	-6,067	-23,538	-26,583	-30,272	-34,732	-40,110
Itemized deduction changes:							
Repeal gasoline tax deductions	582		862	983	1,121	1,277	1,456
Repeal sales tax deductions	1,672		2,477	2,824	3,219	3,670	4,184
Repeal miscellaneous tax deductions	384		569	649	739	843	961
Deduction for medical and casualty expenses	1,396		1,909	2,119	2,352	2,611	2,898
Repeal political contributions deduction	2		2	4	2	3	3
Repeal capital gains alternate tax	113		140	151	162	174	187
Individual real estate tax shelters	320		61	181	296	407	514
Taxation of unemployment benefits	275		212	207	204	204	214
Tax interest element of annuity contracts	320		12	26	40	57	80
Minimum tax change	229		284	306	329	353	380
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Extend 10 percent investment tax credit to structures (indiv.)	-36	-47	-54	-65	-73	-79	-86
Limit individual tax credits to 90 percent of tax before credits	38		52	58	64	71	79
Tax qualified retirement plans and employee death benefits	30		32	32	33	33	34
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Credit unions	82		22	50	83	123	171
Entertainment expenses	1,125		1,476	1,633	1,771	1,932	2,107
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Phase-out DISC over 3 years	852	193	664	1,228	1,513	1,613	1,751
Phase-out deferral of tax on foreign source income	523		88	280	768	830	897
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At risk limitation (corporations)	10		14	10	8	5	6
Increase investment tax credit limit to 90 percent	-71		-882	-576	-114	-194	-205
Extend 10 percent investment tax credit to structures (corporations)	-1,055	-1,100	-1,389	-1,649	-1,869	-2,074	-2,268
Nondiscrimination rule for health and group term life plans	29		32	33	34	35	36
Full investment tax credit for pollution abatement facilities	-90	-142	-93	-107	-127	-115	-144
Total individual	-11,725	-6,114	-16,783	-18,516	-20,704	-23,442	-26,988
Total corporate	-3,849	-2,398	-5,704	-7,201	-6,659	-7,454	-7,905
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Repeal telephone excise tax	--	-355	-1,200	-900	-500	--	--
Reduce unemployment payroll tax rate	--	--	-850	-900	-950	-1,000	-1,050
Total	-15,574	-8,867	-24,537	-27,517	-28,813	-31,896	-35,943

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Summary of Revenue Effects of Income Tax Reductions, Tax Reforms and Telephone Excise and Unemployment Insurance Tax Reductions

($billions)

	Fiscal Years				
	1979	1980	1981	1982	1983
Individual Income Tax:					
Tax reductions	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms	4.2	7.4	8.9	10.6	12.3
Net change	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation Income Tax:					
Tax reductions	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms	1.1	3.0	4.3	5.0	5.2
Net change	-5.1	-6.5	-6.8	-6.8	-7.6
Telephone excise and unemploy ment insurance tax reductions	-1.6	-2.0	-1.6	-1.2	-1.1
Total	**-25.0**	**-26.6**	**-28.6**	**-30.8**	**-34.9**

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Fact Sheet 2

January 21, 1978

FACT SHEET

Effects of the Tax Program on the Economy

This has been summarized by the President's Tax Message of January 21, 1978:

"These tax reductions are a central part of the Administration's overall economic strategy, which will rely principally upon growth in the private sector to create the new jobs we need to achieve our high-employment objective. The tax reductions will more than offset the recent increase in social security taxes and will provide the consumer purchasing power and business investment strength we need to keep our economy growing strongly and unemployment moving down."

"Together with the programs that I will outline in my Budget Message, these tax cuts should assure that our economy will grow at a 4-1/2 to 5 percent pace through 1979, with unemployment declining to between 5-1/2 and 6 percent by the end of 1979. Without the tax cuts, economic growth would slow markedly toward the end of 1978 and fall to about 3-1/2 percent in 1979. Unemployment would be unlikely to fall below 6 percent and, by the end of 1979, might be moving upward."

"This tax program will mean up to 1,000,000 additional jobs for American workers. It should lead to a pattern of economic growth which is steady, sustainable, and noninflationary."

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Fact Sheet 3

January 21, 1978

FACT SHEET

Effect on Total Tax Burden

The President's Proposal:

The percentage of total personal income that Americans now pay in Federal individual income taxes is 10.7 percent and rising. With the President's tax program, the burden will be 10.3 percent in 1978 and 10.5 in 1979. In contrast, without the program, the share of their personal income that Americans will pay in Federal individual income taxes will rise from its current level of 10.7 percent to 11.4 percent in 1979.

Effect of Inflation:

As personal income rises because of inflation, the proportion of total income paid in income taxes also increases. This is due to the progressive tax rate structure which imposes higher tax rates as taxpayers move into successively higher tax brackets. This structure is based on the sound principle that taxation should be based on ability to pay. But when an increase in income reflects only inflation, a taxpayer's ability to pay is not actually increased. Tax increases in these circumstances reduce after-tax income adjusted for inflation.

Historically, when inflation has increased the income tax burden of Americans, taxes have been reduced. It is now time for another tax reduction to offset the tax effects of inflation.

Relation to Other Taxes: Social Security

The need for increased financing for the nation's social security system will mean increased social security payroll taxes for most workers. A large part of the increased social security funding results from increasing the amount of wages and salary on which social security taxes are paid by workers. As a result, the largest increases in social security taxes, relative to income, will occur at incomes between $20,000 and $25,000.

The effects of these social security tax increases have been taken into account in the President's tax proposal. The recommended tax reductions for individuals generally will more than offset the impact of increased social security taxes in 1979. The attached table shows the income tax reductions, the social security tax increases, and the net tax result for 4-person families at different income levels. The total tax burden, including social security taxes, will be reduced at most income levels, with substantial reductions for taxpayers with incomes under $20,000. In 1979, the aggregate reduction in individual income taxes will be $16.8 billion. The social security tax increase for employees will be $3.9 billion.

Energy

Under the President's energy program now being considered in Congress, individuals would receive per capita rebates to compensate them for increased energy costs due to the crude oil equalization tax. In that manner, energy conservation would be encouraged by the higher energy costs without raising the total tax burden and slowing economic growth. However, in the event that rebates are not included at adequate levels, additional income tax cuts will be proposed to insure that the required energy taxes do not unduly burden individual taxpayers.

Other

Also included in the President's tax proposals are recommendations to eliminate the excise tax on telephone service and to reduce the Federal payroll tax that finances the unemployment compensation fund. Both measures will lower the overall Federal tax burden borne by individuals. The President's proposal to provide a direct Federal subsidy for the borrowing costs of state and local governments will also benefit taxpayers through reduced taxes or improved services at the state and local levels.

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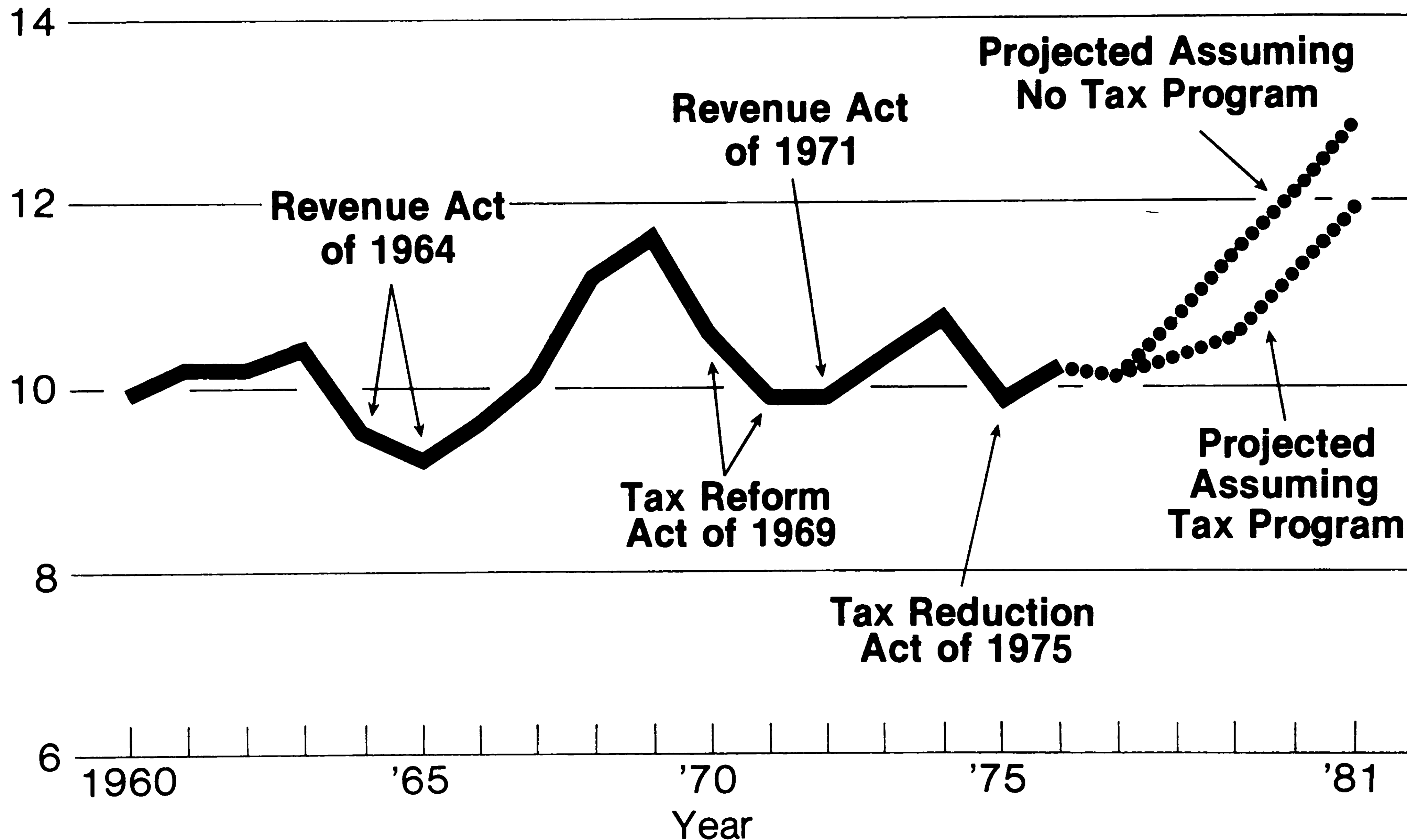
Individual Income Taxes as a Percent of Personal Income, 1960-1982
(Arrows Identify Years of Major Effect of Significant Tax Legislation)



Income Tax and Social Security Tax Burden Table Married Couple with Two Children

(1976 Levels of Income)

Expanded income class ($000)	Income Tax			Social Security tax increase	Average net tax change
	Average tax present law	Average tax under proposal	Average tax change		
Less than 10	9	-79	-88	16	-72
10-15	867	589	-278	30	-248
15-20	1,739	1,461	-278	48	-230
20-30	3,117	2,780	-337	115	-222
30-50	6,287	5,979	-308	192	-116
50-100	16,336	16,088	-248	232	-16
100-200	40,885	41,087	202	268	470
200 and over	127,666	130,473	2,807	145	2,952

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Fact Sheet 4

January 21, 1978

FACT SHEET

Effect on the Distribution of Taxes

The President's Proposal: These tax reform proposals have been structured to give the greatest percentage tax cuts to the lowest income classes, the next greatest to middle income classes, and the smallest cuts to upper income classes. Also, several provisions of this program are designed to equalize the tax treatment of taxpayers with equal ability to pay.

The American tax system has always been designed so that higher income individuals pay a larger share of their income in tax than individuals with lower incomes. The specific proposals that would reinforce the progressive nature of the tax system are (1) replacement of the personal exemption with a per capita credit, (2) changes in the tax rates, and (3) limitations on deductions.

Tax Reductions by Income Level: The attached table shows by income classes the total taxes paid under present law, the total taxes under these reform proposals, and the net change. For example, taxpayers in the $5,000 to $10,000 income class paid $8.2 billion under present law. However, under these proposals they will pay $6.4 billion, a decrease of 23 percent. Taxpayers in the $30,000 to $50,000 income class receive a tax cut of only 5 percent. Thus, the tax reductions as a percent of tax liabilities under present law decline as income rises. In the $100,000 to $200,000 and $200,000 or more classes, there is a tax increase resulting from these proposals for those taxpayers who take advantage of various tax preferences being eliminated or curtailed.

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Effective Tax Rates:

The second table and the chart compares by income class the tax liability and effective tax rates under these proposals with those under current law. In each income class up through the $50,000 to $100,000 class, the tax liability and effective tax rate are less than under present law. In the two top income classes the tax liability and the effective tax rate are greater than under present law. Again, this illustrate the progressive nature of these proposals.

Tax-Free Income Levels:

Another major objective of these proposals is to raise the level of income that is tax-free. This would be done by changing the personal exemption to a personal tax credit and by decreasing the tax rates in the lower income brackets. Under these proposals, single taxpayers would not be taxable if their income is under $3,967 and married taxpayers with two children if income is under $9,256. In both cases, the tax-free levels are substantially above the poverty level for 1977.

Increase Tax Fairness:

These proposals move toward equalizing the tax burden of taxpayers with equal ability to pay. This is accomplished by restricting the use of tax shelters, extending the effects of the minimum tax, limiting deductions of entertainment expenses, repealing the alternative tax on capital gains, and requiring that tax-favored employee benefits be provided on a nondiscriminatory basis.

The result will be that the tax liabilitie of individual taxpayers will depend to a lesser degree on their particular sources of income.

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Expanded Income and Tax Liability Under Present Law
And Tax Proposals (Personal Only)

(1976 Levels of Income)

($ millions)

Expanded Income Class ($000)	Number of Returns (thousands)	Expanded Income	Present Law		Administration Proposal	
			Tax Liability	Effective Tax Rate	Tax Liability	Effective Tax Rate
Less than 5	25,474	57,557	141	0.2%	-251	-0.4%
5 - 10	20,109	149,590	8,227	5.5%	6,368	4.3%
10 - 15	16,106	201,036	18,071	9.0%	15,361	7.6%
15 - 20	11,824	205,086	23,009	11.2%	20,148	9.8%
20 - 30	9,907	237,041	32,778	13.8%	29,593	12.5%
30 - 50	3,347	124,836	22,017	17.6%	20,971	16.8%
50 - 100	985	67,484	16,492	24.4%	16,344	24.2%
100 - 200	198	27,371	8,084	29.5%	8,261	30.2%
200 and over	49	21,573	6,476	30.0%	6,838	31.7%
Total	87,998	1,091,573	135,293	12.4%	123,633	11.3%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 21, 1978

Note: Details may not add to totals due to rounding.

Income Tax Liabilities: Present Law and Administration Proposal
(Personal Income Only)

(1976 Levels of Income)

Expanded Income Class	Present Law		Administration Proposal		Tax Change	
	Tax Liability	Percentage Distribution	Tax Liability	Percentage Distribution	Tax Liability	Change as Percent of Present Law Tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	(percent)
Less than 5	141	0.1%	-251	-0.2%	-392	-278.0%
5 - 10	8,227	6.1	6,368	5.2	-1,859	-22.6
10 - 15	18,071	13.4	15,361	12.4	-2,710	-15.0
15 - 20	23,009	17.0	20,148	16.3	-2,861	-12.4
20 - 30	32,778	24.2	29,593	23.9	-3,185	-9.7
30 - 50	22,017	16.3	20,971	17.0	-1,046	-4.8
50 - 100	16,492	12.2	16,344	13.2	-148	-0.9
100 - 200	8,084	6.0	8,261	6.7	177	2.2
200 and over	6,476	4.8	6,838	5.5	362	5.6
Total	$135,293	100.0%	$123,633	100.0%	$-11,660	-8.6%

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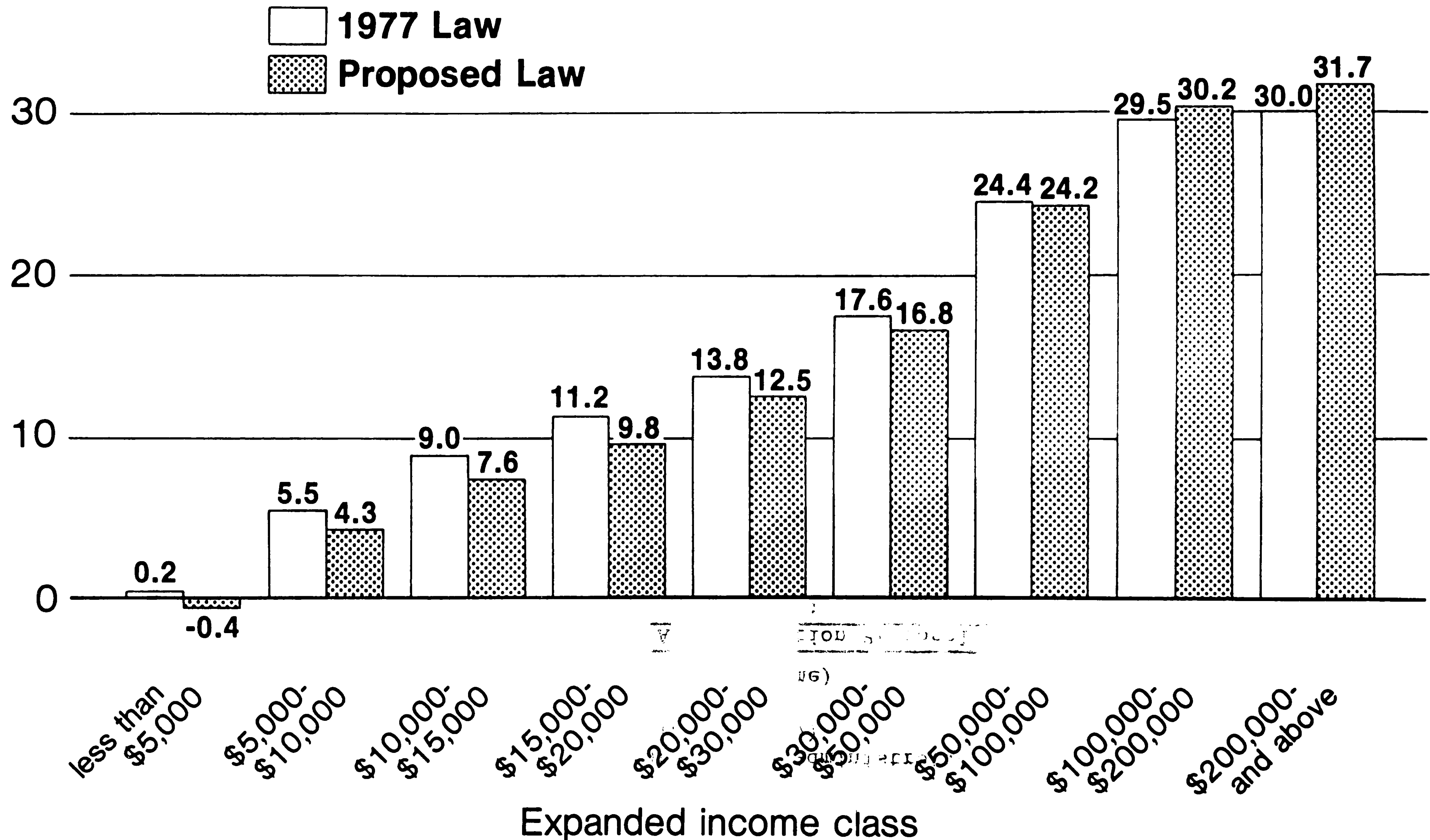
Office of Tax Analysis

January 15, 1978

Note: Details may not add to totals due to rounding.

Tax Program:
Effective Individual Tax Rates -- Taxes as a Percent of Expanded Income. 1976 Level of Income.



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Fact Sheet 5

January 21, 1978

FACT SHEET

Effect on Individual Tax Burdens

Tables: Attached are 6 tables showing tax burdens for 8 income levels for single returns and joint returns with up to 4 dependents. The burdens shown are the average tax per return under present law, the average tax under the President's proposal, and the average change in tax liability in dollars and as a percent of present law liability.

Chart: The attached chart displays the data from the burden table for joint returns with 2 dependents.

Assumptions: The distribution of tax burdens under current and proposed law have been estimated on the Treasury Tax Model, which is based on a random sample of tax returns. The data base has been aged to the 1976 level of income. The estimates for each income class are, therefore, based on the average incomes, deductions, and credits for all taxpayers in that income class. Since the tables and chart are based on sampling techniques they should not be regarded as accurate in detail but rather as representing the general order of magnitude and relationships among the changes contained in the President's proposal.

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Burden Table

Single Returns

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................. dollars		..................)	(.. percent
Less than 10	217	181	-36	-16.4%
10 - 15	1,595	1,519	-76	-4.8
15 - 20	2,768	2,591	-177	-6.4
20 - 30	4,236	3,917	-319	-7.5
30 - 50	8,254	7,660	-594	-7.2
50 - 100	18,465	17,889	-576	-3.1
100 - 200	42,015	41,714	-301	-0.7
200 and over	161,723	167,760	6,037	3.7

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Office of Tax Analysis

January 10, 1978

Burden Table
Joint Returns
No Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	168	95	-73	-43.6%
10 - 15	1,104	983	-121	-11.0
15 - 20	2,084	1,906	-178	-8.5
20 - 30	3,615	3,308	-307	-8.5
30 - 50	6,921	6,535	-386	-5.6
50 - 100	17,020	16,647	-373	-2.2
100 - 200	40,403	40,956	553	1.4
200 and over	132,121	137,140	5,020	3.8

Office of the Secretary of the Treasury
Office of Tax Analysis

January 10, 1978

Burden Table
Joint Returns
One Dependent

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	65	-38	-103	-157.8%
10 - 15	1,024	824	-200	-19.5
15 - 20	1,922	1,696	-226	-11.7
20 - 30	3.392	3,063	-329	-9.7
30 - 50	6,709	6,327	-382	-5.7
50 - 100	16,938	16,625	-313	-1.8
100 - 200	41,993	42,264	271	0.6
200 and over	121,583	125,202	3,620	3.0

Office of the Secretary of the Treasury
Office of Tax Analysis

January 10, 1978

Burden Table
Joint Returns
Two Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	9	-79	-88	-975.6%
10 - 15	867	589	-278	-32.1
15 - 20	1,739	1,461	-278	-16.0
20 - 30	3,117	2,780	-337	-10.8
30 - 50	6,287	5,979	-308	-4.9
50 - 100	16,336	16,088	-248	-1.5
100 - 200	40,885	41,087	202	0.5
200 and over	127,666	130,473	2,807	2.2

Office of the Secretary of the Treasury
Office of Tax Analysis

January 10, 1978

Burden Table
Joint Returns
Three Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(..................	dollars	..................)	(.. percent .
Less than 10	-41	-81	-40	-97.7%
10 - 15	693	367	-326	-47.0
15 - 20	1,562	1,218	-344	-22.0
20 - 30	2,867	2,514	-353	-12.0
30 - 50	5,872	5,609	-263	-4.5
50 - 100	15,924	15,785	-139	-0.9
100 - 200	40,417	40,827	410	1.0
200 and over	126,915	130,397	3,483	2.7

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Office of Tax Analysis

January 10, 1978

Burden Table
Joint Returns
Four Dependents

(1976 Levels of Income)

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
($000)	(.................	dollars	.................)	(.. percent ..)
Less than 10	-64	-70	-6	-9.9%
10 - 15	526	177	-349	-66.3
15 - 20	1,375	985	-390	-28.3
20 - 30	2,590	2,248	-342	-13.2
30 - 50	5,720	5,521	-199	-3.5
50 - 100	16,529	16,593	64	0.4
100 - 200	42,090	42,707	617	1.5
200 and over	127,755	131,298	3,543	2.8

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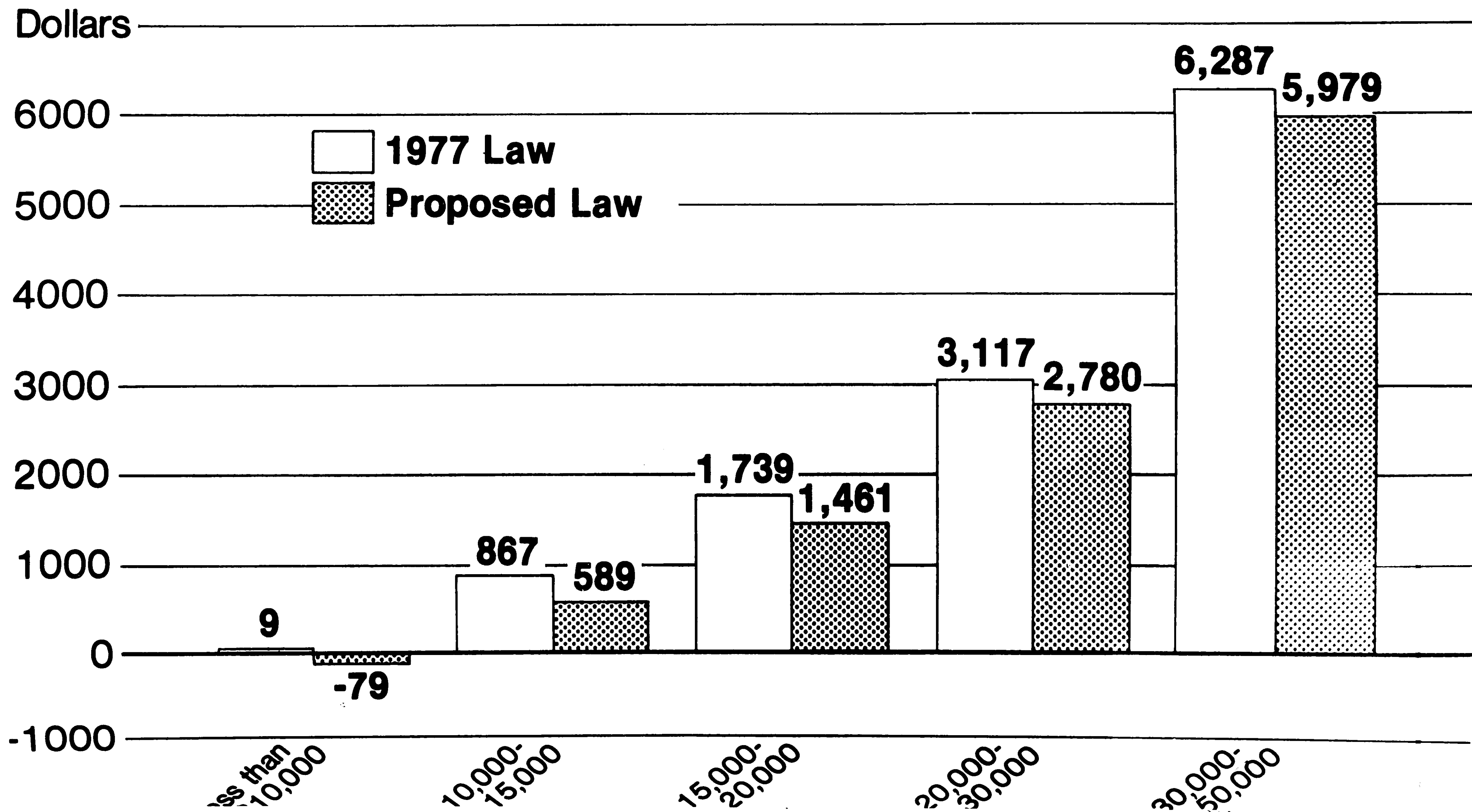
Office of Tax Analysis

January 10, 1978

The President's Tax Program
Average Income Taxes Under Current Law and Under the President's Proposal for a Married Couple with Two Children



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Fact Sheet 5A

January 21, 1978
Department of the Treasury

FACT SHEET

Effect on Individual Tax Burdens by Specific Income Level

Tables: Attached are 6 tables showing tax burdens for specific levels of income for single returns and joint returns with up to 4 dependents. In contrast, burden tables attached to Fact Sheet 5 show tax burdens for income classes based on expanded income. Expanded income is equal to adjusted gross income plus preference income included in the minimum tax less investment interest to the extent of investment income. It more nearly approximates total economic income.

Assumptions: The specific income burden tables assume that all income is fully taxable, as it would be if it were all derived from, say, wages and salaries. Itemized deductions are assumed to total 23 percent of income under present law and 20 percent under the President's proposal. Taxpayers are assumed to begin itemizing their deductions at the income level at which they benefit from doing so. At lower income levels taxes are calculated on the basis of the zero tax bracket amount -- usually called the standard deduction.

Not included in these tables are the effects of a number of the tax reform proposals which would affect income that currently is not fully taxed, such as the proposals restricting tax shelters and the elimination of the alternate tax on long-term capital gains. The examples are more representative of the tax burdens that would apply to lower and middle income taxpayers than of the taxes paid by those with large incomes. As income rises, taxpayers are more likely to have tax preferences that may be reduced by the President's proposal. The amounts of itemized deductions also tend to vary more widely at higher income levels.

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Burden Table

Single Returns

Income	Present law tax 1/	Tax under proposal 2/	Tax change	Percentage change
(............................	dollars	....	)	(... percent ..)
5,000	278	179	-99	-35.6
10,000	1,199	1,165	-34	-2.8
15,000	2,126	2,105	-21	-1.0
20,000	3,231	3,105	-126	-3.9
25,000	4,510	4,265	-245	-5.4
30,000	5,950	5,585	-365	-6.1
40,000	9,232	8,745	-487	-5.3

Office of the Secretary of the Treasury
Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Assumes deductible expenses equal to 20 percent of income under proposed law.

Burden Table
Joint Returns
No Dependents

Income	Present law tax 1/	Tax under proposal 2/	Tax change	Percentage change
(........................	dollars	....	............)	(... percent ...)
5,000	0	0	0	0.0
10,000	761	614	-147	-19.3
15,000	1,651	1,552	-99	-6.0
20,000	2,555	2,390	-165	-6.5
25,000	3,570	3,310	-260	-7.3
30,000	4,712	4,390	-322	-6.8
40,000	7,427	7,110	-317	-4.3

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Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Assumes deductible expenses equal to 20 percent of income under proposed law.

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Burden Table
Joints Returns
One Dependent

Income	Present law tax 1/	Tax under proposal 2/	Tax change	Percentage change
(............................	dollars	..............................)		(... percent ...
5,000	-300	-300	0	0.0
10,000	619	374	-245	-39.6
15,000	1,486	1,312	-174	-11.7
20,000	2,367	2,150	-217	-9.2
25,000	3,360	3,070	-290	-8.6
30,000	4,472	4,150	-322	-7.2
40,000	7,134	6,870	-264	-3.7

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Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Assumes deductible expenses equal to 20 percent of income under proposed law.

Burden Table
Joint Returns
Two Dependents

Income	Present law tax 1/	Tax under proposal 2/	Tax change	Percentage change
(.........................	dollars	.............................)		(... percent ...)
5,000	-300	-300	0	0.0
10,000	446	134	-312	-70.0
15,000	1,330	1,072	-258	-19.4
20,000	2,180	1,910	-270	-12.4
25,000	3,150	2,830	-320	-10.2
30,000	4,232	3,910	-322	-7.6
40,000	6,848	6,630	-218	-3.2

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Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Assumes deductible expenses equal to 20 percent of income under proposed law.

Burden Table
Joint Returns
Three Dependents

Income	Present law tax 1/	Tax under proposal 2/	Tax change	Percentage change
(...........................	dollars	....	........)	(... percent ...)
5,000	-300	-300	0	0.0
10,000	283	0	-283	-100.0
15,000	1,167	832	-335	-28.7
20,000	2,003	1,670	-333	-16.6
25,000	2,955	2,590	-365	-12.4
30,000	4,018	3,670	-348	-8.7
40,000	6,578	6,390	-188	-2.9

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Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Assumes deductible expenses equal to 20 percent of income under proposed law.

Burden Table
Joint Returns
Four Dependents

Income	Present law tax 1/	Tax under proposal 2/	Tax change	Percentage change
(............	...... dollars	....	......)	(... percent ...)
5,000	-300	-300	0	0.0
10,000	128	0	-128	-100.0
15,000	989	592	-397	-40.1
20,000	1,808	1,430	-378	-20.9
25,000	2,737	2,350	-387	-14.1
30,000	3,778	3,430	-348	-9.2
40,000	6,278	6,150	-128	-2.0

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Office of Tax Analysis

January 20, 1978

1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Assumes deductible expenses equal to 20 percent of income under proposed law.

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Fact Sheet 6

January 21, 1978

FACT SHEET

Individual Tax Rates

The President's Proposal:

The marginal tax rates for all taxpayers will be reduced to a range of 12 percent to 68 percent for 1979 and later years.

A change in the rate schedules also will occur in 1978. This will allow a tax reduction for 1978 of approximately one-fourth the 1979 reduction. The 1978 reduction will be reflected in withholding beginning October 1.

Present Law:

Marginal tax rates range from 14 percent to 70 percent.

Reasons for the Recommendation:

The reduction of the tax rates represents the major reduction in taxes in the tax reform package. The lower tax rates in concert with the proposed $240 per capita tax credit assures the progressivity of the tax system by providing the largest percentage reduction in tax at the lowest income levels, and the least at upper income levels. The reduced amount of income taxes collected will help stimulate the economy, more than offsetting any dampening effect of the increase in social security taxes.

Other parts of the tax package propose changes designed to simplify the calculations of taxes for most taxpayers. These changes by themselves would increase taxes. The proposed rate reductions take these changes into account, and for almost all taxpayers will provide net decreases in taxes.

Effect on Taxpayers:	The change in the rate schedule by itself will result in a reduction in tax for all taxpayers. Generally, the largest percentage tax reduction will be enjoyed at the lowest income levels, the next at middle levels, and the least at upper income levels. The attached tables show the present and proposed tax rates.
Effect on Revenue:	The reduction in the marginal rates coupled with the $240 credit will reduce tax liabilities by $23.5 billion in 1979. For 1978, tax liabilities will decrease $6.1 billion.

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Individual Tax Rate Schedules For
Joint Returns

Taxable Income Bracket 1/	Present Law: Tax At Low End of Bracket	Present Law: Tax Rate on Income In Bracket	Tax Proposal: Tax At Low End of Bracket	Tax Proposal: Tax Rate on Income In Bracket
0 - 500	0	14%	0	12%
500 - 1,000	70	14	60	12
1,000 - 2,000	140	15	120	14
2,000 - 3,000	290	16	260	16
3,000 - 4,000	450	17	420	17
4,000 - 8,000	620	19	590	18
8,000 - 12,000	1,380	22	1,310	19
12,000 - 16,000	2,260	25	2,070	20
16,000 - 20,000	3,260	28	2,870	23
20,000 - 24,000	4,380	32	3,790	27
24,000 - 28,000	5,660	36	4,870	32
28,000 - 32,000	7,100	39	6,150	36
32,000 - 36,000	8,660	42	7,590	39
36,000 - 40,000	10,340	45	9,150	42
40,000 - 44,000	12,140	48	10,830	44
44,000 - 48,000	14,060	50	12,590	48
48,000 - 52,000	16,060	50	14,510	48
52,000 - 54,000	18,060	53	16,430	51
54,000 - 62,000	19,120	53	17,450	51
62,000 - 64,000	23,360	53	21,530	51
64,000 - 76,000	24,420	55	22,550	54
76,000 - 88,000	31,020	58	29,030	57
88,000 - 90,000	37,980	60	35,870	57
90,000 -100,000	39,180	60	37,010	60
100,000 -110,000	45,180	62	43,010	60
110,000 -120,000	51,380	62	49,010	62
120,000 -130,000	57,580	64	55,210	62
130,000 -140,000	63,980	64	61,410	64
140,000 -150,000	70,380	66	67,810	64
150,000 -160,000	76,980	66	74,210	65
160,000 -175,000	83,580	68	80,710	65
175,000 -180,000	98,780	68	90,460	66
180,000 -200,000	97,180	69	93,760	66
200,000 and over	110,980	70	106,960	68

Office of the Secretary of the Treasury
Office of Tax Analysis

January 17, 1978

1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $3,200.

Individual Tax Rate Schedules For
Single Returns

Taxable Income Bracket 1/	Present Law: Tax At Low End of Bracket	Present Law: Tax Rate on Income In Bracket	Tax Proposal: Tax At Low End of Bracket	Tax Proposal: Tax Rate on Income In Bracket
0 - 500	0	14	0	12
500 - 1,000	70	15	60	13
1,000 - 1,500	145	16	125	15
1,500 - 2,000	225	17	200	15
2,000 - 3,000	310	19	275	18
3,000 - 4,000	500	19	455	19
4,000 - 6,000	690	21	645	20
6,000 - 8,000	1,110	24	1,045	20
8,000 -10,000	1,590	25	1,445	22
10,000 -12,000	2,090	27	1,885	23
12,000 -14,000	2,630	29	2,345	25
14,000 -16,000	3,210	31	2,845	25
16,000 -18,000	3,830	34	3,345	29
18,000 -20,000	4,510	36	3,925	29
20,000 -22,000	5,230	38	4,505	33
22,000 -24,000	5,990	40	5,165	33
24,000 -26,000	6,790	40	5,825	38
26,000 -28,000	7,590	45	6,585	38
28,000 -32,000	8,490	45	7,345	41
32,000 -36,000	10,290	50	8,985	46
36,000 -38,000	12,290	50	10,825	50
38,000 -40,000	13,290	55	11,825	50
40,000 -44,000	14,390	55	12,825	51
44,000 -48,000	16,590	60	14,865	57
48,000 -50,000	18,990	60	17,145	58
50,000 -52,000	20,190	62	18,305	58
52,000 -54,000	21,430	62	19,465	60
54,000 -60,000	22,670	62	20,665	60
60,000 -62,000	26,390	64	24,265	60
62,000 -64,000	27,670	64	25,465	63
64,000 -70,000	28,950	64	26,725	63
70,000 -76,000	32,790	66	30,505	63
76,000 -80,000	36,750	66	34,285	66
80,000 -88,000	39,390	68	36,925	66
88,000 -90,000	44,830	68	42,205	66
90,000 -100,000	46,190	69	43,525	67
100,000 and over	53,090	70	50,225	68

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1/ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by $2,200.

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FACT SHEET

Per Capita Tax Credit

The President's Proposal:

A personal tax credit of $240 will be allowed for each taxpayer or dependent. An additional $240 credit will be allowed for taxpayers who are aged or blind.

Present Law:

A personal exemption of $750 is allowed for the taxpayer and each dependent. An additional exemption is allowed for taxpayers who are aged or blind. Also, taxpayers are permitted a general tax credit of $35 per exemption, or 2 percent of taxable income up to a credit of $180, whichever is greater. (The personal exemption and general tax credit will be replaced by the proposed personal tax credit.)

Reasons for the Recommendation:

A personal credit rather than a deduction for each exemption will reduce taxes by the same dollar amount for each family member regardless of a taxpayer's income.

The proposed credit and the rate schedule are designed to increase the progressivity of the tax system and to increase the level of income at which individuals first begin to pay taxes on their earnings.

The personal tax credit is an important step toward simplifying the tax system. Having both a credit which may be calculated in two different ways and an exemption is confusing and the source of many taxpayer errors. Assuming that either the existing exemption or the general credit should be eliminated, a credit is more consistent with other government programs. For example, per capita rebates of energy taxes can readily be added to the credit.

Effect on Taxpayers: The tax effect of the proposal will vary according to income level and family size. Generally, this proposal will lower taxes for families with incomes under $20,000 and raise them for those with incomes above that level. However, these effects will be modified by the proposed reductions in the tax rates so that most taxpayers with incomes under $100,000 will have tax reductions.

Effect on Revenue: The $240 credit, by itself, will not change revenues, based on 1976 income levels. The tax decreases for low income families will be offset by the tax increases for high income families. However, changes in other provisions will result in a reduced tax burden for almost all taxpayers.

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FACT SHEET

Deductions for State and Local Taxes

The President's Proposal: The only state and local taxes that may be itemized as a personal deduction will be income and real property taxes.

Present Law: In addition to state and local income and real property taxes, deductions are currently allowed for sales, personal property and gasoline taxes, if a taxpayer itemizes personal deductions.

Reasons for the Recommendation: Eliminating sales, personal property and gasoline taxes as itemized deductions will simplify preparation of tax returns and reduce both record-keeping burdens and errors that result in costly and time-consuming audits of tax returns.

More taxpayers would take the standard deduction if there were fewer deductions to itemize. The proposal will not adversely affect the sales tax as a tool of state and local governments, since over three quarters of all taxpayers do not claim the deduction, and the tax benefit of the average deduction for those who do is not significant. The deduction for gasoline taxes runs counter to the country's energy goals. Both deductions complicate tax collection by generating substantial numbers of errors. There is no direct relationship between the amount of the deduction and the amount of taxes actually paid since most sales and gasoline tax deductions are determined from tables. Much the same result can be obtained by lowering tax rates and eliminating these deductions.

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Effect on Taxpayers:	The preparation of tax returns will be simplified. For all taxpayers, rate reductions will more than offset the small tax increase from the elimination of these deductions and record-keeping burdens will be reduced.
Effect on Revenue:	This proposal will increase tax liabilities $3.9 billion in calendar year 1979.

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FACT SHEET

Political Contributions

The President's Proposal: The deduction for political contributions will be repealed, but the alternative credit will be retained.

Present Law: Either an itemized deduction of up to $200 or a credit of half of the first $100 is allowable for political contributions on a joint return.

Reasons for the Recommendation: These provisions provide a windfall for those who would contribute anyway. The deduction provides a larger benefit to high tax bracket contributors than to those in low tax brackets. The credit treats taxpayers at all income levels uniformly. Having the alternative of a credit or a deduction complicates tax returns and causes confusion.

Effect on Taxpayers: Higher income taxpayers will obtain slightly less tax benefit from the first $200 of their political contributions.

Effect on Revenue: Tax liabilities will increase by less than $5 million per year.

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Fact Sheet 10

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FACT SHEET

Medical and Casualty Deductions

The President's Proposal:

Medical expenses and casualty losses will be deductible only to the extent that, when combined, they exceed 10 percent of adjusted gross income. Health insurance premiums and drug expenses will be treated like all other medical expenses. In addition, medical expenses will include only expenditures customarily made primarily for medical purposes.

Present Law:

If a taxpayer itemizes his or her personal deductions, 50 percent of the first $300 of health insurance premiums is fully deductible. Also deductible are medical expenses over 3 percent of adjusted gross income. Medicines and drugs over 1 percent of adjusted gross income and the remaining portion of health insurance premiums may be counted toward the 3 percent floor.

Uninsured casualty losses in excess of $100 are also deductible.

Reasons for the Recommendation:

This proposal will make the tax system simpler and fairer. Present law requires burdensome record-keeping, and complex regulations govern the specific items that are deductible. Both the medical and casualty loss deductions were originally intended to provide relief for extraordinary expenses which reduced the taxpayer's ability to pay.

The changing relationship between medical costs and income has resulted in many taxpayers deducting normal expenses. Similarly, many of the casualty losses under present law do not involve extraordinary losses which impair the taxpayer's ability to pay. Higher income taxpayers particularly are able to use the deductibility of casualty claims to self-insure through the tax system.

Relief from ordinary medical and casualty expenses can be provided simply and fairly through tax rate reductions, while deductions are retained for truly extraordinary medical expenses and casualty losses.

Eliminating deductions for items such as swimming pools, air conditioning, and travel to resort areas is appropriate, since they often involve substantial nonmedical benefits out of proportion to their medical benefits.

Effect on Taxpayers:

The deduction for medical and casualty expenses will be limited to extraordinary or above average expenses.

Higher income taxpayers will no longer be able to use the casualty deduction to self-insure at low cost through the tax system.

The effect of eliminating the existing deductions will be more than offset by tax reductions for most people. Taxpayers will be spared substantial record-keeping burdens and disputes about the amount of casualty losses.

Effect on Revenue: This proposal will increase tax liabilities $1.9 billion in calendar year 1979.

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FACT SHEET

Entertainment Expenses

The President's Proposal: Deductions will be totally disallowed for entertainment facilities such as yachts, hunting lodges, and club dues. Deductions for one-half the cost of meals now allowed as a business expense will be disallowed. Deductions for entertainment activities, such as the cost of tickets to theatre and sports events, will be disallowed.

Present Law: Relatively few restrictions are imposed by present law on the deductibility of entertainment expenses. Under present law, costs of country club memberships, lunches, dinners, world series or super bowl tickets, and vacation trips have all been claimed as deductions on the ground that such entertainment is ordinary and necessary in the taxpayer's business. While Congress in 1962 enacted some restrictions on entertainment deductions, the experience since then is that most of such entertainment is still being deducted. Thus, the cost of tickets to theatres and sports events is deductible under present law merely because the previous morning or the next day the parties talk business. The cost of meals eaten by people who happen to have business relationships are deductible even though no business is done or discussed.

Reasons for the Recommendation: As the tax law exists today, deductibility of entertainment expenses is an open invitation to charge personal expenses to Uncle Sam, to the detriment of the vast majority of taxpayers not able to

make such claims. The subjectivity and flexibility of present law encourages taxpayers to deduct entertainment expenses which, though not clearly deductible, are "arguably" so.

Allowing deductions for the luxuries of life breeds disrespect for the law and impairs the integrity of the tax system. As President Kennedy said 16 years ago: "Expense account living has become a byword in the American scene. This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well."

Even expenditures which are business related provide benefits to the participants which most taxpayers must buy with after-tax dollars. Disallowance of the deduction is the substantial equivalent of taxing the income to those who enjoy the benefit.

Effect on Taxpayers: Taxpayers currently deducting entertainmen expenses will pay higher taxes, or, more likely, enjoy a smaller tax cut than others. Also they might be induced to reduce total entertainment expenses. Reasonably priced restaurants will suffer no decline in business. The proposal will not hurt business generally. American businesses will soon adjust to selling on the basis of the relative superiority of the products rather than by providing purchasers with a good time.

Effect on Revenue: The proposed changes will increase tax liabilities $1.2 billion in calendar year 1979.

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FACT SHEET

Foreign Conventions

The President's Proposal:

Expenses incurred to attend a convention, seminar, or other meeting held outside of the United States and possessions may not be claimed as a business expense deduction unless it is reasonable for the meeting to be held outside of the United States because of the composition of the membership or the specific purposes of the organization. For qualified foreign meetings the deductions allowed for subsistence may not exceed 125 percent of the government per diem for the area.

Present Law:

In 1976, Congress provided that business expense deductions can be taken for no more than two foreign conventions per year. Deductions are not allowed unless the individual attends approximately two-thirds of the scheduled business activities of the convention and these activities must cover most of the time the individual is not in transit to or from the site. The time spent by the individual at the convention sessions must be verified (under oath) by a convention official. Also, the subsistence expenses for which deductions are taken cannot exceed the per diem rates which are available to Federal employees for government trips to the same locations. Finally, the deduction for transportation expenses outside of the United States cannot exceed the lowest coach, or economy, rate charged by a commercial airline.

Reasons for the Recommendation:

This proposal will increase tax fairness and simplicity. Although foreign conventions may serve a valid business purpose, they involve a high potential for deducting the cost of a vacation at the expense of taxpayers generally. Although changes in the tax code enacted in 1976 curbed some abuses, deductions for two conventions a year were permitted, subject to a number of specific requirements and limitations. Adoption of this proposal will eliminate for legitimate foreign conventions most of the current rules that are considered burdensome. Finally, the proposed new rules will eliminate all deductions for foreign conventions where there is no valid reason for holding them abroad.

Effect on Taxpayers:

The number of taxpayers taking tax deductible foreign trips which are essentially vacations will be significantly reduced.

Effect on Revenue:

The proposal will have no significant revenue effect.

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FACT SHEET

First Class Air Fare

The President's Proposal: Deductions for first class air fare will be disallowed to the extent that they exceed coach fare for the same flight.

Present Law: Except in the case of travel to foreign conventions, first class air fare is deductible if incurred in connection with the taxpayer's travel away from home on business.

Reasons for the Recommendation: The proposal would make the tax system fairer. For most people, first class air fare is a luxury. Present law requires the many taxpayers who cannot afford first class fare for themselves to subsidize such travel by others. The additional personal comfort provided by first class accommodations is not necessary for the conduct of business. Both ends of the plane arrive at the same time.

Effect on Taxpayers: Taxpayers who continue to use first class air fare will have to pay for the additional cost out of after-tax dollars.

Effect on Revenue: This proposal will increase tax liabilities by $0.3 billion in calendar year 1979.

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FACT SHEET

Minimum Tax

The President's Proposal:

The provision that allows half of an individual taxpayer's regular tax liability to be deducted from preference income before the 15 percent minimum tax is imposed will be eliminated. Capital gain on the sale of a personal residence will not be subject to minimum tax. The minimum tax for corporations will not be changed.

Present Law:

A 15 percent minimum tax is imposed on certain preference income in excess of $10,000 or half of an individual's regular tax liability, whichever is greater. Preference income subject to the minimum tax includes income that would otherwise escape current taxation because of provisions which, for example, exclude from income one half of capital gains, permit accelerated depreciation on real estate, and allow deductions for depletion of minerals in excess of the amounts that would be allowed on the basis of cost.

Reasons for the Recommendation:

The proposal will make the tax system fairer, by raising the effective tax on those with substantial preference income. Tax preferences may serve a purpose in encouraging investment in some activity. However, they reflect adversely on the fairness of the tax system when they are used excessively by high income individuals to eliminate the tax on a substantial amount of their other income. The minimum tax serves to reduce this inequity. Under present law, however, two persons with equal amounts of tax preferences can pay vastly different amounts of

minimum tax because of differences in their regular tax liability. The proposal will treat equally two taxpayers with a given amount of preference income. Taxpayers whose preference income is relatively modest will continue to be exempted from the minimum tax through the $10,000 deduction.

Effect on Taxpayers: Taxpayers with a regular tax liability in excess of $20,000 will pay more tax on their tax preference income. Taxpayers with regular tax liability of $20,000 or less or with tax preferences of $10,000 or less will not be affected by the proposal. Taxpayers with capital gain on the sale of a residence will no longer be subject to minimum tax on the gain.

Effect on Revenue: This proposal will increase tax liabilities $0.3 billion in calendar year 1979.

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FACT SHEET

Real Estate Depreciation

The President's Proposal: Taxpayers generally will be required to base their depreciation deductions for buildings on the average depreciable lives now in use by all taxpayers as reported in surveys conducted by the Treasury. Deductions generally will be computed under the straight-line method. However, the 150 percent declining balance method will be permitted for new multi-family housing through 1982, when depreciation will be limited to the straight-line method. Low-income housing will be depreciated under the most accelerated methods through 1982 when it will be limited to the 150 percent declining balance method.

Present Law: Each building owner claims depreciation based on his or her own estimate of the building's useful life under the facts and circumstances. Taxpayers are allowed depreciation deductions over these lives using the 200 percent declining balance method for new residential rental properties and the 150 percent declining balance method for new nonresidential properties. These accelerated methods permit taxpayers to recover their costs more rapidly than under the straight-line method.

Reasons for the Recommendation: Depreciation claimed under existing methods is not uniform and clearly overstates the true decline in real estate value. The lack of uniformity favors sophisticated, high-income taxpayers.

Excessive depreciation enables profitable real estate investments to be reported as tax losses. The Tax Reform Act of 1976 closed up many tax shelter schemes and restricted others. However, these changes were not generally applied to real estate investments, which consequently have increased in popularity as tax shelters. Many high-income taxpayers continue to avoid taxes by claiming these artificial losses from real estate tax shelters.

These proposals will substantially reduce incentives to promote real estate tax shelters, particularly those which rest on shaky economic foundations and whose elimination is in the long run interest of the real estate industry and its normal investors.

The use of established depreciable lives will make the depreciation of real estate generally uniform. The use of guideline lives for buildings will simplify administrative procedures for determining proper depreciation.

Effect on Taxpayers: Taxpayers, mostly with high incomes, who benefit from accelerated depreciation methods will pay higher income taxes.

Housing investment will not be adversely affected because the present differential incentives for housing will be maintained through 1982. In the interim, the Administration will study the most effective forms of governmental assistance to meet our housing needs.

Effect on Revenue: This proposal will increase tax liabilities $0.1 billion in calendar year 1979, rising to $0.8 billion in 1983.

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FACT SHEET

Tax Shelters

The President's Proposal:

The use of tax shelters to avoid or reduce income taxes will be restricted by:

-- extending to closely held corporations and to all activities except real estate the rule limiting losses that can be used to offset other taxable income to the amount the taxpayer actually has "at risk" in the activity;

-- treating as corporations for tax purposes limited partnerships with more than 15 limited partners, other than those primarily engaged in residential real estate;

-- authorizing the IRS to carry out tax audits of partnerships and to determine taxable income at the partnership level;

-- limiting the amount of tax liability which can be offset by the investment credit to 90 percent of tax liability;

-- imposing taxes currently on the earnings of most deferred annuities not purchased under qualified retirement plans.

Present Law:

Taxpayers continue to invest in tax shelters through loans for which they are not personally liable and deduct paper losses which exceed any actual losses that they might incur. A taxpayer is considered to be at risk to the extent of cash and other property the taxpayer contributes to the activity and also to the extent of any borrowings with respect to which the taxpayer has personal liability.

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Limited partnerships allow the partners to deduct their pro rata share of partnership losses while enjoying practically all the advantages that result from a corporate form of business organization. But under the corporate form losses normally are not passed through to the shareholders.

The IRS must determine the taxable income of each partner separately since it cannot audit at the partnership level.

The investment tax credit may offset completely the first $25,000 of tax liability.

Earnings on deferred annuities, perhaps including those that provide a considerable degree of investment control by the purchaser, are not taxed until the annuity is received.

Reasons for the Recommendation:

These measures will make the tax system fairer by restricting the ability of high-income taxpayers to pay less income tax than others with like incomes. The spectacle of high income individuals not paying their fair share of tax seriously undermines the morale of moderate income Americans.

In the Tax Reform Act of 1976, Congress adopted a rule limiting the deductibility of certain tax shelter losses to the amount "at risk." But new types of shelters, which avoid the explicit restrictions of the 1976 Act, have been created, extensively promoted, and widely marketed. These shelters serve no public purpose.

Taxpayers seeking to avoid paying their fair share of the tax burden should not benefit from large limited partnerships that have the characteristics of corporations or from the difficulties in carrying out tax examinations of tax shelter activities. Allowing the IRS to audit partnerships as a distinct economic unit would result in more efficient and effective review of questionable tax shelters.

Taxpayers should not be able to use deferred annuities to avoid current taxation of regularly recurring investment income.

Effect on Taxpayers: Taxpayers, chiefly with high incomes, who are able to use tax shelters to avoid or reduce their tax payments, will pay higher taxes.

Effect on Revenue: These proposals will increase tax liabilities $0.1 billion in calendar year 1979, rising to $0.2 billion in 1983.

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FACT SHEET

Capital Gains

The President's Proposal: Fifty percent of long-term capital gains will contine to be excluded from an individual taxpayer's taxable income, but the special 25 percent alternative tax on the first $50,000 of capital gains will be repealed.

Present Law: One-half of a long-term capital gain is included in an individual's tax base (thus the effective rate of tax ranges from 7 to 35 percent). A special limit provides that $50,000 of these gains each year are not to be taxed at over 25 percent. A taxpayer in the 70 percent tax-bracket with $50,000 of capital gains can use the alternative tax to reduce his or her tax on the capital gains by nearly 30 percent of the capital gains tax otherwise due.

Reasons for the Recommendation: The elimination of the 25 percent alternative tax on capital gains of up to $50,000 in any one year will end an unjustified benefit for taxpayers whose marginal tax rates exceed 50 percent -- single taxpayers with taxable incomes of more than $38,000 and married taxpayers filing a joint return with taxable incomes over $52,000. Thus, the proposal will make the tax treatment of capital gains more equitable without disturbing the favorable treatment of capital gains in general.

The alternative tax introduces significant additional complexity into an individual's tax planning and its repeal will simplify the tax laws.

Effect on Taxpayers: Taxpayers now using the alternative tax will pay higher taxes on the first $50,000 of their long-term capital gains. The special income averaging rules provide relief for taxpayers who have occasional large capital gains.

In 1974, the most recent year for which information is available, of the 5.4 million taxpayers reporting capital gains, 76,317, or less than 1.5 percent, elected the alternative tax.

Effect on Revenue: This proposal will increase tax liabilitie $0.1 billion in calendar year 1979.

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FACT SHEET

Medical, Disability, and Life Insurance

The President's Proposal:

The present tax exemption for premiums paid and benefits received under employer established health, accident and disability plans will continue to be given only for such plans which do not discriminate in favor of officers, shareholders, and higher paid employees. Tax-free status also will continue for employer-paid premiums on the first $50,000 of group life insurance coverage, but only if the plan which provides the coverage does not discriminate in favor of officers, shareholders, and higher paid employees.

Present Law:

Tax exemption is permitted for plans that discriminate against lower paid employees. Existing provisions of law, which will be retained for non-discriminatory plans, favor employer-paid coverage over insurance purchased by an individual. Premiums paid by an employer are deductible by the employer and are not recognized as income to the employee. The premiums paid by an individual for disability insurance and life insurance are not deductible by the individual and those for medical insurance are deductible only to a limited extent. Thus, individual premiums are generally paid out of taxable income, while employer-paid premiums are paid, in effect, with tax-free funds.

Reasons for the Recommendation:

The proposal will increase tax fairness by making tax incentives more effective in fostering the social objective of more comprehensive health, disability, and life insurance for Americans.

The substantial tax incentives for medical, disability, and life insurance make sense only if they encourage wide coverage, particularly for those least able to purchase insurance protection. Denying these tax benefits to plans that discriminate in favor of officers, shareholders, and the higher paid employee will support national objectives of providing wider and better protection against ill-health, disability, and family protection at loss of the breadwinn

The proposal will make these plans consistent with other Federal policies relating to employee benefits. Non-discrimination already is a condition for receiving tax benefits for pension programs and group legal service plans.

Effect on Taxpayers: Denial of the tax exemption to plans which discriminate will tend to encourage wider health, disability, and life insurance coverage for low and middle income workers under employer-paid plans. Those least likely to secure their own protection will benefit. On the other hand, this proposal by itself will raise taxes for individuals covered by discriminatory plans.

Effect on Revenue: This proposal will increase tax liabilitie less than $50 million in calendar year 1979.

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FACT SHEET

Employee Death Benefits

The President's Proposal: The $5,000 employee death benefit exclusion will be repealed.

Present Law: The first $5,000 paid by an employer on account of the death of an employee is not included in taxable income.

Reasons for the Recommendation: Tax exemption is of greater benefit to those subject to tax at high marginal rates. Death benefit plans frequently discriminate in favor of officers, shareholders, and higher paid employees. The payments by employers that are covered by the current provision are typically deferred wages owed to high income taxpayers. There is no reason for favoring these high income employees and their heirs at the expense of other taxpayers.

Adequate tax relief for the heirs of employees at all income levels will continue to be provided through the tax exemption for insurance proceeds.

Effect on Taxpayers: The heirs of some taxpayers, chiefly people with high incomes, will pay higher taxes.

Effect on Revenue: This proposal will increase tax liabilities less than $50 million in calendar year 1979.

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FACT SHEET

Qualified Retirement Plans

The President's Proposal:

"Qualified" retirement plans will no longer be permitted to exclude entirely lower paid employees whose total wages are below the social security wage base. For every 1.8 percent in contributions or benefits provided under a retirement plan on compensation above the wage base, at least 1 percent in contributions or benefits will be required on compensation below the wage base.

Present Law:

"Qualified" retirement plans receive preferential tax treatment. Contributions for an employee and the earnings on them are not taxed until the employee receives these amounts, usually as pension benefits on retirement. Also, employer contributions to the plan are immediately tax deductible.

Qualified plans are not permitted to discriminate in favor of officers, shareholders or higher paid employees. But, under present law, the non-discrimination requirement can be met by a plan that is "integrated" with social security so that it provides no coverage for employees below the social security wage base. The wage base is the amount of wages or salary on which social security taxes are paid and benefits are calculated. It is set at $17,700 in 1978 and is scheduled to rise to $29,700 by 1981 with automatic inflation adjustments thereafter.

Reasons for the Recommendation:

Special tax treatment of qualified plans is justified because social security alone does not provide adequately for retirement. In view of this, lower paid employees should not be subject to exclusion from private pension plans on the ground that they are covered by social security.

Social security replaces smaller proportions of pre-retirement income at higher income levels than at incomes below the wage base. Therefore, an employer whose plan, in combination with social security, tends to provide substantial replacement of pre-retirement earnings for lower-paid employees should be permitted to provide similar replacement at higher income levels even though employees at the higher levels receive proportionately greater benefits from the private plan. Thus, greater contributions above the wage base can be equitable, but only if lower-paid employees receive adequate protection.

Effect on Taxpayers: The proposal will have little impact on employers whose pension plans are already designed to provide adequate retirement income at all compensation levels. It will affect those plans designed to shelter income for a few employees while excluding all lower-paid employees.

Effect on Revenue: The revenue effect will be very small.

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FACT SHEET

Unemployment Compensation Benefits

The President's Proposal:

Unemployment compensation benefits will be included in taxable income of taxpayers with income from all sources (including unemployment compensation) in excess of $20,000 if single or $25,000 if married. Fifty cents of unemployment compensation benefits will be included in taxable income for each dollar of total income in excess of $20,000 for single taxpayers and $25,000 for married taxpayers.

Present Law:

Unemployment compensation benefits paid under government programs are not now taxable.

Reasons for the Recommendation:

The exclusion of unemployment benefits is worth more to taxpayers in higher marginal tax brackets than to those in lower brackets. Thus, unemployment compensation is particularly attractive to those who work part of the year at high wages and pursue personal interests while drawing unemployment benefits in the remaining months. It is also attractive to those who have substantial property income, or have a spouse with earnings. Families and individuals with high income from all sources should be taxed on unemployment benefits. These benefits replace wages which are themselves taxable. Not taxing these benefits creates undesirable work disincentives.

Effect on Taxpayers:

Taxpayers receiving unemployment compensation benefits who have more than $20,000 of income (including unemployment compensation) if single, or $25,000 if married, will pay higher taxes.

Effect on Revenue: This proposal will increase tax liabilities $0.2 billion in calendar year 1979.

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FACT SHEET

State and Local Taxable Bond Option

The President's Proposal:

State and local governments will have the option of issuing either conventional tax-exempt bonds or taxable bonds which will receive a subsidy from the Treasury for a fixed percentage of their interest costs. The choice will be entirely a matter for the state or local government to decide. For 1979 and 1980, the Federal Government will pay 35 percent of the interest costs on taxable bonds issued by state and local governments. For bonds issued thereafter, the interest subsidy will be 40 percent of the interest costs.

Present Law:

Interest payments received from debt obligations issued by state and local governments and their instrumentalities are exempt from Federal taxes. In contrast, all debt obligations issued by the Federal Government are subject to Federal income tax.

Reasons for the Recommendation:

The proposal will make an important contribution to tax fairness and increased efficiency in the use of public resources.

The tax exemption of interest on state and local bonds is essential to local government and should not be interfered with in any way. At the same time the windfall to higher income persons who do not pay tax on such interest can be reduced.

The tax exemption on state and local bonds is also an inefficient means of aiding state and local governments, since less than three quarters of the tax loss to the Treasury actually accrues to state and local governments through

lower borrowing costs. Providing a subsidy to state and local governments which issue taxable bonds will be a more efficient means of reducing the borrowing costs of these governments since in the long-run each dollar of net subsidy cost will provide $4 of benefits to the state or local governments. With the proposed subsidy on taxable bonds, state and local governments will save interest costs equal to $90 million the first year and $1.3 billion in the fifth.

Jurisdictions continuing to issue tax exempt bonds will also gain because the reduced supply of such bonds will allow governments to sell them at lower interest rates.

Effect on Taxpayers: The proposal will have a direct tax effect only on those persons who wish to purchase tax exempt bonds as a means of shielding part of their income from taxation. Because some state and local bond issues will be taxable, the supply of tax exempt issues will be reduced. Thus tax exempt bonds will be sold with lower interest rates, reducing their benefit to taxpayers and lessening tax avoidance.

The proposal will also provide a benefit to state and local taxpayers through lower interest costs on government borrowings.

Effect on Revenue: The net cost to the Federal Government of the taxable bond option will consist of the subsidy payments on taxable bonds, minus the higher revenues from taxes on interest income on the taxable bonds. The estimated net costs for calend year 1979 and 1983 are less than $50 million and $0.6 billion, respectively.

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FACT SHEET

Industrial Development Bonds

The President's Proposal:

Interest on industrial development bonds issued for pollution control and industrial parks will no longer be tax exempt. Also, bonds issued by state and local governments to finance hospital construction for private non-profit institutions will no longer be tax exempt unless there is a certification by the State that a new hospital is needed.

The size of projects which may be financed with tax exempt "small issues" of industrial development bonds will be increased from $5 million to $10 million, but the tax exemption will only be allowed for facilities constructed in economically distressed areas. Industrial development bonds that continue to qualify for tax exemption may be issued as taxable bonds with the Federal Government subsidizing 35 percent of the interest costs of taxable bonds issued in 1979 and 1980 and 40 percent of the interest costs of bonds issued thereafter.

Present Law:

Industrial development bonds are securities issued by state and local governments for the benefit of private borrowers. Under current law, interest on these bonds are tax exempt only in the following cases:

-- bonds issued to provide financing for certain facilities such as pollution control equipment, sports arenas and convention halls, airports and industrial parks;

-- small issues where the amount of the bonds sold does not exceed $1 million or the total capital expenses on the facility being financed do not exceed $5 million; and

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-- facilities (including hospitals) of private, nonprofit organizations.

Reasons for the Recommendation:

The tax exemption for interest on pollution control bonds should be eliminated because these bonds finance private facilities and, because under another proposal in the tax reform program, pollution control equipment installed in existing plants will receive ample subsidy by being made eligible for the full 10 percent investment tax credit in addition to receiving 5 year amortization of capital costs. Similarly, interest on the industrial development bonds for the development of industrial parks should be eliminated as these too are essentially private facilities.

Tax exemption of interest income on industrial development bonds increases the inequity of the tax structure. It also creates incentives for inefficient private investment decisions and drives up the cost of municipal finance.

Ending the tax exemption for bonds issued to finance construction of unneeded hospital facilities for private nonprofit hospitals will eliminate an undesirable incentive to build excess facilities and will support the Administration's efforts to control rapidly growing hospital costs.

Also, restricting to distressed areas the use of tax exempt financing for small issues of industrial development bonds will curtail the total volume of tax exempt bonds issued and will channel this subsidy to areas most in need.

Effect on Taxpayers: Restricting the use of tax exempt industrial development bonds will limit the amount of interest income which escapes taxation. It will also curtail the use of tax exempt financing by private borrowers.

Effect on Revenue: This proposal will increase tax liabilities less than $50 million in calendar year 1979, rising to $0.3 billion in 1983.

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Fact Sheet 24

January 21, 1978

FACT SHEET

Accrual Accounting for Agricultural Corporations

The President's Proposal:

All farm corporations will be required to use accrual accounting methods except those taxed like partnerships (Subchapter S Corporations) and those with less than $1 million of gross receipts. Noncorporate syndicates will also be required to use accrual accounting.

Present Law:

The 1976 Tax Reform Act required accrual accounting methods for farm corporations except "family farms," regardless of size, which may use the cash method. A "family farm" is a corporation in which at least 50 percent of the stock is owned by members of the same family, including distant relatives. Farm syndicates were made subject to some, but not all, of the restrictions on use of the cash method. Prior to the 1976 Act, all farms generally could use the cash accounting method.

Reasons for the Recommendation:

Apart from farming, the tax rules generally require taxpayers who sell products to report their income by the accrual method, and thereby accumulate their production costs in inventory until the product is sold. Cash accounting permits immediate deduction of expenses incurred whether or not the product is sold. Absentee, or non-active, farm owners have enjoyed unfair competitive advantages over the active farmer through this tax shelter, which permits them to claim artificial losses. This proposal will deal with the principal remaining tax shelters where "losses" from farm corporations or syndicates attributable to the treatment of capital costs and

inventories under cash accounting are used, for tax purposes, to offset income derived from other sources. Eliminating the present inducement for artificial expansion of farming operations to create "tax losses" will remove unfair competition the real farmer now faces.

Effect on Taxpayers:	The proposal generally will affect only a few large farms, for the most part concentrated in the poultry industry, and farm syndicates promoted as tax shelters. The shift to accrual accounting will require large corporate family farms as well as noncorporate farm syndicates to account for inventories and amortize certain capital costs, rather than treating them as current expenses.
Effect on Revenue:	It is estimated that this proposal will increase tax liabilities $40 million in calendar year 1979, and less than $10 million in 1983.

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Fact Sheet 25

January 21, 1978

FACT SHEET

Taxation of Financial Institutions

The President's Proposal:

Commercial banks will be required to base future additions to their bad debt reserves on their own actual experience in the current and 5 preceding years. In effect, this accelerates the transition rule enacted in 1969.

Mutual savings banks and savings and loan associations will be required to reduce their special bad debt deduction of 40 percent of net taxable income to 30 percent over a 5-year transition period.

Credit unions will be taxed on their income for the first time. After a 5-year transition period, they will be taxed on the same basis as savings and loan associations.

Present Law:

Commercial banks may claim a deduction for bad debts based on a fixed percentage of their eligible loans, regardless of their actual losses. The deduction is now at the level of 1.2 percent, and will drop to 0.6 percent in 1982. Not until 1988 will banks be required to base their bad debt deduction on actual loss experience.

Mutual savings banks and savings and loan associations which invest a significant portion of their deposits in real estate loans are entitled to a special deduction (known as an addition to a reserve for bad debts) equal to 41 percent of their taxable income in 1978. This deduction has been phased down from higher levels, and will phase down to a permanent level of 40 percent in 1979.

Credit unions are exempt from income tax.

Reasons for the Recommendation:

The proposals will increase tax fairness by lessening differences in the taxation of financial institutions and other businesses, and among different kinds of financial institutions, in a gradual manner that will not disrupt financial markets.

Commercial banks are adequately protected under the method which bases their additions to bad debt reserves on actual loss experience. They, and other financial institutions, enjoy special protection against losses under a tax law provision which will not be changed, allowing them to carry net operating losses back 10 years and forward 5 years. In contrast, the carryback and carryforward periods for nonfinancial concerns are 3 and 7 years, respectively. With this ability to spread losses over longer periods of time there is no reason to continue the special bad debt reserve provision for commercial banks until 1988.

The special tax treatment for mutual savings banks and savings and loan associations arose at a time when these institutions provided services for a limited group of members. Although this is no longer true, these institutions still continue to pay tax at well below the regular corporate rate. The retention of three-quarters of the existing subsidy for mutual savings banks and savings and loan associations, when combined with the much greater incentives for housing, such as the deductibility of real property taxes and interest, will continue to provide adequate tax incentives for home ownership.

There is no reason to continue to distinguish credit unions from other financial institutions. The powers and services of credit unions have expanded greatly over the past several years, so

that they are no longer truly mutual institutions with limited common bonds. Credit unions are most analogous to thrift institutions in the functions they perform and thus should be taxed on the same basis.

Effect on Taxpayers: The changes, by themselves, will increase the taxes paid by the affected financial institutions.

Effect on Revenue: These changes will increase tax liabilities $0.3 billion in calendar year 1979.

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Fact Sheet 26

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January 21, 1978

FACT SHEET

Elimination of DISC

The President's Proposal: DISC tax benefits will be reduced by one-third in 1979, two-thirds in 1980, and 100 percent in 1981 and thereafter.

Present Law: U.S. corporations may defer tax on a portion of their export-related income by channeling it through a domestic subsidiary, usually a paper company, called a Domestic International Sales Corporation (DISC). Special pricing rules on transactions between the parent and its DISC permit a favorable allocation of profit to a DISC. Prior to 1976, the taxation of half of a DISC's income was deferred as long as these profits were invested in export-related assets. In 1976 the portion of the income eligible for deferral was further limited to income in excess of 67 percent of the company's average export income in a moving base period. The purpose was to limit the benefits to increased export activity and to deny them where the exports would clearly have occurred anyway.

Reasons for the Recommendation: DISC has turned out to be a far more costly and less effective program than originally claimed. There are more effective and evenhanded means of providing tax relief to business. A recent Treasury study indicates that DISC may have contributed only $1 billion to $3 billion to U.S. exports in 1974 (less than 3 percent of U.S. exports for that year) at a tax revenue cost of $1.2 billion. DISC was conceived as a means of reducing American export costs when exchange rates were fixed. Changes in flexible exchange rates now provide a far better means of adjusting to changes in the competitive position of U.S. exports.

Effect on Taxpayers:	The tax savings from using DISCs will be eliminated over 3 years.
Effect on Revenue:	This proposal will increase tax liabilities $0.7 billion in calendar year 1979, rising to $1.8 billion in calendar year 1983.

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Fact Sheet 27

January 21, 1978

FACT SHEET

Terminating Deferral

The President's Proposal:

"Tax deferral" of earnings of U.S.-controlled foreign corporations will be phased out over a 3 year period by treating an appropriate fraction -- one-third in 1979, two-thirds in 1980, and the entire amount in 1981 and thereafter -- of a controlled foreign corporation's gross income, deductions, and taxes eligible for the foreign tax credit as having been earned or incurred directly by the U.S. shareholder. The earnings of a U.S.-controlled foreign corporation will be taxed currently whether or not those earnings are paid to the U.S. shareholders (usually parent companies) as dividends.

Foreign taxes in excess of the amounts that may be credited against U.S. taxes in any one year will be usable to offset U.S. taxes imposed for 3 years in the past. They may also be carried forward to offset U.S. taxes for 7 years in the future. (The carryback and carryforward periods are now 2 and 5 years respectively.)

U.S. shareholders will be allowed to claim losses incurred by their controlled foreign corporations.

Unrealized gains and losses, resulting from changes in the value of the U.S. dollar as compared to other currencies, will not be taken into account unless the U.S. shareholder elects. That election may be revoked 10 years after it is made with respect to future tax years only.

U.S. shareholders may be allowed to continue to defer the payment of taxes on certain types of income under specific tax treaties.

Present Law:

Generally, income from a controlled foreign corporation is not taxed to the U.S. shareholder until it is distributed in the form of dividends. This provision is referred to as "tax deferral" on the earnings of U.S.-controlled foreign corporations.

There are exceptions for controlled foreign corporations that have what is known as tax haven income and for foreign personal holding companies. Certain other provisions of the tax law prohibit the shifting of income or deductions for tax avoidance purposes. For example, one provision requires arm's length prices for transactions between a corporation and its controlling shareholders to prevent shifting income from a country imposing higher taxes to one where taxes are lower.

Another provision attempts to insure that reorganizations involving foreign corporations are not for tax avoidance purposes by generally treating the reorganizations as taxable events. Other sections of the law provide rules for determining whether income is from domestic or foreign sources and allocating deductions to the appropriate source of income.

Reasons for the Recommendation:

By eliminating tax deferral, U.S. businesses will have no incentive to invest overseas solely for the tax benefits available. The proposal will end any adverse effects on investment in the United States and on the creation of domestic jobs that may result from tax deferral.

Also, these provisions will lessen the incentives U.S. corporations now have to manipulate their international operations to avoid U.S. taxes.

The current tax laws and regulations relating to foreign corporations and international business transactions are so complicated that only the largest companies can afford the cost of sophisticated tax planning. This creates a definite competitive disadvantage for the smaller companies and those more oriented toward operations within the United States.

Effect on Taxpayers: The incentive for U.S. companies to invest in foreign countries simply because they provide special tax advantages will be greatly reduced. Generally, taxpayers will no longer be required to interpret the extremely difficult sections of the tax laws and regulations relating to foreign corporations.

Effect on Revenue: The proposed change will increase tax liabilities \$0.1 billion in calendar year 1979, rising to \$0.9 billion in calendar year 1983.

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Fact Sheet 28

January 21, 1978

FACT SHEET

Communication Taxes

The President's Proposal: The excise tax on communications -- chiefly telephone services -- will be repealed as of October 1, 1978.

Present Law: Amounts paid for telephone services and teletypewriter exchange services generally are subject to a communications excise tax. The rate for 1978 is 4 percent. Exemptions are provided for private communications services if they are charged for separately. The tax is being phased out by reducing the rate 1 percent a year through 1981.

Reasons for the Recommendation: Repeal of the tax will continue the comprehensive overhaul of the exicse tax system that began with the Excise Tax Reduction Act of 1965. It will reduce the cost of living both directly and by lowering business costs. The reduction of business costs, if passed through in the form of price cuts, will reduce inflation through lower consumer prices and through the effect of these lower prices on cost-of-living adjustments in wages. Repeal will be particularly beneficial to lower and middle income individuals who bear a disproportionate share of the present excise tax.

Effect on Taxpayers: Repeal will save individual telephone users about $650 million in 1979. Businesses will save about $550 million on their communication costs.

Effect on Revenue: This proposal will decrease tax liabilities $1.2 billion in calendar year 1979.

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Fact Sheet 29

January 21, 1978

FACT SHEET

Unemployment Tax Rate Reduction

The President's Proposal:

The Federal unemployment insurance tax will be reduced from 0.7 percent to 0.5 percent, effective January 1, 1979.

Present Law:

The unemployment compensation program is a Federal-state insurance system designed to provide temporary compensation for the loss of wages by unemployed workers. Funds accumulated from payroll taxes paid by the employer on the first $6,000 of earnings of each worker permit payment of benefits to unemployed insured workers.

To help defray the costs of Federal supplements to the regular unemployment compensation program, the net Federal tax was increased to 0.7 percent beginning January 1, 1977. That rate will continue until certain general revenue advances to the unemployment trust fund have been repaid. The tax rate would then revert to 0.5 percent.

Reasons for the Recommendation:

Reduction of the Federal employer payroll tax for unemployment insurance will assist in reducing inflation. The rate reduction will reduce employer wage costs, which, if passed through in the form of price cuts, will reduce inflation directly through lower consumer prices and, indirectly, as these lower prices work through cost-of-living-adjustment clauses to smaller wage increases.

The tax cut will be greatest, as a percent of wages for low-wage workers, thus partially offsetting the increased employer costs associated with recent minimum-wage legislation and increasing demand for low-skilled labor.

Effect on Taxpayers:	Starting in 1979, employers will pay less unemployment insurance tax.
Effect on Revenue:	There will be an $0.8 billion reduction in unemployment insurance liabilities in calendar year 1979.

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January 21, 1978

FACT SHEET

Reduction of the Corporate Tax Rates

The President's Proposal: The corporate tax rate on taxable income in excess of $50,000 will be reduced permanently by three percentage points to 45 percent effective October 1, 1978, with an additional reduction of one percentage point on January 1, 1980. The rate applied to the first $50,000 of taxable income will be reduced by two percentage points effective October 1, 1978.

Present Law: The present corporate tax rates are 20 percent on the first $25,000 of taxable income, 22 percent on income in excess of $25,000 up to $50,000, and 48 percent on all income in excess of $50,000.

Reasons for the Recommendation: These tax reductions, together with the extension of the investment credit, will assure the continuance and strengthening of the present economic recovery and will promote long-term capital formation. Increased capital formation can contribute both to economic demand needed for continued economic expansion and to increased productive capacity that will help avoid bottlenecks and inflationary pressures as the economy moves ahead.

The portion of GNP devoted to investment needs to be increased in the years ahead. Moreover, the efficient use of new capital needs to be assured. Additional jobs are needed for a growing labor force, to meet the goals of the National Energy Plan and to provide a cleaner environment and safer workplaces. The real income of workers can grow over the long run only if productivity is enhanced with new machinery and more efficient plants. Dependence on foreign oil can

be minimized only if electric utilities and industrial plants acquire the new capital necessary to convert to coal and other non-petroleum fuels. An improved environment and safer jobs also requires new facilities.

The corporate tax reductions are designed to spur the economy by stimulating capital formation. First, the lower taxes will have an immediate, favorable effect on corporate cash flow. Because retained earnings are the principal source of financing for corporate investments, the improved cash flow will provide for more capital expenditures. Second, the lower tax rates will increase after tax profits on investment projects. This improved return on investment will be an incentive for corporations to increase capital spending. Additionally, an increase in corporate dividends and the prospective growth in share prices resulting from higher after-tax earnings will stimulate the public to place more of their savings in corporate equities.

Effect on Taxpayers: The proposal will provide an immediate, direct tax reduction for both large and small corporations.

Effect on Revenue: For calendar year 1979, the rates are estimated to reduce corporate income tax liabilities $6.0 billion.

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FACT SHEET

The Investment Credit

The President's Proposal:

The temporary 10 percent investment credit will be made permanent.

The investment credit will be extended to new industrial buildings and to investments made to rehabilitate existing industrial buildings. Generally only manufacturing and utility buildings will be eligible for the credit. Industrial structures placed in service after December 31, 1977 will be eligible for the credit to the extent of construction costs incurred after that date. Expenditures made after December 31, 1977 to rehabilitate existing industrial structures will be eligible for the credit.

Investment credits will be allowed to offset 90 percent of tax liability in any year. They will not be permitted to offset a taxpayer's complete tax liability.

The full 10 percent investment credit will be extended to pollution control equipment that now qualifies for the special 5-year amortization.

Present Law:

The 10 percent rate of the investment credit is scheduled to revert to 7 (4 for utilities) percent on January 1, 1981.

The investment credit is available for investment in business machinery and equipment but not for investment in buildings or their structural components.

Investment credits may be used to offset all of the first $25,000 of tax liability, but no more than 50 percent of the remainder.

Certain qualified pollution control equipment is now eligible for a maximum investment credit of only 5 percent if the taxpayer elects to amortize the cost of this equipment over a 5-year period.

Reasons for the Recommendation:

Together with the recommended 4 point reduction in the corporate tax rate, the proposed liberalization of the investment credit will help stimulate increased levels of business investment.

A particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures. The investment stimulus provided by the credit should, therefore, be extended to investments in industrial structures.

Increased investment is also needed to improve the capacity of the economy to supply goods and services and to insure that future growth is not aborted by capacity shortages.

The declining rate of business investment is related to a slowdown in the growth of productivity. Increased capital formation can help accelerate the growth of productivity, maintain and improve American competitiveness in world markets, and facilitate the introduction of new technology.

A permanent credit is necessary to assist businesses in making long-range capital investment decisions and to stimulate capital formation.

Extending the investment credit to industrial structures will encourage businesses to carry out more balanced investment programs. Also, under present law, there are many disputes now

caused by the need to distinguish between equipment, for which the credit is available, and buildings and their structural components, for which it is not.

New businesses and businesses facing temporary setbacks or the need to make major adjustments to economic changes cannot fully use the investment credit because of the 50 percent limit on offseting current tax liability.

Effect on Taxpayers:

The proposal will reduce the overall tax burden on business.

Increasing the percentage of tax liability that can be offset by investment credits to 90 percent will aid companies with large investment needs and relatively low taxable incomes.

Taxpayers with tax liabilities of less than $25,000 will no longer be able to use investment credits to offset their entire tax liability.

The increased investment credit for certain pollution control equipment will reduce the costs of compliance with environmental standards in the case of existing plants, many of which were constructed when pollution control standards were less stringent.

Effect on Revenue:

These proposals will reduce tax liabilities approximately $2.4 billion in calendar year 1979, the first full year of the proposed changes.

By 1983, it is estimated that the proposed changes will reduce tax liabilities $7.2 billion, of which $4.5 billion is attributable to permanent extension of the 10 percent credit.

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Fact Sheet 32

January 21, 1978

FACT SHEET

Simplification of ADR

The President's Proposal:

The Asset Depreciation Range (ADR) system, which establishes procedures for taxpayers to depreciate their assets, will be simplified.

Salvage value will be disregarded under the revised system. Elaborate reporting requirements will be replaced by Treasury surveys which will require responses from only a small number of taxpayers each year. Only the straight-line and declining balance methods of depreciation will be allowed under ADR.

Present Law:

Under the ADR system, the IRS prescribes a range of guideline lives which taxpayers can use in setting the useful lives of their assets. Use of these lives by a taxpayer avoids disagreements between the taxpayer and IRS agents on audit as to what are the proper useful lives of the taxpayer's assets. Estimated salvage value in excess of 20 percent of cost limits the extent to which depreciation can be taken under ADR.

Taxpayers electing ADR are required each year to file detailed information about their assets.

Taxpayers electing ADR are permitted to use the sum of the years' digits, the 200 percent declining balance, and the straight-line methods of depreciation.

The ADR system, which was intended to simplify depreciation, occupies twenty pages in the printed regulations. Part of this length is due to the elections available to taxpayers in computing depreciation.

Reasons for the Recommendation:

Only about one half of one percent of all corporate taxpayers elected ADR in the last year for which figures are available (1974). However, over 90 percent of taxpayers with depreciable assets of greater than $1 billion elected ADR. More taxpayers will be encouraged to use a simplified ADR system, and the IRS will gain the administrative benefits which ADR provides.

Eliminating salvage value completely from the ADR calculations will have relatively little practical effect, but will simplify the system in its descriptic and its operation.

Eliminating the yearly reporting requirement will remove a significant burden from taxpayers who wish to adopt ADR. Surveys will provide the Treasury with sufficient information to keep current the figures needed for setting useful lives under ADR.

By eliminating some of the elections available to taxpayers under ADR, the description, application, and administrati of ADR will be substantially simplified.

Effect on Taxpayers:

The proposal will make the ADR system accessible to a greater number of taxpayers.

Effect on Revenue:

This proposal will have a negligible impact on revenue.

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January 21, 1978

FACT SHEET

Small Business

The President's Proposal:

Taxes on small business will be reduced and the rules governing Subchapter S corporations, depreciation, and losses on investments in small businesses will be made simpler and more liberal.

Tax Cuts. Corporate tax rates will be reduced permanently to 18 percent on the first $25,000 of income, 20 percent on the next $25,000, and 44 percent (45 percent, from October 1978 through 1979) on any additional income. For example, if a small corporation makes $50,000 in 1979, it will pay only $9,500 in taxes, or almost 10 percent less than in 1977.

Subchapter S. A Subchapter S corporation will be allowed to have as many as 15 shareholders, and it will be easier for shareholders to deduct Subchapter S losses. Also some technical rules that now apply to Subchapter S corporations will be simplified.

Depreciation. A simple table of useful lives of equipment will be prepared for use by small business. The table will permit small businesses to take allowances for depreciation that are similar to those now available to larger businesses under the Asset Depreciation Range (ADR) system. These changes are in addition to a proposal that will simplify the ADR system for all businesses.

Stock in a Small Business. An exception in present law (section 1244 of the Internal Revenue Code) that treats a loss on certain stock in a small business

as an ordinary loss will be broadened, increasing the amount of stock that can come under the exception. Also, some technical rules that could prevent stock in a small corporation from coming under the exception will be eliminated.

Present Law:

Tax Cuts. Under present law, a corporation pays a tax of 20 percent on its first $25,000 of income, 22 percent on the next $25,000, and 48 percent on any additional income. For example, if a small corporation made $50,000 in 1977 it paid $10,500 in taxes. The tax on income between $25,000 and $50,000 is scheduled to revert to 48 percent on January 1, 1979.

Subchapter S. Generally, a Subchapter S corporation is taxed like a partnership. In other words, the shareholders pay tax on the earnings of the corporation, but the corporation itself generally does not pay any tax. Similarly, if a Subchapter S corporation loses money, the sharehholders are generally (but not always) allowed to deduct the losses. A new Subchapter S corporation cannot have more than 10 shareholders under present law. Many other technical rules also apply to a Subchapter S corporation.

Depreciation. All businesses are allowed to deduct the cost of depreciation, or wear and tear on machinery and other equipment. The shorter the useful life of equipment, the greater the allowable amount of depreciation. Under present law, most small businesses estimate the useful life of equipment. These estimates are subject to dispute by an IRS agent.

Stock in a Small Business. Generally, a loss on stock is a capital loss and is thus treated less favorably than an ordinary loss. However, an exception in present law (section 1244 of the Internal Revenue Code) treats a loss on certain stock in a small business as an ordinary loss.

Reasons for the Recommendation:

Economic Stimulus. Today, many small businesses badly need equity capital to modernize and expand. The largest source of equity capital for small businesses is retained earnings, or profits left over after taxes. Therefore, the proposal will allow small businesses to retain more earnings after taxes in order to assist them to modernize and expand.

In addition, the proposal will make it easier for small businesses to attract outside equity capital. An investor in a small business takes a great many risks. Change in technology and market conditions, larger competitors, and, in many cases, imports pose a continuing threat to the survival of a small business. These risks discourage potential investors and make it difficult for a small business to raise outside equity capital. The proposal will change the tax law so that if an investor loses money on stock in small business, it will be easier to deduct the loss. This change will reduce the risk of investment in a small business and therefore will make it easier for small businesses to attract outside equity capital. Small business will on balance benefit from the modifications of the investment credit.

Simplification. The proposal is also designed to simplify the tax law for small business. This will make it easier for small business to comply with the law, and will reduce the number of disputes between small business and the IRS.

Effect on Taxpayers:	The proposal will cut taxes and simplify the law for small businesses.
Effect on Revenue:	The proposal will reduce tax liabilities $0.4 billion in 1979.

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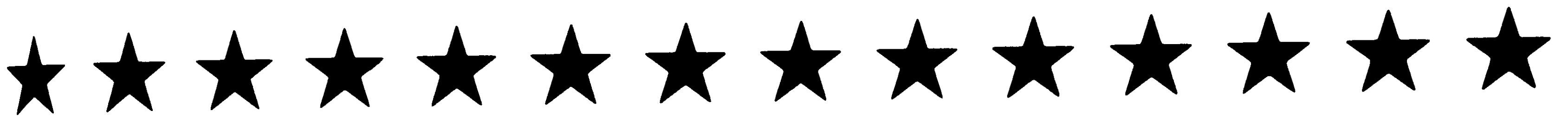

Detailed Descriptions and Supporting Analyses of the Proposals

DEPARTMENT OF THE TREASURY
Washington, D.C.

The President's 1978 Tax Program

Detailed Descriptions
and Supporting Analyses
of the Proposals

January 30, 1978

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I

Overview of the Tax Reduction and Reform Act of 1978

FISCAL STIMULUS AND ECONOMIC GROWTH
ACHIEVED BY THE TAX PROGRAM

The Need for a Tax Cut

To achieve the economic goals outlined in the President's Budget and Economic Messages, prompt, permanent tax reductions for both individuals and corporations are required. Such reductions are needed not because the U.S. economy is weak today, but rather to strengthen and maintain the current economic expansion, and to assure the future productivity of the economy. The unemployment rate has declined by more than two and a half points from its peak in 1975, but unemployment remains unacceptably high. To assure that it will continue to decline through 1979, the economy must continue to grow at a rate of 4-1/2 to 5 percent.

To maintain this growth rate will require a fiscal offset to the drain on consumer purchasing power from higher taxes and inflation. The outlook for future increases in consumption is dimmed by the recently legislated increases in social security taxes, which will reduce consumer take-home pay in 1978 and especially in 1979 and subsequent years. Furthermore, without personal tax reductions, inflation would operate to move individual taxpayers into higher marginal tax brackets, increasing their effective tax burden just as though higher rates had been enacted.

The tax cut is also designed to stimulate business investment. In recent years, the growth in the stock of productive capital in the United States has been inadequate. During the current recovery, the level of business investment has been particularly sluggish. Real business investment during the fourth quarter of 1977 was three percent below its previous peak (during the first quarter of 1974). This weakness was particularly noticeable in investment in non-residential structures which, during the fourth quarter of 1977 (corrected for inflation), remained 14 percent below its peak during the third quarter of 1973.

The sluggishness of business investment could become a major long-run problem. For the longer term, an increasing portion of GNP must be devoted to investment in order to

facilitate the introduction of new technology and to expand and modernize the nation's stock of capital, thereby raising the overall productivity of the economy and reducing inflationary pressures. Additional capital is needed to equip a growing labor force, to meet the goals of the National Energy Plan, and to provide a cleaner environment and safer workplaces. In addition, the real income of workers can grow over the long run only if labor productivity is enhanced. Increased capital formation, which provides new and more efficient productive facilities, can help accelerate the growth of labor productivity, offsetting inflationary pressures and improving U.S. competitiveness in world markets.

Moreover, growth in the stock of capital must be accompanied by increased efficiency in its use. Much of the current capital stock is outmoded. It is energy intensive, predicated on the existence of cheap energy--something that will not occur again. Similarly, much of the existing capital was constructed when environmental standards were less stringent than they are today. The achievement of a more efficient capital stock will require high levels of new investment, which in turn requires a tax program that will assure adequate after-tax returns to capital.

Finally, the composition of the existing capital stock has been distorted by features of current tax law. For example, opportunities for tax-sheltered investments and more lightly-taxed investment abroad, as well as restrictions on the investment in industrial facilities eligible for the investment credit, all tend to discourage the most efficient allocation of capital resources. These tax impediments to an efficient overall stock of capital must be removed.

In a suitable fiscal environment, the private sector is capable of strong economic growth, but a tax cut is necessary at this time to ensure that the present expansion is not choked off by Federal taxes claiming a rising share of income. A balanced tax program is needed to strengthen and extend the current economic expansion in a non-inflationary way, to improve the capacity of the economy to supply goods and services, to increase real wages over time, and to insure that future growth is not aborted by capacity shortages. If the vigor of the current economic expansion is to be maintained and the unemployment rate is to be reduced below six percent, legislation must be enacted promptly.

The Proposals in General

The specific tax proposals will be discussed in detail below, but their general magnitude is presented in Table IA-1. Individual tax changes, reflecting primarily the $240 credit and the new individual rate schedules, will provide a gross tax cut for individuals of $23.5 billion in 1979 and,

Table IA-1

Summary of Tax Proposals
($ billions)

Proposal	Revenue Effect 1979
* Reduce Individual Tax Rates and Adopt $240 Personal Credit	-23.5
* Limit Itemized Deductions	+5.8
* Restrict Tax Shelters and Other Opportunities to Receive Tax-Preferred Income	+1.0
* Restrict Deductions for Entertainment and Travel Expenses . . .	+1.5
* Reduce Corporate Tax Rates	-6.0
* Liberalize Investment Tax Credit	-2.4
* Curtail Business Tax Preferences	+1.1
* Reduce Telephone Excise and Unemployment Taxes	-2.0
TOTAL	-24.5

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after allowing for revenue raising reforms, a net reduction in individual income tax liabilities of $16.8 billion. Corporate changes consist of rate reductions and liberalization of the investment credit. These cuts, together with business tax reforms, yield a net reduction of almost $6 billion in 1979. In addition, both businesses and individuals will derive benefits from the $2 billion reduction in telephone excise taxes and a reduction in the payroll tax for unemployment insurance.

While these measures will tend to increase the budget deficit during 1979, the stimulus to the economy, which will lead to higher levels of economic activity during 1979, should offset about 35 percent of the initial revenue loss by 1980. With the proposed tax cuts, the unemployment rate will continue to decline throughout the period.

The Personal Tax Proposals

The largest single aspect of the package, introduction of the $240 credit and reduction of the individual tax rates, will become effective October 1, 1978, while most of the reforms, which generally lead to revenue gains, become effective January 1, 1979. Thus, the net tax reduction for individuals during calendar 1978 will be slightly over $6 billion, increasing to almost to $17 billion by 1979. The phase-in of this stimulus is such that its impact will be felt primarily during late 1978 and 1979, when it will be most needed.

The Business Tax Proposals

The benefits to the economy from the individual tax cuts will be augmented by the business tax program. This program not only will provide the stimulus to regain full employment, but it will also correct the current imbalance between the growth of productive capacity and the growth of the labor force. In the long run, this program will operate to increase the share of national output devoted to expansion and modernization of the nation's capital stock. Thus, the business tax proposals are designed to achieve multiple objectives, while assuring the continued vigor of the national economy.

First, and of overriding importance, is the stimulation to capital formation both in the near future and over the longer term. A significant cause of the recent sluggishness in business investment has been the low after-tax rate of return on investment. There has been a downward trend in the rate of return on reproducible assets since the mid-1960's, a trend that must be reversed. To this end, corporate tax rates will be reduced as of October 1, 1978, and further reduced on January 1, 1980. The 10 percent investment tax

credit will be made permanent, and will be extended to the construction or rehabilitation of industrial and utility structures. The full investment credit also will be extended to all pollution abatement facilities currently amortized over five years with a five percent credit. In addition, investors will be permitted to use these credits to offset 90 percent of tax liability in any year. Effective as of the first of January 1978, these liberalizations of the credit together with the corporate rate cuts will have a substantial impact on business investment beginning in 1978, an impact that will grow in 1979 and thereafter.

These tax reductions will stimulate capital formation in two ways. First, the lower taxes will have an immediate, favorable effect on corporate cash flow, facilitating the financing of capital expenditures. Second, the lower tax rates will increase after-tax profits on investment, creating incentives for corporations to increase capital spending. While there are substantial delays in the response of capital expenditures to stimulative measures, prompt enactment of this tax program should induce increased investment spending even during the current calendar year.

The degree of permanent investment stimulus in the program may be measured by the overall reduction in tax on returns from all investment, including the reductions in individual tax rates as they apply to dividends, interest, rents, royalties, capital gains, and profit of noncorporate enterprises. Even after allowances for revenue raising reforms, there will be a significant reduction in overall taxation of income from ownership of capital. 1/ As measured at 1979 levels of income, the entire tax program, when fully phased in, will reduce taxes on capital income by an estimated $7.3 billion. The elements of the program included in this estimate are set forth in Table IA-2. The table discloses that the combined amounts of individual and corporate rate reductions and liberalization of the investment credit will substantially outweigh selective tax increases from business reforms. This permanent, net reduction in taxes on investment income will provide a lasting incentive to capital formation.

It is equally important that the increase in aggregate capital spending be allocated in an efficient way. Efforts must therefore be made to reduce incentives in the tax system that give rise to inefficiencies in the allocation of capital. The restructuring of the investment credit and a number of the reforms in the business tax proposals are directed toward this goal.

Table IA-2

Change in Tax on Capital Income

($ millions)

Proposal	Full Year 1979
Individual rate reductions, $240 credit, and itemized deductions (capital income only) 1/	-1,832
Repeal alternate tax for individuals	140
Minimum tax change	284
Real estate shelters	666
Financial Institutions	224
Taxable bond option	257
Tax credits limited to 90 percent of individual liability	52
At risk limitation	13
Elimination of deferral of tax on foreign source income	660
Phase out of DISC	1,032
Corporate family farm accounting	35
Investment tax credit:	
Extend to structures	-1,443
Increase liability limit to 90 percent	- 84
Pollution abatement facilities	- 120
Corporate tax rate reductions	-7,203
Total for capital income	-7,319

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1/ Capital income items are: dividends, interest, rents, royalties, capital gains, proprietorship, and partnership income.

For example, the investment credit currently applies to industrial equipment, but not to the buildings needed to house that equipment. Thus, the tax system encourages businesses to build a capital stock that is "over-equipped" and "under-housed" relative to what it would be under a more neutral tax system. Extending the credit to industrial structures will eliminate this bias.

Other efficiency losses stem from variations in the tax rates paid by different industries. Such variations occur because of the very different way in which different forms of business income are taxed. The present tax proposals seek to encourage a more efficient allocation of capital resources by reducing the tax incentives that distort investment decisions. This would be accomplished by making effective business tax rates more equal through repeal of some special provisions for taxing business income. These include the phase-out of DISC, the elimination of tax deferral on foreign source income, changes in provisions for bad debt reserves by financial institutions, and increasing the taxation of tax shelters and other tax preference items.

Overall Impact of the Tax Program

In the absence of this tax program, the share of the nation's output going to the Federal government will continue to rise. The Social Security tax increases, the unemployment insurance tax increases, and the "inflation tax" increases would mean that in fiscal year 1979, Federal receipts would be equal to 20.4 percent of GNP. The Administration's tax program would reduce this share to 19.3 percent.

A similar pattern is reflected in individual income taxes as a percent of personal income. Under current law, this ratio would rise to 10.7 percent in calendar year 1978 and 11.4 percent in 1979--close to its historic high (11.6 percent in 1969). The Administration's tax program will reduce these ratios to 10.3 percent and 10.5 percent, respectively, thus working to offset the fiscal drag on the economy.

While the impact of the entire tax package on the performance of the economy will be modest in 1978, it will become significant in 1979. In the absence of the tax package, we would expect the unemployment rate to remain steady at 6.3 percent or move slightly upwards. The tax stimulus will increase output by $40 billion by the end of 1979, creating one million more jobs and reducing the rate of unemployment below six percent. Forecasting the performance of the economy beyond 1979 is hazardous, but it seems clear that, in the absence of the tax package, there would be further softening of the economy, while with the tax package the economy will continue to expand.

Such economic stimulus is not entirely without cost: while the rate of inflation will continue to decline each year, it would decline more rapidly in the absence of the stimulus. In proposing this package, the Administration has made the judgment that the production of an additional $40 billion of goods and services (in 1977 prices) and the creation of almost a million new jobs is worth the risk of an extra one-tenth of one percent in the inflation rate at the end of 1979.

The tax program is thus a key element in the Administration's overall economic plan, which relies principally upon growth in the private sector to create the jobs needed to achieve high employment. The tax program is designed to offset such fiscal changes as the "inflation tax" and increased social security taxes that would otherwise tend to limit economic growth. It will reform our present system in order to achieve greater equity and simplification. The tax program will also raise the rate of return on investment, to stimulate expansion and modernization of our capital stock, increasing employment in the short run and raising productivity and removing capacity bottlenecks in the future. At the same time, the tax program avoids excessive stimulation, for potential inflationary pressures are still present in the economy. The reductions in the telephone excise tax and the unemployment insurance tax work directly against such pressures by reducing the cost of output. Other aspects of the Administration's economic program will also help in restraining inflation, most notably the expenditure restraint contained in the fiscal year 1979 Budget and the program for voluntary wage and price restraint. Taken together, all these programs will enable the U.S. economy to enjoy steady, sustainable, non-inflationary economic growth.

<u>Footnote</u>

1/ Regardless of whether the tax on capital income is paid by corporations or individuals.

INCREASED EQUITY ACHIEVED BY THE TAX PROGRAM

One important goal of the Administration's tax proposals is to restructure the law to increase the extent to which it reflects the two basic principles of tax fairness. The first principle, generally referred to as horizontal equity, is that people with comparable incomes should pay a comparable amount of tax. The second principle, vertical equity, is that tax liabilities should increase with increasing ability to pay; that is, the tax system should be progressive. Although other objectives of the income tax system may at times come into conflict with the principles of equity, our income tax structure -- if it is to be maintained -- must rest on this foundation.

Effective administration of our income tax depends upon the perception by taxpayers that the system is basically equitable. If honest citizens begin to doubt the equity or fairness of the system, the level of voluntary compliance will be diminished. Therefore, when taxpayers with an equal ability to pay are taxed at vastly different rates, or when higher income taxpayers are taxed at lower rates than lower income taxpayers, the viability of our income tax system becomes threatened.

Vertical Equity

Progressivity. The income tax has always been designed to be progressive, so that higher income individuals are to pay a larger share of their incomes in tax than lower income individuals. The Administration's tax proposals would reinforce the current progressivity of the income tax. The proposals are structured to give the lowest income classes the greatest percentage reductions in tax liability, the next greatest reductions to the middle income classes, and the smallest reductions to the upper income classes. In fact, the average taxpayer with an expanded income 1/ of $100,000 or more will have a slight tax increase. As a result, as shown in Table IB - 1, taxpayers with expanded income of up to $30,000 will bear a smaller proportion of the total tax burden, while those with expanded income of $30,000 or more will bear a greater proportion.

This increase in progressivity will be accomplished through replacement of the personal exemption with a personal credit and a restructuring of the tax rates. In addition, the proposals to provide further limits on tax shelters, to treat interest income from annuities the same as other

Table IB-1

Income Tax Liabilities: Present Law and Administration Proposal
(Personal Income Only)

(1976 Levels of Income)

Expanded Income Class	Present Law		Administration Proposal		Tax Change	
	Tax Liability	Percentage Distribution	Tax Liability	Percentage Distribution	Tax Liability	Change as Percent of Present Law Tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	(percent)
Less than 5	141	0.1%	-251	-0.2%	-392	-278.0%
5 - 10	8,227	6.1	6,368	5.2	-1,859	-22.6
10 - 15	18,071	13.4	15,361	12.4	-2,710	-15.0
15 - 20	23,009	17.0	20,148	16.3	-2,861	-12.4
20 - 30	32,778	24.2	29,593	23.9	-3,185	-9.7
30 - 50	22,017	16.3	20,971	17.0	-1,046	-4.8
50 - 100	16,492	12.2	16,344	13.2	-148	-0.9
100 - 200	8,084	6.0	8,261	6.7	177	2.2
200 and over	6,476	4.8	6,838	5.5	362	5.6
Total	$135,293	100.0%	$123,633	100.0%	$-11,660	-8.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 15, 1978

Note: Details may not add to totals due to rounding.

interest income, to repeal the alternative tax on capital gains and to tighten the minimum tax will enhance the equity of the tax system by restricting the extent to which individuals can lower their tax merely by the choice of their investments. The taxable bond option will reduce the extent to which high-bracket taxpayers can increase their after-tax income by holding tax-exempt bonds.

Chart IB-1 and Table IB-2 below, provide a comparison of effective tax rates under present law and the Administration's proposal.

Tax Reform and Poverty Levels. A major equity objective of reform of the individual income tax is the elimination of any income tax upon people whose incomes are at or near poverty levels. Since poverty level income is sufficient to purchase only minimum amounts of food, shelter, and other necessities, imposition of income tax on income below these levels is inappropriate.

The tax-free level of income is defined to be the maximum level of adjusted gross income at which no income tax is paid by a taxpayer who does not itemize deductions. The tax-free level is determined by the combination of personal exemptions, personal credits, and the zero bracket amount (or standard deduction) 2/.

In recent years, the tax-free level of income has been increased primarily through increases in the size of a minimum standard deduction. Under the tax proposals, the tax-free level will rise primarily from the change of the personal exemption to the personal credit.

Raising the tax-free levels of income also serves to limit the overlap of the income tax system with the welfare system. Under most welfare programs, there is a phase-out of benefits as income rises. If welfare benefits are reduced at the same level that income is taxed, a wage earner can face a situation where he can keep little if anything from an additional dollar of earned income. Therefore, to avoid strong disincentives to work at low income levels, it is desirable that tax-free levels of income be set high enough to prevent a dollar of increased earned income from causing both a reduction in welfare assistance and an increase in income tax liability.

A comparison of the tax-free levels of income and poverty levels is presented in Table IB - 3. Under the Administration's tax proposals the tax-free level of income would rise substantially above the poverty level for 1979.

It should be noted that the poverty level is defined in terms of total income, while the tax-free level of income is defined in terms of adjusted gross income for a taxpayer who

CHART I-B-1

Tax Reform Program: Effective Individual Tax Rates -- Taxes as a Percent of Expanded Income. 1976 Level of Income.

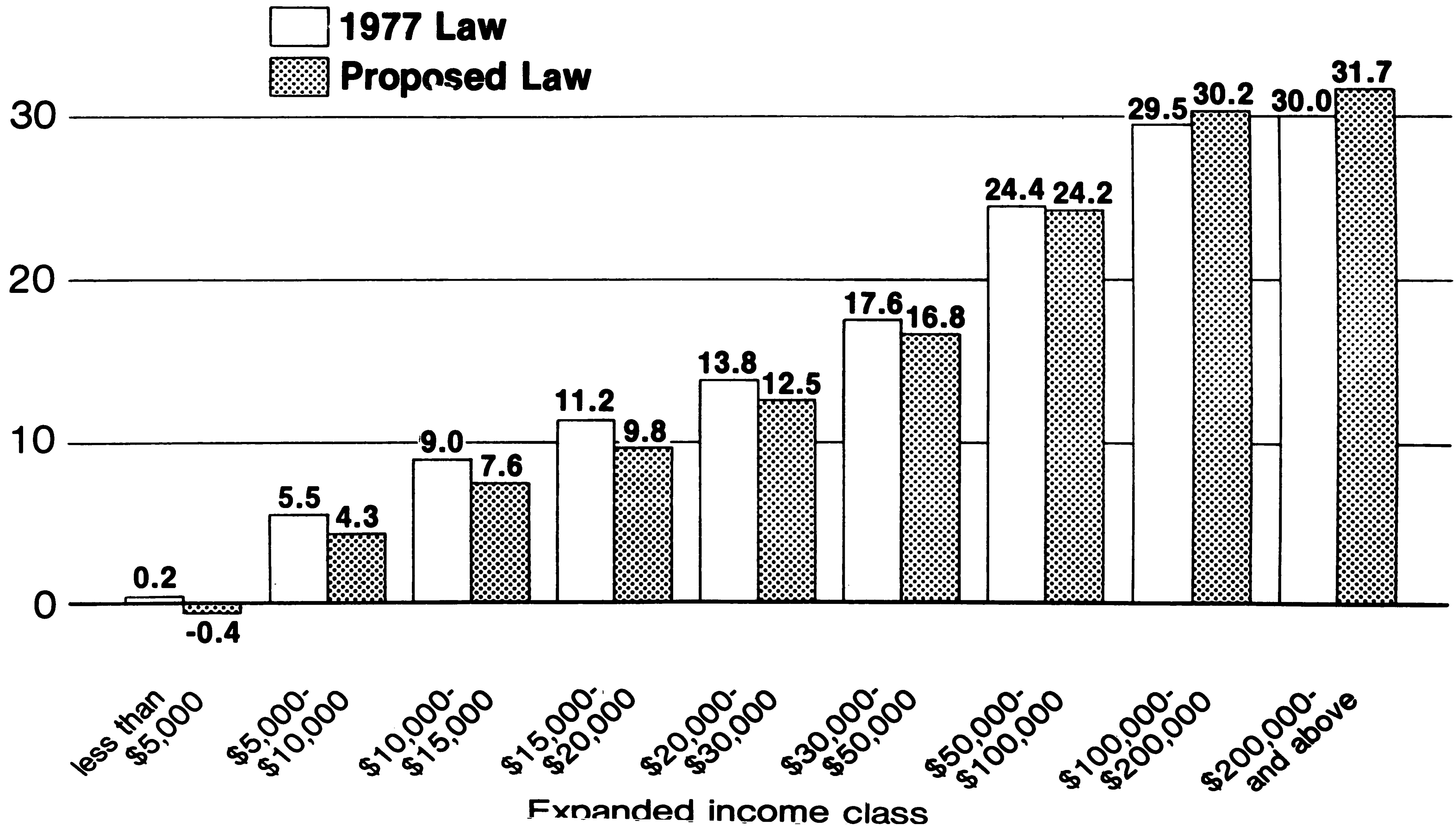

Table IB-2

Expanded Income and Tax Liability Under Present Law And Tax Reform Proposals (Individual Only)

(1976 Levels of Income)

($ millions)

Expanded Income Class ($000)	Expanded Income	Present Law Tax Liability	Present Law Effective Tax Rate	Tax Reform Proposal Tax Liability	Tax Reform Proposal Effective Tax Rate
Less than 5	57,557	141	0.2%	-251	-0.4%
5 - 10	149,590	8,227	5.5	6,368	4.3%
10 - 15	201,036	18,071	9.0%	15,361	7.6%
15 - 20	205,086	23,009	11.2%	20,148	9.8%
20 - 30	237,041	32,778	13.8	29,593	12.5%
30 - 50	124,836	22,017	17.6	20,971	16.8%
50 - 100	67,484	16,492	24.4	16,344	24.2%
100 - 200	27,371	8,084	29.5	8,261	30.2%
200 and over	21,573	6,476	30.0	6,838	31.7%
Total	1,091,573	135,293	12.4%	123,633	11.3%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 12, 1978

Note: Details may not add to totals due to rounding.

TABLE IB-3

Tax-Exempt and Poverty Levels

Of Income

Family Size 1/	Tax-Exempt Levels of Income Under Current Law 2/	Tax-Exempt Levels of Income Under Proposal 2/	1979 Poverty Levels 3/
1	3,200	3,967	3,449
2	5,200	6,553	4,438
3	6,200	7,922	5,429
4	7,200	9,256	6,954
5	8,183	10,589	8,223
6	9,167	11,884	9,280

Office of the Secretary of the Treasury
Office of Tax Analysis
Jan. 26, 1978

1/ Family size assumed to equal number of exemptions. For family sizes greater than two, families are assumed to file joint returns and be two parent families
2/ Excludes Earned Income Credit.
3/ Non-farm families.

does not itemize and does not receive additional credits because of age or blindness. Thus, for some taxpayers, the tax-free level of income may be higher than the numbers reported in the table. This higher level may be the result of nontaxable income such as social security payments, extra credits, additional exemptions for age and blindness, or itemized deducions in excess of the zero bracket amount.

Employee Benefits -- Employer programs designed to provide retirement income to employees or to provide protection in the event of illness, death or disability receive favorable tax treatment. The President's proposals relating to qualified retirement plans and Social Security and medical, disability and life insurance provided by the employer will assure that a greater portion of the benefits from these plans will inure to rank and file employees.

Horizontal Equity -- Equal Incomes, Equal Tax

The tax proposals are also designed to move in the direction of equalizing the tax treatment of taxpayers with an equal ability to pay. The tax reform proposals previously described will reduce the disparity in tax treatment arising from choice of investment. Also, the President's proposal relating to entertainment benefits will tend to equalize the tax burden between those who are able to arrange their business activities so as to enjoy entertainment which is deductible and those who must provide these amenities out of after-tax dollars.

Finally, for taxpayers with over $20,000 of income if single and over $25,000 of income if married, at least some portion of their unemployment benefits will be taxed. These taxpayers with unemployment benefits will, therefore, be taxed more like other taxpayers at a comparable income level whose income is from other sources.

Footnotes

1/ As used here, the term "expanded income" is generally a taxpayer's adjusted gross income plus items of tax preference (not otherwise included in adjusted gross income).

2/ Before the Tax Reduction and Simplification Act of 1977, there was no zero bracket amount but rather a minimum standard deduction (low income allowance).

SIMPLIFICATION ACHIEVED BY THE TAX PROGRAM

In our tax system, equity and public policy goals often conflict with the desire to achieve simplicity. Many deductions and credits are allowed in order to further public policies; however, government spending via the tax system invariably adds complexity to the tax laws. In many cases, factual situations are distinguishable and arguably ought to be taxed differently in the interest of equity. However, the more distinctions which the tax system recognizes, the more complicated it becomes and the more difficult it is to determine tax liability in even the most ordinary situations.

Some complexity in our tax laws cannot be avoided since the law must reflect the enormous complexity and vitality of the American economy. It is essential to our system of self-assessment, however, that the law be understandable to the people to whom it applies. At the present time even routine applications of the tax laws frequently are not understood. Our tax laws must be made simpler, especially for the average taxpayer who does not have access to high priced professional counsel.

The President's proposals include important steps toward simplification, without sacrificing equity. For both individual and business taxpayers, the proposals will reduce the amount of time and energy spent on recordkeeping and tax computation. They will also reduce the frequency of disputes between taxpayers and the Internal Revenue Service. For individuals the most significant gain in simplification is that about 6 million individual taxpayers will be able to determine their tax liability without itemizing deductions. Even those who continue to itemize will be required to keep fewer records and to make fewer and easier calculations.

These proposals continue the Administration's efforts toward simplification which began with the Tax Reduction and Simplification Act of 1977. That Act provided a flat standard deduction (now called the "zero bracket amount"). The Act also provided new tax tables that 95 percent of all taxpayers are able to use. These taxpayers no longer are required to make separate calculations for the standard deduction, personal exemptions, or the very complicated general tax credit.

The proposals which will simplify the tax laws are as follows:

Itemized Deductions

Under the proposals, certain itemized deductions will be reduced or eliminated. This will make it easier for individuals to prepare their own tax returns, eliminate much recordkeeping, and reduce audit and administrative burdens on both taxpayers and the Internal Revenue Service.

The itemized deductions for state and local general sales taxes, personal property taxes and gasoline taxes will be repealed. Also the deductions for medical expenses and casualty losses will be combined into one "extraordinary expense" deduction which will be available only to the extent that these expenses exceed 10 percent of adjusted gross income. This proposal will eliminate the need for taxpayers to compile and retain detailed records unless their medical expenses and casualty losses are unusually large and seriously impair their ability to pay taxes. It will also eliminate many disputes between taxpayers and the IRS over the nature of medical expenses and the extent of casualty losses.

Reductions in tax rates applicable to individuals will substantially offset increases in tax liabilities which would otherwise result from these changes in the treatment of itemized deductions. Since these expenses are incurred in a relatively uniform manner, they can be reflected in the structure of tax rates.

Capital Gains

Generally, the Internal Revenue Code permits an individual taxpayer to deduct 50 percent of any net long-term capital gain from adjusted gross income. However, a special rule applies to the first $50,000 of net long-term capital gain realized in any one year. Instead of paying regular tax on one-half the gain, the individual taxpayer may elect to pay a 25 percent "alternative tax" on the entire gain up to $50,000. A taxpayer who does so may not utilize the averaging provisions of the Code. Therefore, two sets of calculations are required by taxpayers to minimize tax liability -- one based on the alternative tax and no averaging and one based on averaging but no alternative tax. Repeal of the alternative tax will simplify treatment of capital gains and computation of tax.

Political Contributions

The Internal Revenue Code now permits an itemized deduction for up to $200 of political contributions by a married couple filing jointly. As an alternative, a credit against tax of half of the first $100 of political contributions is permitted. To treat political contributions more equitably and to eliminate the complexity which results from an alternative deduction or credit, the deduction for political contributions will be repealed. Also, this will permit the tax return form to be shortened.

Personal Credit

The replacement of both the personal exemption and the general tax credit by a $240 personal credit represents an important conceptual simplification.

Small Business

Complexities in the tax law are especially burdensome for small businesses. Computation of the depreciation deduction is a particular source of complexity. In computing the deduction for depreciation, small businesses are now required to estimate the useful life of property. These estimates often provoke disputes with the IRS. To prevent these disputes from arising, the IRS will prepare for use by small businesses a simple table to determine the useful life of property.

Salvage value is another source of unnecessary complexity. The burdensome calculations have little practical effect on the depreciation deductions allowed. The proposal will permit small businesses to disregard salvage value if the table lives are used.

Losses on the sale of stock of certain small corporations can offset ordinary income. Under present law this beneficial treatment is available only if the taxpayer complies with complicated procedures when the stock is offered. Many taxpayers fail to receive this beneficial treatment because they are unaware that these procedures exist. Under the proposal this special treatment will be made automatic.

The ADR System

The Asset Depreciation Range (ADR) system, an optional method for computing depreciation, is designed to minimize disputes between taxpayers and the IRS. However, many taxpayers have not been able to use the ADR system because it is complicated and imposes burdensome reporting requirements. Several technical changes are proposed to simplify the ADR system, including replacing the current reporting requirements with a survey of sample taxpa

Real Estate

The ADR system generally does not apply to real estate. As a substitute for the ADR system, a simple table for use in computing depreciation of real estate will be provided. This will eliminate disputes between taxpayers and the IRS over the useful life of buildings.

Investment Credit

The proposed extension of the investment credit to industrial and utility structures will reduce disputes between taxpayers and the IRS caused by the need under current law to distinguish between two categories of equipment since equipment which is a structural component of a building is not eligible for the credit. Although it will be necessary to distinguish between industrial and other structures, this should be a simpler line to draw. Also, the expansion from 50 percent to 90 percent of the amount of tax liability that may be offset by an investment credit will reduce the need for taxpayers to use complicated carryover provisions or to engage in lease arrangements.

Deferral and DISC

The proposed phase-out of the deferral of income of controlled foreign subsidiaries and the DISC provision will eliminate some of the most complex provisions of the Code and reduce the circumstances where other little-understood rules must be applied.

Travel and Entertainment Expenses

The elimination of deductions for entertainment expenses such as theater tickets, yachts, and hunting lodges will reduce recordkeeping requirements and eliminate a source of taxpayer disputes. The proposed rules regarding expenses of attending foreign conventions will eliminate burdensome recordkeeping resulting from the 1976 Act's partial solution to the problem of vacations disguised as business-related conventions.

Ordering of Credits

The proposal will simplify the treatment of tax credits. Under present law, some credits can be taken against certain special taxes such as the minimum tax, but others cannot. The proposal will provide a uniform base for all credits.

II

Tax Treatment of Individuals

INDIVIDUAL TAX RATES AND THE PERSONAL CREDIT

Present Law

Three elements of the tax law that affect all individual taxpayers are the personal exemption, the general tax credit, and the schedule of tax rates. An individual is allowed an exemption of $750 for himself and for each dependent. On a joint return, both husband and wife are allowed exemptions. Additional $750 exemptions are allowed for individuals who are aged or blind.

The general tax credit is equal to (a) $35 for each personal exemption, or (b) two percent of the first $9,000 of taxable income, whichever is greater.

There are four rate schedules -- joint, single, married filing separately, and head of household. 1/ Under, the joint table, the first bracket, or zero bracket, includes $3,200 of taxable income. No tax is paid on income in the zero bracket. The other tax rates range from 14 percent (for the first $1,000 of taxable income in excess of this zero bracket amount) to 70 percent in the highest bracket (more than $200,000 over the zero bracket amount). For single taxpayers, the zero bracket includes the first $2,200 of taxable income. Rates range from 14 percent for the first $500 in excess of the zero bracket amount to 70 percent in the highest bracket (more than $100,000 over the zero bracket amount). The schedule for the separate returns of married persons is obtained from the joint schedule by dividing all dollar amounts by two. Finally, a single taxpayer with a dependent may qualify to use the head of household schedule. Under this schedule, tax liability is the average of the amounts that would be owed on a joint return and a single return with the same taxable income above the zero bracket amount.

Reasons for Change

The economy requires a substantial tax cut to ensure that the current recovery is sustained. In particular, individual income tax reductions are needed to offset both increases in social security taxes in 1978 and 1979 and to counteract the tendency of inflation to increase the share of personal income that taxpayers pay in Federal income tax. Although major income tax cuts are needed to offset the restraining effects, or fiscal drag, of rising tax collections on the economy, the opportunity is afforded at the same time for restructuring the tax system to achieve other important goals. In particular, rates and credits can

be designed to make the tax system more equitable and more progressive and to simplify the tax laws.

First, a personal credit is more equitable than an exemption in that it grants equal tax relief at all levels of income. A personal exemption reduces the amount of income subject to tax. The value of the exemption is dependent upon the marginal rate of tax which would otherwise apply to the income that is excluded and, therefore, rises with income. For instance, for a taxpayer in the 14 percent bracket, a $750 exemption is worth $105 in tax savings, while, for a taxpayer in a 50 percent bracket, a similar exemption is worth $375. A personal credit, on the other hand, reduces the amount of tax liability by the amount of the credit. Thus, the value of the credit does not depend upon the taxpayer's marginal tax rate or his income.

To the extent that the tax system relieves taxpayers of the burden of dependents, this relief should not be greater for high income taxpayers than it is for low and middle income taxpayers. Also, a credit is more appropriate than an exemption for providing assistance to taxpayers who are blind or aged. The expenses of blindness or age affect all blind and aged taxpayers without regard to their income, and accordingly, there is little justification for designing a tax assistance program which provides greater benefits as income rises.

Second, rates and credits can be changed to increase the level of income at which the taxpayer first begins to pay income tax. The income tax should avoid taxing those families with income near or below poverty levels.

Third, structural changes can be made to simplify the tax law. The combination of the personal exemption plus the general tax credit creates needless confusion for the average taxpayer trying to understand how his liability is determined. Also, the elimination of $5.8 billion in itemized deductions (see ITEMIZED DEDUCTIONS) will lead to substantial simplification of the tax law. However, to ensure that the average taxpayer enjoys the full benefits of simplification, the money saved by eliminating these itemized deductions will be used to further reduce tax rates.

Finally, the tax system should be designed in such a manner that changes in the law can be easily accomodated. Future changes may make use of the income tax system to rebate energy taxes or to meet the needs of those on welfare. In both cases -- energy rebates and welfare assistance -- it may be desirable to provide the same per capita tax benefits at every level of income. This can be most easily accomplished through modification of a personal credit.

General Explanation

Under the proposal beginning with 1978 a personal credit of $240 will replace the personal exemption and the general tax credit. For each exemption that a taxpayer is allowed under present law, he will be allowed a personal credit. Thus, for example, if a husband and wife file a joint return, they will both be allowed a personal credit.

Marginal tax rates will be reduced for all taxpayers. For 1979 and later years, the lowest rate will be decreased from 14 percent to 12 percent. The highest rate will be decreased from 70 percent to 68 percent. In many tax brackets, the reduction in rates will be even greater. For 1978, there will be a transitional rate schedule which will allow changes to begin in the last quarter of the year and which will result in a net tax reduction approximately one-fourth the size of the reduction for all of 1979. Tables IIA-1 and IIA-2 show the proposed reduction in rates for married couples filing joint returns and for single individuals.

Table IIA-1

Individual Tax Rate Schedules For Joint Returns

Taxable Income Bracket	Present Law		Tax Proposal		1978 Tax Proposal	
	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket
0 - 3,200	0	0%	0	0%	0	0%
3,200 - 3,700	0	14	0	12	0	14
3,700 - 4,200	70	14	60	12	70	14
4,200 - 5,200	140	15	120	14	140	15
5,200 - 6,200	290	16	260	16	290	16
6,200 - 7,200	450	17	420	17	450	17
7,200 - 11,200	620	19	590	18	620	19
11,200 - 15,200	1,380	22	1,310	19	1,380	21
15,200 - 19,200	2,260	25	2,070	20	2,220	23
19,200 - 23,200	3,260	28	2,870	23	3,140	26
23,200 - 27,200	4,380	32	3,790	27	4,180	30
27,200 - 31,200	5,660	36	4,870	32	4,380	33
31,200 - 35,200	7,100	39	6,150	36	6,700	36
35,200 - 39,200	8,660	42	7,590	39	8,140	40
39,200 - 43,200	10,340	45	9,150	42	9,740	43
43,200 - 47,200	12,140	48	10,830	44	11,460	45
47,200 - 51,200	14,060	50	12,590	48	13,260	48
51,200 - 55,200	16,060	50	14,510	48	15,180	48
55,200 - 57,200	18,060	53	16,430	51	17,100	52
57,200 - 65,200	19,120	53	17,450	51	18,140	52
65,200 - 67,200	23,360	53	21,530	51	22,300	52
67,200 - 79,200	24,420	55	22,550	54	23,340	55
79,200 - 91,200	31,020	58	29,030	57	29,940	56
91,200 - 93,200	37,980	60	35,870	57	36,660	60
93,200 - 103,200	39,180	60	37,010	60	37,860	60
103,200 - 113,200	45,180	62	43,010	60	43,860	61
113,200 - 123,200	51,380	62	49,010	62	49,960	62
123,200 - 133,200	57,580	64	55,210	62	56,160	63
133,200 - 143,200	63,980	64	61,410	64	62,460	64
143,200 - 153,200	70,380	66	67,810	64	68,860	66
153,200 - 163,200	76,980	66	74,210	65	75,460	66
163,200 - 178,200	83,580	68	80,710	65	82,060	67
178,200 - 183,200	93,780	68	90,460	66	92,110	67
183,200 - 203,200	97,180	69	93,760	66	95,460	69
203,200 and over	110,980	70	106,960	68	109,260	70

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Table IIA-2

Individual Tax Rate Schedules For Single Returns

Taxable Income Bracket	Present Law		Tax Proposal		1978 Tax Proposal	
	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket	Tax At Low End of Bracket	Tax Rate on Income In Bracket
0 - 2,200	0	0%	0	0%	0	0%
2,200 - 2,700	0	14	0	12	0	14
2,700 - 3,200	70	15	60	13	70	15
3,200 - 3,700	145	16	125	15	145	16
3,700 - 4,200	225	17	200	15	225	17
4,200 - 5,200	310	19	275	18	310	18
5,200 - 6,200	500	19	455	19	490	19
6,200 - 8,200	690	21	645	20	680	20
8,200 - 10,200	1,110	24	1,045	20	1,080	20
10,200 - 12,200	1,590	25	1,445	22	1,480	24
12,200 - 14,200	2,090	27	1,885	23	1,960	25
14,200 - 16,200	2,630	29	2,345	25	2,460	28
16,200 - 18,200	3,210	31	2,845	25	3,020	31
18,200 - 20,200	3,830	34	3,345	29	3,640	33
20,200 - 22,200	4,510	36	3,925	29	4,300	35
22,200 - 24,200	5,230	38	4,505	33	5,000	37
24,200 - 26,200	5,990	40	5,165	33	5,740	39
26,200 - 28,200	6,790	40	5,825	38	6,520	40
28,200 - 30,200	7,590	45	6,585	38	7,320	44
30,200 - 34,200	8,490	45	7,345	41	8,200	45
34,200 - 38,200	10,290	50	8,985	46	10,000	50
38,200 - 40,200	12,290	50	10,825	50	12,000	55
40,200 - 42,200	13,290	55	11,825	50	13,100	55
42,200 - 46,200	14,390	55	12,825	51	14,200	55
46,200 - 50,200	16,590	60	14,865	57	16,400	60
50,200 - 52,200	18,990	60	17,145	58	18,800	60
52,200 - 54,200	20,190	62	18,305	58	20,000	60
54,200 - 56,200	21,430	62	19,465	60	21,200	62
56,200 - 62,200	22,670	62	20,665	60	22,440	62
62,200 - 64,200	26,390	64	24,265	60	26,160	64
64,200 - 66,200	27,670	64	25,465	63	27,440	64
66,200 - 72,200	28,950	64	26,725	63	28,720	64
72,200 - 78,200	32,790	66	30,505	63	32,560	65
78,200 - 82,200	36,750	66	34,285	66	36,460	65
82,200 - 90,200	39,390	68	36,925	66	39,060	68
90,200 - 92,200	44,830	68	42,205	66	44,500	68
92,200 - 102,200	46,190	69	43,525	67	45,860	69
102,200 and over	53,090	70	50,225	68	52,760	70

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Analysis of Impact

The proposals for the personal credit and the change in marginal tax rates will reduce individual income tax liabilities by $23.5 billion in 1979. As shown at 1976 levels of income in Table IIA-3, the proposed credit and rate structure will increase the progressivity of the Federal income tax. The largest percentage reduction in tax will occur at the lowest income levels, the next greatest at middle income levels, and the least at upper income levels. The new credit and rate schedule will provide tax reduction at every level of income, and, on average, will more than offset income tax increases proposed elsewhere in the program except for taxpayers at the highest levels of income.

Futhermore, for most taxpayers, the income tax reductions provided by the rate changes and the personal credit (despite the tax increases resulting from a loss of itemized deductions) will yield a net reduction in combined income and payroll tax liability through 1979 even after the scheduled social security tax increases are considered. Tables IIA-4 and IIA-5 compare the combined income and FICA taxes under 1977 law and proposed law for 1978 and 1979. Included in the calculations are the FICA tax increases resulting from legislation enacted prior to 1977 as well as the increases contained in the Social Security Financing Act Amendments of 1977. The tables assume a four person, one-earner family with wage income at various levels. With the exception of those who have virtually no income tax liability, the proposed income tax cuts will offset the increase in social security taxes for families with wage income up to $25,000 in 1978 and $20,000 in 1979.

Furthermore, as shown in Table IIA-6, the personal credit and, to a slight degree, the reductions in tax will raise tax-free levels of income substantially. For a married couple with two dependents, the tax-free levels will rise from $7,200 to $9,256. These changes will also result in 5.9 million returns becoming non-taxable.

The proposed rate cuts and the personal credit have been designed as a single package. Nonetheless, the separate effect of the credit by itself is of interest. Under the present tax rate schedule, a "break-even" level of income may be defined as that level at which the substitution of a $240 credit for the current $750 exemption and the general tax credit leaves a family with the same tax liability. As the example below demonstrates, for a family of four which does not itemize, the break-even level of income is $20,200. If tax rates were not changed, all families of four below this income level would have a tax decrease, and all other four person families would have a tax increase.

Example:

"Break-Even" Income Level for a Family of Four 2/

	Present Law	Proposed Law (assuming present law rate schedule)
Adjusted gross income	$ 20,200	$ 20,200
Less personal exemptions	3,000	--
Taxable income	17,200	20,200
Tax before credits	2,760	3,540
General tax credit	180	--
Per capita credit	--	960
Tax after credits	$ 2,580	$ 2,580

Table IIA-3

Change in Tax Liability

$240 Personal Credit and Rate Changes vs Current Law

(1976 Levels of Income)

Expanded Income Class	Tax Liability Under Present Law	Change in Tax Liability	
($000)	($ millions)	($ millions)	(Percentag
Less than 5	141	-423	-300.0
5-10	8,227	-2,008	-24.4
10-15	18,071	-3,149	-17.4
15-20	23,009	-3,587	-15.6
20-30	32,778	-4,687	-14.3
30-50	22,017	-2,215	-10.1
50-100	16,492	-879	-5.3
100-200	8,084	-216	-2.7
200 or more	6,476	-143	-2.2
TOTAL	$135,293	-$17,305	-12.8

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Table IIA-4

1978

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax			1978 Proposed Tax			Change in Tax		
	Income tax 1/	FICA tax 2/	Total tax	Income tax 1/	FICA tax 3/	Total tax	Income tax	FICA tax	Total tax
(............				dollars					............)
5,000	-300	292	-8	-300	303	3	0	11	11
10,000	446	585	1,031	192	605	797	-254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	965	3,145	2,042	1,071	3,113	-138	106	-32
25,000	3,150	965	4,115	3,025	1,071	4,096	-125	106	-19
30,000	4,232	965	5,197	4,150	1,071	5,221	-82	106	24
40,000	6,848	965	7,813	6,748	1,071	7,819	-100	106	6
50,000	9,950	965	10,915	9,855	1,071	10,926	-95	106	11
100,000	28,880	965	29,845	28,640	1,071	29,711	-240	106	-134

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1/ Assumes deductible expenses equal to 23 percent of income.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Calculated under present law rate and base for 1978 (6.05 percent and $17,700), employees' share only.

Table IIA-5

1979

Combined Income Tax and FICA Tax Burdens

Four Person, One-earner Families

Wage income	Present Law Tax			1979 Proposed Tax			Change in Tax		
	Income tax 1/	FICA tax 2/	Total tax	Income tax 3/	FICA tax 4/	Total tax	Income tax	FICA tax	Total tax
(...dollars...)									
5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	134	613	747	-312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	965	3,145	1,910	1,226	3,136	-270	261	-9
25,000	3,150	965	4,115	2,830	1,404	4,234	-320	439	119
30,000	4,232	965	5,197	3,910	1,404	5,314	-322	439	117
40,000	6,848	965	7,813	6,630	1,404	8,034	-218	439	221
50,000	9,950	965	10,915	9,870	1,404	11,274	-80	439	359
100,000	28,880	965	29,845	29,470	1,404	30,874	590	439	1,029

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1/ Assumes deductible expenses equal to 23 percent of income under present law.

2/ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ Assumes deductible expenses equal to 20 percent of income under proposal.

4/ Calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table IIA-6

Tax-Exempt and Poverty Levels

Of Income

Family Size 1/	Tax-Exempt Levels of Income Under Current Law 2/	Tax-Exempt Levels of Income Under Proposal 2/	1979 Poverty Levels 3/
1	3,200	3,967	3,449
2	5,200	6,553	4,438
3	6,200	7,922	5,429
4	7,200	9,256	6,954
5	8,183	10,589	8,223
6	9,167	11,884	9,280

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1/ Family size assumed to equal number of exemptions. For family sizes greater than two, families are assumed to file joint returns and be two parent families.
2/ Excludes Earned Income Credit.
3/ Non-farm families.

Table IIA-7 shows this "break-even" income level for various family sizes again assuming the present tax rate schedules apply.

In the absence of changes in the rate structure, a personal credit would be a highly progressive tax change, and by itself would increase taxes in the upper range of the income distribution. However, these tax increases have been avoided or limited under the Administration's proposal by changing the whole structure of marginal tax rates.

The net effects of substituting the $240 personal credit for the exemption and general tax credit under present law, and of restructuring the schedule of marginal tax rates may be summarized as follows:

(1) The tax system will be made more progressive but not to the degree that would be accomplished by instituting the $240 credit by itself.

(2) A substantial increase will occur in tax-free levels of income so that those at or near poverty levels will have no income tax liability.

(3) The tax structure will be made more equitable. An additional dependent will result in the same tax savings regardless of an individual's income level.

(4) The tax structure will be simplified by combining several provisions of the law into one.

(5) The tax system will also be made more adaptable to future changes in policy. Rebates of energy taxes, for example, could easily be made through modifications of the personal credit.

Table IIA-7

"Break-Even" Levels of Income

$240 Credit in Lieu of Exemptions, Credits and Rate Schedule of 1977 Law

Number of Exemptions	"Break-Even" Level
	(millions of dollars)
1	7,075
2	12,500
3	16,700
4	20,200
5	21,950
6	22,700

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Note: The case of one exemption is for a single return; cases of more than one exemption are for joint returns. Assumes taxpayers have no itemized deductions in excess of the zero bracket amount.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-6,067	-23,538	-26,583	-30,272	-34,732	-40,110

Footnotes

1/ There is also a separate schedule for estate and trusts.

2/ The example assumes the taxpayer has no itemized deductions in excess of the zero bracket amount.

ORDERING TAX CREDITS

Present Law

There are eight nonrefundable tax credits: the general tax credit, the credit for the elderly, the foreign tax credit, the investment credit, the political contributions credit, the WIN credit, the child care credit, and the jobs credit. In addition, certain tax credits are refundable, including the earned income credit and other credits which involve a repayment of taxes previously paid.

Several sections of the Code must be examined to determine the order in which these credits may be claimed. Moreover, some credits which may be carried over and applied against tax liabilities in other tax years must be taken in the current tax year prior to credits which expire that year if unused. Finally, the tax base against which the credits may be claimed varies. Some credits can be taken against certain special taxes (such as the minimum tax) while others cannot.

Reasons for Change

As a structural matter, the provisions which govern the order in which credits are allowed and the taxes against which they can be applied are unduly complex. Moreover, no consistent theory underlies the present variations in the tax base against which certain credits may be claimed. Significant simplification and consistency can be achieved by providing in a single section a uniform tax base against which credits are applied in a prescribed order.

The order in which credits must presently be taken may result in the unjustified loss of credits that expire if unused. This occurs because some of the credits that may be carried to different tax years are applied before other credits that expire if unused. For example, a taxpayer must take the foreign tax credit, which can be carried over to later taxable years, before the child care credit, which cannot be carried over. Thus, instead of using the child care credit in the current year and the foreign tax credit next year, a taxpayer is required to use the foreign tax credit currently, even though the child care credit expires unused. A taxpayer should not be required to use a credit that may be carried over before a credit that cannot.

General Explanation

The order in which tax credits must be taken as well as the tax base against which all nonrefundable credits must be applied will be prescribed in a single section of the Internal Revenue Code. All credits that expire if unused in the year they arise will be taken prior to credits that may be carried over. Refundable credits will be taken last.

The base against which nonrefundable credits may be applied will be limited to the amount of tax imposed by the section pursuant to which the primary income tax liability of the particular taxpayer is determined. Thus, the tax base will not include special taxes such as the minimum tax and the tax on accumulation distributions from trusts.

Effective Date

The proposal will apply to taxable years beginning after December 31, 1978.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

Technical Explanation

Under the proposal, a taxpayer will be required to take credits in the following order:

(1) All credits which are nonrefundable and for which no carryover is allowed, including (a) the personal credit (which under the Administration's proposal replaces the present personal exemption and general tax credit), (b) the credit for the elderly, (c) the political contributions credit, and (d) the child care credit. Since all these credits are limited to tax liability and cannot be carried over, no order need be prescribed.

(2) The foreign tax credit.

(3) The investment credit and the WIN credit. 1/ Since under the Administration's proposal the base and carryback and carryover periods of these credits will be identical (see INVESTMENT CREDIT), no order need be prescribed.

(4) The refundable credits (the withholding credits; the credit for certain uses of gasoline, special fuels, and lubricating oil; and the earned income credit). 2/

Individuals will be allowed to take nonrefundable tax credits only against the tax imposed by section 1 of the Internal Revenue Code or taxes imposed in lieu thereof. Corporations will be allowed to take nonrefundable credits only against the applicable normal tax and surtax (imposed by sections 11, 511, 802, 821, 831, 852, or 857 of the Internal Revenue Code) or taxes imposed in lieu thereof. Both individuals and corporations will be allowed to take refundable credits against all taxes imposed by the Internal Revenue Code.

Footnotes

1/ The jobs credit will not be affected by this proposal because it is not allowable for taxable yers beginning after December 31, 1978.

2/ The Energy bill, which is now in conference, provides for residential and business energy credits. Upon enactment, an adjustment in the ordering of credits will be required.

ITEMIZED DEDUCTIONS

INTRODUCTION

One of the major principles underlying our system of taxation is that individuals with equal income should pay the same amount of tax regardless of how they spend their income. This is implemented by not allowing deductions for personal, living, or family expenses. Over the years, many exceptions to this principle have been introduced into the tax laws. The exceptions generally are justified on one of two grounds. First, some deductions are allowed in order to further a public policy. For example, by allowing a deduction for charitable contributions, charitable organizations are able to attract more contributions than would otherwise be possible. Second, certain deductions are allowed on equity grounds in recognition of the fact that substantial expenditures which are unanticipated and unavoidable reduce an individual's ability to pay tax. Deductions for medical expenses are justified on this basis.

All deductions for personal, living, or family expenses are in conflict with the goal of simplicity. For the average taxpayer, these deductions are one of the greatest sources of complexity in the tax laws. A taxpayer has to maintain burdensome records to substantiate the deductions, and has to cope with extremely complicated statutory rules to calculate the deductions. Furthermore, a taxpayer faces the task of having to support the correctness of the deduction if the tax return is audited.

Several of the provisions which allow deductions for personal, living, or family expenses can be greatly simplified without sacrificing either policy goals or equity. In general, the deductions for which changes are proposed are claimed in approximately the same amounts by taxpayers within the same income group. The President's tax proposals limit the availability of the deductions and at the same time lower individual tax rates so that the tax burden on most taxpayers who itemize will not increase. This is illustrated by Table IIB-1.

Table IIB-1

Distribution and Average Amount of Tax Change under the President's Proposals
for Tax Returns under Present Law Using Itemized Deductions,
by Income Class

Expanded Income Class	Number of Returns		Returns with Tax Decrease		Returns with Tax Increase	
	All Returns (millions)	Returns with Tax Change 1/ (millions)	Percentage	Average Decrease	Percentage	Average Increase
Under $5,000	0.53	0.14	94.9%	$ -62	5.1%	$ 27
$ 5,000 - 10,000	1.76	1.34	79.2	-94	20.8	60
$ 10,000 - 15,000	3.48	3.36	78.9	-155	21.1	74
$ 15,000 - 20,000	4.59	4.56	89.4	-207	10.6	106
$ 20,000 - 30,000	6.29	6.26	93.6	-306	6.4	119
$ 30,000 - 50,000	2.74	2.73	88.4	-391	11.6	266
$ 50,000 - 100,000	0.89	0.88	80.1	-519	19.9	725
$100,000 - 200,000	0.19	0.19	58.8	-614	41.2	1,641
$200,000 and over	0.05	0.05	31.0	-2,196	69.0	6,979
TOTAL	20.52	19.52	87.3%	$-268	12.7%	$295

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1/ Most tax returns with no tax change are nontaxable under present law.

As described below, changes are proposed with respect to deductions for the following items: medical care expenses, casualty and theft losses, taxes, and political contributions. The proposed changes will result in approximately six million taxpayers switching to the standard deduction. In addition, the administrative burden on taxpayers who continue to itemize will be significantly reduced.

DEDUCTIONS FOR MEDICAL CARE EXPENSES AND CASUALTY AND THEFT LOSSES

Present Law

An individual is allowed a deduction for medical care expenses and casualty and theft losses only if he elects to itemize deductions on his tax return.

Calculating the deduction for medical care expenses is a formidable task. The deduction consists of two components: (a) the lesser of $150 or one-half of the amounts paid for medical insurance, plus (b) the amount by which medical care expenses exceed 3 percent of the taxpayer's adjusted gross income. For purposes of the 3 percent computation, amounts paid for medical insurance are included as medical care expenses to the extent they are not deductible under (a), and amounts paid for medicine and drugs are so included to the extent they exceed 1 percent of adjusted gross income. Of course, in order to make the calculation a taxpayer must first determine whether and to what extent expenditures qualify as medical care expenses. Furthermore, to support the deduction the taxpayer must keep records dividing medical expenses into three categories: medical care insurance, medicine and drugs, and all other medical care. An Internal Revenue Service study of 1973 tax returns 1/ indicates that of those taxpayers deducting medical expenses, more than 75 percent claimed the wrong amount.

Deductions for casualty and theft losses are calculated independently of the deduction for medical care expenses. Regardless of the amount of an individual's income, each such loss is deductible to the extent it exceeds $100. The same Internal Revenue Service study indicates that of those taxpayers deducting casualty and theft losses, more than 64 percent claimed the wrong amount.

Reasons for Change

A common rationale underlies the deduction for medical care expenses and the deduction for casualty and theft losses. Substantial expenditures which are unanticipated and unavoidable reduce an individual's ability to pay tax. To prevent an unwarranted hardship, a deduction should be allowed for these expenditures.

To determine whether unanticipated and unavoidable expenditures are substantial and so have impaired an individual's ability to pay tax, it obviously is necessary to aggregate all such expenditures. Current law, however,

fails to do this. The deduction for medical care expenses and the deduction for casualty and theft losses are computed independently of one another.

Furthermore, the separate floors provided in the respective provisions allow deductions even though expenditures could have been anticipated or are not substantial. In 1978 the average taxpayer will spend approximately 8 percent of income on medical care. This means that today for the average taxpayer medical care expenditures can be characterized as unanticipated only if they exceed 8 percent of income. Nevertheless, an individual with medical care expenses in excess of 3 percent of income is allowed a deduction. In the case of casualty and theft losses, the statute allows a deduction even though the expenditures are not substantial. The $100 floor is merely a de minimis rule. The homeowner who loses a $200 tree in a windstorm has not had his ability to pay tax reduced.

The allowance of deductions even where expenditures and losses could have been anticipated or are not substantial results in millions of taxpayers itemizing deductions even though they have not experienced extraordinary expenses, or losses. Also, the tax laws, in effect, provide insurance against loss for individuals in high-tax brackets. For example, through reduction of tax liability, a taxpayer in the 68 percent marginal bracket can recover from the Federal Government 68 cents for each dollar of casualty loss in excess of $100. There is no reason for the Federal Government to provide this benefit.

The deductions for medical care expenses and casualty and theft losses should be combined and the floor on these deductions should be set at 10 percent of income. Consistent with the rationale for their allowance, medical care expenses and casualty and theft losses would be deductible only under extraordinary circumstances. Furthermore, wealthy individuals could no longer rely on the Government to provide insurance against loss since the "insurance coverage" would apply only when the loss was extraordinary in comparison to income.

In addition, several elements of the medical care deduction provision are theoretically inconsistent or unnecessarily complex and can be simplified.

- Medical insurance premiums should be treated the same as any other medical care expense. Present law allows $150 of medical insurance premiums to be deducted without regard to the 3 percent floor on the ground that people with insurance do not incur large unreimbursed medical expenses and so would otherwise be unable to utitize the deduction. This

rationale is inconsistent with the theory underlying the deduction since payment of the premiums is not unanticipated or unavoidable. It is also inconsistent with the fact that individuals who claim the standard deduction are not allowed to deduct medical insurance premiums.

- The separate 1 percent floor on amounts paid for medicine and drugs should be eliminated. Present law imposes the 1 percent floor in order to deny a deduction where amounts expended on medicine and drugs are not extraordinary. A combined floor for medical expenses and casualty and theft losses would achieve the same purpose and the complexity of a separate floor could be eliminated.

- The definition of medical care expenses should be tightened. Frequent disputes arise over the deductibility of expenditures which produce substantial nonmedical benefits. For example, the Tax Court recently sustained a medical expense deduction for a substantial portion of the cost of a $194,000 indoor swimming pool. Disputes such as this can be prevented by restricting deductions to expenses incurred primarily for medical purposes.

General Explanation

Medical care expenses and casualty and theft losses will be deductible only to the extent that, in the aggregate, they exceed 10 percent of adjusted gross income. A casualty or theft loss will be taken into account only to the extent it exceeds $100.

Medical insurance premiums and expenses for medicine and drugs will be treated just like any other medical care expenditures. The special deduction for insurance premiums and the special 1 percent floor for medicine and drug expenditures will be repealed. The definition of medical care expenses which qualify for deduction will be amended so that the cost of facilities, services, and devices will be deductible only if they are of a type customarily used primarily for medical purposes, and are in fact intended primarily for medical use of the taxpayer or a dependent.

Analysis of Impact

Adoption of the new hardship deduction will reduce by 11.1 million, or 83 percent, the number of taxpayers who itemize their medical expenses and nonbusiness casualty and theft losses under current law (see Table IIB-2). Consistent

Table IIB-2

Numbers of Taxpayers Using Present Medical and Casualty Deduction and Proposed Hardship Deduction
(Compared to 1976 Law at 1976 Levels of Income)
(millions of taxpayers)

Expanded Income Class	Proposal Excluding Hardship Proposal				Proposal Including Hardship Deduction		
	Medical and/or Casualty Deduction	Medical Deduction		Casualty Deduction	Using Hardship Deduction	Not Using Hardship Deduction but Itemizing	Switching to Standard Deduction
		Insurance Premiums Only	Other Medical Expenses				
$ 5,000 or less	0.4	*	0.4	*	0.3	0.1	*
$ 5,000 - 10,000	1.3	0.2	1.1	0.2	0.6	0.4	0.3
$ 10,000 - 15,000	2.2	0.4	1.7	0.3	0.5	1.0	0.6
$ 15,000 - 20,000	2.8	0.9	1.9	0.3	0.4	1.8	0.6
$ 20,000 - 30,000	3.9	1.7	2.2	0.4	0.3	3.1	0.6
$ 30,000 - 50,000	1.9	1.1	0.7	0.2	0.1	1.7	0.1
$ 50,000 - 100,000	0.6	0.4	0.1	0.1	*	0.6	*
$100,000 - 200,000	0.1	0.1	*	*	*	0.1	*
$200,000 and over	*	*	*	*	*	*	*
TOTAL	13.3	4.9	8.2	1.5	2.2	8.9	2.3

Office of the Secretary of the Treasury
Office of Tax Analysis

January 28, 1978

* Less than .05 million.

with the rationale for allowing these deductions the hardship deduction will be utilized only by individuals whose ability to pay tax has truly been reduced as a result of substantial expenditures which were unanticipated and unavoidable. Over 35 percent of amounts currently deductible on account of medical expenses and casualty and theft losses will continue to be deductible by these individuals. All other taxpayers will be spared the administrative burden involved in claiming and substantiating the medical, and casualty and theft loss, deductions.

Most significantly, these changes will cause 2.3 million taxpayers to switch to the standard deduction. For these taxpayers the burden of compliance will be vastly reduced since they will be relieved of the numerous difficulties encountered in itemizing deductions. In addition, the proposed revision of the medical expense portion of the deduction will simplify the burden of compliance for those taxpayers claiming the hardship deduction.

Table IIB-3 shows the distribution of tax increases by income class for this proposal at 1976 levels of income.

Effective Date

The proposal will be effective for taxable years beginning after December 31, 1978.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Year					
1978	1979	1980	1981	1982	1983
--	1,909	2,119	2,352	2,611	2,898

Footnote

1/ Study prepared under the Taxpayer Compliance Measurement Program of the Internal Revenue Service, Cycle 5 of the individual income tax returns filed phase.

Table IIB-3

Revenue Effect of Hardship Deduction
with 10 Percent Floor

Expanded Income Class	Revenue Increase ($ in millions)	Percent of Total
$ 5,000 or less	1	0.1%
$ 5,000 - 10,000	41	2.9
$ 10,000 - 15,000	143	10.2
$ 15,000 - 20,000	237	17.0
$ 20,000 - 30,000	401	28.7
$ 30,000 - 50,000	308	22.1
$ 50,000 - 100,000	173	12.4
$100,000 - 200,000	53	3.8
$200,000 and over	39	2.8
TOTAL	1,396	100.0%

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Office of Tax Analysis

January 28, 1978

DEDUCTION FOR TAXES

Present Law

An individual who elects to itemize deductions on his income tax return is allowed a deduction for the following State and local taxes 1/ even if they are not related to any business activity:

1. income taxes
2. real property taxes
3. sales taxes
4. gasoline taxes
5. personal property taxes

In addition, with certain limited exceptions, all State and local, and foreign, taxes related to business activity are deductible in the year paid or incurred. A taxpayer other than a regular corporation must capitalize and amortize real estate taxes paid during the period real property is under construction.

Reason for Change

The deduction for State and local income taxes is necessary to assure that the aggregate marginal rate of income tax is not confiscatory. The deduction for real property taxes reflects long-standing public policy to encourage home ownership. In addition, the deductibility of these taxes imposes only a small recordkeeping burden on taxpayers. This is not true for other taxes which are currently deductible.

Nonbusiness sales, gasoline, and personal property taxes. In the case of sales taxes, gasoline taxes, and personal property taxes, there are no significant policy reasons to justify an exception from the general principle that people with equal income should pay the same amount of tax regardless of how they spend their income. These taxes are relatively small in amount. For example, a married taxpayer with $30,000 of adjusted gross income who drives 12,000 miles a year for personal purposes reduces his tax liability only by about $30 on account of the gasoline tax deduction and by about $65 on account of the sales tax deduction. Because of their relatively small size, and because a large portion of these taxes is paid by taxpayers who do not itemize deductions, deductibility is not a major factor to a State or local government in determining the rate of tax to impose. The deduction for personal property taxes

does encourage State and local governments to impose personal property taxes on automobiles in lieu of license and similar fees which are nondeductible. There is no policy reason to encourage this shift.

Aside from policy considerations, deductibility of sales and gasoline taxes raises substantial administrative problems. The average taxpayer incurs small amounts of these taxes in hundreds of separate transactions over the course of a year. Maintaining adequate records to calculate and substantiate the deduction would place an enormous burden on taxpayers. Moreover, auditing these records would place an unwarranted burden on the Internal Revenue Service in view of the extremely small amount of revenue generally involved in the deduction claimed on any one return. An Internal Revenue Service study 2/ of 1973 tax returns indicates that of those taxpayers deducting State and local taxes (other than real estate and income taxes) more than 53 percent claimed the wrong amount.

In recognition of these administrative problems, the Service permits taxpayers to use standard tax tables to determine the amount of their sales and gasoline tax deduction. For taxpayers using these tables, there is no direct relationship between the amount of the deduction and the amount of taxes actually paid. The absence of a direct relationship further weakens any policy argument in favor of the deductibility of these taxes. In effect, taxpayers who itemize are being allowed a mini-standard deduction in lieu of deducting the actual amount of taxes paid. This is especially true in the case of the sales tax since the table is based primarily on adjusted gross income. It is also true in the case of the gasoline tax. Although the table is based on miles driven, there is generally no way to check the accuracy of the amount claimed, and many taxpayers claim an average amount regardless of the number of miles they actually drive. In addition, allowing a deduction for the gasoline tax is inconsistent with our national energy policy which seeks to encourage gasoline conservation.

Definition of "taxes". Recently, uncertainty has developed as to whether employees may deduct State unemployment disability fund taxes withheld from their wages. The revenue collected from these taxes is used to provide insurance against loss of wages resulting from injuries or illnesses which are not job related. In several states, the tax is levied only if the employer does not provide private coverage. The Internal Revenue Service takes the position in published Revenue Rulings that these taxes in reality are a nondeductible personal expenditure for insurance coverage. However, the United States Tax Court has disagreed with the Service's position in two cases and has held that these taxes are an "income tax" and so are deductible by employees.

The payor of the unemployment disability fund taxes receives an economic benefit in the form of insurance coverage which is directly related to the amount of the taxes. Amounts received under these insurance policies as compensation on account of injuries or illness are not includible in income. Because of this exclusion, it is inappropriate to allow a deduction for the taxes paid to acquire the insurance coverage. A combined deduction-exclusion creates tax-exempt income, and, therefore, is inconsistent with basic principles of taxation. In addition, regardless of whether these taxes technically constitute an "income tax", it is inequitable to allow a deduction to individuals in one State who acquire the insurance coverage through a State program, while denying a deduction to individuals in another State who acquire their insurance coverage privately.

Business taxes. Taxes related to a business activity generally are deductible in the year paid or incurred even if they constitute part of the cost of a capital asset. In this respect, a deduction is inconsistent with the general principle that the cost of a business asset should be recovered through depreciation over the life of the asset. For example, a person constructing a building for business use can deduct sales taxes imposed on his purchase of building materials even though the other expenses relating to the construction of the building generally have to be capitalized and recovered through depreciation. There is no reason why these taxes should receive special treatment.

General Explanation

State and local sales taxes, gasoline taxes, and personal property taxes not related to a business activity will no longer be deductible. Payments for unemployment disability fund taxes will not be deductible by employees.

Taxes relating to a business activity will be deductible under normal tax accounting principles. If the taxes relate to the acquisition of a capital asset they will have to be capitalized. However, as under present law State and local income taxes and real property taxes generally will be deductible in the year paid or incurred.

Analysis of Impact

Limiting the deduction for taxes will result in an increase of approximately 3.8 million in the number of individual taxpayers using the standard deduction.

Among income groups the greatest increase in tax burden as a result of the proposal will be only 3 percent (a 0.5 percentage point increase in effective tax rates).

Effective Date

The proposal will be effective for taxable years beginning after December 31, 1978.

Revenue Estimates

Change In Tax Liability ($ millions)					
Calendar Years					
1978	1979	1980	1981	1982	1983
--	3,908	4,456	5,079	5,790	6,601

Technical Explanation

Section 164(a) will be amended to eliminate the deduction for State and local (and foreign) sales, gasoline, and personal property taxes which are not business related. Section 164(a) will be amended to provide for the future that State unemployment disability fund taxes are not deductible by employees. The amendment will overrule prospectively the decisions in two Tax Court cases: James R. McGowan, 67 T.C. 599 (1976) and Anthony Trujillo, 68 T.C. 670 (1977).

The last sentence in section 164(a) will be eliminated. As a result of this change, business related taxes other than those specifically listed in section 164(a) will be deductible in the same manner as other business expenditures generally. In other words, these taxes will be deductible currently under section 162 or 212 unless they relate to the acquisition of a capital asset in which case they will be capitalized. Taxes specifically listed in section 164(a) (i.e., State and local, and foreign, income taxes and real property taxes) will continue to be deductible when paid or incurred, unless section 189 applies.

Footnotes

1/ Foreign real property taxes and, if the taxpayer elects not to claim a credit, foreign income taxes are also deductible.

2/ Study prepared under the Taxpayer Compliance Measurement Program of the Internal Revenue Service, Cycle 5 of the individual income tax returns filed phase.

DEDUCTION FOR POLITICAL CONTRIBUTIONS

Present Law

Under present law, an individual who elects to itemize deductions on a tax return is allowed a deduction for specified political contributions. The deduction is allowed for the first $100 ($200 on a joint return) of contributions. In lieu of the deduction, an individual, whether or not itemizing deductions, can claim a credit equal to one-half of the first $50 ($100 on a joint return) of contributions. Corporations, estates, and trusts cannot claim the credit or deduction.

Reasons for Change

The tax subsidy for political contributions was intended by Congress to be an incentive for political contributions. In practice, the deduction and credit generally benefit only those few taxpayers who would contribute anyway, and they are used disproportionately by high-income contributors.

The effect of the optional deduction is to provide a greater tax benefit to those taxpayers who itemize, a relatively small group (24 percent of all taxpayers currently and estimated to be less than 17 percent under the other proposals in this package) who generally have higher incomes than nonitemizers. This is illustrated by Table IIB-4 which shows the distribution of the tax credit and the deduction for political contributions by income class for 1975.

With a deduction, high-bracket taxpayers can make the same dollar contribution more cheaply than low-bracket taxpayers. Put another way, the greater the income of the itemizer (the higher the marginal tax rate), the greater the benefit to the taxpayer of the deduction. There is no policy reason for attempting to provide a greater tax incentive to taxpayers with high incomes.

For example, two married couples that both contribute $200 receive different tax treatment if one itemizes. The couple that itemizes and is in the highest marginal tax bracket will receive 2.7 times the benefit of the couple that does not itemize. In a 68 percent marginal bracket (the highest proposed), the couple that itemizes and contributes $200 would receive a tax benefit of $136. The couple that contributes the same amount and uses the standard deduction would claim the tax credit and receive a tax benefit of only $50.

Table IIB-4

Deduction and Tax Credit for Political Contributions
by Income Class -- 1975

Adjusted Gross Income Class ($000)	Credit and Deduction	Tax Credit		Deductions	
	Percent of Returns in Income Class (%)	Number of Returns (000)	Amount of Credit ($000)	Number of Returns (000)	Amount of Deductions ($000)
0 - 10	1.1%	424	7,022	41	2,684
10 - 20	3.3	610	15,428	213	14,740
20 - 30	5.7	302	8,531	177	15,990
30 - 50	10.6	180	4,917	110	11,020
50 - 100	18.4	48	1,463	96	10,501
100 and over	29.4	5	183	50	6,443
TOTAL	2.7%	1,569	37,546	688	61,378

Office of the Secretary of the Treasury
Office of Tax Analysis

November 2, 1977

Source: Preliminary 1975 Statistics of Income.

Moreover, a recent study concludes that tax incentives have had an insignificant impact on the level of contributions to political campaigns, 1/ and merely provide a windfall to high income taxpayers who would contribute anyway. In the past, taxpayers with income of over $20,000 have claimed tax benefits for political contributions more than 25 times as often as taxpayers with income under $5,000. Moreover, within the lower income group, individuals frequently contribute and do not claim the tax benefits to which they are entitled. Among contributors, higher income taxpayers claimed these tax benefits almost three times more often than lower income taxpayers.

In addition, the present option of a credit or deduction unnecessarily complicates both the tax return and the instructions.

General Explanation

The deduction for political contributions will be repealed. The credit for political contributions will, however, remain.

Analysis of Impact

The elimination of the deduction for political contributions will result in all taxpayers receiving equal tax benefits from their political contributions. Contributions to political campaigns will not be greatly reduced. Significant simplification will be achieved. Tax forms and instructions will be shortened. Individuals will no longer need to make alternative computations to determine whether the credit or deduction is more advantageous to them.

Effective Date

The political contributions deduction will be eliminated for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	2	4	2	3	3

Footnote

1/ D.W. Adamany and G.E. Agree, Political Money, 125-128 (1975). This study is based in part upon data compiled in the Twentieth Century Fund Survey, along with data provided by the IRS and the States of California and Oregon, two states which provide tax incentives for political campaign contributions. This is the only published study which considers the impact of tax incentives on political contributions.

CAPITAL GAINS -- REPEAL OF ALTERNATIVE TAX

Present Law

The tax rate applicable to the net capital gain realized by an individual taxpayer is generally equal to one-half of the taxpayer's regular tax rate. However, an individual taxpayer may elect to pay a 25 percent alternative rate on the first $50,000 of net capital gain. An individual will choose this alternative rate only if his marginal tax rate exceeds 50 percent.

More specifically, if an individual taxpayer has a net capital gain for the taxable year (i.e., net long-term capital gain exceeds net short-term capital loss), the taxpayer can deduct an amount equal to 50 percent of the net capital gain. The 50 percent exclusion in effect makes the tax rate applicable to the gain equal to one-half of the taxpayer's regular rate.

The "alternative tax on capital gains" involves a special computation under which the total tax is the sum of: (1) the tax otherwise payable on all income other than net capital gain for the year; (2) a tax of 25 percent on the first $50,000 of long-term capital gain ($25,000 in the case of a married individual filing a separate return); and (3) a separate tax on the amount of net capital gain, if any, in excess of $50,000, computed at the taxpayer's highest rate brackets after taking into account the deduction for capital gains. In effect, the taxpayer will benefit from a maximum tax of 25 percent on the first $50,000 of long-term capital gain plus the 50 percent deduction for the balance of net capital gain. By choosing the alternative tax, however, a taxpayer must forego regular income averaging.

Prior to 1969, the 25 percent alternative tax was not limited to $50,000. In retaining the alternative tax for that amount of long-term capital gains, the Congress indicated that it thought that taxpayers with relatively small amounts of capital gains should continue to be eligible for the alternative tax. However, the present alternative tax applies whether a taxpayer's capital gains are large or small and, as is indicated below, is useful only for high income taxpayers.

Reasons for Change

The deduction for capital gains provides a significant tax benefit for individual taxpayers, reducing the tax on net

capital gain by 50 percent. The alternative tax, on the other hand, benefits only those taxpayers with the highest incomes. A taxpayer in the 70 percent bracket with $50,000 of capital gain can use the alternative tax to reduce the tax on that income by nearly 65 percent. For example, if a taxpayer has ordinary income of $50,000 which is taxable at 70 percent, the tax on that income will be $35,000. However, if that income is in the form of a net capital gain, the taxpayer will, under the alternative method, be required to pay a tax of only $12,500 on the net capital gain.

The alternative tax is only $5,000 less than the maximum tax on $50,000 of capital gain (70 percent of $25,000, or $17,500, as compared to $12,500). Yet it introduces significant additional complexity into the tax calculation. The alternative tax computations are themselves complex. But, in addition, because taxpayers electing the alternative tax cannot use regular income averaging, they must compute their tax under the two special methods (income averaging and alternative tax) in order to determine which will produce the greater tax savings.

The existence of the alternative tax can also affect the structuring or timing of transactions to maximize the benefit of this special provision. For example, a high-income taxpayer may enter into an installment sale solely to spread any gain over a number of years and thereby multiply the impact of the alternative tax on the transaction. Similarly, a taxpayer who has already recognized long-term capital gains of $50,000 for a year may postpone an additional capital gain transaction until the following year in order to subject the gain to the alternative tax.

General Explanation

In order to make tax benefits for capital gains more uniformly applicable, the alternative tax for noncorporate taxpayers will be eliminated. The deduction for capital gains will remain unchanged.

Analysis of Impact

The proposal will affect only noncorporate taxpayers in marginal tax brackets above 50 percent. For example, it is estimated that for 1976, 88 million tax returns were filed, and 7.4 million reported gains from sales of capital assets. Of those returns, 186 thousand, or 2.5 percent of all returns with net capital gains, used the alternative tax to compute at least some part of the tax liability. Using 1976 levels of income and taking into account the Administration's other proposals, over 78 percent of the net taxable gain taxed under the alternative tax would be reported on returns with expanded incomes of over $100,000. (See Table IIC-1.)

Table II C-1

Capital Gains in Adjusted Gross Income and Capital Gains Taxed at Alternative Rate

(Proposed Law at 1976 Levels of Income)

Expanded Income Class (thousands)	All Taxpayers with Capital Gain or Loss: Number of Returns (thous.)	Amount of Net Gain ($ bil.)	Percent of Total	Taxpayers Electing Alternative Tax: Number of Returns (thous.)	Amount Taxed At Alternative Rate ($ bil.)	Percent of Total
Less than $ 5	910	$ 1.2	6 %	--	--	--
$ 5 - $ 10	1,068	0.9	4	--	--	--
$ 10 - $ 15	1,239	1.2	6	--	--	--
$ 15 - $ 20	1,138	1.6	7	--	--	--
$ 20 - $ 30	1,428	2.6	12	--	--	--
$ 30 - $ 50	980	3.6	17	1	*	*
$ 50 - $100	457	3.6	17	101	$.06	23 %
$100 - $200	116	2.5	12	64	1.4	49
$200 and over	36	3.9	19	19	0.8	28
TOTAL	7,372	$21.0	100 %	186	$2.8	100 %

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Office of Tax Analysis

January 6, 1978

* Less than $ 0.5 billion or less than 0.5 percent

Upon repeal of the alternative tax, all long-term capital gains will be treated similarly. All such gains will be taxed at one-half of the ordinary rates. However, high-income taxpayers will no longer receive even more preferential treatment on the first $50,000 of such gains.

It should be recognized that only high tax bracket taxpayers who currently use the alternative tax will be affected. Many taxpayers who would otherwise be eligible to use the alternative tax forego its benefits because they receive even greater benefits from income averaging. Such taxpayers would not be affected by repeal of the alternative tax. Taxpayers who sell small businesses at a large gain generally should fall into this category. 1/

Effective Date

The proposed change will be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	140	151	162	174	187

Technical Explanation

The proposal will apply to all gains recognized in taxable years beginning after December 31, 1978. Thus the alternative tax will not apply to the ratable portion of gain recognized by a calendar year taxpayer for 1979 as the result of an installment sale which occurred in 1977. Similarly, the alternative tax will not apply to gain recognized in a transaction occurring within a taxable year to which the proposal applies, even though the transaction is completed pursuant to a binding obligation entered into before the effective date of the proposal.

Footnote

1/ For example, assume that a married individual owns a small business which was sold at the end of 1977 at a gain of $200,000. The business has resulted in taxable income of $60,000 each year for the last five years, including 1977. The taxpayer has no dependent children, had no other income for 1977, and filed a joint return for 1977. In this case, the taxpayer would be in the 53 percent bracket for 1977 if the sale were not made. If the sale at a gain of $200,000 is made, the tax computed at the regular rates (taking into account the deduction for capital gains) is $81,288. The alternative tax computation results in a lesser tax of $80,008, but income averaging produces an even lower tax of $76,840--a saving of $4,448 compared to the tax at the regular rates and a saving of $3,168 compared to the tax computed under the alternative tax.

TAX SHELTERS

INTRODUCTION

The Tax Reform Act of 1976 took some steps toward curbing the continued proliferation of tax shelters. Direct limitations were imposed on certain activities, particularly farm operations, motion pictures, and sports franchises; the partnership rules were tightened to reduce abuse; a rule was introduced to limit deductions in certain activities to the amount the taxpayer has "at risk"; minor changes were made in the tax treatment of real estate, oil and gas and equipment leasing; and the minimum and maximum taxes were changed to have additional impact on tax shelters.

Despite these changes, tax shelter activity has not diminished. Tax shelter promoters have reacted to the 1976 Act by developing a wide range of investments specifically designed to avoid the limitations of the 1976 Act. In 1977, widely advertised tax shelters involved such diverse activities as master phonograph records, lithographic plates, books, Christmas trees and research and development. Securities agencies, brokerage houses, and news media all report tax shelter activity during 1977 far in excess of 1976 levels. The Securities and Exchange Commission (SEC) reports registrations offering a total tax shelter investment of $1.2 billion during the first ten months of 1977, as compared to $690 million during the same period in 1976. The National Association of Securities Dealers (NASD) reports that during 1977, its members made 182 public offerings of tax shelters with total investments of $1.8 billion; during 1976, 196 offerings for a total of $1.2 billion were made. These statistics do not include officially unreported shelter deals (so-called "private placements"), which by some estimates are at least ten times the volume of public offerings. For example, in Ohio the number of registrations of limited partnerships (the majority of which are tax shelters) was 570 in 1975, 779 in 1976, and 931 in 1977.

Under the Internal Revenue Code, taxable income can deviate substantially from economic income. These deviations are frequently a result of deductions being taken into account earlier than the income to which they relate. Such

timing differences create so-called "paper losses", that is, situations in which taxable income during the initial years of an activity is significantly less than true income.

Taxpayers engaged in the activities giving rise to these tax preferences can reduce their tax liabilities directly, or when they cannot, they may realize a portion of the economic benefit of the preferences by selling the tax benefits to others. The investment vehicle used to transfer the tax preferences is often referred to as a tax shelter. Although shelters take a wide variety of forms and include a great diversity of activities, the common characteristic of tax shelters is the generation of "tax losses" which are available as deductions not only against the taxpayer's share of taxable income from the tax shelter investment, but also against his taxable income from other sources, such as his business or profession. Through such investments taxpayers who take no active part in the subsidized activity are able to "shelter" their regular income from tax. The result is that taxpayers with substantial economic income are able to reduce tax liabilities simply by purchasing tax preferences.

Tax shelters may possess as many as three major tax-saving features. The first, as described above, is deferral. A tax shelter generates substantial tax losses in the early years of the investment which are used to reduce the investor's tax liability on his unrelated income. The investment generates taxable income, if any, only in later years. Thus, tax liability on the investor's regular source of income is deferred until income resulting from the tax shelter investment is realized. The economic effect of deferral is equivalent to an interest-free loan from the Federal Government. For the same amount of deductions, the size of the "loan" increases as the investor's marginal tax rate increases.

The tax benefit of deferral may be continued by investing in additional tax shelter investments at the time that the initial shelters begin generating taxable income. The tax losses generated by the newly purchased tax shelters are used to offset the tax liability on the older tax shelters, thereby so extending the period of deferral as to approximate a complete exemption.

The second important element of many tax shelters is leverage. Leverage is the use of someone else's money to finance an investment activity. Frequently, a tax shelter is structured so that an investor, or the investor's partnership, borrows 80 percent or more of the purchase price of the investment. Since an investor is allowed deductions not only with respect to his equity, but also with respect to the borrowed funds, he can greatly increase the benefits of deferral by incurring deductions which substantially exceed his equity investment.

In the most abusive tax shelters, a nonrecourse loan (i.e. a loan for which the investor has no personal liability, directly or indirectly) is provided by the seller of the property in order to finance a highly inflated purchase price. This nonrecourse debt allows the investors to claim inflated deductions without risking their own capital. In many cases the tax savings resulting from the inflated deductions are so great that the investors completely ignore the economics of the underlying business transactions.

A further problem of leveraged tax shelters of this type is that investors frequently fail to report the taxable income which arises when the nonrecourse debt which financed the investment is cancelled. To the extent the Service is unable to discover this failure to report income, the deferral of tax produced by shelters is made permanent. Investors neglect to report this income for several reasons. Promoters of shelters often fail to mention that cancellation of the nonrecourse debt produces income. Also, this taxable income is not accompanied by any cash flow from the investment with which the investor can pay the tax. Finally, it is extremely difficult for the Service to discover on audit that the events which produce this income have occurred.

The third tax savings feature of many tax shelter investments is the conversion of ordinary income into capital gains at the time of the sale or other disposition of the asset used in the tax shelter or of the taxpayer's interest in the shelter. Conversion occurs when the portion of the gain which reflects the accelerated deductions (taken against ordinary income) is taxed as capital gains. (If the taxpayer is in a lower tax bracket in the year of disposition, he effectively "converts" the tax rate as well.) Various "recapture" provisions have been enacted in recent years, the effect of which has been that conversion benefits are not available for many investments.

In order to facilitate the sale of these tax benefits to those not directly engaged in the activity, a limited partnership is most commonly chosen as the investment vehicle for tax shelters. The partnership form is chosen because it allows the immediate flow-through to the investors of the tax preferences and also provides investors with limited liability. Flow-through is available since partners -- unlike shareholders of corporations -- obtain an immediate deduction on their return for their share of partnership tax losses. Moreover, by making the tax shelter investors limited partners, their financial risk -- like that of shareholders -- is limited to their equity in the partnership.

In many cases interests in tax shelter limited partnerships are publicly offered for sale to potential investors throughout the country. As a prerequisite to such public sale the partnerships must comply with applicable Federal or State securities laws, which require protections for the investor-limited partners (e.g., transferability of shares) not commonly enjoyed by limited partners. In fact, in the usual publicly syndicated tax shelter venture the limited partners enjoy the same protections and benefits as corporate shareholders, while receiving the additional benefit (which makes the transaction marketable) of the immediate enjoyment of losses generated by the tax shelter activity.

The marketing of interests in these tax shelter ventures are directed at taxpayers whose marginal tax rates are 50 percent or above. Promotional literature on tax shelter offerings clearly advise potential investors that the primary benefit of the investment is the tax deductions generated in the early years of the investment; the prospect of any future economic gain is clearly of secondary importance. In a recent article on tax shelters published in a leading financial periodical, a tax shelter promoter admitted that:

> We don't even want people to buy our programs based on (the program's) economics . . . . If we find that anybody's going to purchase a program from us based on the expectation or necessity of receiving money, we recommend he not try it . . .

Also, careful examination of the promotional literature demonstrates that typically a substantial part of the investors' initial cash contribution is used to pay promotional expenses, rather than to purchase assets to be used in the tax shelter activity.

The continuing spectacle of high income taxpayers paying little or no tax through the use of tax shelters seriously undermines taxpayer morale. Low and middle income persons who cannot benefit significantly from tax shelters strongly resent the fact that they must bear the greatest burden of taxation, while certain high income taxpayers can obtain extensive tax relief.

Although some tax preferences, such as the investment tax credit (as well as most other tax credits), and the special allowance for percentage depletion of minerals, were enacted or continued in order to encourage investment in certain industries or activities, other preferences are the unintentional by-products of legislative or administrative actions. These include the expensing of periodical circulation costs and research and development expenditures (enacted to resolve disputes concerning the proper tax

treatment of such expenditures), and cash-basis accounting for farms (allowed by the Internal Revenue Service to assist unsophisticated taxpayers in determining their tax liabilities). The cost to the Treasury in foregone revenues is multiplied considerably when these accounting distortions are packaged for "sale" to those not active in the business. Thus, one cannot argue that tax shelter arrangements simply facilitate more complete implementation of the tax benefits intended by Congress. Changes are needed to eliminate tax preferences which neither encourage desired economic activity nor facilitate the proper measurement of income for those engaged in business.

Further, even where investment in intentionally favored activities is concerned, a very serious problem is presented by the illegal or highly questionable enhancement of tax shelters through inflated purchase prices financed with nonrecourse debt. Too often, tax shelter promoters and investors take extremely questionable positions knowing that the substantive and administrative provisions of the Code greatly inhibit the Service's ability to police illegal or questionable tax shelter activities.

Summary of Proposals

(a) The Administration proposes to reduce certain tax preferences directly so that the deduction is more nearly based on the actual economic income or loss of the taxpayer.

Real Estate. Depreciation of real estate will be limited to either (1) straight line depreciation based on a zero salvage value and useful lives determined by the Treasury to be the average useful lives used by taxpayers or (2) depreciation based on the taxpayer's particular facts and circumstances. Taxpayers who use the facts and circumstances alternative would not be permitted to depreciate real estate in any tax year below its current salvage value. However, in order to maintain investment in low income and multi-family housing, this real estate will be depreciated on a more favorable basis.

Accounting by Agricultural Corporations. All farming syndicates which under the Tax Reform Act of 1976 were limited in their ability to deduct the cost of poultry, farm supplies such as feed, and the development costs of fruit and nut trees will be required like corporate farms to use the accrual method of accounting in the same manner as other business corporations. (This proposal which also applies to all corporate farms with gross receipts of more than $1 million is more fully described in the section on corporate preferences.)

Deferred Annuities. Deferral of tax may be achieved by deferring the recognition of income as well as by

accelerating deductions. One type of income deferral shelter involves the purchase of tax deferred annuities by high-income taxpayers as a way (to quote from a promoter's sales literature) to "pile up interest indefinitely, and not pay a penny of taxes until you take your money out -- usually at retirement when your tax bracket is likely to be lower. By not paying taxes on the interest every year, you actually earn extra income with Uncle Sam's money." Such contracts usually permit a purchaser to withdraw earnings, not in excess of amounts previously paid for the contract, at any time on a tax-free basis. Under a recent court decision, it also appears that high-income taxpayers may be able to avoid paying tax currently on the income earned through the annuity even when they are able to direct the investments to be made by the company.

Under the Administration's proposal, insurance companies will be required to report each year to the purchaser of a deferred annuity the actual amount earned on his investment and the purchaser will be required to include this amount in income. This treatment will not apply to one annuity contract per taxpayer, the annual contributions to which do not exceed $1,000.

(b) Direct limitations on tax preferences cannot be accomplished in some instances because the continued Federal subsidy of certain industries is regarded as essential or because a totally accurate matching of deductions against income will produce unduly complex accounting rules. In these cases, proposals are made to curtail abuse. In particular, it is desired to prevent uneconomic, gimmicky investments that waste the supply of venture capital without producing needed goods or services.

Extension of At Risk Rules. The effectiveness of the at risk limitation added by the Tax Reform Act of 1976 (relating to the use of nonrecourse financing) will be enhanced by extending its application to certain closely held corporations and to all activities other than real estate.

Limited Partnerships Treated as Corporations. Those newly formed limited partnerships that have more than 15 limited partners will be classified as corporations for tax purposes.

Partnership Audit. The Internal Revenue Service will be provided with a more effective tool to police partnerships, including tax shelter limited partnerships, by authorizing the Service to audit and make binding tax determinations at the partnership level.

(c) Finally, in order to curtail excessive utilization of tax preferences the Administration proposes

Minimum Tax. The deduction for half of the regular tax paid in the case of individuals will be eliminated; the deduction against preference income will thus be limited to $10,000.

Investment Tax Credit. Currently, the investment tax credit and work incentive (WIN) credit may offset completely the first $25,000 and $50,000, respectively, of tax liability. This offset will be allowed instead only to the extent of 90 percent of tax liability.

EXAMPLES OF TAX SHELTER ABUSE

A. The Continuing Tax Shelter Problem

Thousands of high-income taxpayers continue to avoid payment of their fair share of income tax. The most popular techniques by which they do so are generally referred to as tax shelters. Tax shelters -- thought by many to have been eliminated by the 1976 Reform Act -- have continued to thrive during the past year Low and moderate income taxpayers are particularly annoyed when they read of high-income taxpayers utilizing tax shelters or see newspaper advertisements and articles in magazines extolling new tax shelter techniques and their promoters. This publicity undermines compliance generally. Frustrated and angered taxpayers who cannot afford to invest in these tax shelters may resort to their own "tax shelter" devices, such as "forgetting" to report income from a second job.

Sales of tax shelters have become a regular part of business commerce For example, the following advertisements appeared in the Wall Street Journal of December 23, 1977, in the midst of prime tax shelter retail season:

RESTAURANT AND/OR BAR
Red Bank, NJ. Exclnt location on river. Seats 150. Perfect for 1st class restaurant or discotheque. (C) liquor license (pkg goods). Busn and/or bldg priced for quick sale. Call
201-741-2525

5:1 TAX SHELTER
Excellent opinion letter in the agricultural area. 1977 Salesmen please call
(602) 256-4870

Bakery With Outlets
So Jersey seashore, est 50 yrs. bldg. equipt. machinery, fixtures, trucks, etc. $250,000. Fred Siris Realtor, 10 Haddon Ave. Westmont NJ 08108.

BOAT RENTALS—MARINA
Established business in busy Seaside Heights, NJ. new showroom, great potential, asking $490,000 with terms. Call 201-431-4707

TAX SHELTER—5 to 1 cattle breeding shelter available for corporation. Invest $400,000 over next 5 years, write-off over $2,-000,000 during same period. For more information call
(303) 660-1423

A year old established retail business in Albuquerque, New Mexico. Currently doing 2 million plus (3 locations). Credit impeccable. $300,000./offer/ will consider some paper.

AVAILABLE
INTERNATIONAL
BANK
Principals only
Box H-521, Wall Street Journal

400% SHELTER
August 1976 coal lease. Operating mine. Contract miner. 1977 cash flow. For attorney or accountant with large individual or corporate clients. CINEWORLD CORP. John F. Rickert, Pres., P.O. Box 610276 No. Miami, Fla. 33161
(305)891-1181

Sales of tax shelters have become so profitable that major brokerage houses can no longer afford to overlook this source of revenue. An article in the July 25, 1977 issue of Forbes Magazine, page 27, entitled "Gimme Shelter" explains

> **Tax shelters are booming again, in good part because inflation, prosperity and our progressive tax laws keep pushing more and more people into brackets where paying really hurts. Given Merrill Lynch's fine reputation, it appealed to customers who wouldn't trust an ordinary tax-shelter deal. "In 1975 we attracted $53 million in [tax shelter] equity investments," Loughlin says, leaning back in his chair. "Last year, $77 million; this year we expect to do over $100 million."**
>
> **Merrill Lynch is by no means alone. Today nearly every retail brokerage house in the country has discovered the potential of tax shelters as a new source of business.**
>
> **Sales commissions run from 6% to 8.5% of the money invested, the kind of return that energized all those mutual fund salesmen back in the Sixties and Fifties.**
>
> **Last year tax shelters attracted at least $2.4 billion. About $1.2 billion of that was in public placements registered with the Securities & Exchange Commission or with state agencies. The other half (or more) is in private placements, which are limited to 35 or fewer investors and which do not have to register with the SEC. Private placements are the province of not only the brokers, but a whole army of lawyers, accountants and promoters—some sharp, some of them just sharks.**
>
> **This year's take in tax shelters—public and private—could be higher still. The industry's rule of thumb is that anyone who has part of his income in the federal 50% bracket is a prospect. Published Internal Revenue Service data for 1973 (the latest figures) showed 568,849 taxpayers at the 50% level or higher that year. That's a lot of potential business. Since then, many more thousands of rock singers, TV personalities, doctors, airline pilots, lawyers and assorted executives have joined the top brackets.**

B. Illustrations of the Problem

Would you invest $65,000 of your own money to buy the rights to a book about the life story of a virtually unknown bodybuilder written by an unknown author? Probably not, unless you determined that the chances of making a profit justified this enormous risk. Tax shelter promoters, however, devise schemes to entice wealthy investors to do exactly this. How? By making Uncle Sam a silent partner in the investment.

In one such tax shelter, the investor invests $65,000 of his own cash. The purchase price for the book, however, is not $65,000 but rather is inflated to $300,000. Does the investor personally owe $235,000? No. The difference is payable only out of a small percentage of the receipts, if any, and only after the investor has been repaid his entire $65,000 cash payment.

Under the terms of the deal, over 1,000,000 copies of the book must be sold before the $300,000 "purchase price" is repaid. The prospectus promoting the deal contains

appraisals from "experts" who, even in their optimistic opinion, place the upward sales limit for the book at 600,000 copies. Thus, even assuming that the appraisals cited by the promoter prove accurate, the projected book sales would repay only two-thirds of the so-called "loan". It is obvious that the "loan" will never be repaid. What then is going on? The answer lies in the purported tax benefits. The investor is encouraged to write-off as rapidly as possible the full $300,000 "cost", thereby giving him tax benefits far in excess of his cash investment. As a result, through tax revenue losses, Uncle Sam has become the major investor in the book.

The key to the shelter is the inflated valuation given to the asset. An asset, such as a book, is difficult to value. Hence, an irresistable temptation is presented to aggressive tax shelter promoters to overstate this value.

Nevertheless, despite difficult questions on valuation, and the near certainty that, if audited, the Internal Revenue Service will contest these aggressive valuations, book shelters have thrived so much so that a major literary (not business) journal felt bound to describe the phenomenon.

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In many of these deals, the tax benefits are so great that the quality of the asset, such as a book or recording, is irrelevant. All that is needed is the appearance of a bona fide transaction, to avoid disqualification as an outright sham. This fact is well described in an article entitled "Ah, Tax Shelters! What Horrors Are Committed in Thy Name" which appeared in the January 23, 1978 issue of Forbes Magazine.

> Cal-Am dutifully warns you in its sales literature that there may be one big problem: the $125,000 purchase price. The IRS has announced that it will scrutinize tax returns in which the "fair market value" of property is less than the nonrecourse debt used to pay for it. But if $125,000 sounds like too much to pay for a master recording by an unknown artist, sit tight: Cal-Am provides you with two appraisals by experts in the music recording business who will attest to its value.
>
> The IRS, of course, may contest the appraisals—particularly in light of what one record-industry source told FORBES: "I visited Cal-Am several months ago because I thought they were interested in purchasing good master recordings. They looked at me like I was crazy. [A Cal-Am official] said: 'Can you get me records for $1,000 or $1,500 apiece?' And I said to him, 'No, I can't.' He said, 'That's the price scale I'm looking for.' And I said to him, 'That's impossible. You're going to have two cellists banging their cellos together for $1,000.' He said, 'I don't care what we have.'" (Our source adds that a typical cost for producing a good master recording is between $45,000 and $100,000.)

Obviously, reasonable men may disagree over the fair market value of an asset. For tax shelter promoters, however, the possibility of reasonable differences of opinion is the excuse justifying the most favorable, and in many cases outrageous, valuation. One way to deal with this problem is for the Service to hire an army of appraisers. Clearly, this is not desirable. The Administation proposes instead to replace the army of appraisers with a simple rule: an investor can deduct tax losses only to the extent of his economic investment in the activity. In the foregoing example this rule will limit the investor's deductions to $65,000. The value of the tax deductions can then never exceed his personal investment. The investor, therefore, will lose some part of his investment unless the deal produces a profit. Under this rule, it is hard to conceive of a prudent person who would invest $65,000, let alone $300,000 of his own money in this venture. An investor could no longer ignore the strong probability that the book will be a flop. The need for this rule is not limited to book deals. Ingenious promoters have packaged tax shelters involving master recordings as well as lithographic plates of original works of art. Obviously, the only limit is the imagination of the promoters. Thus, the rule extends to virtually all activities.

In many tax shelters an investor makes profits while losing his entire cash investment. This interesting phenomenon can be demonstrated by the projected tax savings supplied by the promoter of a tax shelter involving a lithographic plate of an original work of art. As the attached projection shows, for a cash investment of $25,000,

the promoter projects that the cash value of the tax savings during the first four years of the investment to a taxpayer in the 60 percent bracket would exceed $65,000. Thus, assuming that the projections of the promoter can sustain a challenge by the Service, the investor has received almost a 300 percent return simply by losing his entire investment. Even the medieval alchemists could not so skillfully turn lead into gold.

LLOYD PROBBER & ASSOCIATES

STATEMENT OF PROJECTED OPERATIONS
(Unaudited)

Facts used for this projection

Cash investment over two year period	$ 25,000
Note payable	100,000
Total cost to investor (Note 3)	$125,000
Investment tax credit available	$ 12,500
Tax bracket of potential investor for each year of projection	60%
Note principal and interest amortized (Note 3)	None

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Total
A. Income tax effect (Note 1a)												
Income:												
Gross profit on sales (Notes 1b and 4)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Foreclosure of note (Notes 1c and 3)	-	-	-	-	-	-	-	-	-	-	148,272	148,272
Total income	-	-	-	-	-	-	-	-	-	-	148,272	148,272
Deductions:												
Investment tax credit (Note 1d)	20,833	-	-	-	-	-	-	-	-	-	-	20,833
Depreciation (Note 1e)	13,889	24,691	19,204	14,937	11,617	9,036	7,028	5,466	4,251	1,653	-	111,772
Interest (Note 1f)	1,500	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	61,500
Total deductions	36,222	30,691	25,204	20,937	17,617	15,036	13,028	11,466	10,251	7,653	6,000	194,105
Taxable income (loss)	$(36,222)	$(30,691)	$(25,204)	$(20,937)	$(17,617)	$(15,036)	$(13,028)	$(11,466)	$(10,251)	$(7,653)	$142,272	$(45,833)
B. Cash effect												
Cash savings (cost) from taxable income (loss)	$ 21,733	$ 18,415	$ 15,122	$ 12,562	$ 10,570	$ 9,022	$ 7,817	$ 6,880	$ 6,151	$ 4,592	$(85,364)	$ 27,500
Cash distribution (Note 7)	-	-	-	-	-	-	-	-	-	-	-	-
	21,733	18,415	15,122	12,562	10,570	9,022	7,817	6,880	6,151	4,592	(85,364)	27,500
CAPITAL CONTRIBUTED (Note 3)	12,500	12,500	-	-	-	-	-	-	-	-	-	25,000
Net cash benefit (cost)	$ 9,233	$ 5,915	$ 15,122	$ 12,562	$ 10,570	$ 9,022	$ 7,817	$ 6,880	$ 6,151	$ 4,592	$(85,364)	$ 2,500
Cumulative cash benefit (Note 8)	$ 9,233	$ 15,148	$ 30,270	$ 42,832	$ 53,402	$ 62,424	$ 70,241	$ 77,121	$ 83,272	$ 87,864	$ 2,500	$ -

The assumptions and notes contained in this report are an integral part of this projected statement.

See letter of transmittal and confidential memorandum of Lloyd Probber & Associates

Returning to the book shelter deal described above, let's assume for the sake of this discussion that the valuation is reasonable. At a later time, the book is a flop, and the $235,000 note becomes worthless. What happens? The investor has no personal liability for the note so the only thing the investor loses is the copyright asset. However, under the tax laws, the investor must then report as income the amount of the forgiven loan. As noted in the following excerpt from the recent Forbes article, many investors and promoters suffer from convenient memory lapses at this time.

> Even if you manage to escape challenge on your deductions and credits by the IRS, you still may have problems. Remember how you paid for the master recording: $20,000 down, $105,000 in a seven-year, nonrecourse note. Let's assume the record has failed to bring in more than a few dollars of income for you at the end of seven years. So you decide to default on the note. If you did, you'd find yourself stuck with a huge tax bill. After all, you signed a note for $105,000, deducted that amount from your taxes, and have now said that you never intend to pay it off. So the $105,000, and possibly more, is suddenly "recaptured" into income the moment your debt is wiped out.
>
> In other words, you'd better have a very big wad of cash ready to hand over to Internal Revenue. But there is a way out. The nonrecourse note is renewable at your option. So you can roll it over for another seven years, and postpone the day of reckoning.
>
> Okay, but at the end of 14 years, you've got the same problem. That point was raised during a meeting with a Cal-Am official, Don Ferrari, who was talking to a group of prospective Cal-Am salesmen. "Some people," Ferrari said with an expression of mock sadness, "will have lapses of memory at the end of 14 years."

Although the proposed substantive changes will be of enormous assistance in limiting shelter activity, the Service must be able to audit shelters adequately. Many shelter schemes are of such enormous complexity and geographic scope that even the best efforts of the Service are unable to cope fully with the logistical problems presented.

A common practice in tax shelter deals is to "layer" one partnership on top of another in arrangements that involve investors from coast to coast. For example, consider the arrangement illustrated on the following page. This tax shelter which the Service is presently examining contains four tiers of partnerships. The 69 taxpayer partners are scattered throughout the various tiers. There are six partnerships which are mere conduits, although in investigating this tax shelter the Internal Revenue Service must examine the returns of these conduits to identify the actual taxpayers.

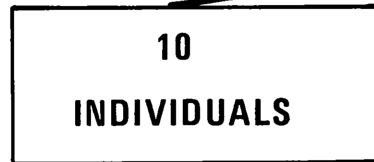
Even where the tax shelter partnership is not structured in a multi-tiered arrangement, the mere number or geographic diversity of limited partner-investors makes the Service's audit task extremely difficult. One group of tax shelter cases presently under examination by the Service involves over 20 partnerships, with an aggregate number of limited partner-investors in excess of 1,600. Certain of these

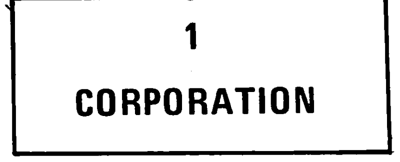
partnerships each have in excess of 400 limited partners who are located from New York to California.

There is no reason to permit highly questionable and sometimes illegal tax positions to go unchallenged by the Service as a result of complexity and subterfuge attributable to taxpayers. As a result, the Administration has proposed streamlining the partnership audit rules so that these complex schemes can at least be adequately scrutinized by the Service.

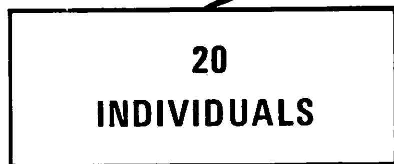
FIRST TIER

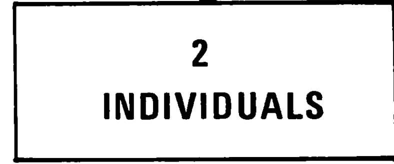
SECOND TIER



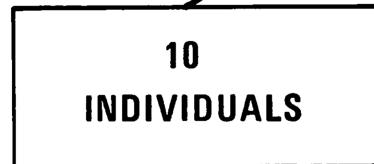


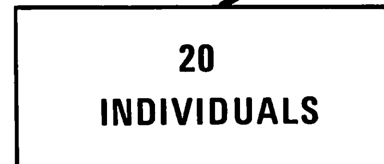
THIRD TIER

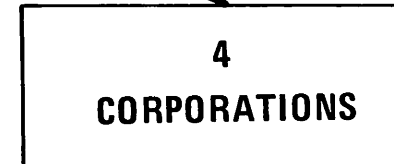




FOURTH TIER







TOTAL RETURNS	
Individual	62
Corporate	5
Trust	2
Partnership	6
	75

REAL ESTATE DEPRECIATION

Present Law

Present law allows a depreciation deduction for the exhaustion, wear and tear of buildings used in a trade or business or held for the production of income.

A building will experience a gradual loss in value over its life equal to the difference between the cost of the building and its salvage value. This loss in value is a cost of producing the rents or other income from the building. The purpose of the depreciation deduction is to provide an accurate measure of the annual taxable income derived from the building by allocating this cost of producing income over the period during which the income is produced. To accomplish this purpose, the total loss in the value of the building must be allocated year-by-year over the life of the building.

If the entire cost of a building were deducted in the year it was placed in service, there would be large tax savings at the beginning of the property's life that would be offset by taxation of the entire gross income from the property (net of operating expenses) during the remainder of its life. The deduction of all of the anticipated depreciation at the beginning of a building's life would be inappropriate because it would not reflect a current loss in its value.

The opposite policy would be equally inappropriate. If a deduction for the loss in value of a building were permitted only when its amount could be determined with certainty (e.g., when the building was sold), the taxpayer would be required to pay tax on the entire gross income from the property (net of operating expenses) and would receive a refund of the overpaid tax only when a loss was sustained on the building's sale. Taxpayers would properly object that the loss of value occurred during the period of the building's use and should be netted against the income earned during that period, rather than accumulated and deducted in a single year.

The allowance for depreciation is intended to avoid the distortion of income that would result from either of these extremes by permitting annual deductions that reasonably allocate the cost of producing income from the building over the period during which income is produced. Thus, the rate at which a taxpayer recovers his investment in a building

through depreciation deductions is, in general, intended to correspond with the gradual loss of that investment as the property deteriorates physically or becomes obsolete. Under present law the amount of the annual depreciation deduction is a function of three factors:

(1) the estimated useful life of the asset: the length of time it will be used in the taxpayer's trade or business or held for the production of income;

(2) the salvage value of the asset: the amount which the taxpayer estimates will be realized upon sale or other disposition of an asset when it is no longer used by that taxpayer; and

(3) the method of depreciation: the method of apportioning the property's decrease in value from its original cost to its salvage value over its useful life. 1/

Methods of depreciation.

Until 1954 the most common method of depreciating buildings was the straight-line method. Under the straight-line method, which is now required only for used nonresidential real property, the annual deduction for depreciation is a pro rata portion of the difference between a building's cost and its estimated salvage value.

Accelerated methods of depreciation (*e.g.*, the declining balance method) allow more depreciation in the early years of an asset's life and less in later years.2/ These accelerated methods, first permitted on a limited basis by administrative practice in 1946, were specifically authorized by the Congress in 1954, when its primary focus was the depreciation pattern of industrial machinery and equipment. However, these faster methods of depreciation are now generally permitted to be used for all assets, including buildings.

New residential rental buildings may be depreciated at a rate of up to 200 percent of the straight-line rate (or the sum of the years-digits method, which gives approximately the same results). Other new buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate. Used residential properties can be depreciated at a rate of up to 125 percent of the straight-line rate; only used nonresidential properties are limited to the straight-line method.

Useful life and salvage value.

While depreciation methods for buildings are specified by statute, estimates of useful life and salvage value are made by the taxpayer subject only to the requirement that

they reflect all the "facts and circumstances" bearing on the taxpayer's anticipated use of the property.

The taxpayer must make subjective judgments to estimate both the useful life and the salvage value of a building when it is first placed in service. To the extent that a taxpayer makes a judgment underestimating a building's useful life and salvage value, the taxpayer overstates depreciation during the shorter life claimed, producing premature deductions.

In 1971 Congress requested a Treasury study of the useful lives over which taxpayers were in fact depreciating buildings, intending to establish useful lives for buildings under the class life system of depreciation (Asset Depreciation Range, or "ADR"). The Treasury study, completed in 1974, showed that taxpayers almost always assume salvage values of buildings to be zero and claim useful lives that are significantly shorter than the relevant lives for buildings published previously by the Internal Revenue Service (Rev. Proc. 62-21, 1962-1 C.B. 418). (See Table IID-1.)

Instead of estimating the overall useful life and salvage value of a building, taxpayers may allocate the cost of a new building among its various components (e.g., the building shell, wiring, plumbing, roof, ceiling, flooring) and then may estimate separate useful lives and salvage values for each of these components. It is not uncommon for a single building to be divided into more than 100 separate components.

Reasons for Change

Present law authorizes a reasonable deduction for depreciation to ensure that the annual income derived from a building is clearly reflected. The current procedures for determining depreciation deductions for buildings do not produce depreciation deductions which are reasonable. The use of useful lives and salvage values that are far less than are economically justifiable are combined with the accelerated methods permitted by statute to produce excessive depreciation deductions that distort income and enable taxpayers, especially high-income taxpayers, to avoid taxes.

Straight-line method more appropriate.

Prohibiting use of the accelerated methods of depreciation for real estate is supported by (1) prior Congressional action, (2) studies of actual economic declines in the value of buildings, and (3) the realities of the marketplace.

1. Prior Congressional action.

Accelerated methods of depreciation for real estate were

Table IID-1

Comparison of 1962 Guidelins and
Lives Claimed (In Years)

Building Type	Guideline Lives Under Revenue Procedure 62-21	Average Lives Claimed by Taxpayers (New Buildings Only)	Percentage of Taxpayers Claiming Lives Shorter Than Guideline Lives
Retail (including shopping centers)	50	36	93
Warehouse	60	37	99
Factory	45	37	77
Apartment	40	32	78
Office	45	41	91
Bank	50	43	79

Office of the Secretary of the Treasury January 27, 1978
Office of Industrial Economics

Source: Office of Industrial Economics, Department of the Treasury, Business Building Statistics (GPO, Washington, 1975).

permitted virtually as an afterthought. When the Congress originally authorized the accelerated methods in 1954, it was primarily concerned with the depreciation pattern of machinery and equipment; the purpose of the accelerated methods was to afford a more realistic timing of depreciation deductions by properly recognizing the early obsolescence of these assets. 3/ Obsolescence may affect the length of building lives as it does those of machinery and equipment. However, experience demonstrates that the technological obsolescence of buildings is not nearly as rapid as that of machinery and equipment.

The potential physical lifetimes of most buildings are extremely long. That is, with reasonable maintenance, there is no physical reason that most buildings cannot remain in service for hundreds of years, as many buildings currently in use attest. In spite of the physical durability of buildings, they are frequently removed, abandoned, or converted to another use, most often for reasons that are social, cultural, and political, rather than physical. These changes occur gradually. The rapid technological changes in the fields of computer technology, electronics and production machinery, for example, do not equally affect real estate.

The legislative history indicates that in authorizing accelerated methods of depreciation the Congress did not consider the different pattern of the loss in value of buildings compared to that of machinery and equipment. The allowance of the accelerated depreciation methods for buildings simply happened, and was not intended as a device to stimulate real estate construction.

In 1969 the Congress recognized the distinction between the depreciation pattern of buildings and that of machinery and equipment. The Tax Reform Act of 1969 restricted the use of the accelerated methods of depreciation for buildings. Further recognition that the Congress has viewed the straight-line method as a more appropriate one for buildings is provided both by the recapture rules and by the definition of tax preference items.

The recapture rules, enacted in 1964, generally require that the portion of gain realized on the disposition of a building equal to the excess of accelerated over straight-line depreciation be recognized and taxed as ordinary income rather than as capital gains. The excess of accelerated over straight-line depreciation is also considered an item of tax preference for purposes of the minimum and maximum taxes, introduced in 1969.

2. Studies of actual declines in value.

Recent studies of the actual economic depreciation pattern of real estate unequivocally conclude that any method of tax depreciation for buildings that yields deductions more accelerated than those produced by the straight-line method over the lives presently in use is unjustifiable.

A study conducted for the Treasury in 1970 investigated the actual economic depreciation (in constant dollars) of real estate. This study concluded that allowable tax depreciation--even on the straight-line method over useful lives of 40 to 60 years--greatly exceeds the actual economic depreciation of both office and apartment buildings:

> "For both office and apartment buildings we find that the tax depreciation rules--even after the 1969 revision--confer substantial subsidies. For example, the true depreciation of office buildings in the first year is less than one-tenth of that allowed under straight line depreciation. Indeed, true depreciation for office buildings falls short of that allowed by the straight line method for each of the first 45 years of the office building's useful life. We calculate that on a before tax basis, the straight line depreciation allowed by the law yields a subsidy of 18 percent of the purchase price while double declining balance adds approximately 10 percent more.

"The results are similar for apartment buildings. In the first year, true depreciation is less than one-fourth of that allowed under the straight line method and true depreciation does not exceed the tax allowance until after the passage of 40 years. The straight line tax depreciation methed confers a subsidy of 14 percent while accelerated methods can double this. In both industries a reverse sum of the years digits method would approximate true depreciation." 4/

Another Treasury study compared tax and economic depreciation (in constant dollars) on the basis of the extensive data collected in connection with the Treasury's 1974 ADR survey of lives actually being used to depreciate buildings. 5/ This study also concluded that even straight-line depreciation, given current lives in use, greatly exceeds economic depreciation.

3. Realities of the marketplace.

The inappropriateness of accelerated methods of depreciation for buildings is clearly demonstrated by the disparity between the implied rates of decline in building values and the lending practices of major financial institutions. These institutions lend hundreds of millions of dollars each year, accepting buildings (and their sites) as security. These lenders must be concerned with the true rates of depreciation of the properties they take as collateral. If a property depreciated more rapidly than the loan was repaid, the lender would find the value of the collateral to be insufficient to recover the unpaid balance of the loan in the event of default.

The behavior of equity investors in buildings also clearly demonstrates that accelerated depreciation is unrealistic. These investments, if the investors' tax depreciation schedules are to be believed, have rates of return that are not only well below prevailing market rates, but that are sometimes even negative. These points are illustrated by the following example.

Example

Assume an investor purchases a newly constructed office building and its site for $1 million. The site has a value of $120,000. The investor finances the purchase with $250,000 of his own funds and a loan of $750,000 from an insurance company. The loan has an interest rate of 9 percent per annum, will be amortized over 22 years and is secured by the property. The building is fully rented and generates $104,051 annual revenues, net of operating expenses. 6/

The financial results for the first five years are shown in the following table. Depreciation is shown under both the

150 percent declining balance and straight-line methods based on a 30-year useful life.

	150% Declining Balance	Straight-line
1. Operating income before interest and depreciation	$ 520,255	$ 520,255
2. Mortgage amortization	71,390	71,390
3. Depreciation	199,072	146,665
4. Interest	325,753	325,753
5. Cash flow (item 1 less items 2 and 4)	123,112	123,112

The depreciation deducted under the 150 percent declining balance method in the first five years is almost three times as great as the mortgage amortization required by the lender. If the depreciation deductions accurately reflected true depreciation, the lender's margin of safety (i.e., the excess of the property's value over the loan balance) would be reduced from 33 percent to 18 percent. To maintain the 33 percent margin of safety, the lender would anticipate no more than approximately $95,000 of economic depreciation over the five-year period. In contrast, tax depreciation computed on the basis of the 150 percent declining balance method is $199,072.

To calculate the investor's before tax rate of return, assume that the property will be sold after ten years. The annual cash flow from the property is $24,623. If the 150 percent declining balance method with the 30-year useful life accurately reflected true depreciation, the property would sell for $646,890 after ten years. From the proceeds of the sale, the investor would have to repay the remaining balance on the mortgage of $568,767. The net cash from the sale would be $78,123. Given that the investor committed $250,000 when the property was purchased, the rate of return on the investment is 4.17 percent. This is an unrealistically low figure for rates of return to equity investors in an environment where mortgage rates are 9% and higher. If investors truly anticipated rates of return of this size, no investment in buildings would occur. Clearly, in order to earn a reasonable return on equity, the sales value, and hence the undepreciated basis at the end of ten years, should be substantially higher than that implied by presently allowable deductions. Even straight-line depreciation over a 30-year useful life provides a rate of return of only 6.53 percent. A similar example for apartment buildings for which the investor uses 200 percent declining balance depreciation produces a negative rate of return.

Need for guideline lives.

The Treasury has consistently attempted to make the calculation of depreciation for all kinds of property simple, uniform and administrable by providing guideline systems for the determination of useful lives. Guideline lives which taxpayers may elect and not have challenged by the Internal Revenue Service have generally been established for most depreciable property, but are not currently used for buildings.

The present facts and circumstances test for determining building depreciation is a cumbersome and inexact process that produces widely varying depreciation allowances. There is no evidence that these variances reflect actual differences in declines in value. In addition to being inequitable, the present system is also costly for both taxpayers and the government.

Uniform guideline lives for real estate would (1) provide simplicity, certainty, and relieve the administrative burdens imposed by the facts and circumstances test, and (2) ensure that similarly situated taxpayers are treated consistently.

1. Facts and circumstances foster disputes.

Under the facts and circumstances test, taxpayers must estimate useful lives and salvage values of buildings in the year they are first used in a trade or business or held for the production of income. The facts and circumstances test thus requires both taxpayers and the Internal Revenue Service to predict technological, social, cultural, and political events to determine a reasonable allowance for depreciation.

It is not surprising that under this subjective standard, requiring numerous judgments on which reasonable persons could differ, disputes frequently arise over the appropriate useful lives of buildings. A 1977 report prepared by the General Accounting Office (GAO) on ways in which the tax laws could be simplified identifies disputes over useful lives of depreciable property as one of the tax issues most frequently in controversy. 7/ These disputes, involving basically factual issues, require taxpayers and the government to devote substantial time, effort and expense to the determination of a mutually acceptable useful life.

It is unreasonable, and as demonstrated by the empirical testing of the depreciation rules that have been used for buildings to date, virtually impossible, to base economically justifiable rates of tax depreciation on these taxpayer-by-taxpayer predictions.

2. Facts and circumstances inequitable.

Prohibiting use of accelerated methods of depreciation for real estate is insufficient by itself to prevent unrealistic depreciation deductions that distort income and produce artificial losses. In fact, depreciation on real estate tax shelters currently being sold to high-income taxpayers is frequently computed under the straight-line method to avoid the unfavorable impact of the excess of accelerated over straight-line depreciation under the minimum and maximum taxes and the recapture rules. These taxpayers are able to obtain the benefits of unrealistically large depreciation deductions without resorting to the accelerated methods by playing the "audit lottery" and by using the component method of depreciation.

The audit lottery: Internal Revenue Service audits indicate that, in the absence of objective guidelines, many high-income taxpayers are taking aggressive "tax return positions" in claiming useful lives far shorter, and salvage values much lower, than are justified by the facts and circumstances.

These taxpayers have little to lose by claiming short useful lives and low salvage values. In the event the taxpayer's return is not selected for audit, the excessive depreciation deductions produce artificial losses that reduce the taxpayer's tax liability. The odds are that the taxpayer's return will not be audited.

On the other hand, if the taxpayer's return is audited and his estimated life challenged, the taxpayer merely regards the estimated useful life on the return as a "first offer" to the Internal Revenue Service. (The Internal Revenue Serivce rarely asserts penalties in these cases, since the taxpayer will be able to argue that the tax return position is justifiable under the facts and circumstances.) In the absence of objective guidelines, these disputes become negotiations between the taxpayer and the Service to arrive at a useful life that will be mutually acceptable. Because the government cannot afford to allocate significant resources to litigate these basically factual issues, which would have little or no value as precedents, disputes over the useful lives of buildings are almost always settled administratively.

Thus, instead of similarly situated taxpayers being treated equally, the facts and circumstances test ensures that aggressive taxpayers--not necessarily those who experience the most rapid depreciation of their buildings--will take the largest depreciation deductions.

Component depreciation: The use of the component method to depreciate buildings has become increasingly popular in

recent years--particularly in tax shelter real estate deals. This recent popularity may be explained in part by the fact that, in actual practice, component depreciation results in the acceleration of deductions into the early years of a building's life that are far greater than are justified by the facts and circumstances. One of the principal reasons for this unwarranted acceleration of deductions is that the abuses of the facts and circumstances test are compounded under the component method.

Taxpayers divide a building into its component parts and then assign useful lives to those parts that are unreasonably short. For example, the longest lived component of a building is its structure or "shell." Taxpayers using the component method frequently assign a life to a building shell equal to the life the Treasury previously suggested for that type of building in Revenue Procedure 62-21 (e.g., 45 years for office buildings). However, the previously suggested lives were composite lives; that is, they were averages of all building components of which the shell was only one. The shell life was 67 years. It is clearly inappropriate to use the shorter composite building lives for shells. Since the shell of a building ordinarily accounts for approximately one-half of a building's cost, an underestimation of its useful life greatly accelerates depreciation deductions for a building.

In addition to assigning the lowest possible lives to a building's components, to further accelerate depreciation deductions taxpayers allocate disproportionately large portions of a building's cost to the shorter-lived components. For example, it is common practice for an owner of a new building to assign the entire cost of the plumbing contract to a separate component called "plumbing", and then to assign a short life to that account on the ground that the fixtures will be replaced after a few years. However, a large part of the cost of installing plumbing in a building is associated with the permanent piping within the building. This piping ordinarily will have a useful life equal to that of the structure itself.

A sample of a few of the many cases which have come to the attention of the Internal Revenue Service shows that taxpayers are using component depreciation to claim unrealistically large deductions on the basis of unjustifiably short building lives. (See Table II D-2.)

TABLE II D-2

Examples of Abuse of the Component Method
(In Years)

Type of Building	Approximate Cost	Normal Life Estimated by IRS Engineer	Composite Life Claimed by Taxpayer under Component Method
Apartment	$1,200,000	40	10
Apartment	1,000,000	40	15
Apartment	1,000,000	40	15
Apartment	981,000	40	15
Apartment	1,300,000	40	15
Apartment	800,000	40	20
Apartment	1,000,000	40	18
Office	635,000	45	17
Office	375,000	45	17
Industrial	130,000	45	16
Industrial	65,000	45	13
Industrial	31,000	45	16
Industrial	31,000	45	20
20 Motels	35,000,000	35 - 40	24 - 27
Shopping Center	1,850,000	40	20
Shopping Center			
1st Phase	1,900,000	35 - 40	19
2nd Phase	6,000,000	35 - 40	16

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These abuses of the component method cannot be handled effectively by audit enforcement procedures. In an audit involving the depreciation claimed for a large building, the sheer complexity of examining a very large number of components, frequently in excess of 100, makes it virtually impossible for the agent to thoroughly examine the accounts in the limited time available. A related problem is that many large buildings are owned by partnerships. A single taxpayer may be a member of several partnerships; consequently, examination of one return necessitates consideration of complex depreciation schedules for many large buildings.

Real estate shelters.

The excess of tax depreciation over true economic depreciation in the early years of a building's life produces deductions that both offset income earned from the property during these years and shelter other income of the taxpayer.

Real estate tax shelters have been labelled and are sold as a lucrative means for high-income taxpayers to shelter their income from other sources. The Tax Reform Act of 1976, which cut back somewhat on real estate tax shelters, also encouraged their growth by leaving them relatively untouched in comparison with other tax shelters.

The increased popularity of real estate shelters was noted in a recent article entitled "Outwitting Uncle Sam: Despite 'Reform', Tax Shelters Continue to Thrive":

> "Owing to restrictions imposed by the 1976 act on other programs, real estate has become more popular than ever as a haven. It is the only major shelter using non-liability financing for tax deductions which has been allowed to continue the practice and to utilize partnerships to receive the benefits. Accordingly, money has been pouring into real estate shelters, especially in the Sunbelt where industrial growth is strong." 8/

General Explanation

Under the proposal, taxpayers will be able to elect one of two ways to depreciate buildings. Under the first option, taxpayers will depreciate their buildings based on zero salvage value and the average useful lives now claimed by taxpayers as determined by the Treasury study requested by Congress in 1971. These lives are listed in Appendix A. Taxpayers who make this election will be required to use the straight-line method of depreciation. It is anticipated that most taxpayers will elect this option.

The second option is one which maintains the integrity of the guideline system while affording a meaningful alternative for taxpayers whose buildings rapidly decline in value. Under this option, a taxpayer will be permitted in any year to depreciate a building to its current salvage value, based on a facts and circumstances test. The determination of current salvage value, below which a taxpayer may not depreciate a building, will be made annually and will be the building's fair market value. The taxpayer will have the burden of establishing the fair market value of the building.

More advantageous methods of depreciation will be provided for low-income and new multi-family housing. After 1982, the advantage for new multi-family housing and used low-income housing will be eliminated and that for new low-income housing reduced.

The proposal will provide simplicity and certainty to taxpayers and will substantially relieve the administrative burden imposed upon both taxpayers and the government under the facts and circumstances test. Under the guideline life option, taxpayers will receive uniform deductions and will know in advance of investing in real estate the depreciation allowances that will be permitted. Under the facts and circumstances option, the relevant facts, namely the property's current fair market value, will be ascertainable without resort to subjective judgments as to uncertain future events.

Analysis of Impact

The proposed changes in tax depreciation rules for buildings will help correct abuses of the tax system with little impact on the underlying process of capital formation in real estate. The proposal particularly impacts on high-income passive investors in real estate syndications. A reduction in the volume of this kind of financing will have little effect on real estate capital formation because real estate syndicate promotions are largely predicated on the marketing of tax losses. They often attract investors unqualified to judge the long-term economics of real estate projects and consequently finance projects which, even including the tax benefits, fail to yield a normal rate of return. These investments are socially wasteful and adversely affect the long-run health of real estate markets.

Because the real estate industry is highly competitive, in the long-run the proposal may be expected to result in higher market rentals. However, the increase in market rentals required to maintain after-tax returns on real estate investments will be quite small. On the basis of recent data on operating costs, mortgage financing terms, site-building cost ratios, and taking into account the proposed changes in

both the tax rates and the real estate depreciation rules, it is estimated that increases in market rentals will be only 1.2 percent for shopping centers and 0.7 percent for office buildings. For housing (other than low-income housing), the increase in required rentals will be 1.4 percent during the period through 1982 when declining balance depreciation at 150 percent of the straight-line rate is permitted, and an additional 1 percent thereafter.

Moreover, recent studies have concluded that current depreciation practices for real estate may even induce a shortening of the economic lives of buildings. Based on the 1970 study conducted for the Treasury, Taubman and Rasche found that a shift from the accelerated to the straight-line method would lower the supply of office space by only a very small amount, in part because the economic lives of buildings would be lengthened by a few years. They estimated that the use of accelerated rather than straight-line depreciation diverted more resources to the office building market, but less than one-sixth of these resources were made available to renters in additional space. "Even if it were true that subsidies were justified, it is impossible to justify a type of subsidy that causes so much pure waste," they concluded. 9/ The same general effect occurs with respect to apartment buildings.

Revenues lost through real estate shelters (from accelerated rather than straight-line depreciation, expensing rather than capitalizing construction period interest and taxes and failure to recapture excess depreciation) are remarkably inefficient tax expenditures. The recent study of real estate tax shelters by the Congressional Budget Office finds that only about 40 to 60 percent of the revenue lost by the government--estimated at $1.3 billion annually--goes to the builder/developer and thus to help reduce rental costs. The balance of the revenue loss does not produce compensatory increases in the flow of financial capital. Part of this inefficiency is attributable to the fact that investors frequently are in higher tax brackets than the pricing of the shelter reflects. Consequently, the highest bracket taxpayers receive windfalls. The remainder of the tax expenditure is absorbed by the costs of organizing syndicates and marketing the shares.

In addition to being inefficient, almost all of the current tax expenditure supports investment in buildings other than low- and moderate-income housing, such as office buildings, shopping centers and luxury apartments. The CBO Shelter Study estimated that only 11 percent of the government's $1.3 billion annual expenditure on real estate tax shelters assists low- and moderate-income rental housing construction. Approximately 35 percent subsidizes office buildings, shopping centers and other commercial buildings and the remainder (54 percent) subsidizes middle- and upper-income rental housing.

It is essential that, given the inefficiency of tax shelters, tax and nontax subsidies for housing be reviewed and coordinated. It is equally important, however, that there be no major changes in this segment of the industry while the review is completed. Consequently, accelerated depreciation deductions will be continued generally through 1982 for specific housing areas.

Effective Date

The proposal is generally effective for buildings acquired after December 31, 1978.

In the case of used low-income and new multi-family housing, the limitation to the straight-line method of depreciation will be effective for buildings acquired after December 31, 1982. The limitation to the 150 percent declining balance method of depreciation for new low-income housing will also be effective for buildings acquired after December 31, 1982.

In the case of construction begun prior to the relevant date (January 1, 1979 or January 1, 1983), the new rules will not apply if original use of the building begins with the taxpayer.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	101	299	490	672	849

Technical Explanation

Taxpayers will be permitted to depreciate buildings on the basis of zero salvage values and the average lives now in use as determined by the Treasury study requested by Congress in 1971. Appendix A lists these lives by classes of buildings and also lists the lives of building components.

Taxpayers who make this election will be required to use the straight-line method of depreciation for their buildings, including buildings depreciated under the ADR system of depreciation. Although taxpayers will be able to use lives

longer than the guideline lives, except under the facts and circumstances option described below, there will be no allowance of lives shorter than the guideline lives. For the few buildings for which ADR classes are established, the ADR life will be used.

As an alternative to using the average useful lives and straight-line method, a taxpayer will be able to elect on his tax return to use a facts and circumstances test that will permit a depreciation deduction in any year sufficient to decrease the basis of the building to its fair market value as of the end of the year.

By limiting depreciation to the current fair market value of the property, taxpayers and the Internal Revenue Service will not have to speculate as to the effects of future events on the value of the property. The determination instead will be made under the facts and circumstances which exist at the time the deduction is claimed.

Once the facts and circumstances test is elected for a structure a taxpayer has constructed or acquired, the taxpayer will not be permitted to change to the guideline system.

The facts and circumstances option may be illustrated by the following example. Assume a calendar year taxpayer purchases a building for $500,000 on January 1, 1981; the taxpayer will be allowed a depreciation deduction for 1981 of $25,000 as long as the taxpayer can establish that the fair market value of the building on December 31, 1981, is not greater than $475,000. If the fair market value of the building remains at $500,000 during 1981 no depreciation deduction will be allowed. The fair market value will be determined by reference to objective standards, including the current sales price of comparable structures and the amount of rental income the building produces.

The component method of depreciation will not be permitted for new or used buildings. Prescribed guideline lives will be required for components placed in service after the original construction or acquisition of a building by a taxpayer. The useful lives in Appendix A are based on averages of lives used by taxpayers using the component method as well as by taxpayers using composite building lives. Consequently, the shorter building lives that are produced by the component method already have been taken into account.

Used buildings.

The guidelines shown in Appendix A are based on taxpayer estimates of useful lives for new buildings. Detailed

examination of the Treasury Department data shows that taxpayers who purchase buildings that are less than 6 years old assign them useful lives which are roughly the same as those assigned to new buildings. The useful lives assigned by taxpayers decline gradually for older buildings, but stabilize at approximately 75 percent of the period assigned to new buildings.

Therefore, based on the Treasury survey, the depreciation period for used buildings not older than 5 years will be the same as that for new buildings of the same class. The depreciation period for buildings older than 5 years but younger than 22 years will be the guideline life for new buildings of the same class less 1.5 percent of that guideline life for each year of the building's age in excess of 5 years. For buildings 22 years or older at the time of acquisition, the depreciation period will be 75 percent of the life for new buildings in that class. Useful lives computed under these rules will be rounded to the nearest half year. For example, if a taxpayer acquires a 20 year old building that had an original guideline life of 35 years, under the guideline life option the building will have a useful life of 27 years.

Subsidized housing

Low-income and new multi-family rental housing will not be limited to straight-line depreciation for buildings acquired before January 1, 1983. Until 1983, new low-income housing will be allowed a depreciation deduction based on the 200 percent declining balance or sum of the years-digits method and new multi-family rental housing will be allowed a depreciation deduction based on the 150 percent declining balance method. Used low-income housing will continue to be depreciated on the 125 percent declining balance method.

After 1982, multi-family and used low-income housing will be limited to the straight-line method, and new low-income housing will be allowed a depreciation deduction based on the 150 percent declining balance method.

For purposes of these rules, low-income housing will be defined as it was most recently by the Congress in applying the special recapture rules (section 1250 of the Code). Rental housing will be defined by reference to section 167(j)(2)(B) of the Code; multi-family dwellings will be multiple dwelling housing with more that four apartments.

Taxpayers who own subsidized housing and elect to use the facts and circumstances test will not be permitted a depreciation deduction in any year which will decrease the basis of the property below its current fair market value.

Footnotes

1/ For example, if upon purchase of a building for $10 million a taxpayer estimates that he will use the building for 30 years, estimates salvage value at the end of that period to be $4 million and uses the straight-line method of depreciation, the taxpayer will take depreciation deductions of $200,000 each year ($6 million divided by 30). Salvage value limits the depreciation deduction either by reducing the amount subject to depreciation, under the straight-line method, or by setting a floor below which no depreciation deductions may be taken, under a declining balance method.

2/ Under the 200 percent declining balance method, for example, a taxpayer is permitted a depreciation deduction up to twice the straight-line rate applied to the unrecovered cost (i.e., cost less accumulated depreciation for prior taxable years).

3/ Congressional Research Service, "Study of Legislative History of the Rapid Depreciation Provision," in Congressional Record, March 1, 1974, at 4948; Congressional Budget Office, Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives (GPO, Washington, May 1977), at 22-23 (hereafter "CBO Shelter Study").

4/ This study was conducted for the Treasury by Paul Taubman and Robert Rasche. See, e.g., Taubman and Rasche, "Subsidies, Tax Law, and Real Estate Investment," 5 Economics of the Federal Subsidy Programs 343 (1972), Joint Economic Committee.

5/ This study was conducted for the Treasury in 1974-1976 by Charles R. Hulten and Frank C. Wykoff.

6/ The assumptions concerning the terms of the financing and the income from the building are derived from the American Council of Life Insurance, Investment Bulletin, No. 766, August 26, 1977.

7/ Letter Report to the Joint Committee on Taxation from the Comptroller General, U.S. General Accounting Office, "Tax Issues Generating a Significant Level of Controversy" (Report No. GG7-78; June 15, 1977).

8/ Barron's, September 19, 1977, p. 20.

9/ Taubman and Rasche, supra, at 360.

APPENDIX A

PROPOSED BUILDING GUIDELINE CLASSES AND DEPRECIATION PERIODS

Buildings

Two groups of classes are provided for buildings. The first group includes complete buildings. The appropriate class for a given building is determined by the predominant use of the building. However, certain types of buildings which are explicitly covered by other asset guideline classes (such as farm buildings, service stations, railroad station and office buildings, and telephone central office buildings) are not included in these classes. For these buildings, their ADR class lives will be used.

The second group of classes includes replacement building components. The appropriate class for a given component is determined by the type of component, without regard to the type of building of which it is a part.

Buildings--Complete

These classes include structural shells of buildings and all original components thereof, such as machinery and equipment that serves heating, plumbing, air conditioning, illumination, fire prevention and power requirements; machinery and equipment for the movement of passengers and freight within buildings; interior partitions, both fixed and movable; floor and wall coverings, doors, windows, ceilings and other items of interior finish; and associated land improvements. (Land improvements which constitute the principal asset of a taxpayer in a given location, to which buildings are incidental, such as golf courses and race tracks, are not included.) These classes also include structural shells and all original components of building additions which expand the floor space of the existing buildings to which they pertain.

Office buildings (including bank buildings)

Office buildings--three or fewer floors above ground 30

Office buildings--more than three floors above ground 40

Industrial buildings

Factories

Includes all buildings directly related to manufacturing processes on contiguous parcels of land 35

Repair garages and shops

Includes all buildings housing equipment for repair of industrial machinery or vehicles (except those directly related to manufacturing processes, which are included in the factory building classification). Includes new car dealership buildings 30

Storage buildings

Warehouses

Includes all buildings used for storage of consumer goods, machinery, raw materials, foodstuffs (except grain elevators), or finished manufactured goods 35

Grain elevators 40

Retail buildings

Includes buildings in which goods, including prepared food, are sold to the public.

Retail buildings--less than 50,000 square feet of indoor floor space on contiguous parcels of land 30

Retail buildings--50,000 or more square feet of indoor floor space on contiguous parcels of land 35

Service buildings

Theater buildings. 35

Recreational services buildings (except stadia and arenas) 30

Medical services buildings
Includes nursing homes, hospitals, clinics, and physicians' and dentists' office buildings. 35

Common carrier passenger terminals (except railroad stations) 25

Other service buildings

Includes buildings in which other services are provided for the public, such as barber shop buildings, appliance repair buildings, laundry and dry cleaning buildings (except central laundry and dry cleaning plants, which are included in the factory classification), and photographic studios 30

Residential buildings

Single-family and two-family dwellings. . . 30

Apartment buildings--three or fewer floors above ground 30

Apartment buildings--more than three floors above ground 35

Hotels and motels--three or fewer floors above ground 30

Hotels and motels--more than three floors above ground 35

Buildings--replacement components

Includes all capitalized expenditures for building components for existing buildings (except roof coverings) 20

Roof covering

Includes felt and asphalt, corrugated metal, plastic, shingle, or other types of weather-proofing membranes 15

MINIMUM TAX FOR INDIVIDUALS

Present Law

To ensure that individuals 1/ with large amounts of economic income do not take excessive advantage of special deductions or exclusions under the Code, a minimum tax of 15 percent is imposed on the amount of items of tax preference in excess of the greater of $10,000 or one-half of a taxpayer's regular tax liability. The items of tax preference subject to the minimum tax include:

1. Special provisions which accelerate deductions for depreciation including the excess of accelerated over straight line depreciation on real property.

2. The amount by which the deduction for percentage depletion exceeds the basis of the property.

3. Itemized deductions (other than medical and casualty deductions) in excess of 60 percent of adjusted gross income.

4. The excluded one-half of capital gains.

Reasons for Change

The minimum tax, which was introduced into the Code by the Tax Reform Act of 1969, initially reduced the number of nontaxable high income persons (returns with $200,000 or more of adjusted gross income (AGI)) from 300 or 1.62 percent of all returns in their income class in 1969, to 111 or 0.73 percent of all returns in their income class in 1970. However, in later years, the trend was reversed. The number of nontaxable returns increased from a low in 1971 of 82 or 0.45 percent of all returns in the income class to highs of 244 and 230 (0.78 and 0.67 percent) in 1974 and 1975 (see Table IID-3). Congress reacted to this development by strengthening the minimum tax provisions in the Tax Reform Act of 1976. The number of nontaxable high income returns is expected to be substantially reduced as a result of the 1976 Act. (Data for 1976, the first year the 1976 Act applies, will be available April 1978.)

Table IID-3

Number and Percentage of Nontaxable Income Tax Returns with Adjusted Gross Incomes of $200,000 or over

Year	Number of Returns	Percent of All Returns with AGI of $200,000 or over
1966	154	1.26%
1967	167	1.07
1968	222	1.15
1969	300	1.62
1970	111	0.73
1971	82	0.45
1972	108	0.47
1973	164	0.64
1974	244	0.78
1975	230	0.67

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January 11, 1978

Source: Statistics of Income

However, the problem of untaxed preference income is not limited to nontaxable returns. For example, in 1974 for each nontaxable return with AGI of $200,000 or more, there were more than four returns with equally high incomes and effective tax rates of less than 10 percent. 2/ The minimum tax under current law does not affect those taxpayers who make excessive use of preferences but who have a large regular tax liability. The current offset against preferences equal to one-half of regular tax paid allows persons who pay a regular income tax to avoid any tax on preferences. It thus undermines an important purpose of the minimum tax--the imposition of a fair share of the tax burden on taxpayers receiving large benefits from certain tax preferences. Clearly, two individual taxpayers with preferences of $100,000 each will have very different minimum tax liabilities under present law if one has a regular tax liability of $200,000 and the other has none. To impose the same burden on both of these taxpayers, the offset to the minimum tax base for one-half of the regular tax liability must be repealed.

The offset for regular tax liability also distorts the impact of the minimum tax on those taxpayers using this offset instead of the $10,000 exclusion. In effect, preferential deductions, such as excess itemized deductions, are subjected to a higher rate of tax than preferential exclusions, such as the exempt portion of capital gains. 3/ There is no indication that this result was intended by Congress.

Thus, the proposal deletes the offset for one-half of an individual taxpayer's regular tax liability. No changes will be made in the basic description of preference items, although some (accelerated depreciation on real estate) would be affected by reason of other proposals.

In one respect, however, the minimum tax would be liberalized for individual taxpayers. Application of the minimum tax to the sale of a principal residence could create an undue hardship inconsistent with the purposes of the minimum tax. At present, the Code allows a taxpayer to avoid completely any current tax on gain from the sale of a principal residence when he buys another principal residence of at least equal value within a prescribed period of time. If a taxpayer is unable to take advantage of that provision, the regular tax on the gain should not be augmented by the minimum tax. Thus, capital gains from the sale of a principal residence will be excluded from the minimum tax base.

General Explanation

The basic structure of the minimum tax will be retained,

but the offset for one-half of regular tax liability would be repealed in the case of individuals.

In the case of the sale of a principal residence, all recognized capital gain will be excluded as an item of tax preference. However, a taxpayer will not be able to use this exception to avoid the minimum tax on the sale of a substantial amount of land surrounding a principal residence. Thus, for example, upon the sale of a ranch, including the seller's principal residence, only a reasonable portion of the land adjacent to the residence will be covered by the principal residence exclusion.

Analysis of Impact

Eliminating the half-tax offset for individual taxpayers will raise taxes by $228 million on a total of 91 thousand taxpayers, virtually all of whom will have expanded incomes (adjusted gross income plus tax preferences and less investment interest to the extent of investment income) of over $50,000 (see Table IID-4).

Table IID-4

Effect of Eliminating the Half-Tax Offset for Individuals

Expanded Income Class	Number of Returns With Increased Minimum Tax (Thousands)	Amount of Increased Minimum Tax ($ in Millions)
$ 50,000 to $100,000	15	$ 4
$100,000 to $200,000	47	47
$200,000 and over	29	177
	91	$ 228

Office of the Secretary of the Treasury
Office of Tax Analysis
December 22, 1977

Effective Date

The changes in the minimum tax would be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	284	306	329	353	380

Footnotes

1/ The minimum tax with some modifications also applies to corporations; the tax as it applies to corporations will not be changed under this proposal.

2/ Office of Tax Analysis, Department of the Treasury, High Income Tax Returns: 1974 and 1975, March 1977.

3/ If an individual taxpayer already subject to the minimum tax on itemized deductions incurs additional expenses which are itemized deductions, the amount of the taxpayer's preference items will increase by the amount of the expenses. At the same time, the taxpayer's tax liability will decrease. Therefore, the amount to which the minimum tax rate is applied will increase by more than the amount of the additional deduction, since, for taxpayers not using the $10,000 exclusion, the minimum tax is imposed on the difference between total preferences and one-half of total regular tax liability. On the other hand, a larger capital gain will increase the taxpayer's regular tax liability, and thus the amount subject to the preference tax will increase by less than the additional preference from the capital gain transaction.

AT RISK

Present Law

A significant attack on tax shelters was made by the Tax Reform Act of 1976 through enactment of the "at risk" rules. Generally, the at risk rules have been effective. However, there are some weaknesses in the rules, and promoters have designed tax shelters to exploit these weaknesses.

A taxpayer is allowed to deduct the purchase price of an asset over the life of the asset. The higher the purchase price, the larger the deductions. Ordinarily, arm's length negotiations between a buyer and a seller assure that purchase price equals fair market value. A buyer does not want to pay more than the property is worth; a dollar of tax deduction does not offset a dollar of economic loss. Abusive tax shelters, however, are able to create highly inflated purchase prices, and thus highly inflated tax deductions, through the use of nonrecourse debt, i.e., debt that entails no personal liability on the part of the borrower. Nonrecourse debt allows investors to claim inflated deductions without risking their own capital. The seller is not risking any funds in making the loan since the loan is part of the purchase price that is paid to him. Also, the seller does not incur additional tax liability on account of the inflated purchase price because under acceptable methods of tax accounting the seller can report his gain pro rata as cash is received.

For example, in a typical shelter of this type, an individual taxpayer would purchase the distribution rights to a book for $100,000. The rights might be worth considerably less. The individual would pay $20,000 out of his own capital and borrow the remaining $80,000 from the seller on a nonrecourse basis. The seller would report his gain only as cash was received. The nonrecourse loan would be payable to the seller solely out of the receipts from the distribution of the book. The investor would deduct the full $100,000 purchase price even though he had invested only $20,000. For a taxpayer in the 60 percent bracket, these deductions would have an after-tax value of $60,000, or three times his actual cash investment. The taxpayer could thus obtain a substantial return on his investment without regard to any expected economic profit from the activity.

Even if income were never realized from distribution of the book, the taxpayer would not suffer the full economic

loss represented by his tax deductions. The loan would be "repaid" by reconveying the book rights to the seller-lender. Assuming that the rights were fully depreciated, this "repayment" of the loan would produce taxable income for the investor equal to the outstanding balance of the loan. In such circumstances, many investors fail to report what they call "phantom" income. On audit, it may be difficult for the Internal Revenue Service to detect this income because the taxpayer does not receive any cash in the year the income arises. Even if the investor pays the taxes he owes, he still obtains the benefits of deferral from the time he claims the deduction to the time he reports the income. Furthermore, he can attempt to increase the period of deferral by extending the term of the loan. Frequently, a delayed repayment date has no business purpose and is designed solely to provide the investor with the benefits of deferral, or the opportunity to evade reporting the income entirely.

The new at risk rules effectively identify tax shelters that are based on inflated purchase prices, and prevent investors in those shelters from deducting tax losses that they can never bear economically.1/ The at risk rules limit deduction of tax losses to the amount of a taxpayer's economic investment in an activity. Any tax losses in excess of the amount of such investment cannot be deducted until the taxpayer's economic investment in the activity increases. For example, in the tax shelter described above the investor would be able to deduct only $20,000, which is the amount of his own capital at risk.

Under present law, the at risk rules apply to investments in all activities except real estate. However, the at risk rules generally do not apply if a taxpayer invests in an activity directly (and not though a partnership). The at risk rules apply to direct investments only if they are made in movies, farming, leasing of property other than real estate, or oil and gas.

For the most part, the at risk rules do not apply to corporations. However, they do apply to personal holding companies and to Subchapter S corporations. In addition, they apply to a corporation which invests in an activity (other than movies, farming, leasing of property other than real estate, or oil and gas) through a partnership.

There are several theories on which the Internal Revenue Service can attack tax shelter transactions that are not subject to the at risk rules. The success of the attack, however, depends on establishing elusive facts, such as the fair market value of unique property. Because of this, attacking these shelters under present law through an expanded audit program is difficult, expensive, and relatively unproductive. 2/

Reasons for Change

The at risk rules can be an effective means for dealing with certain tax shelter abuses that cannot be adequately dealt with on a case by case basis. They do not interfere with legitimate business transactions because they do not prevent a taxpayer from deducting losses that could possibly reduce his real wealth. There are, however, three weaknesses in the present at risk rules.

First, although they apply to all activities except real estate, the at risk rules do not apply to direct investments in most activities. Tax shelter promoters have exploited this weakness extensively and developed a wide range of investments suitable for direct ownership. For example, the following investments were widely advertised for direct sale to individual owners at the end of 1977: master phonograph records, lithographic plates, books, 3/ Christmas trees, coal mining, gold mining, and research and development. These investments were generally priced within the reach of upper middle class taxpayers. For example, a gold mine was sold by the square foot.

Second, the at risk rules generally do not apply to corporations. One leading member of the tax bar has commented on this as follows:

> "It is difficult to find any logical reason for this favored treatment of corporations. It probably arises from the perception (clearly erroneous) that it is individuals who reap the maximum benefit from tax shelters, and from the view (equally erroneous) that tax shelter syndicates do not generally include corporate limited partners. . . .If the Act is successful in closing the tax shelter syndication market to many individuals, the purveyors of tax shelters eventually will saturate the corporate market.
>
> Tax shelter investments are as available to corporations as ever. To the extent individuals have been effectively legislated out of this market, the corporate investors should have less competition and therefore better terms. Of course, many corporations seeking tax shelter investments may be (and are) privately and very closely held. Indeed, tax shelter holds much attraction for those with section 531 problems; accumulated earnings are available to buy shelter. Publicly owned corporations, with the exception of financial institutions and insurance companies which represent the principal market for equipment leasing tax shelters, generally have not indulged in pure tax shelter transactions." 4/

Under present law, the at risk rules do apply to personal holding companies. Personal holding companies are more likely than most other corporations to invest in tax shelters because they are closely held. Five or fewer shareholders must own more than 50 percent of the stock of a personal holding company. A closely held corportion may be able to pass the benefits of a tax shelter through to its shareholders, if the shareholders are also employees. 5/ Thus, an investment made by a closely held corporation in a tax shelter may be equivalent to an investment made directly by the shareholders. Even if the controlling shareholders are not all employees, tax shelters may be used to defeat the accumulated earnings tax. 6/

On the other hand, these opportunities are generally not available to widely held corporations. Few employees of a widely held corporation are able to control the timing and amount of their compensation, and no shareholder is likely to be able to control the corporation's investment policy. In addition, few widely held corporations are subject to the accumulated earnings tax. Further, a widely held corporation is unlikely to enter into a transaction that has no economic substance because such a transaction may be challenged either by shareholders or the Internal Revenue Service. A widely held corporation generally is subject to frequent audits by the Internal Revenue Service and to the public disclosure requirements of the Securities and Exchange Commission.

It has been common for widely held corporations to invest in only one kind of tax shelter--equipment leasing. However, equipment leasing by corporations has the desirable effect of making the tax incentives to new investment more efficient. Typically, the lessee does not have enough income to make full use of these tax incentives (chiefly the investment credit and accelerated depreciation). On the other hand, the lessor (typicaly a bank) does have enough income. The equipment lease allows the lessor to realize the benefit of the tax incentives, and to pass at least part of the benefit along in a form that the lessee can use--lower rents. Because the same corporate tax rate applies to both the lessee and the lessor, the tax benefit is no greater than Congress intended it to be. However, if the lessor is a closely held corporation, there can be an abuse. As previously explained, an investment made by a closely held corporation in a tax shelter may be equivalent to an investment made directly by the shareholders. Where this is so, and where the shareholders are in tax brackets above the maximum corporate rate, the tax benefits will exceed those which Congress intended to provide. Thus, equipment leasing by a closely held corporation may lead to tax abuse, even though equipment leasing by a widely held corporation is generally a desirable activity.

Although widely held corporations have made limited use of other tax shelters thus far, they may enter the market after other taxpayers have been excluded by these proposals. The Administration will continue to monitor tax shelter activity and will propose further expansion of the rules in this area if new abuses develop.

The third weakness in the at risk rules is that, if read literally, they require the taxpayer to be at risk only for the brief moment that the deductions are allowed. Therefore, it may be possible to defeat the at risk rules by careful timing. For example, in 1979 an investor puts $100,000 at risk and deducts $60,000. In 1981, the investor withdraws $90,000 of his original investment. Although the remaining $10,000 could not support a deduction of $60,000, the investor may have succeeded in circumventing the at risk rules.

General Explanation

Under the proposal, the at risk rules will extend to all activities except real estate. They will apply whether an investment is made directly or through a partnership. In addition, the at risk rules will extend to all closely held corporations (i.e., to all corporations that have five or fewer controlling shareholders). Further, a special provision will be added to prevent taxpayers from using careful timing to circumvent the at risk rules.

Nonrecourse loans have traditionally been used to finance the purchase of real estate. They are used for legitimate financial reasons and not to avoid taxes. Therefore, the at risk rules will not be extended to real estate. The Administration is, however, making other proposals to deal with certain real estate tax shelters.

Effective Date

The proposed changes will apply to transactions entered into after December 31, 1978.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	14	10	8	5	6

Technical Explanation

The Internal Revenue Code now contains two different sets of at risk rules. The first set (section 465 of the Code) applies to four activities--movies, farming, leasing of property other than real estate, and oil and gas. It applies whether an investment in one of these four activities is made directly or through a partnership. The second set of at risk rules (section 704(d) of the Code) applies to all other activities, except real estate. However, it applies only to investments that are made through a partnership (and not to those that are made directly). The Administration proposal will extend the first set of rules (section 465) to all activities except real estate. Therefore, the second set of rules (section 704(d)) will become unnecessary and will be repealed.

The at risk rules will also be extended to apply to all closely held corporations (i.e., all corporations in which five or fewer shareholders own more than 50 percent of the stock). Thus, the at risk rules will apply to any corporation that meets the stock ownership test for a personal holding company, regardless of the source of the corporation's income. On the other hand, the at risk rules will be restricted to Subchapter S and closely held corporations, and will not apply to other corporations in any circumstances.

In addition, a new provision will be added to ensure that taxpayers cannot use careful timing to circumvent the at risk rules. This provision will require a taxpayer to recognize income if three conditions are met. First, the taxpayer has deducted losses from an activity. Second, the taxpayer reduces the amount that he has at risk in the activity during a subsequent taxable year. Third, the losses taken as deductions exceed the amount remaining at risk. (For this purpose, the amount at risk is not reduced by losses.) If these three conditions are met, the taxpayer must recognize income to the extent that the losses taken as deductions exceed the amount remaining at risk. For example, a taxpayer buys a movie for $100,000 in cash and deducts losses of $60,000 in 1979. In 1981, he borrows $90,000 on a nonrecourse loan secured by the movie. At the end of 1981, the taxpayer has only $10,000 remaining at risk in the movie (disregarding the losses sustained in 1979). Therefore, he must recognize $50,000 7/ (i.e., $60,000 - $10,000) of income 8/ in 1981.

Footnotes

1/ The at risk rules are also effective against tax shelters that transfer deductions from a low bracket taxpayer to a high bracket taxpayer. For instance, in the example in the text, the at risk rules would limit the buyer's

deductions even if the purchase price of the book equalled fair market value. This limitation is necessary to prevent tax abuse if, for example, the seller is a corporation in the 44 percent tax bracket and the buyer is an individual in the 68 percent tax bracket.

2/ In Rev. Rul. 77-110, 1977-1 Cum. Bull. 58, the Internal Revenue Service stated that the basis of a movie does not include the portion of the purchase price paid with a nonrecourse loan made by the seller and secured by the movie, if the fair market value of the movie does not approximate the amount of the loan. Aggressive tax shelter promoters have either disregarded the ruling or else relied upon highly questionable appraisals, and continued to sell this type of investment.

3/ In Rev. Rul. 77-397, I.R.B. 1977-44, the Internal Revenue Service stated that the at risk rules do apply to the direct acquisition and leasing of master phonograph records. In News Release IR-1921 dated December 23, 1977, the Service announced that the principles of Rev. Rul. 77-397 apply to similar arrangements involving books, lithographic plates, musical tapes and similar property. Aggressive tax shelter promoters, however, have taken the position that the ruling is incorrect and have continued to sell these investments. In this area, the proposed legislation will be a helpful confirmation of existing law.

4/ Martin J. Rabinowitz, Some Reflections on the Social and Economic Impact of the Tax Reform Act of 1976, 31 The Tax Lawyer 163, 171-172 (1977).

5/ A simple example illustrates the possible advantages. Assume Mr. A, a taxpayer in the 60 percent marginal bracket, is the sole shareholder of corporation X and that in year one X has $20,000 of taxable income before payment of a bonus to A.

Case 1. At the end of year one, X distributes the $20,000 to A as a bonus. X is allowed a $20,000 deduction and has no taxable income for the year. A pays $10,000 of tax (the maximum tax on earned income) and invests the remaining $10,000 in a bond that yields 10 percent before tax. In year two, A will earn $1,000 in interest on the bond and pay $600 of tax, leaving him with $10,400 after tax.

Case 2. X invests in a tax shelter that produces $20,000 of deductions in year one and a matching $20,000 of income in year two. The deductions allow X to reduce its taxable income to zero in year one, so that it has $20,000 of cash and no tax liability. X invests the $20,000 in a bond that yields 10 percent before tax. At the end of year two, X has $2,000 of income from the bond plus $20,000 of income from the tax shelter. X pays the $22,000 to A at the end of

year two as salary and owes no corporate tax. A will pay $11,000 of tax (the maximum tax on earned income) and be left with $11,000.

In Case 2, A's investment yield on his $10,000 of after tax salary is $1,000 rather than $400 as a result of the use of a tax shelter at the corporate level.

6/ If a corporation has an unreasonably large accumulation of earnings, it may be subject to an accumulated earnings tax. The tax is up to 38-1/2 percent of the corporation's taxable income (after certain adjustments). However, if a corporation invests in tax shelters and reduces its taxable income, it can escape the accumulated earnings tax. Further, by using its earnings to invest in tax shelters the corporation can make it difficult for an IRS agent to detect accumulated earnings. The agent might find it hard to distinguish between investments in tax shelters and the corporation's regular business assets merely by examining the books of the corporation.

7/ The $50,000 recognized in 1981 recaptures the losses taken as deductions in 1979. Thus, in effect, the taxpayer is denied a deduction for these losses. However, the taxpayer will be permitted to deduct these losses if he increases his amount at risk in the movie in 1982 or any later year.

8/ The $50,000 recognized in 1981 will have the same character as the losses deducted in 1979. For example, if the losses were capital losses, the $50,000 recognized in 1981 will be a capital gain.

CLASSIFICATION OF LIMITED PARTNERSHIPS

Present Law

The Internal Revenue Code currently provides definitions of the terms "partnership" and "corporation." The term "partnership" is defined to include most syndicates, groups, pools, joint ventures, and other unincorporated organizations. The term "corporation" is defined to include associations, joint-stock companies, and insurance companies. These definitions are, however, very general. As a result, in determining whether an organization is properly classified as a partnership or corporation for tax purposes, the principal source of law is the decision of the Supreme Court in Morrissey v. Comissioner, 296 U.S. 344 (1935). The existing regulations draw upon the rationale of this decision in describing corporate and noncorporate characteristics.

In addition, the existing regulations provide that an organization formed as a partnership under local law will not be classified as a corporation for tax purposes unless it has more corporate characteristics than noncorporate ones. This "preponderance" test was adopted in response to the decision in United States v. Kintner, 216 F. 2d 418 (9th Cir. 1954), in an effort to keep unincorporated organizations from obtaining the benefits of corporate pension plans. As a result of this long-standing bias in the regulations, organizations formed as partnerships under the Uniform Limited Partnership Act are nearly always classified as partnerships for tax purposes. This bias was recently criticized by the Tax Court in its decision in Philip G. Larson, 66 T.C. 159 (1976). In that case the Court found that the tax shelter partnership before it more closely resembled a corporation on the basis of the criteria set forth in the Supreme Court's decision in Morrissey. The Court concluded, however, that the existing regulations compelled classification of the organization as a partnership.

Under present law, partnerships are not treated as taxable entities. Each partner is taxed on his share of the partnership income, and each partner is allowed to deduct his share of any partnership losses. Consequently, partnerships are an effective means for joint participation in tax shelters. On the other hand, corporations (except for certain electing corporations with a limited number of shareholders) are taxed as separate entities. Losses sustained by a corporation do not reduce the shareholders' income. Thus, corporations are generally not as effective a

means for joint participation in tax shelters.

Reasons for Change

Syndicated partnerships are being used as the vehicle for many thousands of tax shelters. These tax shelters are advertised in daily newspapers throughout the country. For example, advertisements of a 200% "year end" real estate shelter, a "400% coal shelter," and a "5 to 1 cattle breeding shelter" all appeared in the Wall Street Journal on Thursday, December 22, 1977. Such flagrant exploitation of tax shelters has done much to destroy public confidence in the tax law. Moreover, many publicly marketed shelters owe their success to a widespread misunderstanding of the tax law. Often, participants in tax shelters do not understand that for each artificial deduction they take today, they must include an equal amount in income at some future time. Many participants claim the deductions but fail to report the income.

In addition, a syndicated partnership is, to all intents and purposes, the equivalent of a corporation. The limited partners are not responsible for the debts of the partnership and have no voice in its day-to-day management. As a practical matter, moreover, the syndicated partnership has the same ability to maintain its existence as a corporation, and a limited partner has the same ability to transfer his partnership interest as he would stock in a comparably sized corporation. Were it not for the long-standing bias in the existing regulations, these partnerships would be classified as corporations under the criteria enunciated by the Supreme Court in the Morrissey decision. Because substantive differences between a syndicated partnership and a corporation are minimal, the same tax rules should apply to both.

Further, the Internal Revenue Code treats a partnership largely as an aggregate of individuals. Many limitations, deductions, and credits must be calculated separately by each partner. The tax effect of distributions depends on each partner's adjusted basis in his partnership interest. Special allocations of partnership income and losses and of particular items of income, gain, loss, and deduction can be made, as can special elections affecting the depreciable basis of assets with respect to a particular partner. These features of partnership taxation were intended to offer flexibility, and to preserve some degree of individuality, for the members of small partnerships. In the case of large syndicated partnerships with many passive investors, however, they complicate the law and are both unnecessary and inappropriate.

General Explanation

The proposal will treat a partnership formed after the effective date as a corporation for tax purposes if the partnership has more than 15 limited partners. However, the proposal will not apply to a partnership if substantially all (i.e., more than 90 percent) of the partnership's assets consist of new low-income housing. The Administration plans to study present methods of subsidizing low-income housing. So long as a special benefit is provided to new low-income housing through accelerated depreciation, it would be inappropriate to apply the proposal to such a partnership.

Under the Administration's proposals, the maximum number of limited partners in a partnership--15--will be the same as the maximum number of shareholders in a Subchapter S corporation. Thus, a business organization, whether it is formed under local law as a corporation or a limited partnerhsip, will be allowed conduit tax treatment if it is owned by 15 or fewer passive investors.

Effective Date

Generally, the effective date will be December 31, 1978. However, if substantially all of a partnership's assets consist of housing, the effective date will be December 31, 1982. (As stated above the proposal does not apply to a partnership if substantially all of its assets consist of new low-income housing.)

The proposal will apply to any partnership formed after the effective date. In addition, the proposal will apply to a partnership formed on or before the effective date in two circumstances. First, it will apply if the number of limited partners increases after the effective date. Second, it will apply if a limited partner contributes money or property to the partnership after the effective date (unless the contribution is made pursuant to a binding agreement entered into on or before the effective date). For this purpose, a partner will not be treated as making a contribution merely because the partnership retains some or all of its earnings.

Revenue Estimate

The proposal has a negligible effect on tax liabilities.

Technical Explanation

If a partnership has more than 15 limited partners, it will be treated as a corporation for tax purposes. Once a partnership is classified as a corporation, it will always be treated as a corporation (regardless of any subsequent decrease in the number of limited partners). In applying these rules, the term "partnership" will include any unincorporated organization availed of for investment purposes or for the joint production, extraction, or use of

property. It will be immaterial whether the organization is a joint venture for joint profit, and it will be immaterial whether the organization seeks to elect under section 761(a) not to be treated as a partnership.

Generally, the term "limited partner" will mean a partner whose liability is limited under local law to the amount of his investment (including amounts he is contractually obligated to invest). Five additional classes of investors will also be treated as limited partners. First, if a Subchapter S corporation is a partner in a partnership, then each shareholder will be treated as a limited partner. Second, if a grantor trust is a partner in a partnership, then each person who is treated as an owner of the trust will also be treated as a limited partner. Third, if a partnership is a general partner in a second partnership, then each limited partner in the first partnership will be treated as a limited partner in the second partnership. Fourth, if a partnership is a limited partner in a second partnership, then each partner (whether limited or general) in the first partnership will be treated as a limited partner in the second partnership. Fifth, if a partner assigns his interest in a partnership, and if the assignee includes a share of the partnership income or losses in his own income, then the assignee will be treated as a limited partner. However, a person who is both a general partner and a limited partner will be treated as a general partner for tax purposes, and will not be counted toward the ceiling of 15 limited partners. In addition, a partner who performs full-time personal services for the partnership (or who has performed such services for 36 months or longer) will not be counted toward the ceiling of 15. Further, a husband and wife will not be counted as more than one partner.

In certain circumstances, a partnership could be recognized as such for a period of time, and then be reclassified as a corporation. For example, a partnership with 15 limited partners will be reclassified as a corporation when a 16th limited partner is added. Whenever a partnership is reclassified as a corporation, the partners will recognize gain under section 357(c) of the Code to the extent that the partnership's liabilities exceed its assets.

AUDIT OF PARTNERSHIPS

Present Law

Partnerships are not subject to Federal income taxation. Although the items of income, gain, loss, deduction and credit are computed at the partnership level, they are taken into account separately by each of the member partners. The partners are liable for any Federal income tax in their individual capacities. Partnerships are required only to file an annual information return, which sets forth the items of income, deduction, and credit and includes the names, addresses, and distributive shares of the partners as well as any other information required by regulation.

Since the partnership is not a taxable entity, there is no administrative mechanism for making tax adjustments at the partnership level. Nor is the partnership subject to civil penalties for failure to file, or late filing of, a partnership return. Although the Service may examine partnership books and records in consultation with one or more general partners, the Service must audit each partner separately with respect to partnership matters, even though each such audit may involve the same substantive partnership determinations. 1/ For example, whether a partnership has correctly computed its depreciation allowance for the taxable year, and whether partnership allocations have been properly made, must be separately determined for each member of the partnership. A settlement arrived at by one partner with an agent is not binding on any other partner or on the agent who deals with such partner. Similarly, a judicial determination of a partnership tax dispute may be conclusive only as to those partners who are parties to the proceeding. Thus, each separate deficiency or overpayment attributable to the partnership may be the subject of a separate administrative proceeding, and, at the option of each partner, the subject of a separate judicial proceeding.

Reasons for Change

Present law does not permit the Service to make adjustments to partnership tax items at the partnership level that are binding on the partners. The result is a multiplication of administrative effort and, in some cases, a proliferation of lawsuits to decide the same issue.

The fact that partnership issues are ultimately

determined at the taxpayer level may impose a substantial administrative burden on the Service since it is required to control each taxpayer's return individually while the partnership matter is being determined. Once a partnership issue is raised, the Service must locate and review the partnership return while placing the partner's return in "suspense" pending completion of the partnership audit. Often, the partner return and the partnership return will be filed in different districts. Occasionally, there may be different locations for the partner return, partnership return, principal office or place of business of the partnership, partnership books and records, principal partnership asset and principal general partner. In addition, items relating to a partnership may be reported on an individual return even though the partnership return has not as yet been filed.

Once a partnership return has been selected for review, a decision must be made as to whether an examination of the partnership books and records is warranted. In many cases, where it appears that little or no benefit would accrue from an examination, the audit process ends with review of the partnership return. If an examination is required, the partner who signed the return will be contacted, and arrangements made to conduct the examination. At the same time, the Service must identify, locate, notify and obtain waivers of the individual statute of limitations from each partner. This may be an extremely difficult process. The Service must frequently proceed on the basis of incomplete, inaccurate, or out of date information supplied on the partnership return. Taxpayer-partners may reside in many different Internal Revenue districts. The partnership under examination may itself be a partner in another partnership, and may include as partners other partnerships, as well as corporations, trusts and estates.

If the Service cannot locate the ultimate partners and obtain waivers, the partnership review may be futile since the limitations periods may close for many of the partners. Even if the Service is successful in locating a partner, the partner may refuse to provide a waiver, thereby forcing the Service to issue a deficiency notice for some partners but not for others. As a result, with respect to the same partnership matter, there may be partners who have waived the statute of limitations period, partners who have refused to provide waivers and, therefore, received deficiency notices, and partners who could not be located and whose limitations period closed.

Any partner may separately litigate a partnership issue at any time. A partner need only refuse to extend the statute of limitations, forcing the Service to issue a statutory notice of deficiency. The partner then has the option of proceeding in Tax Court, or paying the deficiency

and contesting the Service's position by means of a claim for refund.

In the case of a contested audit of a large partnership, waivers of the individual statute of limitations will be obtained for as many partners as possible while a limited number of "test" cases proceed through litigation. This "suspensing" of partner returns keeps the returns open for all issues, until the partnership issues are settled. Each separate return represents a separate case requiring individual control and separate pleadings. Joinder is possible with the agreement of the partners, but has not proven particularly effective.

An administrative or judicial determination arrived at with respect to one partner generally does not preclude another partner from challenging the same issue. Partners are free to challenge partnership level determinations and, in effect, reopen the partnership audit in their local districts. Thus, it is impossible to obtain one final binding administrative determination of a tax issue arising from a partnership. This may result in lack of uniformity and consistency.

Current partnership audit rules, therefore, produce two generally undesirable consequences. First, in order to audit a partnership, the Service must separately control each tax return which includes an item attributable to that partnership. Second, even if the Service successfully initiates and manages a partnership audit, each partner may separately determine where and when his partnership matter will be determined.

The problems of effectively auditing partners of partnerships have been present for a long time. However, these problems have been vastly compounded by the widespread use of partnerships in the tax shelter area. The large number of partners involved in syndicated, and often interrelated, tax shelter partnerships makes Service efforts to ensure compliance with the tax laws extremely difficult under existing administrative and judicial procedures.

The size of partnerships, measured by number of partners, has grown dramatically in recent years. Although the total number of partnerships increased by only 16.3 percent in the 10-year period from 1966 through 1975, the average number of partners per partnership increased by 52.6 percent during the same period.

This expansion in size of partnerships is attributable to a rapid increase in the number of very large partnerships. Table IID-5 indicates where this growth has occurred.

Table IID-5

Growth in Size of Partnerships*/

Number of Partners Per Partnership:	2-4	5-10	11-50	51-100	101-500	501 or more	Total Number of Partnerships
Number of Partnerships:							
Year							
1975	909,704	103,434	54,941	2,860	1,610	545	1,073,094
1974	911,951	96,672	49,137	2,328	1,803	377	1,062,268
1973	899,238	90,384	45,505	2,056	1,559	350	1,039,092
1972	867,604	80,200	40,620	2,013	1,266	309	992,012
Percentage change, 1972-1975	4.9	30.0	35.5	42.1	27.2	76.4	8.2

*/ All figures are estimates based on samples Data by number of partners available only from 1972.

During the period 1972 through 1975, the total number of partnerships grew by only 8.2 percent. The larger partnerships, however, proliferated much more rapidly. The largest growth occurred in partnerships with 501 or more partners, which increased by 76.4 percent during the four-year period.

These large partnerships are most often involved in coast-to-coast tax shelter activities. For example:

- o One promoter has put together over 35 partnerships involving over 55,000 partners, for an average of over 1,500 partners per partnership. One of these partnerships has more than 7,500 partners.

- o A group of promoters established over 350 partnerships with more than 3,000 separate limited partner interests. The investors are located in all seven Internal Revenue regions, and in 52 out of the 58 Internal Revenue districts.

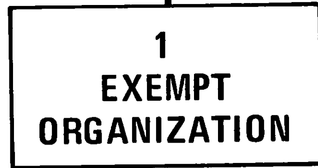
- o Another promoter created over 20 partnerships involving over 5,000 separate investments and more than 1,600 limited partner investors located all across the country. Some of the partnerships have more than 400 partners.

Size alone is not the only troublesome factor. Partnerships may be "pyramided" in multi-tiered arrangements of enormous complexity. Examples of such arrangements appear on the following pages. Tiering is possible since partnerships may include as partners not only individuals, but other partnerships, as well as corporations, trusts, and other entities.

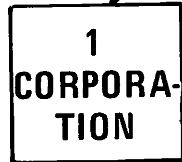
If a trust is a partner, an additional layer of complexity is added as beneficiary returns must be identified, located, and controlled. Worse still, is the partner that turns out to be a partnership. In such arrangements, usually part of tax shelter schemes, tracing may be extremely difficult. Once it is discovered that an entity being audited is a partner, or that a partnership includes as a partner another partnership, it may take many months to identify completely the next partnership tier. New partnership identification numbers are frequently only "applied for" and partnerships frequently file in districts other than the one in which their address is located. Moreover, in a multi-tier situation, the audit will not always begin with the top tier. If the audit begins elsewhere, as it frequently will, the Service must cope with expanding and controlling the audit as upper- and lower-tier entities are identified.

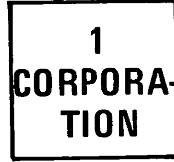
FIRST TIER

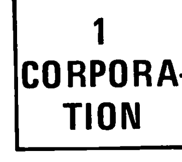
SECOND TIER

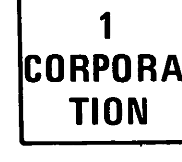


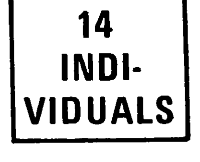
THIRD TIER

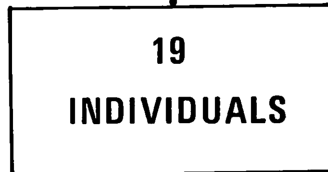


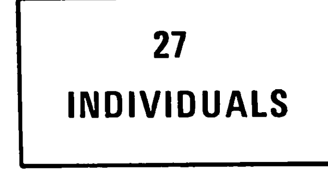












TOTAL RETURNS

Partnership	7
Others	69
	76

FIRST TIER

1 PARTNERSHIP 5 PARTNERS

SECOND TIER

1 INDIVIDUAL

3 TRUSTS

1 PARTNERSHIP 21 PARTNERS

THIRD TIER

UNDETERMINED NUMBER OF BENEFICIARIES

15 INDIVIDUALS

4 TRUSTS

2 PARTNERSHIPS

UNDETERMINED NUMBER OF BENEFICIARIES

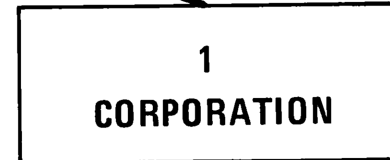
UNDETERMINED NUMBER OF PARTNERS

TOTAL RETURNS

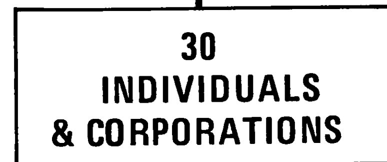
Individuals	at least 16
Trusts	at least 7
Partnerships	at least 4
	at least 27

FIRST TIER

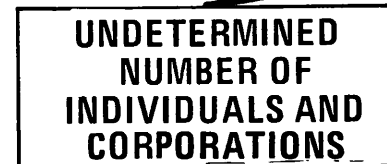
SECOND TIER

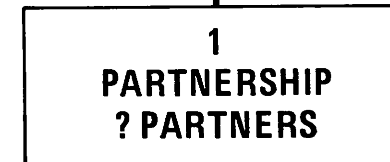


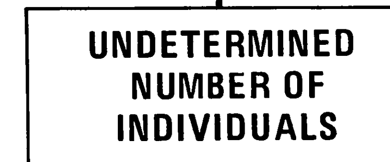
THIRD TIER



FOURTH TIER







TOTAL RETURNS

Individual & Corporate	at least 80
Partnership	9
	at least 89

For example, the Service recently conducted a limited coordinated tax shelter program designed to examine a total of less than 100 partnerships in four primary tax shelter areas: motion pictures, farm operations, real estate, and oil and gas. This limited program resulted in the administrative nightmare of examining the tax returns of approximately 450 partnerships and 23,100 investing partners. In addition, over 50,000 other returns with similar issues were examined. These results highlight the fact that through the partnership rules, a virtually limitless number of taxpayers may be involved with a single partnership. The initial audit sample of less than 100 partnerships required almost 450 partnerships to be audited because of partnership tiering. Such multi-tiered arrangements substantially increase the Service's burden of locating individual partners and auditing their returns within the requisite statute of limitations period.

It has become increasingly clear that tax shelters have proliferated in significant part because promoters and investors believe that there is little risk that the Service can muster an effective audit against the investors in the shelter. Thus, highly creative and ingenious tax positions which are often taken by a tax shelter limited partnership and which are questionable under the law can go unchallenged because of the necessity to audit separately each and every member of the partnership within the requisite limitations periods. If, however, partnerships were audited at the partnership level, potential investors in tax shelters would have to take into account the very high probability that their investments will be subject to close scrutiny by the Service. Given the fact that under current law, most shelter investors do not take the possibility of extensive IRS audit seriously, it may be expected that the full implementation of this proposal will have a significant impact on shelter activity.

General Explanation

Under the proposal, the partnership will be treated as an entity for purposes of the audit of partnership-related issues, including administrative settlement and judicial review. The Service will make determinations at the partnership level of the correct amount of partnership taxable income or loss, and the partners' distributive shares of partnership items. This determination will be conclusive, and the individual partners, as well as the Service, will be precluded from seeking any further substantive review. As under current law, the member partners will remain subject to any changes in tax liabilities resulting from a determination of these issues, but a subsequent audit of a partner's return will be limited to the correct mathematical application of the partnership level determination.

In order to facilitate the audit at the partnership level, each general partner will be presumed authorized to act for the partnership. However, all partners will be accorded the status of interested parties and allowed to participate in all aspects of administrative proceedings.

In order to ensure that all partners have a fair opportunity to participate in the administrative and judicial determination of partnership tax matters, the Service will be required initially to notify each partner that the partnership's books and records are being examined. At the conclusion of the administrative proceeding, either by settlement or ultimate disagreement, the Service will be required to issue a notice of final administrative determination to the partnership, and to notify each member of the partnership accordingly.

The partnership level determination will be subject to the statute of limitations at the partnership level based upon the limitations rules now in effect generally. Any waiver of the period may be consented to by any general partner. Once the statute of limitations has run at the partnership level, the partnership's return becomes final, and there can be no adjustment of items on a partner's return attributable to the partnership. Discrepancies between the partner's return and the partnership's return will then be treated as mathematical errors. Assessments of tax or claims for refund at the partner level based on a final determination at the partnership level may be made at any time within one year after the partnership level determination has become final. Thus, the partnership statute of limitations automatically keeps the partner statute of limitations open for changes attributable to the partnership.

The entity approach extends to initiating changes in partnership items. A partnership will be permitted to initiate a redetermination of partnership items by simply filing an amended partnership return within the partnership's limitations period. However, individual partners will not be permitted to initiate a partnership level redetermination, or to file individual claims for refund based upon partnership matters if the claims are inconsistent with the partnership return.

The partnership may seek judicial review of a final partnership determination, or bring an action for redetermination upon denial of, or inaction with respect to, a partnership-initiated proceeding. This judicial proceeding must be brought in the name of the partnership. The action may be brought in the Tax Court, Federal District Court, or Court of Claims. All partners will be provided an opportunity to participate in the judicial proceeding.

Current law and procedures will generally continue to apply to the review of nonpartnership matters. Such matters may be resolved separately from partnership matters.

It is anticipated that the audit of the partnership will be conducted in the district in which the principal place of business or principal office of the partnership is located. While this may cause inconvenience to some partners under certain circumstances, this provision is essential in order to consolidate the partnership level audit effectively.

Since a meaningful audit at the partnership level places great emphasis on the partnership return, the timely and proper filing of such return should be encouraged. The complete absence of civil penalties under current law for late filing and failure to file is inconsistent with this objective. Thus, under the proposal, the partnership return will be treated as a tax return rather than as an information return. Late filing and failure to file partnership returns will be subject to penalties. As under current law, the return must be filed in accordance with the location of the partnership's principal office or principal place of business.

Effective Date

Existing partnerships. Partnerships existing as of January 1, 1979 will be subject to the rules of this proposal starting with the second taxable year of the partnership beginning after December 31, 1978.

New partnerships. All partnerships formed after December 31, 1978 will be subject to the rules of this proposal.

Revenue Estimate

The proposal will have a negligible effect on tax liabilities.

Footnote

1/ Present law does not require a separate administrative or judicial proceeding for each partner. Any set of partners may voluntarily join together at any stage from district conference through judicial appeal, and consent to a mutually binding determination. However, the Service cannot require any group of partners to join together in a single proceeding and subject themselves to a mutually binding determination.

TAX-SHELTER ANNUITIES

Present Law

A typical annuity contract provides for the issuing life insurance company, in return for a purchase price paid either in a lump sum or in installments, to make periodic payments to the purchaser, usually from the time of retirement until death. 1/ Annuities may be classified broadly into two main groups: immediate annuities and deferred annuities.

The purchaser of an immediate annuity begins to receive annuity payments on, or shortly after, the date the annuity is purchased.

Under a deferred annuity, the purchaser begins to receive annuity payments at a time significantly after the date on which the contract was purchased. Payments under a deferred annuity generally commence when the annuitant attains a given age (e.g., 65). Between the time the premiums are paid and the commencement of annuity payments (the "accumulation period"), the premiums (after deduction of expenses) are invested by the company and earn interest. These earnings may be reinvested by the company, distributed to the purchaser as dividends or, in some instances, may be withdrawn at the purchaser's election.

At the end of the accumulation period the premiums and accumulated interest (less expenses, withdrawals and dividends) constitute a fund that may be used to purchase an annuity at rates originally guaranteed by the insurance company. In lieu of using the fund to acquire an annuity, the purchaser almost always has the option of receiving the amount in the fund as a lump sum cash payment (the "cash option"). The purchaser of a deferred annuity generally does not lose access to the invested funds; in most cases the contract grants the purchaser the right to withdraw his premiums and accumulated interest, in whole or part, at any time before the commencement of annuity payments.

Under present law the interest earned on the premiums deposited in a deferred annuity is not taxed to the purchaser during the accumulation period. Instead, a ratable share of this interest is taxed to the recipient as each annuity payment is received (or is taxed in full on receipt of a lump sum cash payment). The purchaser is thus permitted unlimited deferral of income taxes on the accruing interest until the end of the accumulation period (unless the contract is surrendered before that date).

The rules for taxing dividends and cash withdrawals from annuity contracts during the accumulation period are also favorable. Cash withdrawals and dividends are deemed to come first from principal and are thus tax-free. Only after the purchaser has made withdrawals and/or received dividends in an amount greater than the aggregate premiums paid will such distributions be taxable. In effect, a policyholder may withdraw amounts equal to all or a substantial portion of the interest earned tax-free.

Reasons for Change

Traditionally, most annuity contracts purchased by individuals were immediate annuities. The annuity was viewed as a safe, conservative but low-yielding investment purchased by individuals who wished both to provide for income during their retirement and to ensure against the possibility of outliving their assets.

Where deferred annuities were sold, it was typical for the issuer to guarantee both the rate of interest, usually limited by state law and quite low, at which the principal would grow during the accumulation period and the rates at which an annuity could be purchased at the end of that period. Although taxes were not imposed during the accumulation period, the relatively low yields and high expenses (or "loading" costs) rendered deferred annuities unattractive to high-income taxpayers by comparison with other investment alternatives (e.g., municipal bonds).

In recent years the traditional role of the deferred annuity as a retirement income vehicle has changed dramatically. Emphasizing the combined benefits of tax deferral during the accumulation period, cash options providing for lump sum settlements and the tax-favored treatment of contract withdrawals, brokers and other promoters have been actively marketing deferred annuities to high-income taxpayers as tax shelters. The transformation of retirement annuities into tax shelters was summarized in a recent article in the financial press:

> "HIGH TAX-DEFERRED YIELDS ON ANNUITY POLICIES GIVE THEM FRESH APPEAL TO SOME INVESTORS
>
> * * *
>
> "As everybody knows by now, you can't outperform the stock market. Bond prices may fall. Commodities are risky. Tax shelters are leaky. Gold pays no interest. Savings-account earnings are taxable. So where's the smart money going these days?
>
> "Well, some of it is going into one of the

oldest and dowdiest 'investments' around.

"Insurance. That right. Specifically, insurance that yields a return as high as 7% or 8% with income taxes deferred for as long as you tie up your money.

"This insurance is known technically as a single-premium deferred annuity contract. The name is a little misleading. You may buy a contract and add to your investment by paying more than one premium, and you may buy a contract without ever committing yourself to a lifetime annuity.

* * *

"A tax lawyer with no particular ax to grind says, 'If you need to balance your investments with a fixed-income vehicle, and if you can get 8% that accumulates tax-deferred, then you're in real good shape with this kind of annuity.'

"'Annuities have been in existence a long time,' Shearson Hayden Stone observes. 'Traditionally they carried very low yields of 2.5% - 3% and high sales charges, perhaps as much as 70% of the initial amount invested, and were therefore a poor investment.' That is <u>not</u>, Shearson hastens to add, the kind of annuity now being offered -- 'a modern new deferred annuity which features high guaranteed interest rates.'" 2/

Instead of being sold by insurance salesmen, tax-shelter annuities are being promoted aggressively by stock brokers as a means to accumulate tax-free income. The annuity feature and the provision for income during retirement play a distinctly subsidiary role in the marketing of these annuities. The following promotional literature illustrates their predominantly tax-shelter nature:

"HOW TO POSTPONE TAXES LEGALLY AND EARN INTEREST ON UNCLE SAM'S MONEY . . . With An Investment That Never Goes Down, Always Goes Up, And Is Guaranteed Against Loss.

"If you're successful enough to be in a tax bracket that forces you to share at least 35% of your top dollars with the I.R.S., you deserve something better than congratulations. You need an investment that not only is safe, with good earning rates, but which also allows you to keep more of the interest you earn than you can with regular savings accounts, CD's, or

other investments that do not provide you tax-favored interest benefits.

"Tax deferred annuities have become enormously popular with successful people because the Internal Revenue Code permits you to pile up interest indefinitely, and not pay a penny of taxes until you take your money out--usually at retirement when your tax bracket is likely to be lower. By not paying taxes on the interest every year, you actually earn extra income with Uncle Sam's money!

"To demonstrate how beneficial this tax postponement can be to you, just see what happens when the same amount of money is put into a tax-deferred annuity and a savings account, both at the same rate of interest and for the same length of time -- assuming a continuing interest of 7 1/2 % per year for the entire period illustrated. ($30,000 is used here only as an example. You can put in as little as $5,000, or as much more as you wish.)

	BANK SAVINGS ACCOUNT		TAX-DEFERRED ANNUITY
Age	35% Tax Bracket	50% Tax Bracket	
30	$ 30,000	$ 30,000	$ 30,000
40	$ 48,288	$ 43,351	$ 61,830
50	$ 77,725	$ 62,644	$127,435
60	$125,106	$ 90,524	$262,648
65	$158,722	$108,819	$377,066

"Your money is safe because it is guaranteed by a legal reserve life insurance company. Your cash value (never less than your total payments) may be withdrawn in whole or part at any time. However, as with bank certificates of deposit, withdrawals may be subject to surrender charges.

"And you can take out any part of the money you put in and pay no taxes; while the balance of your principal and all accumulated interest continues to grow tax-free . . . ."

In addition to being more attractive than taxable investments, the high interest rates at which tax-shelter annuities are being offered may actually make them more attractive to some high-income taxpayers than investments in tax-exempt municipal bonds. 3/ For example, if a taxpayer who anticipates being in a 35 percent or lower bracket during retirement invests $30,000 in a deferred annuity bearing interest at a rate of 7 1/2 percent and elects to receive a lump sum cash payment after 20 years, he will realize a return of $87,535 after taxes and expenses. 4/ Municipal bonds of comparable security and maturity would bear interest at approximately 5 1/4 percent per annum. 5/ Thus, an investor who purchased $30,000 of such bonds, and invested the resulting tax-exempt income in additional tax-exempt bonds, would accumulate only $83,476 on his investment after 20 years.

What is perhaps an even more serious abuse of the tax treatment traditionally afforded retirement annuities is presented by a variation of the deferred annuity known as a "wraparound" or "investment" annuity. This device permits a taxpayer to defer paying tax on income from existing investments, such as bank accounts or common stocks, by the simple expedient of "wrapping" an annuity around these investments. The nature of the wraparound or investment annuity, and the dangers inherent in the existing situation, were recently summarized in a financial journal:

> "Keystone Custodian Funds manages over $1.7 billion in mutual funds, but the product that has the company most excited at the moment comes from the company's insurance subsidiary, Keystone Provident Life. The product is called the investment annuity or 'wrap-around' annuity. Keystone is joining a growing number of companies offering this instrument.
>
> "The investment annuity resembles other annuities save for this crucial difference: You determine what securities make up the annuity. In effect, the wraparound allows you to take an existing investment, use it to 'buy' an annuity and thus defer taxes on all interest and dividends.
>
> "Say you have $100,000 of 8.7% American Telephone & Telegraph bonds due in 2002. By wrapping it around an annuity, your account can collect $8,700 a year, and you pay no income taxes until you actually begin collecting on your plan, which can be, if you wish, decades hence.
>
> "'For anyone in the 30% income bracket or higher,' says W. Thomas Kelly, chairman of the First Investment Annuity Co. of America, which invented the product,

'this is something to be seriously looked at.'" 6/

Although the Internal Revenue Service has ruled that these so-called "investment annuities" do not qualify for tax deferral as annuity contracts (Revenue Ruling 77-85, 1977-1 Cum. Bull. 12), under a recent court decision, if sustained, it is possible that these devices can be used by high-income taxpayers to defer tax on their investment income while retaining the same, active control over their investment portfolios as though the annuity never had been purchased. See Investment Annuity, Inc. v. Blumenthal, No. 77-810 (D.D.C. November 9, 1977), notice of appeal filed (D.C. Cir. January 3, 1978).

The ability to defer tax on otherwise taxable investments (such as long-term certificates of deposit) by simply "wrapping" them in what looks like an annuity could turn the deferred annuity into the exclusive method for high-income taxpayers to purchase investment assets. This possibility has not been overlooked by promoters, as evidenced by the following excerpts from sales literature for wraparound annuities:

"HOW DO YOU WANT YOUR INTEREST, WITH OR WITHOUT CURRENT TAXES?"

* * * *

"YOU NO LONGER NEED TO PAY CURRENT TAXES ON INTEREST AND DIVIDEND INCOME WHEN YOU UTILIZE THE BENEFITS OF A TAX-DEFERRED INVESTMENT ANNUITY.

"Unlike other annuities, the investment annuity allows the owner to direct the investment of the funds within his personal custodian account. You may choose from a broad list of accepted assets. This permits you to use our high interest yielding certificate accounts as well as stocks, bonds and mutual funds."

* * * *

"NOW YOU CAN DEFER INCOME TAXES ON CURRENT INTEREST AND DIVIDEND INCOME ON YOUR SAVINGS ACCOUNTS AND OTHER ASSETS. ($10,000 MINIMUM)

"The key is a tax-deferred Investment Annuity. Under Section 72 of the IRS Code, certain tax advantages are available to holders of an Investment Annuity contract.

"The Investment Annuity is a policy for long range

financial planning ($10,000 minimum).

"The annuity policy permits the owner to direct the choice of permitted investments and to change investments, both before and during retirement."

The recent growth in sales of deferred annuities has been dramatic, reflecting the appeal the foregoing abuses have for the investing public. It is at least partly because the rules governing taxation of deferred annuities have not been revised, while the rules governing taxation of other investment vehicles (such as long-term certificates of deposit and original issue discount bonds) have, that the deferred annuity has acquired such substantial recent popularity. Deferred annuities are now virtually the only remaining, widely-available investment vehicle that enables investors to defer taxes on regularly recurring investment income.

Moreover, the current abuses have had undesirable side effects. For example, there has been a substantial diversion of savings into deferred annuities and away from commercial banks, savings and loan associations and other forms of saving. The magnitude of the shift was noted in a recent journal:

"So far in 1977, Americans are shifting funds into these tax-delaying devices at an annual rate of between 800 million and 1 billion dollars, one expert estimates. That's about seven times more than just three years ago.

"The total is expected to soar even higher. People are looking for places to reinvest billions of dollars they socked into savings certificates carrying unusally high rates of interest that were issued in 1973 by banks and other lending institutions and started maturing around the middle of this year.

"Most funds for deferred annuities in the past two years have been coming from cashed-in stocks, bonds, mutual funds and savings accounts. But some families have even mortgaged their houses and put the proceeds into the annuities." 7/

This shift in the flow of savings, induced solely by unwarranted differences in tax treatment, is undesirable.

The current abuses of the deferred annuity also pose a serious threat to the elaborate rules designed by Congress over the past 40 years to safeguard qualified retirement plans, most recently in the Employee Retirement Income

Security Act of 1974. These rules prevent employers from discriminating against lower paid or non-owner employees. However, by purchasing a deferred annuity a self-employed person can obtain tax deferral similiar to that available through a qualified retirement plan (e.g., a Keogh Plan), thereby providing generously for his own retirement without providing retirement benefits for his employees. This may be a particularly attractive option in conjunction with an Individual Retirement Account ("IRA"). An IRA may be established by any individual not covered by a qualified plan. Like a deferred annuity, earnings in an IRA are not taxed currently to the owner. In addition, contributions to an IRA, like those to a qualified plan, are deductible. However, to avoid the use of IRAs by self-employed persons to circumvent the non-discrimination rules applicable to qualified plans, Congress has generally limited annual contributions to an IRA to a maximum of $1,500.

This use of a deferred annuity was publicized in a recent article:

> "Virtually everyone is eligible for the tax break [available through a deferred annuity]. You do not have to work for a company that lacks a pension plan, as you do in order to set up an IRA--an Individual Retirement Account. And if you are self-employed, you do not have to provide pensions for your employees as you do when you establish a so-called Keogh Plan.
>
> "Those features have brought a surge of popularity to the 'nonqualified deferred annuity,' so labeled because it does not qualify as an IRA under the pension-reform law." 8/

Thus, a further reason for revising the current tax treatment of deferred annuities is to forestall their use by self-employed persons as a way to provide for their own retirement with tax-deferred income, while avoiding the expense of providing retirement benefits for their employees.

General Explanation

The proposal will correct the current abuse of using deferred annuities as tax shelters without interfering with their traditional role as investments that ensure retired persons against the risk of outliving their income.

The tax deferral afforded income earned during the accumulation period of a deferred annuity will be eliminated. Income earned during the accumulation period will be taxed currently to the policyholder. This change will apply to all deferred annuities, including variable annuities and the so-called "wraparound" or "investment" annuities. Taxation of earnings annually to each policyholder will bring the tax

treatment of these contracts into line with that applicable to similiar investments such as certificates of deposit and original issue discount bonds. The change will not, however, apply to deferred annuities purchased or provided under a tax-favored retirement plan, such as a qualified retirement plan or an individual retirement annuity.

In recognition of the fact that the traditional deferred annuity can play a legitimate role in planning for retirement, the proposal will permit an individual to designate a single deferred annuity contract, the annual contributions to which may not exceed $1,000, as one for which the tax deferral of present law would continue. The $1,000 annual limitation on contributions should preclude the use of designated contracts by high-income taxpayers as tax shelters, and by self-employed persons as a means to avoid providing retirement benefits for their employees.

The present law treatment of cash withdrawals and dividends from annuity contracts as tax-free returns of principal will be changed. Under the proposal, withdrawals and dividends distributed during any year will be treated as taxable to the extent of untaxed accumulations of income as of the end of the year of distribution; only after these distributions have exhausted the previously untaxed income will they be considered tax-free returns of principal. Loans from the issuing company to the holder of the annuity contract will be treated as distributions for this purpose.

Effective Dates

Income earned after December 31, 1978, and during the accumulation period (i) of non-qualified deferred annuity contracts issued after January 31, 1978, or (ii) on contributions made after January 31, 1978, to non-qualified deferred annuity contracts issued before February 1, 1978, will be taxed currently to the purchaser.

Dividends, cash withdrawals and loans made by the issuing company to the contract holder after December 31, 1978, and during the accumulation period of any non-qualified deferred annuity contract, will be treated as taxable distributions to the extent of the accumulated untaxed income as of the end of the year of the distribution, regardless of when the contract was issued or the income was earned.

Revenue Estimate

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	12	26	40	57	80

Technical Explanation

A. In General

Income earned during the accumulation period of a deferred annuity contract will be taxed to the policyholder in the year credited to his account or otherwise earned. A deferred annuity contract will be defined to include any annuity contract under which the annuity payments commence more than one year after payment of the initial premium. However, it will not include an annuity purchased or provided under a tax-favored retirement plan, such as a qualifed pension or profit sharing plan or an individual retirement annuity, or an annuity purchased with amounts excludable from income under section 403(b) of the Internal Revenue Code.

The issuer of a deferred annuity will be required to report to both the contract holder and the government the amount of interest or other earnings paid or credited in connection with the contract each year. These reporting requirements should not pose significant problems for the life insurance companies that issue annuities.

Owners of the annuity contracts will be required to include in their taxable incomes each year the amount of income reported to them by the company. Amounts taxed to the owner during the accumulation period will be added to the investment in the contract and will not be taxed again when the contract is surrendered or annuity payments are received.

In the case of variable annuities the holder will be taxed only on current investment income, whether or not distributed. No change is proposed in the treatment of realized gains or losses from the sale or other disposition of assets held by the issuer of a variable annuity.

For all deferred annuity contracts, including designated contracts (described below) and contracts issued before February 1, 1978, any dividends distributed or other withdrawals will be treated as having been made first out of accumulated and untaxed income as of the close of the year of

distribution and, to the extent thereof, as taxable during that year. Loans after December 31, 1978, by the issuing life insurance company to the holder of a designated contract or a deferred annuity contract issued before February 1, 1978, will be treated as taxable distributions to the extent of the previously untaxed income under the contract as of the end of the year in which the loan was made.

B. Designated Contracts

An individual will be permitted to designate a single deferred annuity contract, the earnings on which will remain eligible for tax deferral during the accumulation period. The individual will be required to designate the contract as one qualifying for deferral by informing the issuer at the time the contract is purchased. The designated contract must be separate from any other annuity contract held by the same purchaser. The maximum annual premium under a designated contract will be limited to $1,000 per year.

The only contracts that may qualify as designated contracts will be those in which the issuing life insurance company guarantees the purchaser both a return of the aggregate premiums paid in (less any applicable loading or surrender charges) plus the lower of (i) the maximum rate of interest that may be guaranteed under state law for the duration of the contract, or (ii) the rate actually offered for the duration of the contract. Any contract whose value depends, in whole or part, on the value of an underlying investment fund or segregated asset account will not be eligible for designation.

While unwithdrawn interest on a designated contract will be excludable from income, any dividends or other withdrawals from, or loans from the issuer of, a designated contract will be treated as coming first from accumulated and untaxed income and, to the extent thereof, as taxable during the year received.

As in the case of all deferred annuities, the issuing company will be required to report to both the government and the holder of a designated contract the earnings credited to the contract each year. The reporting form will identify the interest earned on a designated contract as being excludable from gross income during the accumulation period. This reporting requirement will ensure that each holder has purchased only a single designated contract and that the contributions thereunder do not exceed the $1,000 annual limitation.

The interest earned during the accumulation period of a designated contract will not be added to the policyholder's investment in the contract, and therefore will be taxed when received by the policyholder as annuity payments or in a lump sum.

C. Existing Contracts

The proposed elimination of tax deferral during the accumulation period of non-qualified deferred annuities will apply to contracts issued before February 1, 1978 only to the extent that the holder makes additional contributions to the contract after that date. Where additional contributions are made after January 31, 1978, subsequent earnings credited to the holder's account will be apportioned between those allocable to prior contributions (the earnings on which will not be taxed currently) and to subsequent contributions (the earnings on which will be taxed currently).

However, dividends, cash withdrawals and loans made by the issuing company to the contract holder after December 31, 1978 will be treated as taxable distributions to the extent of the accumulated and untaxed income as of the end of the year of the distribution, even if such income was earned and credited to the contract before February 1, 1978.

Footnotes

1/ The annuity payments may be made by the company for the life of an individual (a "single life annuity"), for the lives of more than one individual (a "joint and survivor annuity"), or for a specified period of time (an "annuity certain"). The individual during whose lifetime the annuity is payable is called the annuitant and is usually the purchaser of the contract.

2/ Wall Street Journal, May 2, 1977, page 32, Col. 1.

3/ These contracts are offered at interest rates as high as 7 to 8 percent despite the fact that state law reserve requirements applicable to life insurers prevent them from guaranteeing rates in excess of 3-1/2 to 4 percent for the duration of the contract. These limits have been circumvented by the combination of a guarantee of an underlying rate of 3-1/2 to 4 percent for the life of the contract, with an additional 3 to 4 percent guaranteed for shorter periods of time. Even though the full interest rate is not guaranteed for the life of the contract, the sales literature often represents that the purchaser can expect the combined interest paid each year to compare "very favorably to rates then being paid by other fixed money plans."

4/ At 7-1/2 percent compounded annually, $30,000 invested in a deferred annuity would grow in 20 years to $127,436.

Assuming surrender charges of 7 percent (or $8,921), the investor would receive a lump sum of $118,515. Taxes on the gain of $88,515 ($118,515 - $30,000) at 35 percent would amount to $30,980, leaving after tax proceeds of $87,535 ($118,515 - $30,980). If the taxable gain of $88,515 in one year pushed the taxpayer into a bracket higher than 35% he could elect to receive the $118,515 in periodic payments over several years.

5/ The 1977 annual average interest rate on tax-exempt general obligation bonds with a maturity of 20 years and rated AAA by Moodys was 5.21 percent. The 1977 annual average interest rate on such bonds with a rating of AA was 5.36 percent.

6/ Forbes Magazine, May 1, 1976, p. 86.

7/ U. S. News and World Report, October 10, 1977, page 91.

8/ Ibid.

EMPLOYEE BENEFITS

INTRODUCTION

The Internal Revenue Code provides favorable tax treatment for certain forms of compensation. If salary is paid in cash, it will be deductible by the employer and taxable immediately to the employee. However, compensation in other forms, while continuing to be deductible by the employer, may be either excluded entirely from tax by the employee or taxed only at a later date. This tax treatment can be justified only as a means of encouraging compensation to be paid in certain forms so that individuals, particularly lower income employees, will be assured of protection against certain contingencies -- sickness, disability, retirement -- which are particularly difficult to plan for at low income levels.

The tax law falls short of this goal. For life insurance and health plans, there is no requirement that employees at all levels be benefitted. Retirement plans ostensibly must not discriminate in favor of officers, shareholders, or other highly paid individuals to qualify for favorable tax treatment. Nevertheless, under current law too much of the tax subsidy of these arrangements (termed "qualified" plans) can inure to the benefit of the highly paid, and too little to the benefit of the low paid.

Moreover, exclusion and deferral of income are obviously of greater benefit to those taxpayers with high marginal rates. As the tax benefits expand, they seriously interfere with the goal of a progressive tax system and are increasingly unfair to those persons not employed by employers who provide compensation in the favored form.

The Administration proposes to reduce the disparate tax treatment which is based solely upon the form in which compensation is provided. Where such disparity remains, the Administration proposes to assure that it serves a public purpose by requiring that a greater proportion of the tax benefits inure to rank-and-file employees, compared with present law. Thus, the Administration proposes

-- assuring that a greater portion of the benefits from tax-favored qualified retirement plans will inure to the benefit of the lower-paid by modification of the rules by which such plans interrelate with Social Security.

-- requiring as a condition for obtaining favorable tax treatment that group-term life insurance and health and disability plans not discriminate in favor of officers, shareholders, or the highly paid.

-- repealing the $5,000 exclusion for death benefits paid by the employer.

-- taxing unemployment benefits for those with total income in excess of $20,000 per year ($25,000 in the case of a joint return).

QUALIFIED RETIREMENT PLANS AND SOCIAL SECURITY

Present Law

In General--Retirement plans can be classified as two principal types -- "defined benefit" plans and "defined contribution" plans. A defined benefit plan provides that an individual will receive a specified amount upon retirement; a defined contribution plan provides that specified amounts will be set aside each year, and the employee will eventually receive those amounts plus the earnings on them.

These plans qualify for advantageous tax treatment only if they do not discriminate in favor of officers, shareholders, or highly paid persons. The income tax benefits -- which include current deductions for employers, exclusion of the contributions from employee income, and tax exemption for income earned by the retirement fund -- are designed to induce employers to provide pensions. The objective of the anti-discrimination rule is to insure that employers in fact provide pensions for persons at all levels of their workforce, rather than primarily for officers, shareholders, or highly paid persons. When it first established the anti-discrimination rule in 1942, the House Ways and Means Committee reported:

> "The present law endeavors to encourage the setting up of retirement benefits by employers for their employees and in pursuance of this policy permits employers to take as a deduction amounts irrevocably set aside in a pension trust or other fund to provide annuities or retirement benefits for superannuated employees. This provision has been considerably abused by the use of discriminatory plans which either cover only a small percentage of the employees or else favor the higher paid or stock-holding employees as against the lower-paid or non-stock-holding employees. Under the present law, it is contended the officers of a corporation may set up pension plans for themselves and make no provision for the other employees. Such actions are not in keeping with the purpose of this provision.
>
> "The coverage and nondiscrimination requirements would operate to safeguard the public against the use of the pension plan as a tax-avoidance device by management groups seeking to compensate themselves without paying their appropriate taxes." 1/

Specifically, under current law, a plan must provide rank-and-file employees with at least the contributions or benefits expressed as a percentage of pay that are provided

for officers, shareholders, or the highly paid. For example, if an employer contributes 10 percent of pay, or $10,000, to a defined contribution plan for an employee earning $100,000, the employer must also contribute 10 percent of pay on behalf of a lower-paid employee -- for example, $1,200 if the employee earns $12,000 -- in order for contributions not to be discriminatory. However, the law permits an exception to the percent-of-pay rule in the case of plans which take Social Security into account. This process is called "integration".

Specifics of Integration -- An employer is permitted to "count" its employer contributions to the Social Security system in determining whether its plan discriminates in favor of officers, shareholders, or highly paid persons. Thus, employer contributions to a qualified plan may be heavily weighted in favor of higher-paid employees. For example, under a defined contribution plan an employer can contribute 7 percent of pay in excess of the Social Security wage base ($17,700 for 1978), which for an employee earning $100,000 amounts to $5,761. The plan would not be considered discriminatory even though the employer does not contribute anything to the qualified plan for an employee earning less than the wage base, because the employer will be deemed to have contributed 7 percent of pay up to $17,700 to Social Security for all employees. The deemed contribution rate of 7 percent does not depend upon the rate of tax under Social Security, which is currently below that level.

This type of plan is an "excess" plan, because the employer contributes only an amount determined by reference to the employee's pay in excess of the integration level. As the integration level increases, the opportunity to reduce coverage under an excess plan also increases. It is estimated that, beginning in 1981, 94 percent of all employees will earn less than the Social Security wage base, which for that year will be $29,700 (with automatic adjustments thereafter).

The more common type of integrated defined contribution plan is the step-rate plan, which provides some percentage of pay up to the integration level and a higher percentage of pay (but not more than 7 percent higher) above that level. For example, for 1978 an employer can contribute 5 percent of pay up to the Social Security wage base and 12 percent of pay in excess of the wage base for the $100,000 employee, amounting to $10,761, while under this formula a contribution of not more than $600 would be required for the $12,000 employee (5 percent of $12,000).

Defined benefit plans may be integrated in a similar fashion, although they are integrated on the basis of benefits rather than contributions. The rules for integration of these plans are even more complicated than the rules for defined contribution plans.

Integration is widely used. The Congressional Research Service concluded in 1974 that 60 percent of tax-qualified pension plans in existence at that time, covering approximately 25 to 30 percent of participants in the private pension system, were integrated with Social Security. 2/ Integration may be even more popular today given the substantial increases in Social Security taxes and the mandated wider coverage for lower income workers under the Employee Retirement Income Security Act of 1974 (ERISA).

Reasons for Change

Notwithstanding the anti-discrimination requirements and the major reforms under ERISA, retirement plans still afford substantial tax advantages which are more beneficial to a person in a higher tax bracket, because the higher-paid person, for whom more dollars are contributed, defers paying tax on more dollars, and also because deferral provides a greater tax subsidy per dollar for persons in higher tax brackets. Although the degree of difference varies from case to case, under one set of reasonable assumptions, the tax subsidy increases the pension benefit by 140 percent for an executive with a starting salary of $100,000, while the subsidy increases the benefit by only 60 percent for the employee with a starting salary of $10,000. 3/

The disparity is even greater in an integrated plan. An employer making the same dollar contribution (e.g. $5,922) to a private plan would distribute much more to the highly paid person, and much less to lower-paid persons, if the plan were integrated. 4/ Table IIE-1 illustrates how an integration provision affects the distribution of employer contributions to a plan, to the detriment of lower-paid employees.

Table IIE-1

Effect of Integration on Constant Employer Contribution

Salary of Employee	Defined Contribution Plan in 1978 Total Contribution of $5,922	
	Not Integrated (4.08%)	Integrated (7% above $17,700)
$ 10,000	$ 408	$ 0
15,000	613	0
20,000	817	161
100,000	4,084	5,761
Total Employer Contribution	$ 5,922	$ 5,922

The first Social Security law antedated the first nondiscrimination requirement for qualified plans. By the time the Treasury Department proposed a nondiscrimination requirement which was enacted as part of the Revenue Act of 1942, several large plans already existed which integrated benefits with Social Security. Consequently, integration was first developed at a time when there was undoubtedly concern about disturbing large, existing pension plans which had been established before there were nondiscrimination requirements.

Today, however, the integration of pension plans with Social Security is a widely used tax device which can result in lower-paid persons receiving inadequate retirement benefits. Integrated plans often are sold, particularly to smaller employers, on the assumption that such plans either exclude or provide relatively small benefits for lower-paid employees earning below the Social Security wage base. Employers are encouraged -- before they provide any private retirement income for lower-paid persons -- to provide retirement income at higher levels of pay equivalent, on a percent-of-pay basis, to the benefit provided by Social Security for those with lesser earnings.

The above approach therefore suggests two assumptions. First, it assumes that it is more important to provide after retirement the same percent of pre-retirement pay at all income levels than it is to provide minimum benefits for

lower-paid persons. In fact, however, the percentage of pre-retirement earnings that are essential to fulfill basic needs after retirement decreases as earnings increase. Second, and the logical extension of the first assumption, the current tax system implies that Social Security is adequate for lower-paid persons (but not for higher-paid persons), so that only a higher-paid person's retirement income need be tax subsidized through a private plan. In fact, however, if Social Security were adequate for rank-and-file employees, there would be no need for a tax subsidized private pension system at all. If Social Security is not adequate, one must question the extent to which tax benefits must flow disproportionately to higher-paid persons, often to the total exclusion of the rank-and-file, in order to encourage adequate retirement pay at all levels of the workforce.

The inequity in the current system of Social Security integration has been recognized by Congress. Congress has imposed severe limitations on the use of Social Security integration in plans that benefit owners, such as Keogh plans for the self-employed, and it has prohibited integration in plans designed especially for rank-and-file employees--employee stock ownership plans. Further, during the consideration of ERISA, Congress, through the Conference Committee, voted a freeze on further integration as a temporary measure prior to full consideration of the integration question after a two-year Congressional study. Because of last minute opposition, the freeze was deleted by a concurrent resolution of the Congress.

Integration has been defended by employers on the grounds that, without it, they would have to provide more than 100 percent of pre-retirement pay to lower-paid persons in order to provide an adequate percent of final average pay to higher-paid persons. Employers also contend that the cost of an apparently excessive <u>deferred</u> benefit (<u>i.e.</u>, one in excess of 80 percent or 100 percent of final average pay) results in lower current wages for lower-paid persons, and that it unnecessarily lowers their pre-retirement standard of living. One could see some justification for these arguments if, in fact, the employer and Social Security together provided a reasonable percentage (such as 80 percent) of final average pay for the $10,000 employee. But, under the current integration system, there is no requirement that employers provide any specified percentage of final average pay to lower-paid persons.

Social Security integration also has been justified, not on the grounds of encouraging rational public policy, but on the grounds that employers should be able to "count" their contributions to Social Security as part of their overall retirement programs. But there is only a small correlation between an employee's benefits under Social Security and the

amount an employer contributes for that employee. The Social Security benefits of a current employee are not directly funded by his or her employer. Rather, such benefits are largely funded by employer and employee contributions paid after the worker has retired; that is, the Social Security system is essentially on a pay-as-you-go basis.

The basic integration rules, in addition to encouraging inequity, are exceedingly complex; integrated plans, therefore, are less easily understood by participants than are other plans. As the Social Security wage base and benefits have changed over the years, so, too, have the numerous rules which coordinate the Social Security wage base and basic benefit with the way in which a plan can be integrated. Complications also result because plans almost always provide more than retirement benefits (for example, there may be disability and death provisions) and because benefits may be paid at different ages and in different forms (for example, a lump sum distribution or life annuity). The integration rules have elaborate actuarial adjustments for these ancillary benefits and variations as they relate to each type of plan.

General Explanation

The principal abuse of integration is that it uses tax subsidies to permit, and even encourage, benefits to be paid to very highly paid persons while paying none at all to lower-paid persons. The Administration proposes to end this abuse, while still permitting employers to use integration to limit retirement benefits so that benefits from Social Security and private pensions do not exceed a certain percent of pay. This could be accomplished by allowing plans to integrate only if they provided a specified minimum benefit designed to provide full replacement of pre-retirement earnings. This approach, which would add another layer of complexity to the existing integration rules, would entirely deny the benefits of integration to those plans which did not set full replacement as a goal. The proposal, however, does not go this far but rather provides a formula for integration which would approximate the ideal result while, at the same time, virtually eliminating the complexity of integration.

The basic integration rules will be replaced with a formula establishing a maximum ratio of contributions or benefits above and below the integration level. More specifically, so long as a plan provides X percent below the integration level, it could provide up to 1.8 times X percent above that level. In a defined contribution plan, for example, an employer could contribute 9 percent of pay on wages above the plan's integration level if it contributed 5 percent of pay on wages below the integration level.

A similar rule will apply to the type of plan that "offsets" the Social Security benefit against the plan benefit. The offset (or negative part of the formula) will be governed by the positive part of the formula. Specifically, a plan could offset the same percent of Social Security benefits as the percent of final average pay used to compute the plan's gross benefit. That is, a plan could offset by 50 percent of the Social Security benefit if it provided for a benefit of 50 percent of final average pay.

Analysis of Impact

The integration rules proposed here will substantially affect only plans which tend to be highly discriminatory in favor of higher-paid persons by excluding or virtually excluding the rank-and-file. For example, a plan under which an employee received nothing on pay up to the taxable wage base ($17,700 in 1978) and 7 percent of pay in excess of the taxable wage base will no longer qualify. On the other hand, plans designed to provide for the retirement of employees at all levels rather than as a tax shelter for a few highly paid individuals will generally continue to meet the integration tests. For these plans, any required changes will generally be relatively minor.

Tables IIE-2 through 7 show some common formulas under current law and under the proposal and how these formulas will affect employees at different wage levels.

Table II E-2

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan A-- Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 3/ of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 0% up to $11,004 of compensation; 18% over $11,004						
Private pension benefits only	0%	5%	11%	14%	15%	16%
Private pension and social security benefits	54%	41%	30%	25%	23%	22%
Plan under Proposal: 10% up to $11,004 of compensation; 18% over $11,004						
Private pension benefits only	10%	12%	15%	16%	17%	17%
Private pension and social security benefits	64%	48%	34%	27%	25%	23%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the

Table II E-3

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement,
Selected Private Pension Plans Under Present Law and
Under the Integration Proposal

Integrated Defined Benefit Plan B-- Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 of-- 3/					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 0% up to $11,004 compensation; 36% over $11,004						
Private pension benefits only	0%	10%	23%	28%	31%	32%
Private pension and social security benefits	54%	46%	42%	39%	39%	38%
Plan under Proposal: 20% up to $11,004 of compensation; 36% over $11,004						
Private pension benefits only	20%	24%	30%	32%	34%	34%
Private pension and social security benefits	74%	60%	49%	43%	42%	40%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ **Assumes employees retire at age 65 in 1982 with 35 years of service with employer.**

2/ **Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.**

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-4

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan C -- Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for 3/ Employees with Final Average Pay 2/ in 1982 of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 16 1/2% up to $11,004 of compensation; 54% over $11,004						
Private pension benefits only	17%	26%	40%	46%	48%	50%
Private pension and social security benefits	71%	62%	59%	57%	56%	56%
Plan under Proposal: 30% up to $11,004 of compensation; 54% over $11,004						
Private pension benefits only	30%	36%	45%	49%	50%	51%
Private pension and social security benefits	84%	72%	64%	60%	58%	57%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan -- Excess Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for 3/ Employees with Final Average Pay 2/ in 1982 of--					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 52 1/2% up to $11,004 of compensation; 90 over $11,004						
Private pension benefits only	53%	62%	76%	82%	84%	86%
Private pension and social security benefits	107%	98%	95%	93%	92%	92%
Plan under Proposal: 50% up to $11,004 of compensation; 90% over $11,004						
Private pension benefits only	50%	61%	75%	81%	84%	86%
Private pension and social security benefits	104%	97%	94%	92%	92%	92%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ **Assumes employees retire at age 65 in 19 with 35 years of service with employer.**

2/ **Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.**

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

Table II E-6

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement, Selected Private Pension Plans Under Present Law and Under the Integration Proposal

Integrated Defined Benefit Plan E-- Offset Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 of-- 3/					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 50% of final average pay, offset by 83 1/3% of primary insurance amount.						
Private pension benefits only	5%	20%	34%	40%	44%	45%
Private pension and social security benefits	59%	56%	53%	52%	52%	51%
Plan under Proposal: 50% of final average pay, offset by 50% of primary insurance amount						
Private pension benefits only	23%	32%	40%	44%	46%	47%
Private pension and social security benefits	77%	68%	59%	55%	54%	53%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patters of replacement which will be in effect under the Social Security Amendments of 1977 after the

Table II E-7

Administration's Pension Integration Proposal

Effect on Employees: Benefits as Replacement of Earnings at Retirement,
Selected Private Pension Plans Under Present Law and
Under the Integration Proposal

Integrated Defined Benefit Plan F-- Offset Plan	Replacement of Earnings at Retirement (Percent of Final Average Pay) 1/ for Employees with Final Average Pay 2/ in 1982 of-- 3/					
	$5,000	$15,000	$30,000	$50,000	$75,000	$100,000
Present Plan: 100% of final average pay, offset by 83 1/3% of primary insurance amount.						
Private pension benefits only	55%	70%	84%	90%	94%	95%
Private pension and social security benefits	109%	106%	103%	101%	101%	101%
Plan under Proposal: 100% of final average pay, offset by 100% of primary insurance amount.						
Private pension benefits only	46%	64%	81%	89%	92%	94%
Private pension and social security benefits	100%	100%	100%	100%	100%	100%

Office of the Secretary of the Treasury
Office of Tax Analysis

January 25, 1978

1/ Assumes employees retire at age 65 in 1982 with 35 years of service with employer.

2/ Final average pay is assumed to be average over the last 5 years; earnings are assumed to increase at 6% per year.

3/ The Social Security amounts shown do not reflect the special transition minimum benefits available for retirees in the early 1980's. Thus, the numbers reflect patterns of replacement which will be in effect under the Social Security Amendments of 1977 after the transition period.

The new rules will apply only to benefits accruing after the effective date, so that even if an employer chose to increase benefits for some employees, the employer would not be required to fund any increased benefits for periods prior to the effective date.

Also, because elaborate rules will no longer be necessary, administrative costs will decrease for all integrated plans. For instance, the current rules provide different types of adjustments for different types of plans, different benefits, and persons retiring in various years. The proposal will require only minor adjustments in such cases.

Effective Date

The new formulas will apply to benefits accrued for plan years beginning after December 31, 1979.

Revenue Estimate

It is not possible to project the revenue impact of this proposal; the proposal may have a negligible impact on revenues. Some employers would change their plans by providing higher benefits for rank-and-file employees; others might shift their costs by providing somewhat lesser benefits for higher-paid persons to meet the need for more benefits for the lower-paid. It is also possible that the simplified rules and the provision of minimum benefits would encourage some employers to integrate previously nonintegrated plans.

Technical Explanation and Transition Rules

In general -- The current rules relating to Social Security integration will be replaced with a rule under which a plan will not be viewed as discriminatory in favor of officers, shareholders, or highly compensated employees merely because it provides benefits or contributions in the form of:

> X percent of total compensation not in excess of a specified integration level, plus no more than
>
> 1.8 times X percent of total compensation in excess of that level.

The rule will apply to both defined contribution and defined benefit plans and to plans providing unit or flat benefits. The X factor will be specified by the employer.

Adjustments for any pre-retirement ancillary benefits, post-retirement annuity forms, early retirement benefits, or employee contributions will be required only to the extent these features are internally inconsistent. For example, an

X percent/1.8X percent plan will not have to adjust if employee contributions are Y percent up to the integration level and 1.8Y percent in excess of that level (e.g., 3.0 percent and 5.4 percent). If, however, employee contributions are a constant percentage of all compensation, an adjustment will be required. Also, a plan will not have to adjust if the annuity is payable in the form of a 10-year certain and continuous benefit, so long as the annuity both above and below the integration level is paid as a 10-year certain and continuous benefit. And no adjustment will be required even though some plans might use different types of compensation (career average pay, final average pay, etc.), so long as the same type is used to compute benefits both above and below the integration level.

Each separate plan of an employer will be required to satisfy the new rules, or all plans maintained by an employer can be aggregated to satisfy these rules. Thus, for example, if an employer maintains an integrated plan and a nonintegrated plan, contributions or benefits under both plans can be aggregated to determine whether the new integration requirements are satisfied. (However, aggregation will be limited to plans which provide similar degrees of retirement security. For example, a profit sharing plan allowing discretionary withdrawals of employer contributions prior to death, disability, or other separation from service could not be aggregated with a pension plan, since the two plans do not provide similar degrees of retirement security.) Further, as under present law, a plan which does not satisfy the integration rules might nonetheless be nondiscriminatory under the particular facts and circumstances.

Excess plans -- The integration level for a defined contribution or a defined benefit excess plan will be computed in much the same manner as is provided under the current rules. For plans which use the Social Security wage base to measure the integration level (such as a profit sharing plan), the maximum permissible integration level for a particular year will continue to be the Social Security wage base for that year as determined under the Social Security Act. These are fixed amounts ranging from $17,700 to $29,700 for 1978 through 1981, with automatic adjustments after 1981. A plan will not be permitted to use a higher integration level with a smaller spread between the percentage of contributions above and below the higher level. That option would introduce significant complexity and would reintroduce the problem existing under the current rules of disproportionately large benefits for a very highly compensated participant.

For plans using an integration level based upon covered compensation, the Internal Revenue Service will provide new tables of covered compensation. These tables will not take

into account the newly enacted indexing provisions of the Social Security Act, since the future level of indexing cannot be precisely forecast during any current year. The table amounts will be maximums; a plan will not be able to use a higher level of covered compensation by adopting a smaller benefit spread.

Offset plans -- Offset plans maintain a different benefit structure and, therefore, will use a different rule. An offset plan will be permitted to reduce the gross benefit provided under the plan (the plan benefit before reduction for Social Security, usually expressed as X percent times final average pay) with that portion of the Social Security primary insurance amount (PIA) equal to the same percent of the gross benefit percentage. That is, a plan will be permitted to offset up to 50 percent of Social Security if it applies the offset against a gross benefit of 50 percent of compensation, or a plan can offset 100 percent of Social Security if it applies the offset against a gross benefit of 100 percent.

The rule for offset plans will apply to both unit benefit and flat benefit plans. No adjustments will be required for pre-retirement ancillary benefits, post-retirement annuity forms, or early retirement benefits. However, the plan benefit derived from employee contributions will have to be subtracted from the gross benefit before determining the size of the allowable offset. Adjustments for form of pay will have to be made only if compensation other than final average pay is used. In that case, the employee's gross benefit will be determined and divided by final average pay to ascertain the equivalent X.

Transition rules -- The new formulas will apply only to benefits accrued after the effective date. Benefits accrued up to that date can be frozen at their levels under current law. In the case of a final average pay excess or step-rate plan, the benefits can be prorated, based on years of participation, to determine benefits accruing before and after the effective date. Alternatively, the benefit accrued up to the effective date, as if the employee terminated on that date fully vested, can be used to determine pre-effective date accruals. Similar proration rules will apply to offset plans. However, in lieu of these proration rules, a plan can provide a minimum total benefit for each employee (other than a 10 percent shareholder) equal to the employee's benefit computed under the plan as in effect immediately prior to the effective date, determined as though the employee's compensation continued until retirement or severance at the same rate as immediately prior to the effective date.

These transition rules are the same as those currently in use for transitions from the rules in effect prior to

July 5, 1968. The grandfather rules permit a gradual phase-in of the new integration requirements.

Footnotes

1/ The Revenue Bill of 1942, H. Rep. No. 2333, 77th Cong., 2d Sess., 50-51 (1942).

2/ Raymond Schmitt, "Integration of Private Pension Plans with Social Security," Issues in Financing Retirement Income, Studies in Public Welfare Paper No. 18, prepared for the use of the Subcommittee on Fiscal Policy of the Joint Economic Committee, U.S. Congress (Washington, 1974), pp. 173-200.

3/ The executive receives an after-tax pension of $85,145, compared with $14,713 for the lower-paid worker. The executive's pension includes $53,625 in tax subsidy, compared with only $5,655 for the lower-paid worker. Assumptions: Nonintegrated, 15% defined contribution plan; participation ages 35 to 65; 6% annual interest; 4% annual salary increases; joint returns; both employees have outside income equal to deductions and exemptions. The percent of tax subsidy is the ratio of the after-tax pension with tax benefits compared to the after-tax pension without tax benefits. "With tax benefits," 15% goes into a qualified plan; "without tax benefits," the same amount, reduced by taxes paid, goes into a savings account at 6% annual interest.

4/ Note that even in a nonintegrated plan, most of the dollar amount of the contribution, and therefore the tax benefits, goes to the highly paid person, because nondiscrimination is based on a percent of pay.

MEDICAL, DISABILITY, AND LIFE INSURANCE PROVIDED BY EMPLOYER

(1) PLANS WITH FIXED BENEFITS

Present Law

An employee can exclude from gross income the medical, disability, and group term life insurance benefits provided under plans maintained by his or her employer, even though the employer can deduct plan contributions 1/ and even though such a plan (referred to hereafter as a welfare plan) discriminates in favor of the highly paid. Retirement plans, on the other hand, do not receive favorable tax treatment if they so discriminate. Similar nondiscrimination requirements apply to qualified group legal services plans and supplemental unemployment compensation plans.

Reasons for Change

Under current law, an individual cannot deduct the premiums paid for life and disability insurance, and premiums for medical insurance are usually only partially tax deductible. Thus, the exclusion for benefits provided under an employer-sponsored plan affords more favorable tax treatment for those covered than is available for those who must purchase individual coverage.

Non-taxation of certain forms of income is obviously of greater benefit to those in higher marginal tax brackets and interferes with the policy of a progressive income tax. This departure from normal tax policy can be justified only as a means of securing protection for a wide group of employees. There is no reason to favor plans which cover only a highly paid group--persons who can more readily provide for themselves than can rank-and-file employees.

Current law has led to two particularly abusive situations. First, unfunded medical reimbursement plans can be established to cover primarily the stockholders or officers of a corporation. Although such a plan may cover one or a small number of rank-and-file employees for the purpose of countering an argument by the Internal Revenue Service that distributions constitute dividends, it results in clear discrimination against rank-and-file employees. Second, a corporation having a single dominant employee (who

is also the sole or majority shareholder) can adopt a funded or unfunded plan solely to make that employee's health insurance premiums or medical expenses fully deductible.

In the course of auditing returns, Internal Revenue Service agents have found numerous cases of medical plans providing coverage primarily, or only, for employee-shareholders and officers of the employer. The following are some specific instances of this problem reported by IRS auditors:`

(1) Corporation A established a medical plan for its three officer-shareholders. No other employees were covered. Over a three year period, $54,000 in medical bills for officers and their families were paid by the corporation. Over $46,000 of this amount was for the majority shareholder and the shareholder's family.

(2) Corporation B established a medical plan covering both officer-shareholders and some other employees, but with small amounts of coverage for the other employees. Over an eight year period during which the corporation expended $21,794 in connection with the plan, $18,604 was for the officer-shareholders.

(3) Corporation C adopted a medical reimbursement plan for all corporate officers, including the person who owns 100 percent of the corporation's stock. The corporation employs a number of other employees, none of whom are covered by the plan. The child of the 100 percent shareholder will require institutional care for life. The expenses of the child average $8,000 annually. The 100 percent shareholder is in the 50 percent income tax bracket and would not be able to deduct a significant part of the medical expenses because of the 3 percent floor applicable to individuals. The plan discriminates seriously against rank-and-file employees, and the sole shareholder, through control of the corporation, is able to circumvent the limitations on medical expense deductions for individuals.

(4) In a similar situation, corporation D adopted an accident and heath plan for the benefit of the individual who is both the sole shareholder and the sole employee of the corporation. Since there are no other employees, the plan is not actually discriminatory. However, the sole shareholder is in a position in which the limitations on the medical expense deduction for individuals would result in no allowable deduction. The adoption of the plan by the corporation causes a deduction to be available where it would not be available for the ordinary taxpayer who is not able to use a business entity to deduct medical expenses.

The cases cited here are not isolated. Furthermore, these schemes are being actively promoted, as witness an

advertisement in the January 17, 1978, Wall Street Journal entitled "Introducing...The Ultimate Tax Shelter" by Ted Nicholas. Mr. Nicholas, who promotes his book on the advantages of incorporated businesses, writes:

> "There are still other advantages. Your own corporation enables you to more easily maintain continuity and facilitate transfer of ownership. Tax-free fringe benefits can be arranged. You can set up your health and life insurance and other programs for you and your family wherein they are tax deductible. Another very important option available to you through incorporation is a medical reimbursement plan (MRP). Under an MRP, all medical, dental, pharmaceutical expenses for you and your family can become tax deductible to the corporation. An unincorporated person must exclude the first three percent of family's medical expenses from a personal tax return. For an individual earning $20,000 the first $600 are not deductible."

General Explanation

Under the proposal, special tax benefits will continue to be fully available with respect to an employer's medical, disability, or group term life insurance plan only if the plan satisfies certain minimum participation standards designed to prevent discrimination, and if the plan does not discriminate with regard to the benefits it provides. Thus, the plan could not discriminate in favor of officers, shareholders, or highly paid employees -- i.e. the so-called prohibited group, consisting of the same employees who are members of the prohibited group under the qualified retirement plan provisions. If benefits are provided under a discriminatory plan, employer contributions to the plan allocable to members of the prohibited group will be includible in the gross incomes of all covered members of the prohibited group. Exclusions for rank-and-file employees will continue to apply.

In addition, in order to deny special tax benefits for what is essentially an individual purchase of insurance, a limit will be established on the portion of the benefits provided for employee-owners. Similar conditions were applied to group legal services plans under the Tax Reform Act of 1976.

Effective Date

The new rules for welfare plans will apply for taxable years of employers beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
(Including proposal on Cafeteria Plans described below)
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	32	33	34	35	36

Technical Explanation

Plans Covered -- The proposal will apply to group term life insurance plans and accident and health plans which now receive favorable tax treatment under sections 79, 105, and 106 of the Internal Revenue Code. Benefits under these plans include term life insurance; payments during permanent or temporary disability; hospitalization, medical, and surgical benefits; and dental care. However, if any of these benefits are provided under a qualified retirement plan, the retirement plan rules will continue to apply.

Prohibited Group -- Discrimination in favor of a prohibited group of employees, consisting of officers and shareholders of the employer and those who are highly compensated, will not be permitted. This same definition of the prohibited group now is used for qualified retirement plans.

In the qualified plan area, there were previously attempts to circumvent the nondiscrimination requirements by artificially dividing a single business into two corporations under common control, with the members of the prohibited group employed by one corporation and the rank-and-file employees employed by the other corporation. The corporation employing the prohibited group would then establish a retirement plan, contending that the rank-and-file employees did not have to be covered by the plan because they were not employed by that corporation. ERISA attacked this problem by treating all employees as employees of a single employer when their employers are under common control. This will occur whether the employers are corporations, partnerships, or a mixture of those or other types of entities. The ERISA common control rules will apply to welfare plans.

Participation Standards -- (a) Waiting Period. A plan will not be able to provide more stringent conditions on

participation for rank-and-file employees than for members of the prohibited group. For example, a member of the prohibited group could not become a participant immediately upon employment if a member of the rank-and-file could participate only after one year of employment.

A plan should not be required to provide immediate coverage, since adverse selection against the plan could result. On the other hand, too long a waiting period could unduly favor the prohibited group, the members of which often will have more years of service at the inception of the plan. Therefore, a plan will not be discriminatory merely because it requires up to three years of actual employment before commencement of participation. Moreover, the plan could defer participation until the first day of the plan year beginning after the date on which an employee completed three years of employment.

A welfare plan can also meet the participation requirements by satisfying the ERISA participation rules for qualified plans (section 410(a) of the Code).

(b) <u>Permanence</u>. If a welfare plan provides coverage for members of the prohibited group, it will be nondiscriminatory only if it constitutes a permanent program. The test for permanence will be applied in the same fashion as the similar test is applied to qualified plans under section 401(a) of the Code. That is, a welfare plan will be presumed to be permanent at the time it is established. If the plan is terminated within a few years and in the absence of a business necessity, it may be held to be discriminatory from its inception. This rule is designed to preclude the establishment of a plan primarily for the purpose of benefitting a member of the prohibited group, with termination occurring after that member or a beneficiary has received a significant portion of the total benefits provided under the plan.

(c) <u>Eligible Group</u>. Qualified retirement plans historically have been subject to alternative tests for nondiscrimination in coverage. Under the rules in effect since 1942, a qualified plan will not be discriminatory if the plan provides benefits for: (a) 70 percent or more of all employees, or 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding employees who have not satisfied the plan's qualifying minimum age and service requirements, or (b) a group which the Service finds to be nondiscriminatory. These coverage tests will apply to welfare plans. As under ERISA, nonresident aliens and employees covered by collective bargaining agreements (if there is evidence that welfare benefits were the subject of good faith bargaining) can be excluded from consideration in determining whether the

coverage requirements are satisfied. Also, if a welfare plan is maintained pursuant to a collective bargaining agreement, the plan will automatically be viewed as nondiscriminatory with respect to eligibility (and benefits). The latter is not the rule under ERISA.

Benefit Standards -- A plan cannot discriminate on the basis of benefits. With regard to benefits (such as disability or life insurance) which are generally designed to replace wages, discrimination generally will not occur where benefits are proportionate to compensation. Thus, for example, a plan will be able to provide twice as much life insurance coverage for an employee in the prohibited group whose compensation is double that of a member of the rank-and-file.

In the case of health benefits (such as hospitalization, surgical, and medical benefits), the plan will have to provide the same benefits, dollar for dollar, for all employees and, where applicable, for members of employees' families. However, some plans provide options under which the level of benefits will vary with the level of contributions made by participating employees. Discrimination generally will not occur where the same employee contribution buys the same level of benefits and all employees have the same opportunity to make every level of employee contributions allowed under the plan. Discrimination will exist where there is employer coercion or if not more than an insignificant portion of the rank-and-file employees can reasonably afford the higher contributions. Discrimination will not exist merely because a significant number of rank-and-file employees choose to make smaller contributions and therefore receive smaller benefits or merely where, because of family status, a significant number of rank-and-file employees elect cheaper single-only coverage, whereas prohibited group employees make larger contributions and receive family coverage.

Limits on Benefits for Owner-Employees

Not more than 25 percent of the employer contributions can be used to purchase benefits for a class of individuals each of whom owns (directly or indirectly) an ownership interest of more than 10 percent. For example, assume that two individuals each own 50 percent of the stock of a corporation which employs both of them and one other individual. If contributions used to provide benefits for the shareholders exceed 25 percent of the total employer contributions under the plan, allocable employer contributions will be includible in the gross incomes of the shareholders even though all three employees are covered by the plan. (In the case of benefits which are generally designed to replace wages, this test can be applied on the

basis of benefits rather than contributions.) A similar general rule applies to qualified group legal services plans, but at a level of 5-percent ownership. Implementation of this rule at the level of 10-percent ownership matches the level at which the stricter rules for Keogh plans covering owner-employees become applicable.

In the case of an unfunded medical reimbursement plan with 25 or fewer participants, this limitation will be based on amounts of reimbursement rather than contributions. If such a plan has more than 25 participants, the test for discrimination in benefits will be based on benefits promised under the plan.

Determinations by Internal Revenue Service -- The Internal Revenue Service will not make advance determinations regarding whether a welfare plan is nondiscriminatory. Determinations regarding discrimination will be made on audit and will be applied retroactively only if the Internal Revenue Service further determines that the employer did not make a reasonable effort to meet the discrimination requirements or that the permanence requirement has not been satisfied. Alternatively, the plan will not be viewed as discriminatory for a past plan year if, within a reasonable time after the Internal Revenue Service determination, the plan can be (and is) made nondiscriminatory for the plan year.

(2) CAFETERIA PLANS

Present Law

Some plans provide only a single type of benefit, such as medical benefits, or various types of benefits in proportions fixed by the terms of the particular plan. Those plans are subject to the nondiscrimination proposal described above. Other plans, known as "cafeteria plans," are structured differently. These plans provide that a participant may designate how an employer contribution on the employee's behalf should be spent. In some cases, the participant may have the employer contribution paid, in whole or in part, in cash. If the participant's only choice is among benefits which, considered individually, would not result in the inclusion of any amount in gross income, the availability of the choice will not create immediate income. However, different rules apply if the participant may choose among benefits and at least one of those benefits, if offered separately (e.g., cash or group term life insurance in excess of the excludable amount), would immediately be includible in gross income.

As a result of ERISA, an employer contribution to a cafeteria plan in existence on June 27, 1974, must be included in a participant's gross income only to the extent that the participant elects to apply the contribution to a taxable benefit. If the plan was not in existence on June 27, 1974, the employer contribution will be includible in the participant's gross income to the extent that the participant could have elected to apply the contribution to a taxable benefit or benefits. These rules apply with respect to employer contributions made before January 1, 1978. ERISA does not provide specific guidance for contributions made thereafter.

Reasons for Change

A cafeteria plan may discriminate in favor of highly compensated employees of the employer. This can occur in either of two ways. First, rank-and-file employees may be excluded from coverage under the plan. Second, the plan may cover rank-and-file employees and provide for the allocation of employer contributions proportionate to compensation. In such cases, a rank-and-file employee often may obtain adequate medical benefit coverage only by designating most or all of that allocation to pay for medical benefits, which are typically the most expensive benefits provided under the plan. Since members of the prohibited group receive larger allocations of employer contributions, they are able to purchase the same level of medical coverage plus other tax-favored benefits which are not available, as a practical matter, to the rank-and-file participants.

The state of the law regarding cafeteria plans for the future is unsettled. Moreover, even under pre-1978 law, the tax treatment of a participant could differ significantly depending upon whether the plan was in existence on June 27, 1974.

General Explanation

If a cafeteria plan does not discriminate in the distribution of tax-free benefits between the rank-and-file and the prohibited group (officers, shareholders, and highly paid), then an employer contribution allocated to the account of a participant will be includible in the participant's gross income only to the extent that the participant designates all or part of the contribution to be used to purchase taxable benefits.

The nondiscrimination test will require that the plan give employees an equal opportunity to select tax-free benefits (nondiscriminatory coverage). Also, in practice rank-and-file employees could not disproportionately elect to receive taxable benefits in cash or otherwise (nondiscriminatory distribution).

Nondiscrimination generally could be measured with respect to contributions or benefits. However, a cafeteria plan providing health benefits will not be viewed as nondiscriminatory merely because each employee is allocated an equal percentage of pay. Such a plan will have to demonstrate either that overall benefits do not discriminate in favor of the prohibited group or that health benefits are provided equally and that contributions for other benefits represent an equal percentage of pay.

If a cafeteria plan discriminates in favor of the prohibited group, all employer contributions to the plan allocated to members of the prohibited group will currently be includible in the gross incomes of all covered members of the prohibited group. Rank-and-file participants will include only the amounts they designate to be used to purchase taxable benefits.

Effective Date

The new rules for cafeteria plans will apply for taxable years of employers beginning after December 31, 1978.

Technical Explanation

Plans Covered -- The proposal will apply to those welfare plans which allow a participant to designate, to any extent, the amount of allocable employer contributions which may be used to purchase any particular kind of benefit.

Benefit and Contribution Standards.--For cafeteria plans which do not provide health benefits, a two-step test will apply for determining nondiscrimination. First, the plan will have to be nondiscriminatory on the basis of either contributions or benefits. A plan satisfying the coverage requirements generally applicable to welfare plans and allocating an equal percentage of pay to each participant will meet this test.

Additionally, the plan will have to be nondiscriminatory in operation with respect to the allocation of taxable contributions or benefits. The plan will be discriminatory if the allocation of contributions to taxable benefits made by rank-and-file employees is significantly higher, as a proportion of the total allocation of contributions made by those employees, than the allocation of contributions made by members of the prohibited group. Any differences attributable to different family situations will be disregarded for this purpose. Alternatively, this measurement can be made on the basis of benefits by applying the nondiscrimination test applicable to plans not of the cafeteria type.

Although measurement of discrimination can be made on the basis of either contributions or benefits, the same basis for measurement will have to be used for both parts of the two-step test.

For a cafeteria plan providing health benefits, the test will be somewhat different if the plan chooses to determine nondiscrimination on the basis of contributions. Since non-discrimination in health benefits under a welfare plan must be determined without regard to compensation, a cafeteria plan which allocated to participants an amount equal to a specified percentage of pay to be used for health and other benefits will be considered discriminatory. Therefore, in addition to an allocation based on a percentage of pay, there will have to be an equal dollar allocation sufficient to enable lower-paid employees to purchase basic health benefits without precluding them from obtaining other benefits under the plan. Basic health benefits will generally be the amount of health coverage selected by the majority of the prohibited group in a similar family situation.

Footnote

1/ In the case of group term life insurance, the exclusion is limited to contributions for insurance not in excess of $50,000. There is also a limit on the amount of disability benefits which may be excluded from income.

EMPLOYEE DEATH BENEFITS

Present Law

Up to $5,000 of the death benefits paid by an employer because of the death of any employee can be excluded from the gross income of the employee's beneficiaries or estate. This exclusion applies to direct payments and to less direct payments, such as lump sum distributions from qualified retirement plans.

Reasons for Change

The value of an exclusion varies directly with an employee's marginal tax rate. For individuals with income below taxable levels, it obviously is of no significance whether certain compensation is exempt or not. On the other hand, at a 50 percent or higher bracket, nontaxable benefits are equivalent to twice the amount of cash or more. It is, therefore, directly contrary to the principles of a progressive tax system to exempt compensation from tax.

The death benefit exclusion is largely a benefit for wealthy individuals, not only because their marginal income tax rates are the highest but also because they are more likely to receive death benefits which equal or exceed the full amount of the exclusion. Lower-paid individuals receive smaller death benefits, if any.

Further problems have arisen where courts have allowed an employer to deduct an amount which is, in essence, a death benefit but, at the same time, the recipient has been allowed to treat the payment as an excludable gift.

General Explanation

In many cases, a death benefit is clearly designated as such by the death benefit plan or other plan under which it is provided. In such cases, the exclusion for death benefits paid by employers will be eliminated.

In other cases, the status of a benefit as a death benefit or gift is not as clear from the terms of the plan or arrangement under which payment is made. A payment will be treated as a death benefit in any case in which it is occasioned by the death of an employee and deducted by the employer. However, if the employee owns more than a 10 percent ownership interest in the employer or is an officer,

any payment occasioned by the employee's death will be treated as a death benefit whether or not deducted by the employer. In either case, the amount viewed as a death benefit will be includible in gross income by the recipient.

The beneficiaries of employees at all income levels, including lower-paid employees, will continue to receive the protection of the exclusion for life insurance proceeds.

Effective Date

The elimination of the death benefit exclusion will apply to benefits paid after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	32	32	33	33	34

Technical Explanation

A payment made by an employer to the surviving spouse or other beneficiaries of a deceased employee is often claimed by the recipient to be excludable as a gift. Sometimes this occurs even though the employer claims a deduction not allowable in the case of a gift. Under the proposal, if an employer claims a deduction for the payment, the payment will be includible in the gross income of the recipient or recipients. The fact that the employer considered the payment to be an expense deductible for income tax purposes would indicate that the payment was not viewed as a gratuitous transfer. Also, if the deceased employee owned more than a 10 percent ownership interest in the employer or was an officer, the payment will be includible in the gross income of the recipient whether or not deducted by the employer.

It is not clear under present law whether benefits payable under a self-insured plan (perhaps payable from a separate trust) are excludable from income as life insurance proceeds. Such a plan could be subject to serious abuse. For example, an employer might set up a self-insured life insurance plan for a non-discriminatory group of employees, with the expectation that benefits will be provided primarily upon the death of the controlling employee. If the

controlling employee were to die shortly after the plan was established, the benefits payable to his or her beneficiaries might exceed the total assets of the plan. Then, the employer would make an additional, deductible contribution to the plan to cover the balance of the benefits due. If the plan were treated as one providing death benefits, up to $5,000 would be excluded. If it were treated as a plan of life insurance, nothing would be includible in gross income by any individual. After payment of benefits to the beneficiaries of the controlling employee, the plan could be discontinued. Under the proposal it will be clear that payments under a self-insured arrangement are not life insurance and, thus, they will be fully subject to tax.

UNEMPLOYMENT COMPENSATION BENEFITS

Present Law

Compensation in the nature of wage replacement for periods of unemployment is paid through a wide variety of public and private programs and plans, each of which may differ as to sources of funding, and eligibility for and amounts of benefits. The income tax treatment of unemployment benefits also varies, depending primarily upon whether the source of the benefit is a government program or a private plan.

In general, unemployment compensation received pursuant to government programs is, by administrative decision, excludable from gross income. By comparison, unemployment compensation received from employer financed unemployment benefit plans or from the general funds of a union (accumulated from regular union dues) is includible in full in gross income when received. Similarly, unemployment benefits received from employee contributory plans are generally includible to the extent payments received exceed amounts contributed to the plan by the recipient.

Reasons for Change

The present exclusion for unemployment benefits paid pursuant to government programs is incorrect as a matter of proper income definition, tends to create artificial distortions in the labor marketplace, and promotes unjustified vertical and horizontal inequities in the incidence of the income tax.

Compensation paid to individuals during periods of unemployment is, in substance, a substitute for taxable wages. As recognized by the present law treatment of privately funded unemployment compensation plans, unemployment benefits are properly includible in the gross income of a recipient to the extent they exceed nondeductible contributions made by the recipient to acquire the benefits. Unemployment benefits paid pursuant to government programs are substantively equivalent to unemployment benefits paid pursuant to employer funded plans and, like privately funded unemployment benefits, should be includible in gross income.

The present exclusion tends to create a work disincentive and, in certain cases, influences decisions both as to the timing of entry into the labor market and the duration of employment thereafter. It has been estimated that under the present system, government unemployment

benefits on average replace more than 60 percent of lost after tax income. For women as a class, the replacement rate is close to 80 percent. Empirical studies confirm the fact that the existence of unemployment compensation adds to unemployment. The tax-free nature of unemployment compensation increases the incentive to remain unemployed. The exclusion therefore contributes, to some extent, to the period of unemployment and the consequent cost of maintaining unemployment coverage.

Finally, the present exclusion benefits taxpayers subject to tax at higher marginal tax rates more than those subject to tax at lower marginal rates and provides no tax benefits at all to those who would be nontaxable even if all such benefits were included in gross income. Those who derive the greatest benefit from the tax-free treatment afforded unemployment compensation by existing law are the unemployed with other sources of income, those who have spouses with substantial income, or those who earned large amounts of income during some portion of a year and were unemployed for the balance. Indeed, there are those who plan employment patterns to maximize the after-tax benefits available through the receipt of nontaxable unemployment compensation.

Table IIE-8

Distribution of Unemployment Compensation and of Personal Income Tax Savings from Exclusion

Expanded Income	Number of Returns (000) 1/	Percent of All Returns With Unemployment Compensation	Percent of Total Unemployment Compensation	Tax Saving ($millions)	Percent of Tax Savings by Income Class
Under $ 5,000	4,700	41.2	27.3	190	11.0
$ 5,000 - $10,000	2,762	24.2	26.8	438	25.3
10,000 - 15,000	1,863	16.3	19.2	369	21.4
15,000 - 20,000	1,234	10.8	13.7	318	18.4
20,000 - 25,000	485	4.2	6.3	167	9.7
25,000 - 30,000	196	1.7	3.0	92	5.3
30,000 - 35,000	69	0.6	0.9	30	1.7
35,000 - 40,000	36	0.3	1.0	38	2.2
40,000 - 50,000	27	0.2	0.6	25	1.4
50,000 - 75,000	25	0.2	0.7	31	1.8
$75,000 and over	16	0.1	0.5	30	1.7
Total	11,413	100.0	100.0	1,728	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

January 26, 1978

1/ Number of Personal Income Tax Returns which would report Unemployment Compensation were all Unemployment Compensation includible in Adjusted Gross Income.

Nore: Details may not add to totals due to rounding.

As Table IIE-8 demonstrates, the distribution of tax savings attributable to the receipt of excluded unemployment compensation differs markedly from the distribution of such benefits by income class. Those with incomes above $20,000 received 13 percent of the total unemployment compensation paid. Yet 23.8 percent of the savings attributable to the unemployment compensation exclusion went to those individuals. Those with incomes from other sources of less than $10,000 received 54.1 percent of the unemployment compensation but only 36.3 percent of the savings.

General Explanation

In order to eliminate the horizontal and vertical inequity and labor market misallocations produced by the present exclusion for unemployment compensation and yet avoid taxation in hardship situations, benefits in the nature of unemployment compensation paid pursuant to government programs, including trade readjustment allowances, will be includible in the income of taxpayers with adjusted gross income from all sources (including unemployment compensation) in excess of $20,000 if the recipient is single or $25,000 if married.

Effective Date

The provision will be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

	Calendar Years				
1978	1979	1980	1981	1982	1983
--	212	207	204	204	214

Technical Explanation

Benefits in the nature of unemployment compensation paid pursuant to government programs will be includible in income to the extent of one-half of the excess of adjusted gross income (including the total amount of unemployment benefits and disability payments) over $20,000 in the case of single taxpayers and $25,000 in the case of married taxpayers. For example, if a single taxpayer received income from other sources of $22,000 and unemployment compensation of $3,000,

$2,500 (adjusted gross income of $25,000 less the applicable threshold limitation of $20,000, divided by two) of unemployment compensation will be included in income. To prevent abuse of the foregoing income limitations, married taxpayers who desire to exclude unemployment compensation will be required to file joint returns for the taxable period within which such compensation was received.

The proposal will apply to the following programs:

(1) Federal-State Regular Unemployment Insurance Program;

(2) Federal-State Extended Unemployment Insurance Program;

(3) Unemployment Compensation Program for Federal Civilian Employees and Ex-servicemen;

(4) Railroad Unemployment Insurance Program;

(5) Trade readjustment assistance pursuant to the Trade Act of 1974; and

(6) Payments in the nature of unemployment compensation pursuant to the Disaster Relief Act of 1974.

For purposes of determining the includible amount of unemployment compensation, adjusted gross income will include all disability payments received by a taxpayer despite the fact that all or a portion of such payments might be excluded from income under present law. Similarly, for purposes of determining the includible amounts of disability payments, adjusted gross income will include all unemployment compensation received by the taxpayer. For example, if a single taxpayer received income from other sources of $17,000, disability payments subject to exclusion of $3,000 and unemployment compensation of $1,000, the taxpayer's adjusted gross income for purposes of determining both the includible amount of unemployment compensation and the excludable amount of disability payments will be $21,000. Five hundred dollars of unemployment compensation will be includible (adjusted gross income of $21,000 less the applicable threshold limitation of $20,000, divided by two). The entire disability payment will be includible, because the disability payment exclusion phases out on a dollar-for-dollar basis to the extent adjusted gross income exceeds $15,000.

ENTERTAINMENT AND TRAVEL

INTRODUCTION

"Business related" entertainment which is deductible under present law provides personal benefits to the recipient. Sometimes the entertainment provides luxuries. Often it is merely personal entertainment in disguise. Some types of deductible business travel also provide personal benefits. These personal benefits generally are not taxed to the recipient, thereby encouraging this form of consumption over consumption which must be purchased with after-tax dollars.

Allowing entertainment and travel expenses to be deducted, without taxing the related personal benefits to the recipient, has the effect of providing these benefits partially at public expense. In effect, present law requires the many taxpayers who cannot or do not obtain these subsidized entertainment and travel benefits themselves to help pay for the benefits enjoyed by others. These benefits tend to be disproportionately distributed to upper-income taxpayers. Moreover, some types of entertainment and travel deductions are sources of abuse due to the vagueness of the standards applied to determine deductibility.

For these reasons, the President proposes to disallow deductions for some entertainment and travel expenses not taxed to the recipient. In general, the proposals will disallow deductions for:

- expenses of all entertainment activities and facilities, except 50 percent of expenses of entertainment meals;

- first class air fare, to the extent that it exceeds coach fare; and

- expenses of attending foreign conventions which are held outside the United States without good reason.

EXAMPLES OF PROBLEMS UNDER PRESENT LAW

The deductibility of expenses related to owning and operating a yacht is illustrated in the following excerpt from an article entitled "The Great Tax Write-off", which appeared in the February 1976 issue of Motor Boating and Sailing Magazine, at p.63:

"An awful lot of rules for only a limited tax deduction? It isn't really all that complex. As an illustration of how these rules actually work, consider the situation of Robert Gaylor, a young lawyer who recently joined an established law firm. His success with the firm -- in fact, his continued employment -- depends on his contributing to the growth of the company. Robert joined the Lakeside Yacht Club expressly to meet the members, many of whom he considered potential clients. As a result of his participation in the club's activities, he made several valuable contacts which led to an increase in his -- and the law firm's -- practice.

The situation of Dr. Roger Lawrence, an orthopedist, is not very different. Dr. Lawrence bought a 28-foot powerboat on which he entertained other doctors who referred patients to him. Since entertainment of this nature was generally expected of him, and since a substantial number of patients were referred to him as a result of his entertainment, the deduction was allowed.

What specific expenses on your boat are deductible by you as the owner, chief stockholder, employee, or professional when the yacht is used primarily for business entertainment? Certainly all of the following will qualify:

1) Operating costs: gas, oil, tune-ups, phone calls;

2) Maintenance and repairs, and even storage fees;

3) Insurance;

4) Salaries paid to hired hands or workers;

5) Yacht depreciation: A portion of your boat's cost may be written off each year for wear and tear. Your deduction would be the percentage of that figure that represents the entertainment portion of its use;

6) Sales losses: If you sell your boat at a loss after several years of claiming a percentage of its expenses for business entertainment, a fraction of the loss would be deductible. The balance, of course, would be a non-deductable personal loss;

7) Cost of food and beverages during the boat's business use.

* * * * * * * * * * *

Families with children unfortunately find themselves faced with a problem when it comes to determining the business and personal use of a club's facilities. Use of the club by any member of the family constitutes personal use and makes it doubly difficult for the club to qualify as a business entertainment facility. For this reason many members will, as soon as possible under club rules, buy their children junior memberships. Since the junior memberships are not counted as personal use by the parent/taxpayer, the parent is in a better position to establish the more-than-50 percent use for tax purposes. The cost of a junior membership is usually modest when compared to the amount an individual would be permitted to deduct on his own membership for business use."

Advice on how to structure personal consumption expenditures in order to support deductions is readily available. Prentice-Hall, Inc., has published a pamphlet entitled "How to Get Top Trouble-Free Deductions for Travel, Entertainment, and Related Business Expenses Under the Latest Liberalizations and Crackdowns" containing the following headings:

-- Two cases show -- how to use a diary to win every deductible expense.

-- Mix your vacation with a business trip -- let the company foot most of the bill.

-- Bring your wife along and deduct the cost?

-- How to nail down deductions for home entertainment.

-- "On the town"

-- Club dues

-- Yachts, hunting lodges, and other facilities

-- "Quiet business meals" are "directly related."

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ENTERTAINMENT EXPENSES

Present Law

Present law imposes relatively few restrictions on the deductibility of "business" entertainment. To be deductible, entertainment expenses must be "ordinary and necessary" in the taxpayer's business. Voluminous litigation attests to the difficulty of defining the "ordinary and necessary" standard. However, it is clear that "necessary" does not mean "essential." Rather, courts generally have construed the term "necessary" as imposing only the minimal requirement that an expense be appropriate and helpful for the development of the taxpayer's business.

The regulations require that entertainment expenses be reasonable in amount. Theoretically, an entertainment expense is not deductible to the extent that it is lavish or extravagant. However, since one man's "lavish" is another man's "moderate," this requirement is difficult to apply evenhandedly -- and hence difficult to apply at all.

Theoretically, entertainment is deductible only to the extent that it is allocable to the taxpayer's business. However, it is seldom possible to distinguish between personal and business motives in entertainment, let alone to prove that distinction. Further, even entertainment provided for business reasons must produce personal enjoyment in order to have its intended effect. Thus, the personal element in business related entertainment generally is not disallowed.

In short, some taxpayers are in a position to deduct many of the luxuries of life as business entertainment. Costs of country club memberships, cocktail parties, cruises, hunting lodges, lunches, dinners, nightclub shows, yachts, hotel suites, swimming pools, tennis courts, and vacation trips--all can be deductible under present law.

In response to President Kennedy's tax reform proposals, in 1962 Congress enacted several provisions intended to prevent abuse of entertainment deductions. However, <u>most</u> entertainment expenses deductible before 1962 still can be deducted today.

One provision enacted in 1962 requires substantiation of entertainment expenses that are deducted. The taxpayer must substantiate, "by adequate records or by sufficient evidence corroborating his own statement," the amount of expense, time and place of entertainment, business purpose of expense, and business relationship to the taxpayer of any persons

entertained. To the limited extent the IRS can enforce this requirement, it impedes those who previously created entertainment expenses out of whole cloth or simply guessed at what they had spent. However, the substantiation requirement is not a serious obstacle to those who actually incur expenses and keep careful records.

Another provision enacted in 1962 requires that expenses of entertainment activities be "directly related to" or "associated with" the taxpayer's business in order to be deductible. These tests are easy to meet.

While the "directly related" rules purport to require some expectation that business will be conducted at the entertainment event, entertainment is considered "directly related" without a showing that business benefit resulted from the entertainment, or that more time was devoted to business than entertainment, or even that business was discussed. Even the loose "directly related" standard does not apply if meals are furnished under circumstances "conducive to a business discussion." As described in a prominent publication which advises taxpayers how to obtain "trouble-free" deductions, this exception operates as follows:

> Say you take a customer or a client to dinner at . . . [a] restaurant. Or, perhaps you prefer to take him to a hotel bar or cocktail lounge for a few drinks. As long as he's a business associate, you can deduct the tab whether or not you discuss business, make a sales pitch, or even if it's only for goodwill. The only limitation is that the atmosphere must be conducive to a business discussion.

In short, the "directly related" requirement may have little more practical effect than to disallow deductions for entertainment which offers little or no opportunity for business discussion--such as entertainment at night clubs, entertainment at cocktail parties where non-business associates are present, or entertainment which the taxpayer does not attend.

Moreover, even entertainment which offers no opportunity for business discussion is deductible if it meets the "associated with" test. Thus, expenses of an entertainment activity which does not qualify as "directly related" still may be deducted if the activity has some proximity to a business discussion. Under the "associated with" rule, expenses for dinner and a night on the town for the taxpayer, a business contact, and their spouses, are deductible merely because that afternoon or the following morning some of the participants talked or will talk business.

Like expenses of entertainment activities, expenses of entertainment facilities such as yachts and swimming pools may be deductible. (Dues or fees paid to a social, athletic, or sporting club are also considered entertainment facility expenses.) To be deductible, such expenses must meet the "directly related" test, and more than half of the use of the facility must be for business entertainment.

Reasons for Change

Present law on deductibility of entertainment expenses is an open invitation to charge personal expenses to the Treasury, and many taxpayers accept the invitation. Some who have done so in recent years are described below. The expenses described in these examples are deductible under present law.

A New York City taxpayer claimed deductible expenses of $9,665 for business lunches throughout the year. According to the taxpayer's records, he entertained a business client or associate each day for 338 days of the year. The taxpayer skipped his business lunch on Thanksgiving Day, but not on the Friday, Saturday, or Sunday of Thanksgiving weekend. He entertained at top restaurants on an average of 6-1/2 days a week all year, at a cost of well over $20 each lunch time.

In a recent year, an electrical fixture salesman structured his business calls so that he ate breakfast, lunch, and dinner, five days a week, with a customer or purchasing agent either before or after a business discussion. The deductible amount for the year was $8,000, of which $3,000 was spent on the salesman's meals.

A university professor received $30,000 in annual salary and, in addition, many of his expenses were reimbursed. His department did not reimburse him for $1,300 spent to entertain visiting professors, but these expenses were deductible on the basis of his department chairman's statement that entertaining visiting professors was required as part of the professor's job.

A surgeon deducted $14,000 a year for expenses of entertaining doctors who referred patients to him. He entertained the doctors on a yacht, where they discussed patients recently referred. The surgeon claimed that he took care to begin each medical discussion early in the cruise in case a doctor later became seasick.

The corporation of an incorporated dental surgeon had gross income of $500,000, a deduction of $160,000 for the surgeon's salary, and taxable income of only

$26,000. An amount close to $17,000 was deducted for the surgeon's expenses of entertaining dentists who referred patients to him during the year. The surgeon entertained the dentists (and sometimes their wives) at home, at a country club, at sporting events, at restaurants, and at a rental cottage. He entertained the same few dentists the preceding year, and they are his personal friends.

A small corporate manufacturer with few competitors owned a yacht. Before and after business discussions, the corporation entertained customers and potential customers on cruises and fishing trips. Yacht expenses of $67,000 were deductible for the year.

A corporation which operated an iron foundry and machine shop in Virginia owned several hunting and fishing lodges on an island off the coast of North Carolina. The corporation used these lodges to entertain employees of its major customers. Deductible costs of lodge operation and depreciation, plus airplane expenses, were over $100,000 a year.

These taxpayers are not isolated examples. As President Kennedy said 16 years ago:

> ... Too many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene. This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practices as well.

Even when entertainment promotes business and hence can be argued to have a business purpose, the entertainment provides substantial personal benefits to the recipient. It is this personal consumption which distinguishes entertainment from other business purchases, such as advertising.

Reading an advertisement is not comparable to dining at an elegant restaurant, sailing on a yacht, or attending a Sunday football game. Entertainment is more closely analogous to wages; they both provide personal benefits. However, the tax collector withholds a portion of wages before they can be spent for personal consumption while entertainment benefits are now received tax-free.

The benefits associated with business related entertainment tend to be disproportionately distributed to upper-income taxpayers. For example, lunches are deductible

by a lawyer who eats with clients at a club, but not by a carpenter who eats with other workers at a construction site. Costs of giving a party for friends are deductible by a businessman whose friends are his business associates, but not by a secretary or nurse, for whom entertaining cannot be said to have a business purpose. In light of the personal benefits associated with entertainment, the disproportionate availability of entertainment deductions to upper-income taxpayers makes the allowance of such deductions particularly unfair.

And entertainment expenses intended primarily to promote business are not the whole problem. Frequently "business related" entertainment is personal entertainment in disguise. A taxpayer in the 50 percent tax bracket can purchase two tickets to a football game for the price of one if he deducts their cost. Therefore, he has nothing to lose by inviting a friend who is also a business associate to join him for the game. If the expense account fan happens to pick up a little business as a result of this entertainment or to receive a return invitation from the friend, this is all gravy paid for by Uncle Sam. Since it is extremely difficult to distinguish between personal and business intent in entertainment, entertainment which is intended to provide tax-free personal benefits often cannot be disallowed.

In addition to entertainment expenses which are deductible under present law, some <u>non</u>deductible expenses are in fact deducted. The subjectivity of present law encourages taxpayers to deduct entertainment expenses which, though not clearly deductible, are "arguably" so.

For example:

A life insurance salesman recently deducted his tennis club dues on the theory that tennis games enabled him to judge the physical fitness of prospective customers.

A large casino operation in Nevada deducted as promotion expenses the costs of using and maintaining a lake property and a hunting lodge. The annual deduction was $110,000 for the lake property and $350,000 for the hunting lodge.

A practicing attorney with gross income of $150,000 entertained clients throughout the year on his yacht. He claimed deductions of $22,000 for operating the yacht, $19,000 for depreciation of the yacht, and $6,000 for operating an airplane to fly clients to the yacht.

A physician deducted $13,000 a year for expenses of entertaining other physicians at parties, dinners, and a hunting cabin -- all on the theory that any physician is a potential source of referrals.

The sole shareholder-officer of a small corporation deducted the costs of entertaining employees of another corporation from which he bought scrap on a "highest bidder" basis.

The owner of an insurance agency deducted $31,000 one year and $32,000 the next on a claim that every single meal during the two years (except for the meals on one day) was motivated by business.

A medium-size corporation which supplies parts to auto manufacturers deducted $35,000 in each of two consecutive years for lunch expenses of the corporation's three owners and three salesmen. According to their oral testimony, supported only by invoices, the owners and salesmen entertained purchasing agents and other representatives of customers under circumstances conducive to business discussion.

The controlling shareholder of a small retail sales corporation received a salary of $19,000. From this, he deducted $26,000 for the expenses of entertaining at a cottage on a Caribbean island.

Taxpayers may claim "arguably deductible" entertainment expenses in the belief that they are properly deductible, or in the hope or expectation that they will not be audited, or in an attempt to obtain bargaining power for use if they are audited. Whatever the reason, many nondeductible entertainment expenses are in fact deducted. IRS data suggest that about 20 percent of all entertainment expenses deducted on individual returns should not be deducted. Overreporting of this magnitude breeds disrespect for the law and impairs the integrity of the tax system.

Stricter enforcement of present law cannot solve the overreporting problem. Present law on the deductibility of entertainment expenses is so generous, and its application so subjective, that it invites taxpayers to test the boundaries. Determinations of "necessary," "reasonable," "directly related," and "associated with," as well as the allowance of substantiation by means other than adequate records, necessarily leave much to the judgment of the individual IRS agent. They make administration extremely difficult, and uniform administration unattainable.

General Explanation

To reduce the unfairness and abuse associated with present law, the Administration proposes to disallow deductions for expenses of entertainment which is not taxed to the recipient as compensation. In general, deductions for

expenses of all entertainment activities and facilities will be disallowed. However, 50 percent of currently deductible entertainment expenses for food and beverages will remain deductible.

Regardless of the existence of a business purpose, the high level of personal value associated with entertainment justifies the proposed disallowance of deductions. Disallowance is required to achieve the equivalent of including in the tax base the personal value of the benefit to the recipient. Since entertainment meals often involve business conversations, they may be less likely than other forms of entertainment to have personal value to the recipient equal to cost. Fifty percent disallowance is roughly equivalent to allowing a full deduction to the payor and including half of the cost of the meal in the income of the recipients.

This proposal will affect entertainment expenses only. Costs of business travel away from home will continue to be deductible, subject to the limitations proposed with respect to foreign conventions and first class air fare. Travel is less likely to have personal value to the businessman than entertainment, and travel deductions are less subject to abuse. Therefore, it is appropriate to continue to allow them to be deducted.

However, since entertainment is entertainment, no matter where it takes place, entertainment expenses incurred in connection with business travel will be subject to the Administration proposal. For example, if an employee traveling away from home on business entertains associates by taking them to the theater, the cost of the theater tickets will not be deductible. Also, if the only purpose of a trip is to entertain the traveler, no deduction will be allowed. For example, no deductions will be allowed for costs of a cross country trip by business associates to attend the Masters Golf Tournament or the Superbowl.

Certain employer-provided meals will be excepted from the proposal. Present law excludes from an employee's income the value of meals which are furnished to him by his employer on the employer's business premises and for the employer's convenience. In applying this exclusion, meals are considered to be furnished for the employer's convenience only upon a clear and strong showing of business necessity. The proposals do not modify the statutory exclusion, and costs of providing such meals will continue to be fully deductible under the proposals.

Analysis of Impact

The Administration proposal will not hurt American business. If the increased revenue from the proposal is used to lower tax rates, as recommended, the proposal will simply

make it relatively more expensive for businesses to provide entertainment to employees and business associates, and relatively less expensive to lower prices or to increase salaries.

In terms of economic efficiency, the proposed changes will be beneficial. The government will no longer be subsidizing consumption in such forms as yachts, theater tickets, and country club memberships connected with an ostensible business purpose. The government subsidy for entertainment meals will also be reduced. Persons will continue to engage in such entertainment, either on their own or in the company of business associates, if they feel that the benefit derived from the entertainment is worth its cost. Because entertainment expenses will have to be purchased with after-tax dollars, there will no longer be a bias in favor of entertainment over other forms of consumption.

It is true that many forms of business entertainment have become accepted as social custom and are viewed by some businessmen as necessary to attract and keep customers. However, one reason that business entertainment has become accepted as social custom is because the tax system lowers its price. In the long run, social customs related to business entertainment might change if the tax subsidies that encourage it change. Even in the very short run, changes in deductibility of entertainment expenses will affect all business firms engaging in entertainment alike.

The Administration proposal will not have a substantial effect on those industries benefiting from tax incentives for entertainment. Expensive restaurants catering to individuals eating tax deductible meals might suffer some decline in the demand for their services. However, the Administration proposal will cause relatively little, if any, loss of jobs. It is estimated that the total employment reduction in the restaurant industry will be no more than 2 percent, at most, of all such jobs. The rapid employment turnover in that industry will absorb much of any such employment reduction. Hotels and other travel related industries generally will not lose business as a result of the proposal since most costs of business travel and domestic convention attendance will continue to be fully deductible.

It should be emphasized that output and employment in the economy as a whole will NOT decline as a result of the Administration proposal. Any reduced spending on entertainment will be balanced by increased spending on other goods and services by individuals benefiting from the reduced tax rates.

Effective Date

The proposed changes in the deductibility of entertainment expenses will take effect for tax years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	1,195	1,322	1,434	1,564	1,706

Technical Explanation

For purposes of the proposal, as under present law, entertainment activities include any activity of a type generally considered to constitute entertainment, amusement, or recreation. Thus, expenses of activities such as theater parties, attendance at sports events, and fishing trips will be fully disallowed.

For purposes of the proposal, as under present law, entertainment facilities include any facility used in connection with an entertainment activity. Thus, expenses of facilities such as hunting lodges and swimming pools will be fully disallowed. As under present law, dues or fees paid to any social, athletic, or sporting club or organization will be considered expenses of entertainment facilities. Such dues or fees will not be deductible unless the club or organization operates solely to provide lunches under circumstances conducive to business discussion. Dues or fees paid to such business lunch clubs will be treated the same as meal expenses and hence will be disallowed only by half. Similarly, expenses of employer facilities used primarily to provide meals to employees will be treated the same as the expenses of the meals provided.

Costs of business travel away from home will continue to be deductible, subject to the limitations proposed with respect to foreign conventions and first class air fare. Deductible business travel costs include costs of transportation, lodging, and meals. However, they do not include expenses of a trip undertaken purely to provide entertainment to those traveling.

Whether a meal is considered a travel meal or an entertainment meal will depend on the travel status of the person who eats the meal, not the person who pays for it. For example, assume Mr. A lives in New York City, Mr. B is in New York City away from home on business, and they eat a business meal together. Regardless of whether Mr. A or Mr. B picks up the check, Mr. A's meal is 50 percent deductible and Mr. B's meal is fully deductible. For reasons of administrative convenience, all meals consumed at the same time will be presumed to have the same cost. In the example, 75 percent of the total check will be deductible. As a consequence of this rule, meals purchased for those attending a bona fide business convention generally will be deductible.

Where entertainment is furnished to an employee by his employer, the Administration proposal will limit or disallow a deduction to either the employer or the employee, but not both. Rules for preventing double disallowance are as follows: (1) The proposal will not apply to an employer to the extent that he treats entertainment expenses as compensation to the recipient employee. For this purpose, treatment as compensation means treatment as compensation to the employee on the employer's income tax return as originally filed and treatment as wages to the employee for purposes of withholding. Entertainment expenses treated as compensation will remain fully deductible by the employer as wages or salary; at the same time, such expenses will be subject to the proposed disallowance rules for purposes of determining deductibility by the employee. Expenses incurred by an employee and not reimbursed by or charged to his employer also will be subject to the proposed disallowance rules. Of course, the Administration proposal will not operate to allow deductions, but simply to disallow them. (2) Entertainment expenses paid or reimbursed, or entertainment provided, by an employer to an employee and not treated by the employer as compensation will be subject to the proposed disallowance rules for purposes of determining deductibility by the employer, but not for determining deductibility by the employee. Similar rules to prevent double disallowance will apply to independent contractors.

FIRST CLASS AIR FARE

Present Law

Transportation expenses may be deductible if incurred in connection with the taxpayer's travel away from home on business. The deductibility of such expenses depends on the primary purpose of the trip. If the trip is related primarily to the taxpayer's business, expenses of transportation to and from the destination are deductible. These expenses are not deductible if the trip is primarily personal in nature. The primary purpose of the trip is determined on the basis of the facts and circumstances in the individual case.

First class air fare generally is deductible under the above rules. However, first class air fare incurred in connection with travel to attend a foreign convention, is not deductible to the extent that it exceeds coach fare.

Reasons for Change

For most people, first class air fare is a luxury. The primary difference between a first class seat and a coach seat on an airplane is personal indulgence.

The speed of air travel may be a business necessity, but the luxury of first class seating is not. Both ends of the plane arrive at the same time. Coach seating adequately serves the business purpose.

Allowing the full amount of first class fare to be deducted, without taxing the first class portion to the recipient, provides a tax subsidy for first class travel. Thus, present law requires the many taxpayers who either cannot afford first class fare for themselves, or choose to forego it, to subsidize the personal benefits enjoyed by others.

General Explanation

To remove this tax subsidy, the President proposes to disallow deductions for the portion of air fare attributable to first class. The portion of first class fare which is equal to coach fare will remain deductible.

Specifically, the President proposes to disallow deductions for costs of regularly scheduled, commercial air transportation to the extent that they exceed the amount of

the lowest priced, generally available fare for regularly scheduled flights between the same points at the same time of day. A fare will not be considered "generally available" if it is available only to those who fly on stand-by status, purchase tickets a specified period of time in advance, or stay at their destination a specified period of time. The deductibility of costs of air transportation which is noncommercial or not regularly scheduled will not be affected.

This proposal will apply to all currently deductible costs of regularly scheduled, commercial air transportation incurred in connection with the taxpayer's own travel on business (including, as under present law, travel to attend foreign conventions). Under the Administration's separate proposal on deductibility of entertainment expenses, the full amount of any transportation expenses incurred in connection with a trip whose sole purpose is to entertain the traveler will be disallowed.

Where first class air fare is furnished to an employee by his employer, a deduction for the portion of the fare attributable to first class will be disallowed to either the employer or the employee, but not both. For rules to prevent double disallowance, see the Technical Explanation of the Entertainment Expenses proposal.

Analysis of Impact

The major effect of this proposal will be to cause a shift in demand among business travellers using commercial airlines from first class to coach seats. However, some business travellers currently using first class travel may reduce their use of commercial airlines and shift to corporate aircraft.

Since first class seats sell for a higher price than coach seats, these expected shifts will cause some loss of revenue to the commercial airlines. At the same time, a change in airline seating configurations to increase the proportion of space devoted to coach travel would increase airline seating capacity. If these additional available seats are filled, the net loss of revenue to the airlines from the switch will be very small.

The proposal is expected to have little or no effect on overall use of air transportation or on employment in the air transportation industry. Employment will not decline because the existing air fleet will still be used to service roughly the same number of passengers.

Effective Date

The proposed change in the deductibility of first class air fare will take effect for tax years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	281	311	337	368	401

FOREIGN CONVENTIONS

Present Law

Expenses of business travel away from home, including costs of transportation, meals, and lodging, may be deductible. If a trip is related primarily to the taxpayer's business, all travel expenses to and from the destination are deductible; none are deductible if the trip is primarily personal in nature. Even if expenses of traveling to and from the destination are not deductible, subsistence expenses incurred at the destination are deductible if allocable to the taxpayer's business.

Foreign travel is subject to a special allocation rule. If a trip outside the United States lasts longer than a week and 25 percent or more of the taxpayer's time on the trip is devoted to personal pursuits, all travel costs must be allocated between personal and business activities, generally in proportion to the number of days spent on each. Otherwise, the "primary purpose" test applicable to domestic travel applies.

Convention expenses are considered allocable to the taxpayer's business if the relationship between the taxpayer's trade or business and his attendance at the convention is such that by his attendance he is benefiting or advancing the interests of his trade or business. Whether such a relationship exists depends on the facts and circumstances of each case.

In 1976 Congress recognized the growing practice among professional, business and trade organizations to sponsor cruises, trips and conventions during which only a small portion of time was devoted to business activity. Committee reports noted that promotional material often highlighted the deductibility of expenses incurred in attending a foreign convention and, in some cases, described the meeting in such terms as a "tax-paid vacation" in a "glorious" location. Committee reports also noted that some organizations advertised that they would find a convention for the taxpayer to attend in any part of the world at any given time of the year.

In short, many taxpayers were attending foreign conventions primarily to take advantage of opportunities for sightseeing and recreation. However, since it was extremely difficult to distinguish between personal and business motives in taking such trips, often the personal element was

not disallowed. As a result, deductions for attending foreign conventions had become a source of tax abuse.

In an effort to prevent this abuse, the 1976 Tax Reform Act imposed special limitations on such deductions. Those limitations provide that when a person attends more than two foreign conventions in one tax year, no more than the costs of two conventions may be deducted.

With respect to foreign conventions for which a deduction is allowable, the 1976 Act limits the deductible amount. The amount deductible for transportation outside the United States, to and from a convention, generally may not exceed the lowest coach or economy rate charged by any commercial airline for such transportation during the month of the convention. This amount may be deducted in full only if at least half of the days of the trip, excluding transportation days, are devoted to business-related activities; otherwise, only a proportionate amount may be deducted.

The 1976 Act also limits the amount deductible for subsistence expenses. If at least six hours of business activities are scheduled during each day of the convention and an individual attends at least two-thirds of these activities, his subsistence expenses for each convention day may be deducted. If at least three hours of business activities are scheduled each day and the individual attends at least two-thirds, half of his subsistence expenses may be deducted. However, in no event may the amount of subsistence expenses deducted exceed the Federal per diem for the convention site.

Reasons for Change

The present limitations on deductions for attending foreign conventions are inadequate to prevent abuse. These rules allow taxpayers to take two foreign vacations a year at public expense, and opportunities for such vacations are not hard to find. For example, the California Trial Lawyers Association sponsored seminars all over the world for its members in 1977. The promotional booklet advertises as follows:

> Decide where you would like to go this year: Rome. The Alps. The Holy Land. Paris and London. The Orient. Cruise the Rhine River or the Mediterranean. Visit the islands in the Caribbean. Delight in the art treasures of Florence.

The booklet also notes that these trips have been "designed to qualify under the 1976 Tax Reform Act as deductible foreign seminars." This type of advertising breeds disrespect for the tax system.

Another group, the Association of Trial Lawyers of America, is holding its mid-winter convention in Monte Carlo this year. The word "convention" is the closest that a recent 4-page advertisement for the convention comes to mentioning business -- except to note that expenses of attending continuing legal education programs have been held deductible for Federal income tax purposes. The advertisement is devoted to describing the vacation aspects of Monte Carlo, "the jewel of the Riviera" and the "most exciting square mile on earth."

The 1976 tax provisions on foreign conventions not only fail to prevent abuse, but also increase tax complexity. They require close scrutiny of conference agendas and individual attendance records. In claiming deductions, it is particularly difficult for employers to be sure that the required number of hours of business activities were scheduled for each day of each convention and that each employee for whom expenses are deducted actually attended two-thirds of the scheduled activities.

General Explanation

To prevent abuse and simplify the law, the President proposes that expenses of attending a foreign convention be deductible only if it is as reasonable to hold the convention outside the United States and possessions as within. For purposes of this proposal, as under present law, conventions include seminars and similar meetings. The factors to be considered in determining reasonableness of the convention site are the purpose and activities of the convention; the purpose and activities of the sponsoring organization; the residence of active members of the sponsoring organization; the places at which other meetings of the sponsoring organization have been held; and the particular reason(s) why the convention is being held abroad rather than in the United States or possessions.

For example, if a significant portion of an organization's members resided in Canada, it could be considered as reasonable for the organization to hold a convention in Canada as in the United States. Similarly, if the members of an organization composed of individuals engaged in a certain type of business regularly conducted a portion of their business in Mexico, it could be considered as reasonable for the organization to hold a convention in Mexico as in the United States.

With respect to foreign conventions for which deductions are allowable, the limitations on deductible amount which were enacted in 1976 (including the detailed attendance rules) will not be continued. However, subsistence expenses will be nondeductible to the extent that they exceed 125

percent of the Federal per diem for the convention site. Thus, if it is as reasonable to hold a convention outside the United States as within and if the expenses of attending the convention are ordinary and necessary business expenses, then (subject to the allocation rules of pre-1976 law and any disallowance of the first class portion of air fare) the full cost of transportation to and from the convention will be deductible, and subsistence expenses will be deductible up to 125 percent of the Federal per diem.

Where an employee's expenses of attending a foreign convention are paid or reimbursed by his employer, a deduction for such expenses may be disallowed to either the employer or the employee, but not both. For rules to prevent double disallowance, see the Technical Explanation of the Entertainment Expenses proposal.

Analysis of Impact

The proposal will not decrease the number of conventions held outside the United States and possessions for non-vacation reasons. However, as compared to both pre-1976 and present law, the proposal can be expected to reduce the number of conventions held outside the United States and possessions which are essentially vacations at public expense.

Presumably most conventions not held outside the United States as a result of the proposal, will be held inside the United States. Thus, the proposal can be expected to increase the number of conventions held in this country and hence increase employment in some hotels and restaurants in the United States and possessions.

While the proposal can be expected to reduce the overall number of conventions held outside the United States and possessions by American organizations, as compared to present law the proposal probably will increase the number held in neighboring countries such as Canada because business reasons for holding conventions there are likely to exist.

Effective Date

The proposed change in the deductibility of expenses of travel to foreign conventions will take effect for tax years beginning after December 31, 1978.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

III

Tax Exempt Financing

STATE AND LOCAL TAXABLE BOND OPTION

Present Law

Since the adoption of the Federal income tax in 1913, interest on State and local government obligations generally has been exempt from Federal income tax. This exemption represents a recognition of the independent sovereignty of States and their instrumentalities under our federal system as well as the desire to enhance the strength of State and local governments, as entities closest to the people, in solving local problems.

The exemption applies to all State and local government obligations, except for most industrial development bonds and arbitrage bonds. Industrial development bonds are obligations issued nominally by a State or local government to raise funds for private development. (See discussion in TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BONDS.)

Arbitrage bonds are obligations issued to provide funds for financial investment, generally in taxable Federal securities. Since Federal credit underlies the arbitrage bonds, the issuer of such bonds is guaranteed a market and a profit at no risk to itself. Therefore, since 1969 the Code has provided that arbitrage bonds do not qualify for the exemption.

Reasons for Change

The tax exemption of interest on State and local bonds should not be interferred with in any way. Any recommendation for change in current financing mechanisms is intended only to complement rather than to replace tax exemption as a means of aiding State and local governments and to reduce the inequities and inefficiencies that arise when tax exemption provides the <u>sole</u> form of State and local financing.

The tax-exempt market for financing capital outlays of State and local governments is characterized by three interrelated problems. First, from the viewpoint of structural tax policy, tax exemption is an inequitable way of providing a subsidy to the State and local sector. Secondly, the subsidy provided by tax exemption is an inefficient one in that only a portion of the revenue loss to the Federal treasury results in benefits to State and local governments. Thirdly, the municipal bond market, while performing reasonably well over the long term, has, as a result of its tax-exempt character, exhibited periods of considerable instability which have been disruptive of the financial

planning of States and localities. Related to this last consideration, is the longer term concern that the sources of funds for State and local borrowing may not expand sufficiently to accommodate the capital financing requirements of the sector. Each of these problems of the municipal market will be considered in some detail. Each can be mitigated by the taxable bond option which will provide State and local governments with access to the market for taxable bonds in addition to the market for conventional tax-exempt securities.

Tax exemption and tax equity. A tax-exempt source of income, such as the interest on State and local bonds, violates the principles of both horizontal and vertical equity; that is, tax-exempt income reduces the progressivity of the tax structure and fails to tax all income alike. Vertical equity is violated since taxpayers in different income classes and, therefore, in different marginal tax brackets receive varying benefits from tax exemption. Thus, $100 of tax-exempt income is equivalent to $333 in before-tax income to an investor in the 70 percent marginal tax bracket but to only $143 to an investor in the 30 percent marginal tax bracket. Also, for reasons explained below, tax-exempt bonds are generally not economic investments for those in tax brackets below 30 percent. As a significant source of tax-exempt income, interest on municipal bonds, therefore, tends to undermine the progressivity of the tax structure.

Tax-exempt income also is a violation of horizontal equity since all sources of income are not taxed equally. Two taxpayers may have the exact same before-tax income -- in one case derived from wages and salaries and in the other from tax-exempt interest -- but will pay quite different amounts of tax. It has been claimed that holders of tax-exempt bonds do, in fact, pay a tax on their interest income since they receive a lower before tax yield than may be earned on comparable taxable debt. While this is true, this implicit tax on municipal bond interest generally amounts to only 30 percent, far less than the tax high-income investors would pay on fully taxable income.

Tax Exemption as an Inefficient Subsidy. Tax exemption provides a subsidy to State and local governments by enabling them to issue bonds at interest rates below those prevailing on comparable taxable securities. However, as a device to reduce State and local borrowing costs, tax exemption is an inefficient use of Federal funds because the loss in revenue to the Treasury is greater than the reduction in interest costs to the borrower. The difference accrues in the form of windfall gains to high-income purchasers of tax-exempt bonds.

To demonstrate the inefficiency of tax exemption as a subsidy, it is first necessary to determine the actual subsidy which tax exemption provides to State and local

governments. As Table IIIA-1 indicates, tax-exempt borrowers over the years have benefited from interest rates on average equal to about 70 percent of taxable rates. Thus, the implicit subsidy of tax exemption is equivalent to a 30 percent interest rate reduction. The 30 percent implicit subsidy to tax-exempt securities is an average across the maturity spectrum of State and local bonds as well as over time. The current operation of the municipal bond market provides a larger subsidy for securities with maturities of five years or less--on the order of 40 percent below taxable rates--and a smaller subsidy on 20 to 30 year securities--on the order of 25 percent. Thus, as maturities lengthen, interest rates for State and local bonds rise more steeply than those for comparable taxable debt. The reason for this is the domination of the shorter term municipal market by commercial banks. However, to simplify the analysis, the discussion which follows generally considers the market as a whole with an average implicit subsidy of 30 percent.

Although the average subsidy provided by tax exemption is 30 percent, a reasonable estimate of the average marginal tax rate of all purchasers of tax-exempt bonds -- households or individual investors, commercial banks, and other financial institutions -- is about 42 percent. In other words, if municipal bond interest income were subject to tax, issuers of this debt would lose a subsidy of 30 percent of the taxable rate and the Treasury would gain revenues equal to about 42 percent of the taxable rate. This means that less than 75 percent of the Treasury revenue loss flows to State and local governments.

There is no inconsistency in the fact that tax-exempt interest rates average about 70 percent of taxable rates at the same time that the average investor is in the 42 percent marginal tax bracket. Clearly, not all holders of tax-exempt debt are in the 42 percent tax bracket. Some, such as banks and high-income individuals are in higher tax brackets and others with smaller amounts of taxable income are in lower tax brackets. High-income taxpayers generally have a strong incentive to invest heavily in tax-exempt debt, since their after-tax returns from such investments tend to greatly exceed their after-tax returns on comparable taxable securities. Indeed, high tax bracket individuals and institutions comprise the bulk of the purchasers of tax-exempt bonds.

If issuers of bonds, however, wish to borrow more funds than are generally supplied from high-tax bracket individuals and institutions, tax-exempt debt has to be made attractive to potential lenders with more moderate incomes. The only way this can occur is by increasing the tax-exempt interest rate relative to the taxable rate so that tax-exempt bonds yield a higher after-tax return even to those in less than the highest tax brackets. To be sure, the very rich may also

be induced to increase their lending at more favorable tax-exempt rates, but tax-exempt rates will continue to rise until lenders across all tax brackets are supplying the exact amount of funds that State and local governments wish to borrow.

Table III A-1

Tax-Exempt and Taxable Interest Rates

Year	Tax-Exempt Interest Rate (Bond Buyer 20)	Taxable Interest Rate (Moody's Newly Issued Industrials)	Ratio
1960	3.54	4.67	75.8
1961	3.45	4.70	73.4
1962	3.17	4.53	70.0
1963	3.16	4.42	71.5
1964	3.22	4.51	71.4
1965	3.25	4.80	67.7
1966	3.81	5.52	69.0
1967	3.92	5.79	67.7
1968	4.42	6.64	66.6
1969	5.66	7.84	72.2
1970	6.36	8.86	71.8
1971	5.52	7.80	70.8
1972	5.25	7.51	69.9
1973	5.22	7.86	66.4
1974	6.09	8.87	68.7
1975	7.06	9.12	77.4
1976	6.70	8.61	77.8
1977	5.68	8.15	69.7

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This analysis indicates why tax-exempt bonds, on the average, trade at interest rates equal to 70 percent of those on taxable securities. For current levels of borrowing, it is necessary for tax-exempt rates to rise to the point where the investor in the 30 percent marginal tax bracket can benefit from buying tax-exempt bonds. Thus, while it was earlier stated that the average lenders of funds are in the 42 percent tax bracket, the last, or the marginal, lenders of funds are in about the 30 percent tax bracket. The marginal tax rate of the marginal lender determines the interest rate advantage to the issuing governments, but the marginal tax rate of all borrowers together determines the losses to the Treasury. The reason why tax exemption as a subsidy is inefficient is that the marginal tax rate of the last lender is below the marginal tax rate of all lenders taken together.

Individual investors, of course, are not the only source of funds for State and local governments. As considered below, commercial banks play a major role in the municipal bond market as well. Nonetheless, to the extent that State and local governments wish to borrow more than commercial banks are willing to lend, individual investors have to be drawn into the market. To attract individuals in lower tax brackets to tax-exempt bonds, tax-exempt rates must increase relative to taxable rates.

Thus, tax exemption as a source of tax inequity and as an inefficient subsidy are two reflections of the same image. A higher tax-exempt rate relative to the taxable rate means both a lower subsidy to State and local governments and greater windfall gains to high bracket individuals. An investor in the 50 percent tax bracket, for example, would be willing to buy tax-exempt bonds as long as the return was just about one-half of that on taxable instruments. As municipal rates rise to 60 percent, 65 percent and 70 percent of the taxable rate, this investor finds that the after-tax return becomes increasingly above that required to induce him to invest. This extra return is purely a windfall gain for him. Thus, the higher the tax-exempt rate relative to the taxable rate, the smaller the advantage of tax-exempt financing to the borrower and the greater the windfall gains to the lenders.

The Cyclical Volatility of the Tax-Exempt Market. The tax-exempt bond market, largely as a consequence of the tax exemption itself, exhibits a high degree of volatility over the business cycle. While the long-term trend of issues of State and local government securities has been upward as shown in Table IIIA-2, there have been periods of tight money, such as the years 1966 and 1969, when the volume of new issues has either been stagnant or has declined. Moreover, as indicated by the ratio of tax-exempt to taxable interest rates in Table IIIA-1, there is a strong tendency for tax-exempt rates to increase relative to taxable rates in

Table III A-2

Volume of Gross New Issues of Long-Term Municipal Bonds by Year

Year	Gross Issues
1960	7,229
1961	8,359
1962	8,558
1963	10,107
1964	10,544
1965	11,084
1966	11,089
1967	14,288
1968	16,374
1969	11,460
1970	17,762
1971	24,370
1972	22,941
1973	22,953
1974	22,824
1975	29,326
1976	33,845
1977	44,915

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Source: Bond Buyer.

such periods. These phenomena mean that when credit conditions tighten State and local governments experience relatively higher borrowing costs and are among the first borrowers to be crowded out of capital markets.

To understand why the tax-exempt market exhibits this volatility, it is necessary to examine the behavior of the major participants in the municipal bond market. The traditional sources of lending to State and local governments consist of individuals and institutions in sufficiently high marginal tax brackets to find tax-exempt securities attractive. Three groups comprise the major sources of demand for State and local bonds: commercial banks, casualty insurance companies, and household investors. Table IIIA-3 shows the ownership of outstanding municipal securities by these three investor groups and all others taken together by five year intervals from 1960 through 1975. Table IIIA-4 indicates the annual net purchases of State and local bonds by these same investors over the period 1960 to 1976.

Table III A-3

Ownership of Municipal Securities

Year-End Outstandings, Selected Years

(millions of dollars)

Year	Total	Households		Commercial Banking		Nonlife Insurance		All Other	
		Millions of Dollars	Percent	Millions of Dollars	Percent	Millions of Dollars	Percent	Millions of Dollars	Percent
1960	$ 70.8	$ 30.8	43.5%	$ 17.7	25.0%	$ 8.1	11.4%	$ 14.2	20.1%
1965	100.3	36.4	36.3	38.8	38.7	11.3	11.3	13.8	13.8
1970	144.4	46.0	31.9	70.2	48.6	17.0	11.8	11.2	7.8
1975	221.9	67.5	30.4	102.8	46.3	33.3	15.0	18.3	8.3
1977 1/	259.1	79.7	30.8	114.2	44.1	42.8	16.5	22.4	8.7

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Source: Federal Reserve Board, flow of funds data.

1/ Estimated for end of third quarter.

Table III A-4

Net Change in Ownership of Municipal Securities

Seasonally Adjusted Annual Rates

Year	Total: Billions of Dollars	Total: Percent	Individuals: Billions of Dollars	Individuals: Percent	Commercial Banks: Billions of Dollars	Commercial Banks: Percent	Fire & Casualty Insurance Companies: Billions of Dollars	Fire & Casualty Insurance Companies: Percent	All Other: Billions of Dollars	All Other: Percent
1960	5.3	100.0	3.6	67.9	.6	11.3	.8	15.1	.3	5.7
1961	5.1	100.0	1.2	23.5	2.8	54.9	1.0	19.6	.1	2.0
1962	5.4	100.0	-1.0	-18.5	5.7	105.6	.8	14.8	-.1	-1.9
1963	5.7	100.0	1.0	17.6	3.9	68.4	.7	12.3	.1	1.8
1964	6.0	100.0	2.6	43.3	3.6	60.0	.4	6.7	-.6	-10.0
1965	7.3	100.0	1.8	24.7	5.1	69.9	.4	5.5	.0	-
1966	5.6	100.0	4.0	71.4	2.4	42.9	0.7	12.5	-1.5	-26.8
1967	7.8	100.0	-2.3	-29.5	9.1	116.7	1.5	19.2	-.5	-6.4
1968	9.5	100.0	-.5	-5.3	8.6	90.5	0.9	9.5	0.5	5.3
1969	9.9	100.0	9.3	93.9	.6	6.1	1.1	11.1	-1.1	-11.1
1970	11.2	100.0	-.9	-8.0	10.7	95.5	1.5	13.4	-.1	-0.9
1971	17.4	100.0	0.1	0.6	12.6	72.4	3.5	20.1	1.2	6.9
1972	14.7	100.0	2.3	15.7	7.2	49.0	4.3	29.3	.9	6.1
1973	14.7	100.0	5.3	36.1	5.7	38.8	3.6	24.5	.1	0.7
1974	17.1	100.0	8.9	52.1	.5.5	32.2	2.2	12.9	.5	2.9
1975	13.6	100.0	5.0	36.8	1.7	12.5	2.6	19.1	4.3	31.6
1976	15.1	100.0	4.2	27.8	3.0	19.9	4.2	27.8	3.7	24.5
1977 1/	29.0	100.0	9.3	32.1	11.9	41.0	7.2	24.8	0.6	2.1

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1/ First three quarters of year expresse at annual rates.

Source: Federal Reserve Board, flow of funds data.

These tables illustrate the important impact of commercial bank behavior on the municipal bond market. When money is tight, commercial banks first look to meet the demand for loans by their customary business clients, and only as their resources permit do they purchase municipal bonds. Thus, the most difficult periods of financing for States and localities are generally when commercial banks are able to absorb only a small portion of the net issues of municipal debt, such as occured in the years 1966 and 1969 and more recently in 1975 and 1976. During these periods, increased purchases of municipal debt by households only partially offset the decline in commercial bank participation. Borrowing costs to State and local governments rise, and the dollar volume of new issues falls. The reason tax-exempt rates must rise when banks leave the market is to provide a sufficient incentive for households to absorb a larger share of municipal debt. In periods of credit stringency, then, the loss of bank demand for municipal bonds is only partially compensated by increased household purchases. At the same time, the rise in the tax-exempt rate relative to the taxable rate reduces the value of the subsidy provided by tax exemption.

Tables IIIA-3 and IIIA-4 also indicate that the overall participation of commercial banks in the municipal bond market has declined in recent years. Throughout the 1960's, commercial banks absorbed 63 percent of the total supply of State and local debt. In the 1970's commercial banks have absorbed only 40 percent. Table IIIA-5 presents even more sharply the declining role of commercial banks in the municipal bond market. This table shows net changes in holdings of credit market instruments other than U.S. securities by commercial banks since 1965. Through 1971, municipal bonds generally amounted to 50 percent of commercial bank acquisitions of credit market securities. Since 1972, however, partly as a result of the availability of other sources of tax-favored income, the share of such security purchases accounted for by State and local bonds has declined to the range of 20 to 30 percent. Thus, in addition to the cyclical volatility of the market, there is some concern that traditional purchasers of tax-exempt debt will fail to provide funds for State and local capital financing over the longer term. In 1975 and 1976, other investors took up the slack of a reduced volume of purchases by commercial banks. In part these other investors were State and local pension funds whose purchases reflect the unusual circumstances in New York City and State. Since pension funds derive no advantage from tax exemption, they cannot be expected to continue as a permanent source of State and local financing.

Table III A-5

Net Changes in Holdings of Credit Market

Instruments Other Than U.S. Securities by Commercial Banks

Year	State & Local Bonds	Corporate Bonds	Commercial Mortgages	Other Mortgages	Total	State & Local Bonds as Percentage of Total
	(..................billions of dollars				................)	(..........%.........)
1965	5.1	-.1	2.0	3.7	10.7	47.7
1966	2.4	*	2.0	2.7	7.1	33.8
1967	9.1	0.8	1.6	3.0	14.4	63.2
1968	8.6	0.3	2.6	4.0	15.4	55.8
1969	0.6	-.1	1.8	3.7	6.0	10.0
1970	10.7	0.8	1.2	1.0	13.6	78.7
1971	12.6	1.2	3.0	6.7	23.6	53.4
1972	7.2	1.7	5.4	11.4	25.6	28.1
1973	5.7	0.4	6.9	12.8	25.9	22.0
1974	5.5	1.1	5.0	7.9	19.4	28.4
1975	1.7	1.8	3.2	1.1	7.8	21.8
1976	2.9	-0.6	2.6	11.0	15.9	18.2
1977 1/	11.9	-0.4	8.0	18.1	37.6	31.7

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1/ First three quarters expressed at annual rates.

* Less than $0.05 billion.

General Explanation

The Administration proposal will establish an election in the Internal Revenue Code for State and local governments to issue taxable bonds and other debt obligations with the Federal Government paying a fixed portion of the actual dollar amount of the issuer's interest cost. For obligations issued during 1979 and 1980, the Federal Government will pay 35 percent of the interest cost. For obligations issued thereafter, the Federal Government pay 40 percent. All tax-exempt State and local obligations will be eligible for this taxable bond alternative. These include general obligation and revenue bonds issued by a State and local government as well as industrial development bonds, the interest on which is tax exempt. There would be no Federal control over the purposes for which the taxable obligations could be issued. However, obligations held by related entities (such as related pension funds) would be eligible for the election only if the obligations were issued through a competitive public offering. The Federal interest subsidy would be paid to the issuer (or its paying agent) which would act as paying agent for the Federal Government. The Federal Government would not be liable for its portion of the interest until the issuer pays the remaining interest. The proposal would establish an entitlement for State and local governments to assure that funds necessary to pay the Federal Government's portion of the interest would be appropriated annually.

Analysis of Impact

The taxable bond option, under which State and local governments will have the choice of issuing either conventional tax-exempt bonds or subsidized taxable bonds, will deal simultaneously with all of the major problems in the tax exempt bond market. To determine the extent to which the taxable bond option will contribute to tax equity, the efficiency of the subsidy now provided to State and local governments, and the stability of the municipal bond market, it is first necessary to analyze how the option will operate.

Under the taxable bond option, State and local governments which choose to issue taxable bond in place of tax-exempt bonds will receive a Federal subsidy equal to a fixed percentage of the interest costs on the taxable securities. It is important to emphasize the voluntary nature of this plan. State and local governments on their own volition will decide whether they wish to issue subsidized taxable or conventional tax-exempt debt. Since this decision will presumably be made on the basis of which type of security affords the lower net interest cost, State and local governments can only benefit from the plan. If the subsidized taxable bond fails to yield lower net interest costs, States and localities simply will not avail themselves

of it. Furthermore, the higher the subsidy the greater the benefits to the issuing governments.

Nonetheless, some representatives of State and local governments have expressed a concern that the subsidy rate could be too high. The basis of this concern is that if taxable bonds were made too attractive, the tax-exempt market would virtually disappear and issuers would no longer have available a tax-exempt market in the event that the subsidy to taxable bonds were discontinued. On these grounds, the subsidy should never be so high as to completely eliminate the tax-exempt market.

On the other hand, too low a rate of subsidy would clearly undermine the objectives of the plan. A low subsidy would in the first instance accomplish little in solving the basic problems of the tax-exempt market. In addition, the subsidy must be large enough to elicit a sufficiently large volume of issues of the new taxable security to generate market acceptance. If only a slight volume of taxable municipal debt were issued, such debt could very well be regarded as a mere market curiosity with little secondary trading, poor liquidity characteristics, and an attendant loss of interest on the part of potential lenders. Thus, the subsidy under the taxable bond option must be provided at a level which will maintain both the taxable and the tax-exempt alternatives for State and local financing. It must neither be so high as to eliminate the tax-exempt market nor so low as to preclude the development of a taxable municipal market. A permanent subsidy of 40 percent (after a two year transitional subsidy of 35 percent) would maintain markets for both taxable and tax-exempt municipal debt.

The permanent 40 percent subsidy on taxable bonds will operate as follows. For each of their bond issues, State and local governments presumably will accept bids on both a tax-exempt and a taxable basis. Then, after accounting for the Federal subsidy on taxable bonds, they will decide which form of security will yield the lower interest costs. Initially, with market yields unchanged, it may be expected that subsidized taxable bonds would provide the lower interest costs. In fact, to forestall too large an initial shift of financing out of the tax-exempt market which could have a disruptive impact on that market, the subsidy for the first two years of operation of the plan is set at 35 percent rather than 40 percent. As the volume of tax-exempt debt declines in response to the taxable subsidy, interest rates on tax-exempt debt also will decline, since the reduced volume will no longer require higher interest rates to attract marginal lenders.

This decline in tax-exempt rates will itself keep tax-exempt financing attractive, and the flexibility of financial markets will soon effect an equivalence of interest

costs between subsidized taxable and tax-exempt debt. The issuing governments themselves, along with the underwriters of their debt, will be instrumental in bringing this equivalence about since States and localities will tend to issue debt in that sector of the market providing the most advantageous financing terms. Thus, State and local governments will generally face a situation where the interest costs of taxable borrowing (net of the Federal subsidy) will equal the costs of tax-exempt borrowing. At this point, the issuing governments will be indifferent to the particular type of debt they issue, and the form of debt will merely reflect the market preferences of lenders for tax-exempt as opposed to taxable securities.

The voluntary nature of the plan assures that States and localities will gain significant benefits in terms of reduced borrowing costs. They will only choose the taxable option if it offers cost advantages. As long as taxable bonds are issued, however, tax-exempt interest costs will also decline. Thus, a saving in interest costs will occur on the total volume of debt issued and will be independent of the form in which it is issued. The equilibrium outcome, then, will be that under the 40 percent subsidy, tax-exempt interest rates will be 40 percent below taxable rates and States and localities will be indifferent between issuing subsidized taxable or tax-exempt debt.

The benefits of the taxable bond option will accrue to all issuers of tax-exempt debt regardless of their relative credit standings. The Federal Government's agreement to pay a portion of the interest cost on taxable bonds will not in any way constitute a guarantee of the issuer's obligation to pay principal or its portion of the interest cost. Consequently, the taxable bond option will not enable issuers with a poor credit standing to gain any greater access to financial markets than that available to more creditworthy issuers. The taxable bond option will establish a tax-exempt rate for all grades of issuers at approximately 60 percent of the taxable rate for comparable credits. All issuers, therefore--both those with good and poor credit standings--will benefit from a reduction in their borrowing costs.

The new volume of issues of taxable and tax-exempt debt under a 40 percent subsidy is not easy to estimate. It depends not only on what lenders will wish to hold in their portfolios at the new structure of interest rates but also on how quickly they will be able to adjust their portfolios from their current pattern of holdings. A reasonable calculation, based on informed market opinion as well as on estimates derived from econometric models, is that after an adjustment period of possibly five years, about 25 percent of State and local bond issues will be in taxable form and 75 percent in tax-exempt form. This is the likely response to tax-exempt

rates 40 percent below taxable rates rather than 30 percent as under current law. In the short run, however, in order to bring about this large a portfolio shift in long-run asset holdings, perhaps 50 percent of the market will be taxable until final equilibrium is achieved. The revenue estimates provided below reflect these assumptions.

Effects on Equity. On equity grounds, a 40 percent subsidy will mean a higher implicit tax rate on those holding municipal bonds -- 40 percent rather than the current implicit tax rate of about 30 percent. Very high-bracket taxpayers will continue to find tax-exempt bonds to be an advantageous investment since even the increased implicit tax of 40 percent will remain below the explicit taxes they will pay on taxable debt. Nonetheless, the after-tax income distribution in general will exhibit greater equity as a result of the reduced opportunity for tax avoidance by those in high-income tax brackets.

The improvement in tax equity will be brought about in two ways. First, there will be a smaller volume of tax-exempt debt available as some State and local governments choose to issue subsidized taxable rather than tax-exempt debt. Secondly, the tax-exempt debt which continues to be issued will command lower interest rates on the market. For both of these reasons, the dollar volume of interest income avoiding tax would be reduced by about 35 percent under the taxable bond option. At current levels, this will amount to a reduction of tax-exempt interest income of about $4.0 billion.

Effects on Tax Exemption as a Subsidy. The taxable bond option also will increase the efficiency of the current subsidy which tax exemption provides to State and local governments. Under current law, these governments receive less than 75 cents in reduced interest costs for each dollar of tax revenue foregone by the Federal Treasury. The incremental benefit to cost ratio under the taxable bond option is much more favorable. In the first five years of the plan, each dollar of Federal subsidy net of revenue gain will provide between $2 and $2.50 of interest savings. In the long run, this number will rise to over $4 per dollar of net Federal cost.

The high leverage of the taxable bond option as measured by State and local interest saving per dollar of net Federal cost results from two sources. The first, as already noted, is that the subsidy is only paid on issues of taxable bonds, whereas States and localities also benefit from the lower interest rates which will prevail on tax-exempt bonds. The second source of the high leverage of this plan is the fact that a portion of the cost of subsidizing taxable municipal bonds will be recouped as increased tax revenues on the new taxable securities. The result is that the net cost of the

taxable bond option is considerably lower than the gross outlays for the subsidy. Under the assumption that the option is made available on January 1, 1979, the saving in interest costs for States and localities beyond that currently provided by tax exemption is as follows:

Calendar Year
($ billions)

1979	1980	1981	1982	1983
0.1	0.3	0.5	0.9	1.3

Effects on Cyclical Volatility. The taxable bond option will also help to solve the problem of the cyclical volatility of the municipal market. The main source of this short-run volatility, as well as a possible troublesome development in the long run, is the tendency of commercial banks to abandon the tax-exempt market causing tax-exempt interest rates to rise. Under the taxable bond option, the tax-exempt rate will be linked necessarily to the taxable rate by the subsidy percentage. With a 40 percent subsidy, borrowers trying to minimize interest costs will maintain the tax-exempt rate at 60 percent of the taxable rate. If the tax-exempt rate were to temporarily rise to more than 60 percent of the taxable rate, State and local governments would switch their new issues from the tax-exempt to the subsidized taxable market until the tax-exempt rate again declined to 60 percent of the taxable rate. Since the taxable bond option will assure that the tax-exempt rate is effectively tied to 60 percent of the taxable rate, the withdrawal of commercial banks from the tax-exempt market will not cause a rise in State and local borrowing costs. Instead, a decline in commercial bank participation will be reflected in an increased volume of taxable issues as State and local governments compensate for the lost bank demand by turning to other sources of lending such as tax-exempt institutions, life insurance companies and individual investors who are not interested in tax exemption. The taxable bond option will allow these governments to retain the benefit of a constant borrowing cost differential below taxable rates because they will be able to tap new sources of funds and new investors beyond those who now derive advantages from tax-exempt interest income.

Effective Date

The taxable bond option will apply to obligations issued after December 31, 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
—	156	465	863	1355	1808

Outlay Estimate

Change in Outlays
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	199	592	1115	1770	2374

Technical Explanation

The Internal Revenue Code will provide an election for State and local governments, possessions or territories of the United States and the District of Columbia, to issue taxable obligations. The Federal Government will provide an interest subsidy of 35 percent of the interest cost on taxable obligations issued during 1979 and 1980, and 40 percent for obligations issued thereafter.

Form of Election. The election will be made in the form of a notice to the Secretary of the Treasury (or another official designated by the Secretary).

A separate election will be made by the issuer for each taxable issue. It is intended that the election be made at any time before the obligations are, in fact, issued (i.e., before there is a physical delivery of the evidences of indebtedness in exchange for the issue price). Thus, the issuer will be able to request dual bids (separate bids for tax-exempt bonds and for taxable bonds) and make the election based upon the bids received for both types of bonds.1/

An election with respect to any issue will be irrevocable once the obligations are issued. Thus, any notification to the Federal Government relating to an

election could be withdrawn at any time before obligations are issued. No advance ruling or any other form of advance approval by the Secretary or any other Federal official will be required before the election can be made.2/

Eligibility. In general, all obligations the interest on which is exempt from tax under the Internal Revenue Code will be eligible for the taxable bond election. This includes general obligation bonds, revenue bonds, and short-term obligations such as tax anticipation notes. Also, industrial development bonds, the interest on which is exempt from tax under the Internal Revenue Code, and obligations the interest on which is presently tax-exempt under the Housing Act of 1937 will be eligible for the election. The election will not apply to arbitrage bonds, which are denied tax exemption under the Code, non-exempt industrial development bonds and obligations whose exemption derives from provisions other than the Internal Revenue Code or the Housing Act of 1937.

Obligations on which the United States guarantees all or part of the principal or interest or is liable to pay any part of the principal or interest will not be eligible for the subsidy. Further, obligations which the United States is committed to purchase as a means of providing financial assistance will not be eligible for the subsidy. For example, the United States may purchase or promise to purchase obligations at a price higher than the market price as a means of guaranteeing the bonds or subsidizing their interest payments.

Obligations will be eligible for this subsidy, however, even though the United States indirectly provides funds for the payment of part of the principal or interest. For example, obligations issued under Section 8 of the Housing Act of 1937 will be eligible for the subsidy.

Related Entities. The election to issue taxable bonds will not apply to any obligation which is held by an entity related to the issuer if the obligation is not issued pursuant to a public underwriting. This requirement is intended to prevent issuance of taxable bonds at an inflated rate to take advantage of the Federal subsidy. Since a State or local government may be making payments to related entities in any event, its share of an inflated interest rate may not be a real cost. Where these obligations are distributed through a public underwriting, the Federal Government can be assured that the interest rate on any obligation held by related entities is not overstated. In limited circumstances where a State or local government needs immediate funding and there is no public market for the obligations, the Secretary may waive the requirement of a public underwriting if he is satisfied that the interest rate is not artificially inflated.

An issue of obligations will be considered to have been issued pursuant to a public underwriting if the obligations are purchased by independent underwriters for resale to the general public. An issue will not be considered to have been purchased for resale to the general public unless at least 40 percent of the face amount of the issue is acquired for investment by persons which are not related entities. Further, in any case in which an issue is composed of obligations bearing different rates of interest, at least 40 percent of the face amount of the obligations issued at each separate interest rate must be acquired for investment purposes by persons who are not related entities.

Related entities include, in the case of a State, any political subdivision of the State, and, in the case of a political subdivision of a State, the State itself and any other political subdivision of the same State. Thus, unless issued in a public underwriting, bonds of one municipality purchased by another municipality within the same State will not be eligible for the taxable bond election. Furthermore, the State cannot, except through a public underwriting, buy eligible obligations of any of its municipalities nor can municipalities buy eligible obligations of their State. Any agency or instrumentality of a State or political subdivision (including any trust or plan for the benefit of the employees of a State or political subdivision) will be treated as part of the State or political subdivision. Thus, a municipality's pension fund is a related entity of the municipality, of all other municipalities of the State, and of the State. However, a municipal bond bank, whose function is to assist the marketing of obligations of small governmental issuers, will not be treated as a related party. Finally, in the case of obligations issued by an instrumentality of two or more States, all of the States involved and political subdivisions within those States will be considered related entities to the instrumentality.

Arbitrage. The arbitrage bond provisions of the Code currently applicable to tax-exempt bonds will be applicable to taxable bonds issued under the election. Thus, bonds denied the tax exemption under the arbitrage rules of the Code will not be eligible for the subsidy. In determining whether or not an obligation is an arbitrage bond (i.e., whether its proceeds are reasonably expected to be used to acquire securities which will produce a yield materially higher than the yield on the obligations issued), the yield on the issue will be determined with reference only to that portion of the yield which is to be paid by the issuing State or local government. In this way municipalities will have no incentive to issue taxable obligations in order to reinvest the proceeds in other taxable securities.

Payment of Subsidy. The Federal Government will make a payment of 35 or 40 percent (depending on the date on which the obligation was issued) of the interest liability of the issuer on each obligation to which a taxable bond election applies. The Treasury Department will pay its portion of the interest to the issuer (or to a paying agent appointed by the issuer). However, the Federal Government will not be liable for its payment on the obligation until the issuer has paid its portion of the interest on the obligation. Thus, if a State or local government defaults on its interest payment, the Federal Government will not be required to pay its portion of the interest on the obligation. Of course, the Federal Government will pay its portion at any time that the issuer cures its default by making its payment to the holders of the obligation.

The interest subsidy payment will be made without any condition or requirement by the Secretary of the Treasury. Thus, unless the bond or other obligation is determined to be ineligible for the election under the Code, the payment will be made automatically. In addition, the purposes for which the obligation is issued will not be reviewed by the Secretary as long as the obligation qualifies for the election under the Code.

The availability of funds necessary to finance the Federal interest subsidy will be assured by establishing an entitlement for State and local governments to the amount of appropriations necessary to pay the full accrued cost of the interest subsidy. Annual appropriations of the necessary funds will be automatic since, if no funds are appropriated, State and local government issuers will be able to sue the United States in the Court of Claims for payment of the funds. Such legal action will not be necessary since the Congress has not once failed to appropriate funds under entitlement programs.

Footnotes

1/ It is anticipated that bids on issues of serial bonds (i.e., where the bonds in the issue have varying maturities) will often indicate that a State or local government should split its issue, with the longer term bonds being taxable and the shorter term bonds tax-exempt. Nothing in this proposal will prevent a State or local government from splitting such an issue. For purposes of these provisions, however, the taxable bonds and the tax-exempt bonds will be considered to be separate issues.

2/ Of course, if a tax ruling is requested by the issuer prior to making the election, the Treasury Department will require that appropriate documents, as is the case today for tax-exempt bond rulings, be submitted or be made available to show that the obligations included in the issue qualify for the election under the Internal Revenue Code.

TAX TREATMENT OF INDUSTRIAL DEVELOPMENT BONDS

Present Law

Industrial development bonds (IDBs) are obligations which raise capital for private business enterprise but are nominally issued by State or local governments. Most frequently, the proceeds of an issue of IDBs are used to acquire or to construct a facility; the facility is then "leased" to a private user for a rental exactly sufficient to pay debt service on the bonds. The lease generally provides that the private user may purchase the facility for a nominal amount at the end of the lease term. Payment of debt service on the bonds is secured by the rental payments and the facility itself. Generally the nominal issuer is not liable for payment of debt service on the bonds and the holders must look solely to the credit of the private user.

In issuing IDBs a State or local government essentially lends its tax exemption to a private business to enable it to finance facilities at the lower interest rates prevailing in the tax exempt market. In addition, the "lease" agreement between the issuer and the private user is generally treated as a conditional sale contract for Federal income tax purposes; the user is, therefore, able to obtain the tax benefits associated with ownership of the property, including investment tax credits and accelerated depreciation or amortization. State and local governments use IDB financing to assist local industrial development. Since these governments incur no liability on the bonds, which are universally recognized as a debt of the private user, the issuance of IDBs has no direct consequence to the nominal issuer.

Interest on State and local government obligations is generally exempt from tax under the Internal Revenue Code. However, the Revenue and Expenditure Control Act of 1968 denied tax exemption to IDBs, with certain exceptions. In general, a bond is an IDB under the Code if (1) the proceeds of the issue are to be used in any trade or business not carried on by a government or tax-exempt organization and if (2) repayment of principal or interest is secured by an interest in, or derived from payments with respect to, property used in a trade or business. Obligations issued by a State or local government to raise funds for use by a non-profit, charitable organization in its trade or business are not generally treated as IDBs and are thus tax exempt.

The exceptions to the general rule allow tax exemption for IDBs issued to finance certain enumerated facilities and for certain "small issues". The enumerated facilities for which tax-exempt IDBs may be issued without any dollar amount limitation, include:

(1) Residential real property for family units,

(2) Sports facilities,

(3) Convention or trade show facilities,

(4) Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to these facilities,

(5) Public utility facilities used to provide sewage treatment or solid waste disposal and facilities designed for the local furnishing of electric energy or gas,

(6) Air or water pollution control facilities,

(7) Facilities for the furnishing of water, if available on reasonable demand to members of the general public, and

(8) Industrial parks.

There is also an exemption for "small issues" of IDBs in amounts of $1 million or less if the proceeds are used for the acquisition or construction of land or depreciable property. The $1 million limitation applies to all bonds issued to provide facilities in one municipality or county for the same person or group of related persons. At the election of the issuer, the $1 million limitation may be increased to $5 million; if elected, however, the higher $5 million limitation is restricted to projects where the total capital expenditures over a 6-year period will not exceed $5 million.

Reasons for Change

Prior to 1968, interest on industrial development bonds (IDBs) issued by State and local governments had been exempt from Federal income taxation. The use of such IDBs had been growing in importance as a mechanism by which State and local governments sought to attract plants to their communities. Through the use of IDBs, these governments had been able to extend the tax exemption afforded to interest on their securities issued for public investment to interest on bonds issued for essentially private purposes. Of course, as many

States and localities came to utilize this method, the competitive advantage was lost and the increased volume of tax-exempt financing affected the interest cost of public issues. These factors, and fear of increasing revenue losses to Treasury as use of this method of financing long-term private debt expanded, led to the limits on tax-exempt IDBs included in the Revenue and Expenditure Control Act of 1968.

In this Act, Congress did not remove the exemption for all industrial development bonds. In terms of the dollar volume of obligations, the most important of the exceptions that remain is for financing pollution control expenditures. As Table IIIB-1 shows, pollution control IDBs for the years 1973 - 1977 accounted for over 80 percent of private tax-exempt borrowing, and for 6 to 7 percent of all tax-exempt borrowing.

Table IIIB-1

Tax-Exempt Borrowing: 1971-1977

Year	Gross Long-Term Tax-Exempt Borrowing ($millions)	Private IDBs 1/ Pollution Control ($millions)	Private IDBs 1/ Others ($millions)	Pollution Control as Percent of: All Tax-Exempt	Pollution Control as Percent of: Private IDB's
1971	24,370	77	220	0.9	25.9
1972	22,941	563	471	2.5	54.5
1973	22,953	1771	270	7.7	86.8
1974	22,824	1673	340	7.3	83.1
1975	29,326	2134	518	7.3	80.5
1976	33,845	2064	357	6.1	85.3
1977	44,915	2982	476	6.6	86.2

Source: Weekly Bond Buyer

1/ Includes pollution control, small issues and industrial park IDBs. Does not include IDBs of a quasi-governmental character, such as airports, docks, wharves, and residential real property for family units.

As recently as 1971, in contrast, tax-exempt financing of pollution control facilities accounted for less than one percent of all tax-exempt borrowing. In fact, the annual volume of tax-exempt pollution control financing today is more than double the total annual volume of all industrial development bond financing in 1967 ($1.4 billion) which had motivated legislation to limit the use of tax-exempt IDBs. 1/

Table IIIB-2 shows how dramatically tax-exempt borrowing has increased as a source of funds for pollution control expenditures. Using estimates on air and water pollution control expenditures supplied by McGraw-Hill, the table shows that tax-exempt borrowing financed only 2.4 percent of pollution control expenditures in 1971. In contrast, tax-exempt borrowing has accounted for between one-fourth and one-third of all pollution control expenditures for the years 1973 through 1976.

Table IIIB-2

Importance of Tax-Exempt Borrowing for Pollution Control Expenditures

Year	Industrial Pollution Control Borrowing ($millions)	Air and Water Pollution Control Expenditures BEA ($millions)	Air and Water Pollution Control Expenditures McGraw-Hill ($millions)	% of Pollution Control Expenditures Financed by Tax-Exempt Borrowing BEA	% of Pollution Control Expenditures Financed by Tax-Exempt Borrowing McGraw-Hill
1971	77	n.a.	3245	n.a.	2.4
1972	563	3913	4501	14.4	12.5
1973	1771	4938	5687	35.9	31.1
1974	1673	5219	6922	32.1	24.2
1975	2134	6152	6702	34.7	31.8
1976	2064	6336	7713	32.6	26.8

Source: Weekly Bond Buyer, various issues, U.S. Department of Commerce, Bureau of Economic Analysis (BEA) Survey of Current Business, July issues, McGraw Hill, Pollution Control Expenditures; Annual Surveys

In permitting the pollution control exception in 1968, Congress could not have contemplated this large a volume of tax-exempt financing. It was argued at that time that private investments for pollution control could justify some type of Federal subsidy since these investments produced

benefits to the public in terms of environmental improvement for which firms might not be compensated in private markets. Moreover, it was argued that the low level of spending on such investments assured that the revenue loss from exempting the interest on IDBs used to finance them would be small.

Furthermore, whatever their merit in the past, the reasons for allowing tax free interest on IDBs for pollution control no longer apply. In recent years, many pollution control investments have been effectively mandated by the requirements of Federal law and by EPA regulations that firms meet specified emissions standards.2/ Because these regulations compel firms to undertake the desired investments, tax exemption no longer functions as an effective incentive.

Moreover, continuing to allow tax-free IDBs to finance pollution control facilities has three undesirable effects:

1) It lessens tax equity by increasing the amount of interest income which is tax-exempt.

2) It creates economic inefficiencies by encouraging the wrong types of investments in pollution control equipment and by subsidizing some industries relative to others.

3) It raises the cost to State and local governments of borrowing in the tax-exempt market for public sector investments.

Thus, as discussed in detail below, the elimination of tax-exempt financing for pollution control equipment would promote tax equity and economic efficiency and would lower the cost of borrowing to State and local governments.

The two other types of tax-exempt IDBs that relate to borrowing for essentially private purposes are small issue IDBs and IDBs for industrial parks. Repealing the tax-exempt treatment of these bonds would also improve tax equity, increase economic efficiency, and reduce borrowing costs to State and local governments. However, an exception should be made for small issue IDBs in some economically distressed areas to promote economic development where it is most needed.

Finally, it is desirable to limit the use of tax-exempt bonds in financing hospital construction. Limits on such financing are complementary to other proposals included in the Administration's Hospital Cost Containment Act designed to prevent excess expansion of hospital facilities.

General Explanation

The Administration proposal will revise the tax law relating to IDBs in three respects. First, it will repeal the tax exemption for IDBs issued to finance pollution control facilities and industrial parks. These facilities will be placed on the same footing as other purely private facilities. The proposal will thus restrict access to the tax-exempt market to bonds issued to finance activities and facilities which are generally governmental in nature, thereby improving the access of those bonds to the market.

Second, the Administration proposal will revise the small issue exemption by doubling the $5 million small issue limitation to $10 million. The proposal will also limit this exemption to IDBs issued to finance the acquisition or construction of land or depreciable property in economically distressed areas. The utility of the small issue exemption will thus be enhanced, while at the same time the subsidy afforded by tax exemption will be targeted towards those areas in which it is most needed.

Third, as part of the Administration's Hospital Cost Containment program, the proposal will revise the definition of industrial development bonds to deny tax exemption to obligations issued to finance certain hospitals for which a certification of need has not been issued. Under present law, obligations issued by a State or local government to raise funds for use by a non-profit, charitable organization in its trade or business are not generally treated as IDBs and are thus tax-exempt. Under the Administration proposal, the definition of a taxable IDB will be expanded to include obligations issued to finance hospital facilities that are operated by such organizations, unless a need for the facilities has been established under the relevant provisions of the Public Health Services Act or the Social Security Act. If a need for the facility has been established, interest on the bond will remain tax-exempt.

Any industrial development bonds which can be issued on a tax-exempt basis may, at the election of the issuer, qualify for the Federal interest subsidy provided for State and local government issues under the Administration's taxable bond option proposal. (See TAXABLE BOND OPTION.)

Analysis of Impact

Pollution Control Bonds

It is undesirable to continue financing of pollution control investment with tax-exempt bonds because they decrease tax equity, reduce economic efficiency, and increase State and local borrowing costs.

Tax Equity. The existence of an opportunity to earn tax free income from any type of investment reduces the effective progressivity of the tax system by enabling high-income individuals to earn greater after-tax returns on capital than they otherwise would obtain. This windfall to high bracket lenders occurs because individuals in high tax brackets have more to gain from owning a tax free asset than individuals in low tax brackets. As the relative volume of tax-exempt borrowing increases, the interest rates on such bonds as compared to the rate on taxable bonds must rise to make them attractive to investors in lower tax brackets. As a result, the interest rate differential, in equilibrium, between tax-free and taxable bonds will be determined by the relative supplies of the two types of securities and by the statutory schedule of marginal tax rates. In the equilibrium thus determined, the lowest bracket buyer is indifferent between holding tax-exempt and taxable assets, while the higher bracket buyer receives a higher rate than needed to attract him to the tax-exempt asset.

In recent years, the interest rate differential between equivalent quality tax-exempt and taxable bonds has been equal to approximately 30 percent of the taxable interest rate. This means that any taxpayer with a marginal tax rate of above 30 percent would obtain a higher after-tax yield from tax-exempt bonds than from taxable bonds. In effect, the high income investor will pay an implicit tax, reflected in a lower gross interest rate, of 30 percent on tax-exempt securities rather than the rate that would otherwise be determined by his marginal tax bracket.

If the relative supply of tax-exempt bonds continues to increase by the issuance of more pollution control IDBs, the interest rate differential between taxable and tax-exempt bonds will fall, lowering the implicit tax on owners of tax-exempt bonds and increasing their windfall gain. The effective progressivity of the tax system will decrease, moving another step away from the nominal progressivity reflected in the statutory schedule of tax rates.

Eliminating the use of tax-exempt IDBs to finance pollution control investments will increase the amount of interest income subject to tax. The windfall gains to high income lenders from tax-exempt interest would fall, making the tax system more progressive relative to current law.

Economic Efficiency. It may be generally viewed as improper to allow private borrowers to avail themselves of the tax-exempt market. While this view is based on a common notion of fairness, allowing some firms to borrow at privileged rates also can have very harmful effects on economic efficiency by encouraging misallocation of scarce capital resources. More specifically, any special incentive

for investment in pollution control equipment has undesirable efficiency effects in the context of legislated environmental standards.

The efficiency losses from such subsidies are of two kinds. First, because any definition of pollution control investment is necessarily arbitrary, only a limited number of the alternative ways of reducing pollution are subsidized. For example, a firm may reduce pollution by changing production processes or inputs used. However, under current law, only the installation of specifically designated "pollution control" equipment would be eligible for subsidized financing through IDBs.

Secondly, even if firms were to choose to purchase the same type of equipment without the subsidy, the subsidy still causes an efficiency loss through a misallocation of economic resources. The efficiency loss in this case occurs because the subsidy lowers the total cost of production in industries where significant outlays for environmental controls are required, thereby leading to relatively lower prices and relatively higher output in those industries as compared to what market forces would determine. The resource misallocation results from a failure to transmit to the consumer the appropriate economic signals which would induce him to purchase relatively less of those products involving high pollution control costs.

The proposed elimination of tax-exempt pollution control financing will provide firms with an incentive to select the lowest cost alternative among methods of pollution control consistent with existing Federal regulations. It will end the bias towards the defined eligible investments such as "end of the line" types of pollution control equipment fostered by present law tax incentives, and move in the direction of requiring consumers to pay the full cost of pollution control.

Furthermore, efficiency losses from providing a tax subsidy for pollution control facilities are much greater for new plants than for existing plants. Frequently, with existing plants, addition of pollution control equipment eligible for a tax subsidy is either the only feasible way of achieving environmental standards or the lowest cost method even in the absence of a subsidy.

It may also be argued that mandated pollution control investments for plants already in existence should not be fully borne by the firm and the consumers of its products. At the time the plant was initially built the firm may not have anticipated these extra capital requirements. The original investment was presumably made on the assumption that society did not place a high cost on emissions and would not compel firms to reduce pollution.

Current tax law does provide such subsidies for old plants. In addition to tax-exempt IDB financing, pollution control equipment installed in plants in use before January 1, 1976 is eligible for 5-year amortization and a 5 percent investment credit.

To provide continued assistance for existing plants, it is proposed elsewhere in the Administration's tax program to raise the investment credit from 5 percent to 10 percent for pollution control facilities amortized over five years (see REVISIONS TO THE INVESTMENT CREDIT.) Such investments may also be eligible for tax-exempt IDB status under present law. The proposed increase in the investment credit to 10 percent will typically more than compensate the investor for the loss of the interest savings realized by borrowing in the tax-exempt market.

Another proposal in the Administration's tax program is to provide States and localities with the option of issuing taxable bonds with a Federal subsidy in all cases where tax-exempt borrowing is currently allowed. (See TAXABLE BOND OPTION.) The efficiency losses from continuing to allow tax-exempt borrowing for pollution control equipment would be even greater under this plan for a taxable bond option (TBO) than under current law. TBO will lower the interest rate on tax-exempt borrowing from about 70 percent to 60 percent of the taxable rate. Because the subsidy rate to tax-exempt borrowers is thereby increased, the efficiency losses resulting from providing tax exemption for pollution control IDBs are also increased. Thus, while it is desirable to remove pollution control bonds from the tax-exempt market under current law, it is even more important under TBO.

State and Local Borrowing Costs. Allowing private firms to use tax-exempt IDBs for pollution control equipment raises the cost of borrowing to State and local governments. As the supply of tax-exempt bonds increases, their price must fall to attract additional investors in lower marginal tax brackets. Thus, the expansion of the use of IDBs in recent years has had the effect of raising the interest rate paid by State and local borrowers. It is for this reason that the National League of Cities and the Municipal Finance Officers Association have consistently opposed the financing of pollution control investment through the tax-exempt market. 3/

Recent studies have estimated that for each extra billion dollars of tax-exempt borrowing, interest rates on tax-exempt issues rise by 5 to 20 basis points. (A basis point equals .01 percent.) 4/ In 1977, tax-exempt borrowing for pollution control IDBs was equal to almost $3 billion (See Table IIIB-1). Thus, the research findings imply that tax-exempt interest rates in 1977 were from 15 to 60 basis

points higher than they would have been if there were no pollution control IDBs. Using a conservative estimate of 25 basis points or 1/4 of 1 percent, the additional annual interest cost on the $41.5 billion of non-IDB State and local obligations issued in 1977 can be estimated to be in excess of $100 million. This additional cost will occur for each of the 20 or more years these bonds will be outstanding. Savings of this magnitude will occur upon removal of these bonds from the tax-exempt market.

Another way of viewing this saving is to note that at prevailing levels of tax-exempt interest rates, 25 basis points is equal to a reduction in interest costs of slightly over 4 percent. At current levels of debt service (about $9 billion annually), this amounts to an annual interest savings of $360 million when all outstanding obligations have been issued under the new rules.

Elimination of tax-exempt IDBs for pollution control equipment would, therefore, lower the cost of financing State and local public services. The potential loss to State and local governments from continuing this tax-exemption is likely to become greater in future years, because borrowing for pollution control equipment is likely to increase.

The above analysis of the interest savings to State and local governments does not take into account the effects of the proposal to provide State and local governments with the option of issuing subsidized taxable bonds (See Taxable Bond Option). Under the taxable bond option, the tax-exempt interest rate will be a fixed proportion of the taxable rate. In this case, the increase in IDB tax-exempt financing would increase the volume of municipal bonds shifted from the tax-exempt into the subsidized taxable market, but the ratio of tax-exempt interest rates to taxable rates would remain unchanged.

The cost to the Treasury, however, of providing the subsidy to taxable municipal bonds would be increased by allowing pollution control IDBs to remain in the tax-exempt market. Since a relatively larger supply of municipals or tax-exempt IDBs implies a larger volume of subsidized taxable issues, greater subsidy payments are required of the Treasury. Removing pollution control bonds from the tax-exempt market will, therefore, reduce the Federal costs of maintaining the taxable bond option.

Other Industrial Development Bond Provisions

Small Issue IDBs. The $1 million and $5 million small issue IDBs are frequently used by States and localities to promote economic development by attracting new plants. If their use is available to everyone, however, then any potential benefit to one locality in attracting plants is

cancelled by the use of IDBs by other localities. For this reason, it is proposed here to retain the use of small issue IDBs only for those areas most in need of relief. In those areas of economic distress, it is proposed to extend the dollar limit on the amount of capital expenditures eligible for tax-exempt financing from $5 million to $10 million. For areas which do not qualify as economically distressed, the use of tax-exempt small issue IDBs will be disallowed entirely.

This proposal will reduce the losses in tax equity associated with tax-exempt financing, while at the same time channeling the tax subsidy to areas currently experiencing economic distress (for example, urban areas with very high unemployment rates) and requiring special assistance.

Industrial Parks. The tax-exempt financing of industrial parks allowed under current law also represents an unwarranted extension of the privilege of tax-exempt borrowing for purely private purposes. It raises the same issues of tax equity and economic efficiency already discussed. It also contributes to higher costs of State and local borrowing for public facilities.

Hospital Bonds. Finally, it is desirable to limit the use of tax-exempt bonds in financing hospital construction. Under present law, the definition of a taxable industrial development bond generally does not include an obligation issued to finance a trade or business carried on by a private, non-profit charitable organization. Thus, many bonds issued by State and local governments to finance facilities for private non-profit hospitals are not considered to be taxable IDBs and are eligible for tax exemption on the grounds that they have been issued directly or indirectly by States and localities.

The Administration is concerned that excess expansion of hospital facilities is increasing costs of medical care and has, therefore, proposed, in its Hospital Cost Containment Act, that the number of certificates of need for hospital construction be drastically reduced. In order further to reduce incentives for construction of excess hospital facilities, the Administration proposal will not allow tax-exempt IDB financing for hospitals operated by charitable organizations for which a certificate of need has not been issued.

Effective Date

In general, the proposed changes will apply to obligations issued after the date of enactment. The proposed changes will also apply to obligations issued after February 1, 1978 unless it is reasonably expected on the date of issuance of the obligations that at least 85 percent of the

"spendable proceeds" (as defined in Proposed Treasury Regulation 1.103-14(b)(iii)) will have been expended within three years of the date of issuance of the obligations.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years				
1979	1980	1981	1982	1983
26	80	138	198	260

Technical Explanation

The tax exemption for small issues of IDBs provided by section 103(b)(6) of the Code will be amended to provide exemption only for issues the proceeds of which are used for the acquisition or construction of land or depreciable property located in an economically distressed area. For this purpose economically distressed areas will be defined by reference to such factors as (1) an average annual unemployment rate in excess of the national average rate and (2) an average annual growth in employment below the corresponding national rate. These criteria identify those areas with chronic unemployment problems which are attributable to an inability to absorb employable resident workers.

In addition, the proposals will be implemented by amending section 103(b)(6)(D) of the Code to substitute $10,000,000 for all references to $5,000,000, and by deleting sections 103(b)(4)(F) (relating to pollution control facilities) and 103(b)(5) (relating to industrial parks). Finally, section 103(b)(3)(B), which generally provides an exemption from industrial development bond treatment for obligations issued to raise funds for non-profit, charitable organizations, will be amended to deny the exemption to (and thus treat as taxable) obligations issued to finance hospital facilities for such organizations, unless a certificate of

need for the facilities has been issued under section 1523 of the Public Health Services Act or construction of the facilities has been approved under section 1122 of the Social Security Act.

Footnotes

1/ Congressional Record, Volume 114, Part 7, March 28, 1968, p. 8148.

2/ Federal and State regulation issued under authority in Clean Air Act 42 U.S.C. 1857 et. seq. (1970) (prior to 1977 amendments), and Federal Water Pollution Control Act Amendments of 1972, 33 U.S.C. 1341 - 1345 (1972)

3/ See, for example, Municipal Finance Officers Association Policy Resolution adopted April 30, 1975 in Montreal, Canada; and National Municipal Policy, official policy positions of the National League of Cities, most recently adopted in San Francisco, in December, 1977.

4/ John E. Peterson, The Tax-Exempt Pollution Control Bond, Municipal Finance Officers Association, March 10, 1975; Peter Fortune, "Impact of Taxable Municipal Bonds: Policy Simulations With a Large Econometric Model," Federal Reserve Bank of Boston, 1974; John E. Peterson, "Changing Conditions in the Market for State and Local Government Debt," Joint Economic Committee Study, April 16, 1976; and George E. Peterson and Harvey Galper, "Tax Exempt Financing of Private Industry's Pollution Control Investment," Public Policy, Volume XXIII, Winter 1975, Number 1.

IV

Tax Treatment of Business

CORPORATE TAX RATE REDUCTION

Present Law

Under present law, the corporate income tax rates are 20 percent of the first $25,000 of corporate taxable income, 22 percent of the next $25,000 of taxable income and 48 percent of all taxable income in excess of $50,000. These rates will be in effect through taxable years ending in 1978. For subsequent years, the corporate rates are scheduled to become 22 percent of the first $25,000 of taxable income and 48 percent of taxable income over $25,000.

Reasons for Change

Two major objectives of the Administration's tax proposals are to promote long-term capital formation and to strengthen and maintain the current economic recovery. To achieve these objectives, it is necessary to reduce the effective rates of tax on income from capital to provide business with additional incentives to invest.

A reduction in the corporate tax rates will achieve the objective of stimulating capital formation in two ways. First, the reduction in corporate tax liabilities will have an immediate, favorable effect on corporate cash flow. This will facilitate the financing of higher levels of capital spending. Second, the reduction in tax rates will increase expected after-tax profits for any given investment project. This higher expected profitability on investment will constitute a significant incentive to corporations to increase planned capital appropriations. In addition, since these higher after-tax earnings may be expected to lead to either an increase in dividends or a more rapid anticipated growth in share prices, the stock market should be favorably affected, and corporations will find it somewhat easier to obtain external equity financing.

The proposed extension of the investment tax credit to industrial structures, as discussed below, will also help to stimulate investment. However, there are specific reasons why it is desirable to include corporate tax rate reductions in the package as one of the principal tools for stimulating capital formation:

1) A change in the corporate tax rate structure is the most straightforward method of reducing the tax burden on the return from corporate investment.

2) Not all corporations will receive significant benefits from the proposed extension of the investment

tax credit to structures. Reduction of the corporate tax rate will enable all corporations to realize some benefits from the business tax cuts.

3) In the context of the entire proposal, the corporate tax rate reductions are required to prevent a shift of capital away from corporate investments. Given the reduction in the personal income tax rates included in the package, maintenance of a rough balance between taxes on corporate equity income and taxes on other forms of capital income (including debt) requires an accompanying cut in the corporate tax rates.

For these reasons, it is desirable to reduce the rates of tax on corporate income for both small and large corporations.

General Explanation

Effective October 1, 1978, the corporate income tax rates will be reduced to 18 percent of the first $25,000 of corporate taxable income, 20 percent of the next $25,000 of taxable income and 45 percent of all taxable income in excess of $50,000. Effective January 1, 1980, the tax rate on taxable income in excess of $50,000 will be 44 percent. The reductions will be permanent.

Revenue Estimate

Change in tax liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-1,349	-5,965	-8,516	-9,228	-10,010	-10,764

Note: These estimates are based on permanent extension of the present rates.

Technical Explanation

Effective October 1, 1978 the normal tax imposed by section 11(b) of the Code, which currently is 20 percent of the first $25,000 of taxable income plus 22 percent of taxable income in excess of $25,000, will become 18 percent of the first $25,000 of taxable income plus 20 percent of taxable income in excess of $25,000.

The surtax imposed by section 11(c) of the Code, which currently is 26 percent, will be reduced to 25 percent effective October 1, 1978. A further reduction to 24 percent will become effective January 1, 1980. The surtax exemption, which currently is $50,000, will remain at $50,000.

Thus, effective October 1, 1978, the corporate rate will be 18 percent of the first $25,000 of taxable income, 20 percent of the next $25,000 and 45 percent of taxable income in excess of $50,000. Effective January 1, 1980, the top rate will decline to 44 percent.

In the case of a corporate taxpayer whose fiscal year does not begin with the effective date of a rate reduction (in this case, October 1, 1978 and January 1, 1980), existing law provides for the taxpayer to determine its tax liability for the taxable year of transition by computing tentative taxes based on the application to its full year's taxable income of the rates in effect before and after the date of the change, and paying a tax that consists of a portion of each tentative tax determined by reference to the number of days during the taxable year to which the old and new rates applied. In other words, the tax rate for the entire year is a weighted average of the tax rates applicable to the periods before and after the rate change with the weights being the number of days in the year before and after the change.

For example, suppose a calendar year corporation has taxable income of $100,000 in 1978. Under present law, its tax liability for the full year would be 20 percent of the first $25,000 of income ($5,000), 22 percent on the next $25,000 of income ($5,500) and 48 percent on all taxable income over $50,000 ($24,000) for a total tax of $34,500. Under the proposal, the full year's tax liability for the corporation will be 18 percent of the first $25,000 of taxable income ($4,500), 20 percent of the next $25,000 of taxable income ($5,000) and 45 percent of taxable income over $50,000 ($22,500) for a total tax liability of $32,000. There are 273 days in the transition year before the effective date of October 1, 1978, and 92 days on or after that date. Therefore the tax on the corporation for the transition year will be equal to 273/365 of $34,500 (or $25,804) plus 92/365 of $32,000 (or $8,066). Thus, the calendar year corporation's tax liability on $100,000 of taxable income in 1978 is $33,870.

INVESTMENT CREDIT

Present Law

Taxpayers are presently entitled to a credit against their tax liability equal, in general, to 10 percent of their investment in certain qualified productive assets. The rate of this investment credit was temporarily increased to 10 percent from 7 percent as of January 25, 1975, and is scheduled to revert to 7 percent on January 1, 1981. (In the case of investments in certain public utility property, the credit is scheduled to revert, in effect, to 4 percent on January 1, 1981.)

In general, property eligible for the investment credit consists of depreciable property having an estimated useful life of three or more years which is either tangible personal property or other tangible property (such as fixtures and heavy machinery) that is used as an integral part of the productive process. Buildings and their structural components, however, do not qualify for the credit.

To reduce the cost of pollution control equipment required to be installed in plants in use before January 1, 1976, a taxpayer may elect to amortize the cost of such equipment over a 5-year period in lieu of depreciating the equipment over its useful life. However, if pollution control equipment is amortized under this special rule, the investment credit is limited to 5 percent of the cost of such equipment.

The amount of investment credits for any year may be used, dollar-for-dollar, to offset completely tax liability of up to $25,000. Credits in excess of $25,000 may, in general, be used to offset up to 50 percent of tax liability in excess of $25,000. Special provisions, scheduled to be phased out over time, permit public utilities, railroads and airlines to offset more than 50 percent of their tax liability in excess of $25,000 with investment credits. In any year in which the amount of a taxpayer's investment credits exceeds the applicable limits, the excess may be carried back to the three taxable years before, and forward to the seven taxable years after, the year in which the asset was placed in service.

Reasons for Change

The investment credit, originally proposed in 1961 to stimulate the lagging modernization of the country's productive facilities, has proven to be an effective

incentive to capital investment. However, the unavailability of the credit for investments in industrial buildings has impaired somewhat its utility in promoting investment in long-lived manufacturing facilities.

As first proposed by the Treasury in 1961, the investment credit would have been available for investments in industrial buildings. However, while the Congress was examining the Treasury's 1961 proposal, it became apparent that investment in equipment, by historical standards, was lagging behind investment in non-residential structures. By the end of 1961, equipment investment had still not regained the peak level (in real terms) achieved in the third quarter of 1957, while investment in non-residential buildings had surpassed its earlier peak during 1960. Thus, the Committee on Ways and Means concluded that buildings and their structural components should not be eligible for the credit:

> "The credit is available for investments in most tangible personal property. It is also available for limited types of real property, other than buildings. The greater emphasis is placed on equipment and machinery because it is believed the need for such investment is the major requirement of the economy."1/

The decision in 1961, while appropriate at that time, has had a distorting effect on the composition of business fixed investment in the United States. While annual expenditures (in current dollars) for total fixed investment have increased by some 295 percent since 1961, expenditures for industrial structures have increased by only 145 percent. Moreover, during the recent cyclical recovery phase, annual expenditures for industrial structures have actually declined, while other investment expenditures have mildly increased. These developments are reflected in Table IVB-1.

Table IVB-1

Comparison, in Current Dollars, of Outlays for Total Business Fixed Investment and for Industrial Structures

	Business Fixed Investment	Expenditures for Industrial Structures
	1960 - 61 = 100	
1960	100.6	101.3
1961	99.4	98.7
1962	108.1	100.9
1963	113.1	103.2
1964	125.9	126.6
1965	150.3	201.3
1966	171.8	259.2
1967	173.2	235.4
1968	188.3	213.9
1969	208.8	240.9
1970	211.9	232.2
1971	219.5	192.6
1972	246.5	166.1
1973	286.9	221.7
1974	317.8	280.7
1975	314.6	284.8
1976	341.7	255.1
1977	395.6*	245.6*

Office of the Secretary of the Treasury
Office of Tax Analysis

January 19, 1978

* Based on first three quarters only.

Source: Survey of Current Business.

The decision in 1962 to deny the investment credit to buildings was also based, in part, on the favorable depreciation for Federal income tax purposes afforded buildings at that time. In contrast with the situation in 1962, there has been a substantial tightening in the tax treatment of depreciation of structures. Depreciation recapture rules have been extended to real property and it is proposed elsewhere in the President's tax program that the rules governing depreciation of buildings be changed to conform more closely to economic reality. See REAL ESTATE DEPRECIATION. Thus, industrial buildings will no longer enjoy the exceedingly favorable depreciation treatment available in 1962.

Accordingly, it is now appropriate to extend the stimulus provided by the investment credit to investments in industrial structures. This change will eliminate the bias of current tax law against balanced programs of industrial expansion, and will promote increased investment in long-lived productive facilities. Expansion of private investment in manufacturing facilities is essential to avoiding capacity shortages, with resulting inflationary pressures, as the economy continues to move ahead. Modernization of the stock of productive capital is likewise essential to further gains in labor productivity. Finally, this change will eliminate the many disputes occasioned under present law by the need to distinguish between equipment, for which the credit is available, and buildings and their structural components, for which it is not.

The investment incentive provided by the credit can be strengthened further by modifying the provisions of present law that limit current availability of investment credits to 50 percent of a taxpayer's tax liability in excess of $25,000. This limitation both dampens the investment incentive provided by the credit by delaying actual use of credits, and adds to the complexity of the tax laws by compelling some taxpayers either to resort to the use of carryovers, or to engage in complex and costly leasing transactions, to obtain the benefits of the investment credit. Furthermore, in years in which an excess credit can be fully utilized by carrybacks, the procedure for effecting a refund entails cumbersome recomputations of prior years' tax accounts with no compensating gain to either the taxpayer or the Treasury. Relaxing this limitation would thus simplify the tax laws, stimulate capital investment by accelerating the actual availability of investment credits, and promote economic efficiency by reducing the disparity, caused solely by variations in current tax liabilities, in the use of credits by enterprises that have made similar amounts of eligible investment.

It would, however, be incompatible with the goals of the President's tax program to permit investment credits to eliminate completely a person's tax liability. See TAX SHELTERS -- INTRODUCTION. Under present law a taxpayer whose tax liability is $25,000 or less may use investment credits to eliminate that liability in its entirety. Permitting investment credits to offset up to 90 percent of a taxpayer's tax liability for any year would strike an appropriate balance between strengthening the investment incentive provided by the credit, on the one hand, and not permitting the credit to eliminate 100 percent of tax liability for any year, on the other.

The temporary increase in the credit to 10 percent, scheduled to expire in 1981, has had some beneficial effect on the rate of capital investment. However, the temporary nature of the 10 percent rate is an additional variable that must be taken into account by businesses in making long-range investment decisions. This uncertainty diminishes the incentive effect of the credit and is undesirable, particularly when the rate of capital investment is inadequate. For that reason, and because capital formation remains a long-term economic policy objective, the present 10 percent rate of the investment credit should be made permanent.

To reduce further the rising cost of compliance with environmental standards, pollution control equipment added to pre-1976 plants should, in addition to its eligibility for 5-year amortization, be eligible for the full 10 percent investment credit. It is proposed elsewhere in the tax program to eliminate the availability of tax-exempt financing to provide pollution control facilities. However, it is expected that, for eligible taxpayers, the benefit of the additional 5 percent investment credit for pollution control investment in pre-1976 plant generally will offset the loss of tax-exempt financing. See INDUSTRIAL DEVELOPMENT BONDS.

General Explanation

As an incentive to business to expand and modernize its investment in long-lived industrial facilities, thereby reducing the likelihood of future capacity shortages, the investment credit will be extended to industrial structures. This change will extend to otherwise eligible investments made in new industrial buildings as well as investments made to rehabilitate existing buildings.

An industrial structure will include a building and its structural components, but only if the building is used as an integral part of manufacturing, production or extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or if the

building constitutes a research facility used in connection with any of these activities. Thus, for example, buildings used for residential purposes (e.g., apartment buildings, hotels and motels), commercial buildings (e.g., office buildings and retail stores), and buildings used for storage or distributional purposes (e.g., warehouses) will not be industrial structures eligible for the credit. Bulk storage facilities (e.g., grain storage bins and oil storage tanks) will continue to be eligible for the credit. This change in general will be accomplished by deleting the provision of present law that specifically excludes a building and its structural components from the definition of property eligible for the investment credit.

Because property eligible for the credit is generally subject to the depreciation recapture rules applicable to equipment rather than the less stringent rules applicable to real property, buildings for which an investment credit will now be allowed will also be subject to the depreciation recapture rules (section 1245) for equipment.

The provision of present law that limits the current availability of investment credits for any year to $25,000 plus 50 percent of tax liability in excess of $25,000 will be changed to provide that investment credits may offset up to 90 percent of tax liability in any year. Until this change becomes effective (See Effective Dates), airlines, railroads and public utilities will remain subject to the special limitations of current law. Permitting the credit to offset 90 percent of tax liability will both strengthen the incentive provided by the credit and simplify its administration. In addition, a uniform percentage limitation on the use of the credit will eliminate the inequity of present law that allows a complete offset of tax liability through the use of investment credits; the investment credit will no longer be permitted to offset completely the first $25,000 of tax. 2/

To assist business enterprises in making long-range capital investment decisions and to encourage long-term capital formation, the 10 percent rate of the investment credit will be made permanent. Investments in public utility property will remain eligible for the permanent, 10 percent credit.

Investments in pollution control equipment will be eligible for the full 10 percent investment credit, even if an election is made to amortize the cost of such equipment over the special 5-year period.

Effective Dates

Industrial structures placed in service after December 31, 1977 will qualify for the investment credit, but only to the extent of the portion of the adjusted basis of

such structures properly attributable to construction after that date. Otherwise eligible expenditures to rehabilitate existing industrial structures will also qualify for the credit, but only to the extent of the adjusted basis of such structures properly attributable to rehabilitation after December 31, 1977.

For taxable years beginning after December 31, 1978, the investment credit (and investment credit carryovers to such years) will be usable to offset up to 90 percent of a taxpayer's liability for tax. For taxable years beginning after December 31, 1978, investment credits will no longer be available to offset completely the first $25,000 of tax. These changes will apply to all taxpayers, including public utilities, railroads and airlines.

The 10 percent rate of the investment credit will not revert to 7 percent on January 1, 1981, but will be made permanent.

Certified pollution control facilities eligible for the special 5-year amortization period will be eligible for the full 10 percent investment credit, provided that as of December 31, 1977 no election has been made to amortize such equipment over the 5-year period.

Revenue Estimate

Change In Tax Liability
($ Millions)

	Calendar Years					
	1978	1979	1980	1981	1982	1983
Extend 10 percent investment credit to structures	-1147	-1443	-1714	-1942	-2153	-2354
Full Investment credit for pollution abatement facilities	- 142	- 93	- 107	- 127	- 115	- 144
Change investment credit limit to 90 percent for corporations		- 882	- 576	- 114	- 194	- 205
Change investment credit limit to 90 percent for individuals		52	58	64	71	79

Note: These estimates are based on permanent extension of the 10 percent investment credit.

Footnotes

1/ House Report No. 1447, 87th Cong. 2d Sess. (1962), at 9.

2/ The same rule -- that credits may offset 90 percent of tax liability -- will apply to the work incentive credit (section 40 of the Code) which, under present law, may be used to offset the first $50,000 of tax liability plus 50 percent of tax liability in excess of $50,000.

SMALL BUSINESS

INTRODUCTION

The corporate tax cuts described elsewhere in the Administration's tax proposals will particularly benefit small corporations with incomes of $50,000 or less; for these corporations the tax reduction will be nearly 10 percent. The Administration is also making three proposals specifically to assist small businesses. The first proposal will simplify and liberalize the rules (Subchapter S) that treat certain small corporations like partnerships. The second proposal will simplify methods of depreciation for small businesses. And, if an investor loses money on stock in a small business, the third proposal will make it easier for him to deduct his losses. The revenue effect of these changes is estimated to be $400 million in 1979, virtually all of which is accounted for by the reduction in corporate rates.

LIBERALIZATION OF SUBCHAPTER S

Present Law

In general, present law treats a corporation as an entity separate and apart from its shareholders. Income earned by a corporation is taxed to the corporation and distributions are taxed to the shareholders. Losses affect the tax liability of the corporation but not that of the shareholders. Under Subchapter S, however, a qualifying domestic coporation may elect not to pay the regular corporate income tax. Instead, the income of the corporation is taxed to the shareholders whether it is distributed as a dividend or retained by the corporation. In addition, the shareholders are allowed to deduct losses sustained by the corporation. This results, in a general way, in a pattern of taxation similar to that of partnerships. Subchapter S is available only to small corporations with simple structures that are essentially similar to partnerships.

Reasons for Change

Subchapter S reflects concern regarding the tax-induced distortions of business behavior that result from double taxation of corporate income. Such distortions include favoring debt over equity financing, unnecessary retention of earnings in corporate solution, and widespread resort to partnerships for certain types of business activities. Therefore, it is appropriate to revise Subchapter S to eliminate unnecessary barriers to its use. Such barriers arise from the fact that the Subchapter S rules, although revised since enactment, remain complex and are frequently misunderstood in ways that lead to unintended hardships. Complexity in this area is particularly undesirable because Subchapter S generally is limited to, and is best suited for, small businesses. Accordingly, the proposal simplifies and liberalizes Subchapter S.

General Explanation

The proposal will liberalize three sets of rules governing treatment of a small business corporation under Subchapter S. First, it will increase the permitted number of shareholders and relax certain other restrictions on the shareholders of a Subchapter S corporation. Second, it will liberalize the rules governing election and termination of election under Subchapter S. And third, it will liberalize treatment of losses sustained by a Subchapter S corporation. Under present law, a shareholder's deduction for losses cannot exceed his investment in the corporation. The proposal will permit the shareholder to carry excess losses over to subsequent taxable years.

Effective Date

In general, the proposed changes will apply to taxable years of corporations beginning after December 31, 1978. The change permitting carryovers will apply to losses sustained in taxable years beginning after December 31, 1978.

Revenue Estimate

This proposal will have no significant revenue effect.

Technical Explanation

(a) Eligibility for Subchapter S Election

The proposal will make it easier for a corporation to qualify under Subchapter S.

Number of Shareholders. Under present law, a corporation (with certain exceptions) must have ten or fewer shareholders to qualify as a small business corporation (section 1371 of the Code). Under the proposal, a corporation can qualify if it has fifteen or fewer shareholders.

Certain Trusts Permitted as Shareholders. In general, present law requires the shareholders of a qualifying small business corporation to be individuals. Exceptions are provided for grantor trusts and voting trusts, and for transitory ownership (for a period of not more than sixty days) by trusts established under the will of a deceased shareholder (section 1371(f) of the Code). The inability to transfer stock to a testamentary trust except on a transitory basis may cause shareholders difficulty in planning their estates. To alleviate this problem, the proposal will permit the transfer of shares to a testamentary trust established under the will of a deceased shareholder for the term of the trust. Similarly, an *inter vivos* grantor trust that now qualifies as a shareholder will continue to qualify after the grantor's death. A qualifying trust will be required to distribute all income currently to its beneficiaries in shares fixed by the governing instrument of the trust. For purposes of determining the number of shareholders in the electing small business corporation, each beneficiary having a present interest in the trust income will be treated as a shareholder. Because of the general increase to 15 shareholders, special rules that permit the corporation to have more than 10 shareholders in certain limited circumstances (section 1371(e) of the Code) will be repealed.

Husband and Wife as One Shareholder. The rules treating a husband and wife as one shareholder will be simplified and liberalized. In particular, the proposal will eliminate the

requirement that the stock be community property or be held as joint tenants, tenants by the entirety, or tenants in common.

(b) Election to be Taxed Under Subchapter S

The rules governing elections to be taxed under Subchapter S and terminations of such elections (including inadvertent terminations) are unduly complicated and restrictive. These rules will be simplified and liberalized.

Time for Election. Under present law, an election under Subchapter S may be made for a taxable year at any time during the first month of the year or at any time during the preceding month (section 1372(c) of the Code). For a new corporation, the first month of the taxable year does not begin until the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. Unless an election is terminated, it continues in effect and does not have to be renewed annually.

The requirement that an election may not be made more than 30 days before the beginning of a year is an unnecessary trap. For example, a corporation that has decided to make an election six months before the first day of the year may inadvertently fail to make the election in a timely fashion. This possibility will be eliminated by permitting the corporation to make the election at any time before the beginning of the taxable year. Thus, if a corporation decides in June of 1979 to elect Subchapter S for calendar year 1980, it will be able to do so immediately. In addition, an election will be permitted for 60 (instead of 30) days after the beginning of a taxable year.

Termination of an Election. Under present law, termination of an election is generally retroactive to the first day of the taxable year, even if it is caused by an event occurring at the end of the year (section 1372(e) of the Code). This had led to hardship in some cases and opportunity for manipulation in others. Therefore, under the proposal, a termination will generally take effect on the day of the triggering event. However, this rule could enable taxpayers to cut short an electing year -- particularly an initial electing year -- prior to the realization of income while permitting losses to be passed through to shareholders. Therefore, a termination during the first year of an election will take effect retroactively.

Election following Termination. If an election is terminated, present law precludes the corporation (or its successor) from making a new election until the fifth taxable year after the termination (unless the Treasury consents to a new election). This rule has caused difficulty in cases of

inadvertent termination. In many such cases, the termination is not discovered until it is too late for a new election. Moreover, the corporation has acted in reliance on the old election. Therefore, under the proposal, if an election is terminated because a corporation ceases to be a small business corporation (e.g., it has 16 shareholders or it owns 100 percent of the stock of another corporation) and if the corporation qualifies for a later year, filing a timely return as a Subchapter S corporation for the later year will be treated as a binding request for consent to a new election. In determining whether to grant such a consent, the fact that termination was inadvertent will be taken into account.

(c) Net operating loss carryover

Under present law, a shareholder may deduct losses sustained by a Subchapter S corporation to the extent of his adjusted basis in stock and debt of the corporation. The shareholder is not permitted to carry excess losses over to subsequent taxable years. Therefore, if a shareholder's pro rata share of the corporation's losses exceeds his adjusted basis in stock and debt, the excess is not deductible. Under the proposal, these excess losses will become deductible by the shareholder in subsequent years to the extent of subsequent increases in the shareholder's basis in stock and debt. This change is consistent with the present treatment of partnerships. The excess loss will not be transferable and will be deductible only by the same shareholder in a subsequent year.

While the Subchapter S election remains in effect, the carryover will be allowed as a deduction at the end of each subsequent taxable year of the corporation. However, the amount allowed as a deduction will be limited to the shareholder's basis in stock and debt of the corporation at the end of the year (giving effect to all adjustments made during the year). Any unused portion of the carryover will be allowed as a deduction twelve calendar months after the Subchapter S election is terminated. However, the amount allowed as a deduction will be limited to the shareholder's basis in stock and debt at the end of the twelfth month. Whenever the carryover is allowed as a deduction, there will be a corresponding reduction in basis.

Depreciation for Small Business

Present Law

Under present law, a taxpayer generally may claim depreciation either on the basis of the particular "facts and circumstances" bearing on his anticipated use of the property or under the asset depreciation range and class life system ("ADR").

A taxpayer claiming depreciation on the basis of facts and circumstances must estimate the useful life and salvage value for each item of depreciable property used in his trade or business. This can be a cumbersome and inexact process for the taxpayer. Moreover, the taxpayer's estimates are frequently reexamined by auditing agents of the Internal Revenue Service, and any discrepancies between their estimates and the taxpayer's will result in further time and attention being devoted to these factual matters.

As discussed more fully in connection with the President's proposal for simplifying ADR depreciation, the use of ADR depreciation permits a taxpayer to depreciate assets on the basis of prescribed useful lives that cannot be challenged by the Internal Revenue Service and offers substantial other benefits. See SIMPLIFICATION OF ADR DEPRECIATION. On the other hand, the ADR system imposes a number of formal accounting and reporting requirements which may differ from a taxpayer's past depreciation practices.

Reasons for Change

The ADR system provides many advantages for those who adopt it. However, while nearly 92% of corporate taxpayers with depreciable assets of $1 billion or more elected ADR in 1974, only 0.36% of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in that year. The proposal for simplifying the ADR system should encourage more smaller businesses to adopt ADR. However, it is also appropriate to allow the smallest taxpayers to obtain the major benefits which the ADR system allows without requiring them to learn a system which, while simpler in its ultimate operation than depreciation based on facts and circumstances, may seem strange and complex to small businessmen and their bookkeepers.

General Explanation

Under the proposal, the Secretary of the Treasury will be authorized to issue special regulations governing depreciation by small businesses. Under these regulations,

qualifying small businesses will be permitted to depreciate their assets on the basis of prescribed useful lives that cannot be challenged by the Internal Revenue Service. The electing small business will be able to adopt a useful life within the same 20 percent range above and below the prescribed life as is permitted under the ADR system. For example, if the prescribed useful life for furniture is 10 years, a taxpayer will be permitted to compute depreciation on the basis of any period between 8 and 12 years.

A simple table will be published to help taxpayers determine the range of useful lives over which they can depreciate their assets.

Small businesses electing to depreciate assets on the basis of the prescribed useful lives will be able to ignore salvage value in claiming their depreciation deductions (as will taxpayers who elect the new simplified ADR system).

Small businesses will be permitted -- but not required -- to adopt a convention (the "half-year convention") that will enable them to begin computing depreciation for all assets placed in service during a taxable year from the first day of the second half of the taxable year (July 1 for calendar year taxpayers). If a small business does not elect the half-year convention, it may claim depreciation for each asset from the date that asset was placed in service during the taxable year.

Unlike taxpayers who elect the ADR system, qualifying businesses generally will not be required to participate in any special information gathering surveys. When they are required to furnish information, it is expected that the surveys will be conducted in a manner consistent with the limited professional resources normally available to small businesses.

In all other respects, taxpayers will be able to continue to depreciate their assets as they have done in the past.

A qualifying business will be any business whose depreciable assets have an aggregate initial cost of $500,000 or less. For this purpose, only assets for which prescribed lives are in effect will be taken into account. The $500,000 test will be applied at the level of the business (for example, at the partnership level rather than at the level of each partner). Special rules (similar to those now applicable for purposes of the Jobs Credit) will be applied to prevent the division of a large entity into a number of smaller ones in order to take advantage of this provision.

The opportunity to take advantage of this special depreciation system will be available to more than 90% of all corporations, partnerships and sole proprietorships.

Effective Date

The special depreciation system for small businesses provided by the proposal will be applicable with respect to property placed in service by the taxpayer in taxable years beginning after December 31, 1978. It is expected that regulations will be promulgated under this section before March 1, 1980, so that taxpayers filing returns for taxable years ending on December 31, 1979, will have sufficient time to determine whether to elect the new special depreciation system for small businesses on their returns.

Revenue Estimate

The proposal will have no significant revenue effect.

SMALL BUSINESS STOCK

Present Law

Generally, the full amount of an ordinary loss is allowed as a deduction under present law. On the other hand, an individual may deduct capital losses only to the extent of capital gains plus $3,000 of ordinary income. Moreover, $2,000 of net long-term capital loss is required to offset $1,000 of ordinary income. Thus, at most $6,000 long-term capital loss can be used to offset $3,000 of ordinary income in any taxable year. Unused capital losses can be carried over indefinitely to future taxable years.

Under present law, unless an individual is a dealer, a loss on stock is generally treated as a capital loss. However, an exception is provided for "section 1244 stock." A loss sustained by an individual on section 1244 stock is treated as an ordinary loss, up to a maximum of $25,000 in any one year ($50,000 in the case of a husband and wife filing a joint return). This exception is designed to encourage investment in small business by decreasing the risk of such investment.

The exception applies only if the stockholder is an individual (and not a corporation, estate, or trust). The stockholder may purchase section 1244 stock in his individual capacity or in partnership with others. However, the exception applies only to losses sustained by the original purchaser of section 1244 stock, and not to losses sustained by any subsequent purchaser.

Section 1244 stock must be common stock in a domestic corporation. Furthermore, section 1244 stock must be issued pursuant to a plan adopted by the issuing corporation, and must be issued for money or other property (not including stock or securities).

Two additional requirements are imposed in order to limit the benefits of section 1244 to small business. First, a corporation may not issue more than $500,000 worth of section 1244 stock. Second, the total stock offering plus the equity capital of the corporation may not exceed $1,000,000. Thus, a corporation whose equity capital exceeds $1,000,000 cannot issue section 1244 stock.

A further requirement limits the benefits of section 1244 to operating companies. Under this requirement, in the five years before the taxpayer sustains a loss on his stock, the corporation must derive more than 50 percent of its gross income from sources other than royalties, rents, dividends,

interest, annuities, and sales or exchanges of stock or securities.

Reasons for Change

Small businesses need capital to modernize and to maintain a rate of expansion that will permit them to contribute fully to the well-being of the economy. To assist small business in raising the capital it needs, additional steps should be taken to decrease the risk of investment in small business stock.

General Explanation

The proposal will liberalize the rules relating to section 1244 stock. A small business corporation will be permitted to issue up to $1,000,000 of section 1244 stock, which is double the amount permitted by present law. The maximum amount allowed as an ordinary loss in any one year will be increased to $50,000 ($100,000 in the case of a husband and wife filing a joint return), which is also double the amount allowed under present law. The proposal will also eliminate the requirement of a plan and other technical requirements that needlessly restrict the ability of small business corporations to issue section 1244 stock.

Effective Date

The proposed changes will apply to stock issued by corporations in taxable years of the corporation beginning after December 31, 1978.

Revenue Estimate

The proposal will have no significant revenue effect.

Technical Explanation

Generally, the rules relating to section 1244 stock will be liberalized. The size limits on the issuing corporation will be relaxed. A corporation will be permitted to issue up to $1,000,000 of section 1244 stock, instead of the $500,000 permitted by present law. Moreover, the existing $1,000,000 limit on the corporation's equity capital will be completely eliminated.

In addition, the requirement of a plan will be eliminated. All stock issued during a taxable year of the corporation will be section 1244 stock if the aggregate worth of all stock ever issued by the corporation is $1,000,000 or less. (For this purpose, the worth of stock will be the value of the consideration paid for the stock at the time it was issued.) If the aggregate worth of all stock exceeds $1,000,000 at the end of the taxable year, but was less than $1,000,000 at the beginning of the year, then an allocable portion of the stock issued during the year will be treated as section 1244 stock. For example, assume that the aggregate worth of all stock issued by a corporation is

$400,000 on the first day of its taxable year, January 1, 1979. If the corporation issues $900,000 of common stock at $9 per share during 1979, then two out of every six shares issued during 1979 will be section 1244 stock. The corporation will be able to designate certain shares specially as section 1244 stock at the time they are issued. In the absence of such a special designation, each shareholder who purchases stock during 1979 will treat two out of every three of his shares as section 1244 stock. (Fractional shares will not, however, be treated as section 1244 stock. Thus, if a shareholder purchases ten shares of stock during 1979, only six shares will be treated as section 1244 stock.)

Further, a loss sustained by an individual on section 1244 stock will be treated as an ordinary loss up to a maximum of $50,000 in any one year ($100,000 in the case of a husband and wife filing a joint return). These are twice the maximum amounts allowed under present law.

CORPORATE PREFERENCES

REPEAL OF DISC

Present Law

A Domestic International Sales Corporation (DISC) is a special corporation established to shelter export income from taxation. Often it is only a paper corporation with no employees or real business activity. The profits of a DISC are not taxed to the DISC, but are taxed to the DISC shareholders when such profits are distributed or deemed to be distributed.

The shareholders of a DISC (typically a parent corporation which is an operating company) are deemed to receive an annual dividend equal to a portion of the DISC's profits. This deemed dividend is fully taxable to the shareholders. Federal income taxation is deferred on the remainder of the DISC's profits. Because the tax is deferred indefinitely and because the parent can use the DISC's retained profits to finance its own export activity, the deferral of taxation is in effect equivalent to exemption.

Prior to 1976 the deemed dividend was fixed at one-half of a DISC's total profits. However, the Tax Reform Act of 1976 reduced DISC benefits. The incremental provision adopted in that legislation limits DISC deferral to one-half of export profits in excess of 67 percent of average export profits over a four-year base period. For taxable years beginning in 1976 through 1979, the base period years are 1972 through 1975. In 1980 and thereafter, the base period will move forward on a year-by-year basis.

A DISC usually acquires goods from its parent corporation or an affiliated corporation (a "related supplier") and sells them abroad. Alternatively, a DISC may act simply as a commission agent on export sales. Even if the DISC does nothing, paper profits are allocated to it.

The method used for allocating profits between a DISC and its related suppliers is an important part of the DISC statute. The allocation is achieved through special intercompany pricing rules permitting the DISC to realize profits which do not exceed the greater of:

(a) 4 percent of the qualified export receipts attributable to the sale of export property plus 10 percent of related "export promotion expenses," defined as ordinary

and necessary expenses incurred to obtain export profits;

(b) 50 percent of the combined profits of the DISC and its related suppliers attributable to exports, plus 10 percent of related export promotion expenses;

(c) profits based on an arm's-length price.

Neither the 4 percent method nor the 50 percent method may be applied in such a way as to produce a loss to the related supplier while the DISC is earning a profit. These special rules serve, however, to allow U. S. exporters to allocate more income to a DISC, and thus to defer a larger portion of their total tax burden, than they could under the normal arm's-length rule.

Reasons for Change

The principal objectives of the Revenue Act of 1971 were "to increase our exports and improve our balance of payments." 1/ To help accomplish these objectives, the Act added the DISC provisions to the Internal Revenue Code.

The contribution of the DISC legislation to the promotion of exports has, however, been minimal. A 1977 Treasury Department report to Congress estimates the net effect of the DISC program on 1975 U.S. exports to have been between $1 billion and $2.5 billion, less than 3 percent of total U.S. exports of $98 billion for 1975. This estimated increase in exports attributable to the DISC program was achieved at a cost of $1.2 billion in tax revenue. Although U.S. exports have increased dramatically since the enactment of the DISC legislation, this expansion is largely attributable to other factors, including major dollar devaluations, inflation of export prices, and a sharp increase in the real volume of world trade associated with a rapid rate of real economic growth, especially in the Mideast.

The balance of payments arguments originally advanced in support of the DISC legislation are substantially weakened under a system of flexible exchange rates. To the extent that DISC promotes exports, it lessens the depreciation of the dollar in foreign currency markets. Although sudden and abrupt depreciation may be undesirable, a slower and more orderly depreciation encourages U.S. companies to export more and import less. The balance of payments adjustment process may take time, but it does take place. Between 1971 and 1977, the U.S. merchandise trade balance has swung from deficit to surplus to deficit to surplus and now back to deficit again. DISC is thus an anachronism in a world of flexible exchange rates, and a costly and wasteful anachronism at that.

If the United States wishes to assist the balance of payments adjustment process, other programs, such as the contemplated $2.2 billion increase in direct loans and $1.8 billion increase in loan guarantees by the Ex-Im Bank, are clearly preferable to DISC. Not only can Ex-Im Bank loans be more effectively aimed at producing genuine increments in U.S. exports, but the program can be scaled down in periods of balance of payments surplus. DISC is not an appropriate or a particularly effective policy for coping with transitional problems of balance of payments adjustment.

Congress has consistently been more skeptical of the DISC program than previous Administrations. In 1971, Congress cut in half the Nixon Administration's request for a complete deferral of taxation of DISC income. And Congress required the Treasury to report annually on the operation of the DISC legislation in practice. As the revenue cost of the DISC program soared far above initial projections, Congress overrode the opposition of the Ford Administration and further pared the cost of the DISC program. Nevertheless, the revenue cost of the DISC program once again exceeds a billion dollars per year, with little evidence that this money is being wisely spent.

Like all tax reductions, DISC tends to make its beneficiaries more competitive. But the beneficiaries of the DISC legislation tend to be the largest and most profitable of U. S. companies; DISC helps little, and may actually harm, footwear, textile, and steel producers facing competition from imports. Moreover, the substantial domestic costs of the DISC program are out of all proportion to the dubious value of DISC as a "bargaining chip" in international trade negotiations. Thus, continuing skepticism of the value of DISC is well-founded. The DISC program should be repealed.

General Explanation

Tax benefits granted to DISCs and their shareholders are to be phased out over a three-year period beginning in 1979 and ending in 1981.

The phase-out of DISC benefits will be accomplished by increasing the deemed distribution from the present 50 percent of DISC profits attributable to "incremental" exports. For taxable years ending in 1979, DISCs will be deemed to distribute 66-2/3 percent of such profits, and for taxable years ending in 1980 the deemed distribution will rise to 83-1/3 percent. DISC is repealed for the first taxable year ending after 1980. Accumulated past earnings of a DISC will continue to be tax deferred as long as they remain invested in export-related assets.

Analysis of Impact

(1) Impact on Exports, the Balance of Trade, and U.S. Employment

Companies benefiting from the DISC program can cite impressive statistics on the growth of their exports since the DISC legislation was enacted in 1971, on the number of jobs in their company that are dependent on export sales, on the number of jobs in supplier industries indirectly dependent on export sales, etc. Naturally, workers will be alarmed if told that their jobs depend on the continuation of the DISC program. A close examination of company statements reveals, however, little information on the specific contribution of DISC either to export sales or to employment. Disinterested economic analyses of the rapid growth of U. S. exports since 1971 indicate that such growth is largely due to factors other than DISC. The primary contributors to this growth have been:

-- From 1971 to 1974 the dollar fell in value relative to foreign currencies by 13 percent.2/ This decline meant that foreign currency prices of U.S. exports fell relative to prices of goods from other countries, thus making U.S. goods more attractive to foreign purchasers.

-- About half of the increase in the value of U.S. exports from 1971 to 1974 was attributable to general increases in all prices, reflecting worldwide inflation. The price rise was especially rapid for certain agricultural products and industrial supplies.

-- A sharp increase in the real (price deflated) volume of world trade was associated with a rapid rate of real growth. According to United Nations estimates, the real volume of world trade was 30 percent higher in 1974 than in 1971. During this period U.S. exports grew more or less in proportion to world trade; as a consequence, the U.S. share in the exports of industrialized countries rose by only 0.6 of a percentage point, from 18.9 percent in 1971 to 19.5 percent in 1974.

The Treasury Department's most recent report to Congress on the DISC program concluded that, had exchange rates been fixed, DISCs would have contributed only $1 billion to $2.5 billion to net U.S. exports. Much of the growth in exports benefiting from the DISC legislation may have come at the expense of non-DISC exports. The Treasury report pointed out, moreover, that under the system of flexible exchange

rates adopted in 1973, an increase in U.S. exports will increase the demand for dollars in foreign countries. This will, in turn, stimulate U.S. imports by reducing import prices in terms of dollars. The increase in U.S. exports due to DISC is thus offset by an increase in U.S. imports, and the net impact of DISC on the balance of trade is much less than the impact on exports.

DISC supporters often argue that flexible exchange rates have not been successful in restoring the U.S. balance of payments, and that DISC is necessary to reduce the current balance of trade deficit. To support their argument, proponents of the DISC program note that many foreign governments intervene in foreign exchange markets to keep the dollar from depreciating, that foreign import quotas and other trade barriers prevent U.S. exports from expanding as the dollar depreciates, and that foreign demand for many of the goods which the U.S. exports (e.g., agricultural products) does not expand much as their price falls. Even if these assertions were factually correct, however, they would not support the retention of the DISC program.

If depreciation of the dollar does not promote U.S. exports, neither does DISC. Both must work through the same mechanism: making exporting more profitable. As the dollar depreciates, the foreign currency price for U.S. exports translates into a higher dollar value, which raises export profits before and after taxes. With a DISC the tax burden on export income is decreased, so that after-tax profits increase even if before-tax profits are unchanged. If U.S. manufacturers cannot expand their exports when depreciation of the dollar makes foreign sales more profitable, they should not be able to expand those exports because DISC makes those sales more profitable. Thus, the argument that flexible exchange rates do not work is also an argument that DISC does not work.

To assess the further argument of some persons that DISC promotes U.S. employment, it is necessary to translate the impact of DISC on the balance of trade into an impact on employment. This requires estimates of the labor intensity of exports versus imports. If imports indirectly induced by DISC are highly labor intensive, it is possible that the DISC program actually produces a decline in U.S. employment.

DISC represents only one of many ways of reducing taxes, and a tax reduction is only one of the available macroeconomic tools -- expenditure programs, monetary expansion, and debt policy are alternatives -- for stimulating the economy. Therefore, a complete evaluation of the employment impact of DISC would require an analysis of the costs and benefits of alternative programs. Concern about U.S. employment should be -- and is-- reflected in the President's overall budget proposals, rather than in any one part alone.

(2) Impact on the Competitive Position of U.S. Corporations

U.S. exporters often argue that repealing DISC will make them less competitive in world markets. It is true that any tax increase leaves a corporation with fewer funds available for new investment, research and development, and so forth. But it is also true that competitiveness is a fact of business life for all firms, not just the corporations benefiting from DISC. Because of the legal and accounting costs of complying with the complex DISC legislation, larger corporations necessarily make more use of the DISC legislation than smaller corporations do. According to the 1977 Treasury report on DISC, over 60 percent of total DISC tax benefits went to parent companies with more than $250 million in assets.

Moreover, the profit margin on DISC export sales was 14.7 percent, which was more than twice as large as the comparable 6.5 percent margin on sales to the domestic, U. S. market. Those U. S. industries standing most in need of assistance, and which benefit not at all from DISC, are those facing stiff import competition (e.g., footwear, textiles, steel); they often incur losses that they cannot sustain for any extended period of time. Thus, while the DISC program perversely tends to help those industries that need help least, it also helps least those industries that need help most. Clearly, if the ultimate goal is making U.S. corporations more competitive, other measures such as the Administration's proposed corporate tax rate reduction and changes in the investment tax credit are more equitable and effective than the DISC program.

(3) Revenue Cost of DISC

The revenue cost of DISC in calendar year 1975 was $1,390 million. The cost in 1976 was reduced to $870 million because of the "incremental" provisions of the Tax Reform Act. The costs in 1977 and 1978 are projected to be $1.0 billion and $1.2 billion, respectively. A rough estimate of the cost of each additional dollar of net exports due to DISC can be derived by dividing the estimated additional exports of between $1 billion and $2.5 billion by the revenue cost for fiscal year 1975 of $1.2 billion. Each dollar of additional exports thus cost between $1.20 and $.48 in tax revenue -- a very expensive cost-benefit ratio.

Because of its growing concern over the high cost and limited benefits of the DISC program, Congress sought in 1976 to limit DISC benefits to "incremental" exports. Although concern with the DISC program is easy to understand, the 1976 changes appear to have reduced the incentive to export at the same time that they reduced the revenue cost. This is because an increment to exports in 1976 and thereafter will

be reflected in a higher base against which "incremental" exports will be measured in future years. As a consequence, the greater the taxes that are deferred now, the less will be the taxes deferred in the future. The Treasury's most recent report on DISC concluded that the 1976 changes reduced by 40 percent the tax incentive to expand exports. Because the reduction in the revenue cost of the DISC program was also roughly 40 percent, there is no reason to believe that the DISC program is any more cost-effective now than it was prior to 1976. The incremental approach may have produced less waste in absolute terms but it is not a solution to the waste inherent in the DISC program.

(4) Impact on U.S. Trade Relations

The European Community lodged a formal complaint with the Contracting Parties of the General Agreement on Tariffs and Trade (GATT) in July 1972, asserting that DISC was incompatible with Article XVI:4 of the GATT because it constituted a tax subsidy on exports. The United States entered a counter-complaint against the export tax practices of France, Belgium, and the Netherlands.

Four panels of experts were appointed by GATT, one to consider the complaints of the European Community against DISC and three to consider the complaints brought by the United States against the tax practices of France, Belgium, and the Netherlands. Each panel, however, consisted of the same persons.

The panels reported their findings to the GATT Council on November 2, 1976. Each of the panels concluded that the tax practices subject to complaint "in some cases had effects which were not in accordance with [that country's] obligations under Article XVI:4." Therefore, each of the panels found that "there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement (GATT)."

The GATT Council discussed the panel reports at meetings held in November 1976, March 1977, and, most recently, November 1977, but it could not reach agreement on their adoption. Upon adoption, the GATT Council would be in a position to make recommendations to the parties regarding appropriate settlement of the disputes. At the November 1977 GATT Council meeting, U. S. representatives proposed that the Council adopt the reports of all four panels. The U. S. representatives also stressed that the United States was not concerned about European tax systems *per se*, but only with the possible tax-haven abuse of those systems. The United States expressed the hope that the Europeans shared this concern and that this would form a basis for adoption of the four reports.

France, Belgium, and the Netherlands continued, however, to express reservations about the panel findings on their respective tax practices, particularly the definition of export activity, and refused to agree to the adoption of the panel reports by the GATT Council. Since these countries refused to agree on the simultaneous adoption of all the panels' reports, the United States refused to accept unilaterally the panel report on DISC.

Supporters of DISC assert that DISC has certain value as a "bargaining chip" in international trade negotiations. But this factor must be weighed against DISC's substantial and growing domestic cost. When DISC is repealed, the United States will still have every right to expect other countries to bring their tax practices into conformity with GATT. If other countries do not make conforming adjustments, the Treasury, using the very same reasoning as it did before GATT, could find that these foreign tax practices violate U.S. domestic law and, accordingly, are subject to countervailing duties. In repealing DISC unilaterally, the United States will thus not be defenseless in protecting itself against the tax practices of foreign countries.

Effective Date

The phased repeal of DISC will begin for the first taxable year of a DISC ending on or after January 1, 1979 and will be complete in taxable years of DISCs ending after December 31, 1980.

Revenue Estimates

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
193	664	1,228	1,513	1,613	1,751

Footnotes

1/ H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 1 (1971); S. Rep. No. 92-437, 92nd Cong., 1st Sess. 1 (1971).

2/ The 13 percent figure represents the decline in the effective trade-weighted value of the dollar against ten major currencies. Source: Board of Governors of the Federal

TERMINATING DEFERRAL

Present Law

Under present law U. S. citizens, residents, and corporations are subject to U. S. taxation on their worldwide income. Foreign corporations, including foreign corporations controlled by U. S. taxpayers, are generally subject to U. S. taxation only on income earned in the United States.

Although the income of a foreign corporation controlled by a U. S. shareholder is usually consolidated with the income of the U. S. shareholder for purposes of financial reporting, this is not the case for tax purposes. The shareholder's income subject to U. S. tax generally includes only dividends received from the foreign corporation and not the earnings that the foreign corporation retains. The U. S. tax on dividends from the foreign corporation may be offset by a credit allowed for the foreign taxes paid by the foreign corporation.

"Deferral" refers to the practice of not taxing the income of a U. S.-controlled foreign corporation until that income is distributed to the controlling U. S. shareholders. The term "deferral" is employed because the net U. S. tax liability -- equal to the difference between the U. S. tax and the credit for foreign taxes -- is "deferred" until such income is distributed as a dividend.

Deferral does not apply when the nature of the controlled foreign corporation and its income exhibit "tax haven" characteristics. Tax haven income (so-called "subpart F income") is taxed currently to U. S. shareholders regardless of whether they actually receive the income in the form of a dividend. Likewise, U. S. shareholders are taxed on their pro rata share of the retained earnings of a foreign personal holding company, and on the earnings of any controlled foreign corporation which are in effect repatriated to the United States through the purchase of certain U. S. property.

Since the practice of deferral permits the income of controlled foreign corporations to escape current U. S. taxation until that income is repatriated as a dividend, it is important that transfer prices for transactions between U. S. shareholders and their controlled foreign corporations be properly determined. It is also necessary to ensure that reorganizations involving controlled foreign corporations are not undertaken for the purpose of tax avoidance. The tax law presently contains complex provisions designed to carry out these purposes.

Reasons for Change

The fundamental defect in the concept of deferral is that it makes very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U. S. taxpayer. In addition to curing this defect, the termination of deferral will eliminate the tax incentive that U. S. taxpayers now have to locate new investment overseas rather than in the United States.

Terminating deferral will permit the rationalization and simplification of U. S. rules for the taxation of foreign income. Termination will help stimulate competition between large multinational corporations and their smaller competitors, by removing tax benefits which accrue principally to the large multinationals. Finally, terminating deferral will reduce the incentive inherent in present law for U. S. taxpayers to avoid U. S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.

(1) Terminating Deferral Will Preclude Substantial Tax Benefits From Turning on the Choice of Corporate Structure

When losses or large foreign tax credits are desired for U. S. tax purposes, a U. S. taxpayer may obtain these benefits currently by operating overseas through a branch. When foreign income does not generate sufficient foreign tax credits to offset U. S. tax, a current U. S. tax may be avoided by interposing a foreign corporate entity. A U. S. taxpayer is thus permitted to choose, through the form of its overseas operations, between two very different sets of substantive U. S. tax rules.

There is no good reason for this state of affairs. A choice of tax rules should not be accorded simply because business operations are situated abroad rather than in the United States. Such operations, in the case of a controlled foreign corporation, are an integral part of the overall activity of the U. S.-based firm, and the profits from such operations should, for this reason alone, be subject to current taxation in the United States.

In 1969 Congress dealt with a similar situation involving the availability of the $25,000 surtax exemption for each entity in a group of related domestic corporations. Congress took the view that a commonly owned business enterprise should be entitled to only one such exemption, whether it was operated under a single corporate charter or multiple charters and regardless of any genuine business reason for having multiple charters. The issue in the case of deferral is essentially the same: even if fully justified by business considerations, the interposition of foreign corporate charters should not affect the substance of U. S. taxation.

This point is, in fact, already recognized by some provisions of the Internal Revenue Code dealing with foreign income. U. S.

corporations are allowed a foreign tax credit (the so-called "deemed paid" credit) for taxes paid by their foreign subsidiaries. This allowance, which in 1975 amounted to more than $3 billion, reflects a recognition that the existence of a foreign corporate charter should not determine tax substance.

(2) Terminating Deferral Will End a Present Tax Incentive To Invest Overseas

Deferral gives U. S. taxpayers a substantial incentive to invest overseas for purely tax reasons. This incentive arises from a combination of the absence of current U. S. tax on the retained earnings of controlled foreign corporations, and the presence of tax inducements in many foreign countries. These foreign inducements take the form of low tax rates, rapid depreciation, tax holidays, and other special tax advantages not available in the United States.

U. S. investors need not look very far for tax holidays, for such benefits are heavily marketed in the United States. One foreign country, for example, publishes a brochure urging American business to "Get in on the . . . bonanza!" The bonanza includes "tax holidays, unlimited remittance of profits, repatriation of capital, protection against risks and the assistance offered by a friendly government from application to the start of production." Another recent advertisement in a business publication has a banner headline: "Exceptional Return on Investment Continues ...." As the advertisement explains, "export profits . . . . are completely free of tax until 1990. So a U. S. subsidiary . . . . grows faster, and at less cost to the U. S. parent. In spite of the fact that profits can be freely repatriated, U. S. companies ploughed back 65 percent of them and notched up an expansion of U. S. investment of 30 percent." With an exemption from foreign tax and a deferral of U. S. tax, it is easy to understand why profit margins in this country are abnormally high.

Tax incentives to invest abroad stand in conflict with the general policy of the United States to encourage investment of U. S. capital where it will be most productive, whether in the United States or overseas. The elimination of deferral will advance this policy, since it will tend to ensure that foreign investment will be motivated by genuine economic factors.

(3) Ending Deferral Will Permit Simplification of the Rules Relating to Taxation of Foreign Income

The termination of deferral will permit the simplification of U. S. rules relating to the taxation of foreign income. Subpart F, the rules relating to foreign personal holding companies, the rules governing the foreign tax credit, and the rules regarding reorganizations of foreign corporations will all be affected.

The subpart F anti-tax haven provisions originated in a proposal submitted to Congress in 1961 by President Kennedy. The

purpose of that proposal, and of the provisions of subpart F, was to prevent U. S. businesses from exploiting the multiplicity of foreign tax systems and tax treaties so as to reduce or eliminate both U. S. and foreign tax liabilities.

Subpart F as drafted was not, however, structured to eliminate international tax avoidance by U. S. firms. It is focused exclusively upon a narrow class of so-called "tax haven" income. And its provisions are so complex that only a relative handful of persons are capable of understanding all of their implications. Although subpart F has doubtless discouraged many companies from undertaking blatant tax haven operations, highly sophisticated means of circumventing both the specific subpart F rules and their general objectives are available. Moreover, the Internal Revenue Service does not have the resources to mount an effective administrative effort to combat such schemes.

Terminating deferral for all controlled foreign corporations, as this proposal recommends, will permit the replacement of subpart F with a simpler, more comprehensible set of rules for U. S. taxation of foreign income. Terminating deferral will also permit repeal of the Internal Revenue Code provisions relating to taxation of foreign personal holding companies -- another series of provisions aimed at tax haven abuses.

Furthermore, terminating deferral will reduce the importance of the complicated rules relating to both the "deemed paid" foreign tax credit and multinational corporate reorganizations. The rules relating to the credit are not limited to controlled foreign corporations, and will have to remain in effect to cover foreign corporations owned in part, but not controlled, by U. S. persons. They will not, however, generally be required with respect to controlled foreign corporations if deferral is terminated, because a foreign tax credit will be available without regard to the "deemed paid" credit. The rules regarding corporate reorganizations will become less important because the potential for tax avoidance on the transfer of assets abroad will be diminished.

Eliminating deferral will thus have the highly desirable effect of making the U. S. system of taxing foreign income more comprehensible. The present system, complex and internally inconsistent, understood in all its detail by only a very few highly trained individuals, is simply not appropriate in the U. S. tax system. The rationalization of U. S. rules in this area will permit the Administration and Congress to see more clearly where real problems exist and to structure appropriate solutions having no unintended and unforeseen consequences for either taxpayers or the government.

(4) Terminating Deferral Will Help Equity and Competition

The present system of U. S. taxation of foreign income, with deferral as its centerpiece, has produced increasingly

sophisticated methods of tax planning by those involved in multinational transactions. As the Internal Revenue Service has issued new Regulations limiting opportunities for tax avoidance, and as Congress has tightened various rules in the system, taxpayers have become more and more ingenious in avoiding their impact. Offshore financial subsidiaries, holding companies, and captive insurance affiliates have proliferated. Computer programs to guide tax planning efforts have been developed. The major accounting and law firms have devised ever more refined planning techniques.

For example, the "rhythm method" of distributing dividends from foreign companies has become increasingly popular. Under this method foreign corporations only pay dividends to their U. S. parent companies in those years in which their effective foreign tax rate is high, rather than paying smaller dividends on an annual basis. Because of deferral and the "deemed paid" credit for foreign taxes paid by the foreign corporation, U. S. companies are able through this method to minimize U. S. tax on repatriated earnings. The technique illustrates how the existence of contradictory principles for taxing foreign income -- the "deemed paid" foreign tax credit which effectively treats parent and subsidiary as one enterprise, while deferral treats them as separate -- inevitably gives rise to opportunities for tax avoidance.

(5) Terminating Deferral Will Help Stop Practices Used To Avoid U. S. Tax

U. S. taxpayers have many opportunities today to avoid U. S. tax by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations, or imports the same from them. It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States.

In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. To determine whether the assigned transfer prices are appropriate for tax purposes, the United States and many other countries apply an arm's-length standard -- *i.e.*, they require terms that would have been fixed in comparable transactions between an independent buyer and seller. The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. In this situation U. S. taxpayers sometimes seek to reduce U. S. taxes by channeling

income to low-tax subsidiaries and deductions to the controlling U. S. company. Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.

Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.

Since the elimination of deferral will subject U. S. shareholders to current tax on the income of controlled foreign corporations, it may be expected to reduce if not eliminate the incentive to use techniques which serve to transfer excessive income to foreign corporations.

General Explanation

This proposal will phase out deferral over a three-year period. Beginning in 1981 the income of a controlled foreign corporation will be taxable as if it had been earned directly by the U. S. shareholder. This is the rule that has always obtained under the U. S. tax system where foreign operations are conducted by a U. S. taxpayer through a branch, rather than through a foreign corporation. Thus, U. S. tax liability under the proposal will closely approximate the amount that a U. S. shareholder would incur if it operated through a foreign branch. For 1979 and 1980 the above rule will apply to one-third and two-thirds, respectively, of the controlled foreign corporation's income.

The approach taken in this proposal will result in an accurate assessment of the U. S. shareholder's U. S. tax liability. Losses incurred by a controlled foreign corporation will be allowed to offset the U. S. source income of the shareholder. Similarly, foreign taxes imposed on the controlled foreign corporation will be treated as if they had been imposed on the U. S. shareholder and thus will be taken into account currently for purposes of the foreign tax credit rather than when the underlying income is actually repatriated.

The proposal allows the Treasury to consider the negotiation of tax treaties providing, in appropriate situations, that U. S. shareholders will not be taxed currently on certain income of their controlled foreign corporations operating in a treaty country.

Analysis of Impact

(1) Effect on Investment

Investment which is responding to real market forces will not be affected by the termination of deferral. Such investment represents a significant part -- but not all -- of U. S. overseas investment.

Most developed countries impose, in addition to corporate income taxes, withholding taxes on dividends, interest, and royalties paid to U. S. investors. Although the total tax burden in such countries is comparable to or higher than that in the United States, U. S. investment still flows to these countries because their markets are large and growing, consumer incomes are high, the demand for U. S. products is substantial, and a U. S. company can maintain its market position only by investing locally. Likewise, petroleum and other natural resource investments flow to countries with abundant natural resource deposits despite substantial tax and other payments to the governments in those countries. Finally, many less-developed countries attract labor-intensive production with low wage rates rather than tax incentives. These investments are far more typical of U. S. investment abroad than those motivated solely by tax considerations, and they will continue without the added benefits of deferral. Terminating deferral will thus operate to restrict only tax-induced investments.

The United States does not have any general interest in encouraging tax-induced investments. Foreign countries that offer tax incentives are not usually interested only in the type of investment that attracts exports from the United States and thus promotes domestic employment. To the contrary, foreign tax incentives are frequently aimed at the type of investment that promotes exports _to_ the United States and thus displaces U. S. jobs. The United States has no reason to favor the latter category of investments.

There is good reason to believe that eliminating deferral will provide a moderate stimulus to total U. S. investment and employment. For some companies production in the United States is a direct and viable alternative to producing abroad. Some U. S. companies may have been induced by the combination of deferral and foreign tax incentives to stop exporting and start producing overseas. Alternatively, some companies may have stopped supplying the domestic U. S. market with goods made in the United States, electing instead to rely on imports from their own foreign affiliates. Moreover, even when domestic investment is not a direct substitute for foreign investment, domestic production can still benefit indirectly from the repeal of deferral. The capital that would have been used to finance a tax-induced foreign investment can be retained in the United States and used to finance an unrelated, but job-producing, domestic investment. The gains may be substantial in specific industries where foreign tax practices have hastened the export of jobs and capital.

(2) Competitiveness of U. S. Corporations Overseas

Some U. S. companies maintain that they cannot remain competitive in world markets without deferral. Any change which alters corporate tax burdens tends to alter the funds available for new investment, new research and development, and other programs aimed at expansion. But if this is true of deferral, it is equally true of other tax measures such as changes in the corporate tax rate or the investment tax credit.

These other methods of promoting competitiveness are better and fairer than deferral. In order to benefit from deferral, a corporation must invest abroad, not in the United States. As noted above, deferral may encourage companies to invest abroad for export back to the United States, thereby undermining the competitiveness of U. S. companies that choose to stay at home. Zenith Corporation, for example, was forced to go overseas not only by its Japanese competitors (Sony, Panasonic, etc.) but also by its American rivals (RCA, Motorola, etc.) that went abroad to carry out assembly operations. Finally, deferral promotes continued investment overseas; repatriation of profits, which would help domestic investment, is actually discouraged by deferral. None of these perverse side effects of deferral characterizes reduction of the corporate tax rate and expansion of the investment tax credit, measures which the Administration has proposed.

It should be noted, finally, that the competitiveness of a corporation depends on its overall tax burden, not on any single tax provision. Terminating deferral represents only a small offset to the benefits envisioned for companies in the Administration's tax package.

(3) Reactions of Foreign Governments

It is often argued that if the United States terminates deferral, foreign countries will retaliate by discriminating against U. S. investors so that U. S. companies will pay higher taxes to foreign governments rather than the United States. Foreign countries, it is said, may revoke the eligibility of U. S. subsidiaries for tax holidays or accelerated depreciation, or they may deem all earnings distributed and thereby subject to high withholding taxes.

Such developments are, however, unlikely in the case of developed countries. The tax rates in most of these countries match those of the United States. Furthermore, most developed countries have tax treaties with the United States that require nondiscriminatory treatment of U. S. investors. Since residents of developed countries often have substantial investments in the United States, it is doubtful that these countries would risk abrogation of their treaties with the United States.

The United States has tax treaties with only a few less-developed countries, and the tax burden in some of these countries is lower than that in the United States. However, in many cases there will be no reason for these countries to retaliate against U. S. investment, because the termination of deferral will not produce higher U. S. taxes for many of the multinational companies operating within their borders.

Numerous U. S. companies already have an overall excess of foreign tax credits, and more will fall into this category if the U. S. corporate tax rate is reduced to 44 percent, as the Administration proposes. Under the "overall" foreign tax credit limitation -- the only limitation now in effect -- operations in low and high tax countries are combined. In the case of taxpayers with excess foreign tax credits, the United States will not, upon the elimination of deferral, impose any tax on profits from low-tax countries which are "sheltered" by excess credits from high-tax countries. Thus, many U. S. companies operating in foreign countries with a low rate of tax will not bear any more U. S. tax upon the elimination of deferral, and therefore those foreign countries will not have an incentive to raise taxes in retaliation to this proposal.

Furthermore, it is by no means clear that even a low-tax country believing that the end of deferral will subject U. S. investors to a higher U. S. tax burden will choose to retaliate. In the first place, it will be made clear that discriminatory taxes aimed at "soaking up" the difference between a foreign country's rate and that of the United States are not creditable under U. S. law. Low-tax countries desirous of promoting U. S. investments may not wish to take actions that could have the effect of actually penalizing such investments. More likely, such countries may wish to "validate" some of the tax incentives that they offer by seeking treaty provisions under which U. S. investors within their borders would continue to be entitled to deferral.

In some cases the United States may wish to validate the tax incentives that a developing country offers to U. S. investors. For example, investments that promote genuine economic development, have a minimal impact on U. S. employment, or increase U. S. access to critical raw materials may serve the national interest. But rather than giving a blanket incentive to foreign investment of all types and in all countries, the United States should focus the benefits of deferral through its tax treaty program. If deferral is terminated subject to exceptions by tax treaties, less-developed countries will be far more eager to conclude treaties with the United States than they have been in the past and developed countries that have treaties with the United States or are engaged in treaty discussions may be persuaded to offer favorable concessions.

(4) Administrative Impact Upon Taxpayers

It is sometimes argued that terminating deferral will involve serious administrative problems for U. S. companies. U. S. taxpayers, it is said, will not be able to maintain or obtain adequate records reflecting the income and deductions of controlled foreign corporations, particularly when there is no majority U. S. shareholder. It is also argued that the difficulty of translating books and records kept in foreign currency and under foreign standards into U. S. currency and standards justifies the retention of deferral.

The Administration is aware that there may be some administrative difficulties in some situations. However, U. S. companies with overseas branches, which have always been required to report foreign operations currently, have been able to solve these problems. U. S. parent corporations have long reported the earnings of controlled foreign corporations for SEC and general accounting purposes. And since 1962, controlled foreign corporations of U. S. shareholders have translated their books and records into U. S. standards for the purposes of subpart F. Finally, the provisions allowing for a "deemed paid" foreign tax credit, which have been in the law since 1918, require every U. S. corporation owning 10 percent of any foreign corporation (whether or not controlled by U. S. interests) to translate foreign books and records into U. S. standards in order to obtain the benefit of the indirect foreign tax credit. Administrative problems that have been surmountable in these cases will likewise be surmountable when deferral is terminated.

Effective Date

The phase-out of deferral will apply to the first taxable year of each controlled foreign corporation ending in 1979 and to taxable years of U. S. shareholders with which or within which such taxable years of such foreign corporations end.

Revenue Estimates

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
0	88	280	768	830	897

These estimates do not take into account the effect of the proposed reductions in the corporate tax rate. The revenue gain from terminating deferral depends on the spread between the U.S. and average foreign tax rates. Therefore even a relatively small decrease in the U.S. tax rate can substantially reduce the revenue gain from terminating deferral.

Behavioral adjustments could also affect these estimates. Some investors may, for example, increase their actual dividends and thereby incur foreign dividend withholding taxes; this would reduce net taxes paid to the United States.

Other behavioral adjustments could, however, increase U. S. tax revenues beyond the above estimates. U. S. investors may invest more at home and less abroad than they would if deferral were maintained. The reduction of tax incentives to manipulate intrafirm transfer prices in order to shift taxable income away from the United States could produce substantial revenues not taken into account in the estimates. Although the potential revenue gains from these location-of-investment and transfer-pricing adjustments are impossible to estimate, they could easily outweigh any adverse revenue consequences of other behavioral adjustments attributable to the elimination of deferral.

Technical Explanation

(1) Current Inclusion of Income Earned by Controlled Foreign Corporations

The proposal will currently include in the income of U. S. shareholders their pro-rata share of the gross income and deductions of controlled foreign corporations. Income and deductions of each controlled foreign corporation will be treated as having been earned and incurred by the U. S. shareholder. The character of the income or deduction will be the same in the hands of the U. S. shareholder as it would have been if the activity had

been carried out abroad directly rather than through a foreign corporation. Controlled foreign corporations will, however, continue to be treated as corporations for the purposes of rules affecting transfer prices, corporate reorganizations, and other provisions of current law.

(2) Controlled Foreign Corporation

A controlled foreign corporation will be any foreign corporation of which either: (a) more than 50 percent of the total combined voting power of all classes of stock is owned, or is considered owned, by U. S. shareholders; or (b) more than 50 percent in the value of the outstanding stock is owned, or is considered owned, by U. S. shareholders. The use of a voting power test is consistent with present subpart F provisions. The use of a value test is consistent with the foreign personal holding company provisions.

(3) U. S. Shareholder

A U. S. shareholder is a U. S. person who owns, or is considered as owning, either: (a) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation; or (b) 10 percent or more in the value of the outstanding stock of a foreign corporation. For purposes of determining whether a company is a controlled foreign corporation and whether a person is a U. S. shareholder, the meaning of "U. S. person" as well as the constructive stock ownership rules will be substantially the same as those now contained in subpart F.

(4) Percentage Inclusion

The amount of a controlled foreign corporation's gross income and deductions attributable to a U. S. shareholder will be determined in proportion to that shareholder's rights to the net earnings of the corporation. This approach is substantially the same as that set forth in the current Regulations under section 1248.

(5) Treatment of Noncorporate Shareholders

Noncorporate shareholders required to include income and deductions currently will be treated as though such amounts were initially received by a domestic corporation. This rule, the mechanics of which have been developed under subpart F, will ensure equality of treatment between noncorporate and corporate shareholders.

(6) Losses

The excess of deductions over the gross income of a controlled foreign corporation will be treated as if realized directly by a U. S. shareholder, regardless of whether a corporate shareholder meets the stock ownership requirements for filing a consolidated return domestically.

If a U. S. shareholder has an overall foreign source loss attributable in whole or in part to the shareholder's pro-rata share of the losses of one or more controlled foreign corporations, the loss may offset his U. S. source income but will be subject to the recapture rules currently in section 904.

(7) U. S. Branch Rule

Gross income, deductions, and U. S. taxes of a U. S. branch of a controlled foreign corporation will be attributed to the U. S. shareholders of that corporation. This income will not, accordingly, be twice subjected to U. S. tax.

(8) Blocked Income

For the purpose of exchange control, certain foreign countries do not allow the expatriation of earnings derived within their borders. The proposal recognizes that it is inappropriate to tax currently all the earnings of a controlled foreign corporation in cases where distributions to U. S. shareholders have been "blocked" by currency or other restrictions imposed by a foreign country.

The Administration recognizes that the current rules with respect to blocked income may not be appropriate when deferral is terminated. It is anticipated that Regulations will be promulgated to describe those situations that prevailed prior to 1978 that will be treated as creating blocked income. However, any currency or other restrictions that are imposed solely against U. S. shareholders or imposed solely on a shareholder-by-shareholder basis will not be recognized as blocking income.

(9) Repatriation of Previously Taxed Income

Previously taxed income will be excluded from gross income of a U. S. shareholder when such income is distributed to the shareholder or any other U. S. person who acquires any portion of the U. S. shareholder's interest in the controlled foreign corporation.

(10) Basis Adjustments

As gross income and deductions of a controlled foreign corporation are recognized by the U. S. shareholder, an adjustment will be made to the basis of the shareholder's stock in the controlled foreign corporation. Actual distributions from the corporation that are excluded from gross income because they are attributable to previously taxed income will decrease such basis.

(11) Foreign Tax Credit

Since income and deductions will be treated as if realized directly by U. S. shareholders, foreign taxes paid by controlled

foreign corporations, regardless of tier, will be treated as if paid directly by U. S. shareholders. This rule simplifies the foreign tax credit by making unnecessary the "deemed paid" foreign tax credit calculation in the case of U. S. shareholders of controlled foreign corporations. Further, the rule removes an inequity in current law, under which a foreign tax credit is denied for any year in which a foreign corporation has a deficit calculated under U. S. principles, even though taxes were paid to a foreign country.

Eliminating deferral reduces both a corporation's ability to control the effective rate of foreign tax by controlling the source and rate of dividend distributions and the corporation's ability to minimize timing differences in deductions between the United States and foreign countries. To allow for such timing differences, it is proposed that the foreign tax credit carryback be lengthened from 2 to 3 years and that the foreign tax credit carryforward be lengthened from 5 to 7 years. It will be made clear that a foreign tax credit will not be allowed for withholding taxes applied only to U. S. investors, or on a shareholder-by-shareholder basis, or to deemed distributions.

(12) Exchange Gains and Losses

The proposal provides that unrealized exchange gains and losses will be taken into account by a U. S. shareholder. This is the rule for financial accounting purposes and it is similar to a tax rule available to U. S. branches overseas and to the rule used to determine earnings and profits under subpart F. The proposal provides, however, that a U. S. shareholder may elect, with respect to all of its foreign operations, not to take into account unrealized exchange gains and losses. This election is revocable, on a prospective basis, ten years after it has been made.

(13) Accounting, Record Keeping, and Reporting Requirements

Rules will be provided for making elections with respect to controlled foreign corporations, translating amounts from foreign currency, the computation of taxable income and earnings and profits, the keeping of records and accounts, and the reporting requirements of U. S. shareholders.

In general, taxable income and earnings and profits will be computed under U. S. standards. The Administration recognizes, however, that there are differences between U. S. and foreign standards, and will prescribe Regulations describing the extent to which deviations from U. S. standards will be allowed.

(14) Tax Treaties

The proposal allows the Treasury to consider the negotiation of income tax treaties allowing deferral to continue, in appropriate situations, in treaty countries.

(15) Corporations Organized in Puerto Rico and U. S. Possessions

A current provision of subpart F allows a controlled foreign corporation organized in Puerto Rico or a possession of the United States to be excluded from subpart F if it meets certain tests with regard to the source and nature of its income and business. This provision parallels slightly broader statutory protection from U. S. tax granted by way of a special "possessions" tax credit available to electing domestic corporations doing business in Puerto Rico and the possessions (except the Virgin Islands).

This proposal allows U. S. shareholders to continue deferral with respect to income of corporations organized under the laws of the Commonwealth of Puerto Rico or a possession of the United States (including the Virgin Islands). Income that would have been eligible for the possessions tax credit currently provided by the Internal Revenue Code if the controlled foreign corporation had been a domestic corporation will not be taxed currently to U. S. shareholders. Instead, such income will be treated in the same manner as "blocked income."

(16) Transition Provisions

In 1979 and 1980, U. S. shareholders will be required to take into income 1/3 and 2/3, respectively, of the gross income and deductions of controlled foreign corporations. The provisions of subpart F will also apply during these two years, although most of subpart F will be repealed for years after 1980. The 1/3 and 2/3 inclusion in 1979 and 1980 will apply to the income and deductions of a controlled foreign corporation after adjustment for amounts included in income by a U. S. shareholder under the subpart F provisions. Thus, if in 1979 a U. S. shareholder's controlled foreign corporation has $150 of taxable income of which $30 is foreign base company income under subpart F, the inclusion under this proposal for the U. S. shareholder will be $40 (1/3 x ($150 - $30) = $40) and the U. S. shareholder's total taxable income attributable to the controlled foreign corporation will be $70.

The rules of subpart F will apply for purposes of calculating the foreign tax credit attributable to income included under subpart F, and the rules under this proposal will apply for purposes of calculating the foreign tax credit attributable to the additional amounts included in the U. S. shareholder's income under the proposal.

(17) Other Provisions

Various provisions of the Internal Revenue Code are modified or repealed under this proposal. The foreign personal holding company provisions are repealed after 1980. Subpart F is repealed for future operations, although it will be necessary to maintain certain historical aspects. For example, the rules relating to taxation of investments in U. S. property will continue to apply to previously accumulated earnings. Also, it will be necessary to

determine whether actual distributions had been previously taxed under subpart F, and to determine the tax on certain amounts previously excluded from a U. S. shareholder's gross income under subpart F because they were reinvested in qualified shipping assets or in less-developed countries; any amounts thus excluded will be taxable when they are withdrawn from such investment. Section 1248 is also kept in force to handle accumulated earnings.

FINANCIAL INSTITUTIONS

Present Law

Depository financial institutions are not taxed in a manner comparable to other corporate taxpayers. Credit unions are completely exempt from tax; commercial banks, savings and loan associations, mutual savings banks and cooperative banks are allowed to take artificially large deductions for additions to bad debt reserves in computing taxable income. These deductions are allowed under liberal statutory formulas which apply only to these institutions, while other taxpayers must generally compute these deductions on the basis of experience.

Commercial banks are permitted until 1988 to accumulate bad debt reserves equal to a specified portion of their outstanding eligible loans, without regard to actual loss experience. The present statutory provision for commercial banks is a phase-out, enacted in the Tax Reform Act of 1969, of even more generous treatment under prior administrative practice. Until 1982, commercial banks are permitted to build up their reserves for tax purposes to 1.2 percent of eligible loans (in general, loans made in the course of normal customer loan activities). Beginning in 1982 and before 1988, the build-up is permitted to 0.6 percent of eligible loans. Once the tax reserve is built up to these maximum levels, or the higher levels permitted prior to 1969, a bank can in effect continue to deduct actual losses rather than charge losses against its reserve, so long as there is no decrease in outstanding eligible loans. To date, this rule has permitted banks to shelter from tax approximately $4 billion of income. Beginning in 1988, however, commercial banks will have to base further additions to their reserves on actual loss experience.

Mutual savings banks, savings and loan associations, and cooperative banks (commonly referred to as "thrift institutions") are allowed to deduct annual additions to their bad debt reserves equal to a specified percentage of net income. In contrast to the treatment of commercial banks, the preferential treatment accorded thrift institutions will continue indefinitely; the allowable addition is, however, being phased down from 60 percent of net income (allowed prior to the Tax Reform Act of 1969) to a permanent level of 40 percent in 1979. Eligibility for this special percentage method depends on compliance with a comprehensive set of investment standards, adopted by Congress to limit these tax benefits to institutions engaged primarily in home mortgage financing.

The full percentage deduction is allowed only if a specified portion (82% for savings and loan associations and 72% for mutual savings banks) of an institution's investments consist of qualifying assets, primarily home mortgages. The deduction is reduced if the institution has a smaller portion of qualifying assets. The basic standards, however, are easily met by most savings and loan associations because of other regulatory requirements.

Thrift institutions are allowed only half of the investment tax credit available to other taxpayers. The dividends-received deduction otherwise allowable to a thrift institution is also reduced by a percentage equal to the percentage of net income exempted from tax by virtue of the special bad debt deduction.

In addition, in the case of both commercial banks and thrift institutions, the excess of the bad debt reserve deduction, computed under the statutory percentage method, over the deduction which would have been allowed based on experience is an item of tax preference, subject to the minimum tax.

Reasons for Change

Commercial Banks. The allowable bad debt deduction for commercial banks greatly exceeds actual losses. In the period 1955-66, commercial bank bad debt deductions of $5.7 billion exceeded actual losses of $2.1 billion by more than 167 percent. From 1969 through 1975, under the present statutory provisions, deductions exceeded losses by over $400 million. (See Tables IVD-1 & IVD-2). If not corrected the revenue loss from excessive bad debt deductions by commercial banks for the period 1979 through 1982 is expected to exceed $710 million.

The preferential bad debt treatment for commercial banks was developed by administrative action. In 1947, the Treasury Department permitted a bank to accumulate a reserve to reflect a loss rate not exceeding three times its average losses during the previous 20 years; in 1955, banks were permitted to select as a base period any 20 consecutive years after 1927, thus permitting inclusion of the depression years. In 1965, in order to eliminate the disparity in allowable deductions among individual competing banks, the Treasury Department broadened the availability of this special tax treatment to all commercial banks by permitting bad debt reserves equal to 2.4 percent of outstanding loans not insured by the Federal government. This figure is roughly three times the average annual bad debt loss of commercial banks during the period 1928-47.

Table IV-D-1

Bad Debt Losses and the Bad Debt Deduction: 1969-1975

Insured Commercial Banks
($ millions)

	1969	1970	1971	1972	1973	1974	1975	1976
Bad debt losses	489	982	1087	887	1159	1957	3243	3503
as a percent of uninsured loans	0.18	0.36	0.37	0.26	0.28	0.42	0.68	0.72
Bad debt deductions	521	703	867	973	1265	2286	3612	3691
as a percent of uninsured loans	0.20	0.26	0.29	0.29	0.31	0.49	0.76	0.75

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation

Table IV-D-2

Income, Income Shares, Income Taxes and the Bad Debt Deduction: Insured Commercial Banks, 1969-1975

	1969	1970	1971	1972	1973	1974	1975	1976
Gross Income: (millions)	$30,299	$34,456	$36,710	$40,439	$52,994	$68,018	$66,640	$81,004
Percentage distribution:								
Administrative and operating expenses	40.4%	42.6%	42.1%	41.4%	35.8%	32.3%	36.4%	43.6%
Interest paid depositors & creditors	37.7	35.8	36.6	38.1	45.7	51.2	44.9	39.3
Net losses on loans	1.3	2.9	3.0	2.2	2.2	2.9	4.9	4.3
Income attributable to equity	20.5	18.7	18.2	18.4	16.3	13.7	13.8	12.7
Federal income tax	4.3	4.7	3.7	3.2	2.5	2.0	1.8	1.7
Net income after tax	16.3	14.0	14.5	15.2	13.8	11.7	12.0	11.0
Federal income tax as a percent of income attributable to equity	20.7	25.1	20.4	17.3	15.5	14.6	13.3	13.3
Provisions for loan losses as a percent of gross income	1.7	2.0	2.4	2.4	2.4	3.4	5.4	4.6
Excess of provisions for loan losses over net losses	120	-279	-220	86	106	329	369	188
As a percent of gross income	0.4	-0.8	-0.6	0.2	0.2	0.5	0.6	0.2
Additional tax liability that would result from the taxation of loan loss provisions in excess of net losses at 48 percent	58	-134	-106	41	51	158	177	90
As a percent of gross income	0.2	-0.4	-0.3	0.1	0.1	0.2	0.3	0.1
Bad Debt Reserves as a percent of loans other than Federal Funds, Insured Loans, and Loans to other banks	2.2	2.2	2.1	2.0	1.8	1.8	1.8	1.3

Office of the Secretary of the Treasury
Office of Tax Analysis

January 27, 1978

Source: Annual Report of the Federal Deposit Insurance Corporation.

This very generous treatment was justified as a measure to protect commercial banks from possible catastrophic losses. It was argued that a commercial bank should be allowed to allocate a large portion of its income to reserves to protect its solvency during periods of extreme economic distress. However, since banks are not required to set aside the resultant tax saving in the form of cash or other liquid assets, the tax provision does not assure commercial bank solvency. Indeed bank solvency in periods of cyclical financial crises can only be assured by actions of the Federal Reserve system, which is authorized by law to make loans to member banks secured by their business loans and to make purchases of government bonds in the open market. Similarly, security for depositors is provided through deposit insurance. These institutional safeguards, along with continual surveillance of the lending policies of individual banks by Federal and state bank regulatory agencies, protect the banking system and its depositors.

In the Tax Reform Act of 1969 Congress recognized that continuation of the preferential tax treatment of commercial banks was not justified and required the adoption by 1988 of the experience method used by other taxpayers. Further, since 1976 commercial banks and other financial institutions have enjoyed special protection from extraordinary losses in the form of a ten year carryback and five year carryforward of net operating losses. (In contrast, other taxpayers are generally allowed a three year carryback and seven year carryforward of net operating losses.) It is, therefore, appropriate to place commercial banks on the same footing as other taxpayers in determining their bad debt deductions.

Thrift Institutions. Thrift institutions were originally exempt from tax on the same theory that now justifies the exemption for social clubs: there is no income if one deals with oneself. This exemption for mutual savings banks and savings and loan associations was ostensibly ended in 1951. Congress recognized at that time that savings and loan institutions "are no longer self-contained cooperative institutions as they were when originally organized..." (S. Rep. No. 781, 82d Cong., 1st Sess. 28 (1951).) In the long run, "membership" in these institutions was not restricted so that a member's investments and debts were approximately equal, nor was it certain that any given member would receive a proportionate share of the accumulated earnings of the organization. More generally, both mutual savings banks and savings and loan associations offered a full range of depository and lending services to a broad group of persons on terms differing in no significant way from the terms on which the same services were offered by taxable financial institutions. The size and character of thrift institutions required parity between them and their competitors.

Nevertheless, the movement from tax-exempt to taxable

status has proceeded slowly. Notwithstanding the 1951 legislation, thrift institutions were virtually tax exempt until 1962 because of their special deduction for bad debt reserves. Even after a revision of the bad debt reserve deduction in 1962, and until the Tax Reform Act of 1969, mutual savings banks were able to avoid substantially all Federal income taxes, and savings and loan associations were subject to effective tax rates of approximately 15 to 18 percent, only 30 to 35 percent of the then prevailing corporate rate. The 1969 Act increased the effective tax rate for thrift institutions to approximately 50 to 60 percent of the regular corporate rate.

The preferred tax treatment accorded thrift institutions is frequently justified because of the role played by these institutions in the home mortgage market. The thrift institution statutory bad debt deduction, however, is an insignificant factor in encouraging the supply of home mortgages. The ability of thrift institutions to hold mortgages depends critically on the willingness of depositors to hold savings accounts in those institutions; this willingness to hold deposits depends on the pass-book interest rates which the thrift institutions can pay. In turn, the interest rate thrift institutions can pay their depositors depends primarily on mortgage interest yields and the deposit interest rate ceilings imposed by Federal authorities. Finally, mortgage interest yields are governed by the activity of such federally sponsored institutions as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and a long list of public and private mortgage insurance agencies.

Allowance of the artificially high statutory bad debt deduction for thrift institutions undermines the basic policy decision that these entities should be taxable. The bad debt deductions of thrift institutions are typically three to six times their actual losses. (See Tables IVD-3 through IVD-5). Allowance of these deductions at the present statutory levels will result in a revenue loss of $4 billion over the six-year period 1977-1982. Artificial bad debt deductions do not afford thrift institutions protection from insolvency; as in the case of commercial banks, there is no requirement that the institution's untaxed income be set aside to provide for losses. Federal and state regulation and examination, along with the maintenance of secondary mortgage markets by federally sponsored agencies, protect the solvency of thrift institutions The special provision allowing ten year carryback and five year carryforward of net operating losses adequately protects thrift institutions from the tax effects of extraordinary, unprecedented losses.

Table IV-D-3

Bad Debt Deductions and Actual Bad Debts

Savings and Loan Associations and Mutual Savings Banks

($ million)

	1972	1973	1974	1975	1976
Savings and Loan Associations					
Actual bad debts	34	58	86	149	140
Bad debt deduction	923	1042	865	806	1109
Ratio of bad debt deductions to actual bad debts	27.15	17.97	10.06	5.41	7.29
Mutual Savings Banks					
Actual bad debts	36	34	61	52	58
Bad debt deduction	173	204	193	205	218
Ratio of bad debt deductions to actual bad debts	4.81	6.00	3.16	3.94	3.76
Total					
Actual bad debts	70	92	147	201	198
Bad debt deductions	1096	1246	1058	1011	1327
Ratio of bad debt deductions to actual bad debts	15.66	13.54	7.20	5.03	6.70
Losses on bad debts as a percent of uninsured loans	0.03	0.04	0.06	0.07	

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Table IV-D-4

Income, Income Shares and the Bad Debt Deduction:
Insured Mutual Savings Banks, 1969-1975

	1969	1970	1971	1972	1973	1974	1975	1976
Gross Income: (millions)	$3,523	$3,754	$4,471	$5,280	$5,973	$6,335	$7,116	$8,333
Percentage distribution								
Administrative and operating expenses	13.6%	14.7%	14.2%	14.0%	14.4%	14.9%	15.6%	15.7%
Interest paid depositors and creditors	80.0	80.1	76.6	74.8	75.5	78.7	78.0	76.0
Net losses on loans	0.05	0.05	0.1	0.1	0.2	0.2	0.3	0.9
Income attributable to equity	6.4	5.1	9.1	11.1	9.9	6.3	6.1	7.4
Federal income tax	0.4	0.7	1.4	2.1	1.9	1.3	0.9	1.3
Net income after tax	6.0	4.5	7.7	9.1	8.0	5.0	5.1	6.1
Federal income tax as a percent of income attributable to equity	6.3	13.0	15.7	18.6	19.2	20.4	15.5	17.6
Bad debts as a percent of income attributable to equity	0.4	0.5	0.7	0.7	1.5	2.5	5.1	12.8
Additional tax liability that would result from the taxation of all income attributable to equity at 48 percent	94	68	131	173	171	110	140	187
As a percent of gross income	2.7	1.8	2.9	3.3	2.9	1.7	2.0	2.2

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Source: Annual Report of the Federal Deposit Insurance Corporation

Table IV-D-5

Income, Income Shares, and Income Taxes:
Insured Savings and Loan Associations, 1972-1975

	1972	1973	1974	1975
Gross Income: (millions)	$15,323	$18,392	$21,102	$23,905
Percentage distribution				
Administrative and operating expenses	17.2%	17.5%	17.5%	17.5%
Interest paid depositors and creditors	68.2	68.5	72.6	73.7
Net losses on loans	0.2	0.3	0.4	0.6
Income attributable to equity	14.4	13.7	9.5	8.1
Federal income tax	3.4	3.4	2.5	2.1
Net income after tax	11.0	10.3	7.0	6.1
Federal income tax as a percent of income attributable to equity	23.5	24.7	26.4	25.7
Bad debts as a percent of income attributable to equity	1.5	2.3	4.3	7.6
Additional tax liability that would result from the taxation of all income attributable to equity at 48 percent	541	588	435	435
As a percent of gross income	3.5	3.2	2.1	1.8

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Source: Combined Financial Statements, Federal Savings and Loan Insurance Corporation

Credit Unions. Credit unions were excluded from the decision to make other thrift institutions taxable in 1951. Equity now demands, however, that these entities be placed on a parity with thrift institutions, their competitors.

Many credit unions are no longer truly mutual institutions with limited "common bonds" required for membership. The legal concept of common bond has been expanded so that mere residence in a state may be sufficient for membership in a credit union, and even those persons who leave an area may continue to be members. A Federal appeals court even held recently that an institution may qualify as a credit union despite the absence of membership restrictions if most depositors in fact have similar characteristics, a "de facto" common bond. La Caisse Populaire Ste. Marie v. United States, 563 F.2d 505 (1st Cir. 1977).

Many credit unions also are expanding beyond the factory and farm worker constituency that they represented when they were first regulated nationally in 1934 by the Farm Credit Administration. The residential common bond, although presently the least frequently used, is the fastest growing one among Federal credit unions. Furthermore, the size of individual accounts is growing. In Federal credit unions, accounts larger than $5,000 aggregated $2.1 billion at the end of 1970 and $11.1 billion at the end of 1976. This increase and the increase in the median income of depositors indicate that credit unions are appealing to other than low-income workers who have been excluded from access to banking services elsewhere.

The powers and services of credit unions have also expanded enormously, especially over the past seven years, so that they are becoming indistinguishable from other financial institutions. In 1970, Congress enacted Federal share insurance legislation, which insures the accounts of Federal credit unions and about half of the savings in state credit unions. In the Depository Institutions Amendments Act of 1977, Federal credit unions were granted the power to offer credit cards, to loan funds without specific dollar limits for up to 12 years, and to make real estate loans for up to 30 years. Many state-regulated credit unions have similar powers, including the authority to offer interest-bearing checking accounts. There is no correlation between an individual's credit union loans and deposits; persons who become members with a $5 share may borrow up to the institution's lending limit. The state regulated La Caisse Populaire Ste. Marie (St. Mary's Bank), a "credit union," invested more than 80 percent of its loan funds in real estate and had substantial demand deposits.

The sheer growth of these financial intermediaries in the decades since 1951 demonstrates that they should be treated equally with their competitors. In consumer

installment credit, credit unions hold 17 percent of the market and have been the largest factor in the increase in installment credit in the past few years. The assets of some of the largest credit unions exceed or rival large savings and loan associations in some states, and a few credit union groups have even purchased banks. Since the end of 1970, the total assets of Federal credit unions have nearly tripled and those of state credit unions have more than doubled to a total of $45.1 billion for their 33.6 million members. (See Tables IVD-6 and IVD-7.) The numbers are even more striking when compared to the 1951 figures when thrift institutions were made taxable. At that time credit unions had $1 billion in assets and 5.2 million members.

The blurring of the distinction between credit unions and other thrift institutions argues for the same tax treatment for these entities. In the absence of such treatment the tax system elevates form over substance by encouraging banks and other thrift institutions to be organized in the form of credit unions.

General Explanation

The Administration's proposal will require commercial banks to use only the experience method for computing additions to their bad debt reserves. They will thus be allowed to deduct additions to loss reserves based on the larger of their average loan loss experience over the current and five preceding years or actual losses. The present transition rules, which until 1988 allow a build-up in reserves to a percentage of outstanding loans, will be repealed.

The percentage of taxable income method of determining bad debt deductions for thrift institutions will be phased down from its current 41 percent level to 30 percent by 1983. Credit unions will be made subject to tax on the same basis as thrift institutions, and will be permitted to claim the thrift institution bad debt deduction; they will not, however, be subject to the investment restrictions which apply to thrift institutions. The bad debt deduction available to credit unions will be phased down ratably from, in effect, 100 percent of net income under present law to 30 percent over a period of five years.

As a result of these changes, the investment tax credit available to thrift institutions (and credit unions) will be increased to 70 percent of the credit available to other taxpayers. In addition, thrift institutions and credit unions will be made eligible for the full (generally, 85 percent) dividends-received deduction. Dividends received will be excluded, however, from income for purposes of determining the maximum bad debt deduction.

Table IV-D-6

Federal Credit Unions

	1972	1973	1974	1975	1976
Gross Income: (millions)	$1,046	$1,251	$1,504	$1,749	$2,124
Percentage distribution					
Administrative and operating expenses	32.2%	31.3%	29.5%	30.4%	31.9%
Interest refunds	3.5	3.1	2.5	2.2	2.0
Other interest payments	1.4	1.8	2.6	2.9	3.0
Net losses on loans	3.2	3.1	4.4	4.2	2.4
Dividends to shares	49.4	50.8	50.7	52.9	53.2
Income attributable to equity	10.4	9.9	10.4	7.4	7.5
Growth Rate	18.0%	19.7%	20.2%	16.3%	21.5%

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Source: Annual Report of the National Credit Union Administration

Table IV-D-7

Federally-Insured State-Chartered Credit Unions

	1971	1972	1973	1974	1975	1976
Gross Income (millions)	$163	$278	$382	$554	$757	$958
Percentage distribution:						
Administrative and operating expenses	35.1%	35.4%	34.6%	34.4%	32.7%	31.8%
Interest Refunds	3.2	3.1	2.6	2.7	2.2	2.2
Other interest payments	1.4	1.5	1.9	2.4	2.1	2.4
Dividends on shares	48.5	46.8	48.7	47.8	48.2	46.4
Income attributable to equity	11.9	13.2	12.3	12.7	14.7	17.2
Growth Rate	-	70.9%	37.4%	45.1%	36.7%	26.6%

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Source: Annual Report of the National Credit Union Administration

Analysis of Impact

Depository institutions may be organized as stock corporations (generally, commercial banks and some savings and loan associations) or as mutual associations (generally, mutual savings banks, credit unions, and non-stock savings and loan associations). Institutions organized as stock corporations derive most of the funds used to acquire income producing assets from depositors and a relatively small portion from equity investors. A correspondingly large portion of the stock institution's income must be allocated to the cost of deposits and a relatively minor portion to equity. Since the interest cost of deposits and capital debt is deductible in computing taxable income, the burden of federal income tax falls initially on that portion of the institution's income attributable to equity.

Stock financial institutions adjust to changes in the rate of tax on income attributable to corporate equity in the same manner as other corporations. Possible responses by stock institutions to the increased tax burden resulting from these proposals include one or both of the following:

(a) Adjustment of portfolios to increase gross income sufficiently to cover the higher corporate income tax. This could be accomplished by increasing lending rates to customers or switching investment to higher yielding assets.

(b) Reduction of either the nominal interest paid depositors or the battery of "free" services provided them.

Since the gross income and interest expense of these institutions is quite large in comparison to the increase in tax resulting from these proposals, it is anticipated that the proposals ultimately will result in approximately a .03 to .04 percent increase in lending rates by all affected institutions, or in a .02 to .04 percent reduction in rates paid depositors. However, in the case of credit unions, if the full adjustment were borne by shareholders, the reduction would be slightly more than one-half of one percent.

The equity interest in mutual institutions is held, in effect, by depositors. Since "share dividends" (i.e., interest on deposits) are deductible by the institution, the burden of the Federal income tax falls solely on the income of the corporation which is not paid to depositors. A mutual institution will respond to the proposed changes in a manner substantially the same as a stock institution if it desires to maintain the same level of retained earnings as under present law, i.e., it will seek to increase the spread between gross income and its cost of funds to compensate for the additional Federal tax. A mutual institution may, on the other hand, avoid the imposition of additional tax by decreasing that spread. It may reduce its lending rates or,

more probably, increase its "dividend" to depositors.

Effective Date

Repeal of the commercial bank percentage method of computing bad debt deductions will be effective for taxable years beginning after 1978. The phase-down of the percentage method for computing bad debt deductions for thrift institutions and the phase-in of the taxation of credit unions will commence in the first taxable year beginning after 1978. Thrift institutions and credit unions will be allowed the increased investment tax credit and the full dividends-received deduction for taxable years beginning after 1978.

Revenue Estimate

Change In Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	286	367	460	367	487

Technical Explanation

The percentage of outstanding loans method of computing deductible additions to bad debt loss reserves for commercial banks under present law will be repealed.

In the case of thrift institutions, the change in the percentage of net income method (from 41 percent in 1978 to 30 percent in 1983) will be made gradually, with a phase down similar to that in current law. The taxation of credit unions will be introduced gradually by allowing a deduction for bad debts phased down ratably from, in effect, 100 percent of net income for 1978 to 30 percent in 1983. Thrift institutions and credit unions will be permitted a 30 percent bad debt deduction beginning in 1983.

Bad Debt Deduction for Savings and Loan
Associations and Mutual Savings Banks
Under the Percentage of Income Method

For a taxable year beginning in --	The applicable percentage will be -
1979	38%
1980	36%
1981	34%
1982	32%
1983 or thereafter	30%

Bad Debt Deduction for Credit Unions Under the Percentage of Taxable Income Method

For a taxable year beginning in --	The applicable percentage will be -
1979	86%
1980	72%
1981	58%
1982	44%
1983 or thereafter	30%

Under present law the bad debt deduction for thrift institutions is computed as a percentage of taxable income, with certain modifications. Since the dividends-received deduction is reduced for thrift institutions using the percentage bad debt deduction, these institutions are permitted to include the taxable portion of their dividends received in taxable income for purposes of computing their bad debt deduction. Since thrift institutions and credit unions will be allowed a full dividends-received deduction under the proposal, dividends received will be excluded from taxable income for purposes of computing the bad debt deduction.

ACCRUAL ACCOUNTING FOR AGRICULTURAL CORPORATIONS

Present Law

The Internal Revenue Code requires that the accounting method used in preparing a taxpayer's return "clearly reflect income." This restricts the taxpayer's flexibility in choosing among the cash receipts and disbursements method, the accrual method and other permissible accounting methods in computing taxable income. 1/ Most taxpayers who are in the business of selling products are required to use the accrual method of accounting under which the cost of the product must be accumulated in inventory and offset against sales receipts. Expenses are thus properly matched with the income they produce, and taxable income is "clearly reflected" within the meaning of the tax law.

By virtue of administrative rulings issued more than 50 years ago, however, farmers have generally been exempted from the accrual accounting requirement. The reason for this exemption was the impression that farmers lack the financial resources and the expertise necessary to match farming expenditures with the particular farming income. As a result, the simpler cash receipts and disbursements method was permitted, even though it tended to misstate farmers' taxable income.

Limited exceptions from the cash method privilege for farming operations were introduced by the Tax Reform Act of 1976. That Act established the general rule that corporations (and partnerships with a corporate partner) engaged in farming must use the accrual method of accounting and capitalize preproductive period expenses. However, exemptions were provided for (1) nurseries and farms engaged in raising or harvesting of trees (other than fruit and nut trees); (2) corporations with annual gross receipts of $1 million or less; (3) Subchapter S corporations; and (4) corporations where 50 percent or more of voting stock and 50 percent or more of all classes of stock are owned by members of the same family. 2/

Accrual accounting requires that firms match the deductions for farming expenditures with the income related to those expenditures. For example, an accrual farmer cannot deduct currently the cost of feed for his beef cattle; rather, the feed cost is reflected in the opening and closing inventory values of the cattle. Similarly, a farmer on the accrual basis cannot deduct the cost of such items as seed and fertilizer until the resulting crops are sold. In the

case of multi-yield assets such as dairy cattle or apple orchards, the costs of developing the assets to maturity must be capitalized and deducted after maturity through depreciation or, in the case of livestock, through inclusion in inventory values. However, an exception is provided from the capitalization requirement for taxes and interest and any expenses incurred on account of casualties.

In addition to the accounting requirements for corporate farms, the 1976 Reform Act contains related, but less stringent, accounting rules for "farming syndicates." A farming syndicate cannot deduct amounts paid for feed, seed, fertilizer, or other farm supplies until those supplies are actually used or consumed. Moreover, the cost of poultry purchased for use in a syndicate's trade or business must be capitalized and deducted ratably over the lesser of 12 months or their useful life; the cost of poultry purchased by a syndicate for resale can be deducted only upon disposition. And the expenditures incurred to raise a grove, orchard or vineyard to maturity must also be charged to a capital account. For these purposes, a "farming syndicate" is a partnership, subchapter S corporation or other enterprise, such as an agency relationship, which has its participation interests registered or required to be registered with a State or Federal securities agency, or in which more than 35 percent of the entity's losses are attributable to limited partners or other persons not actively participating in the management of the farming enterprise (referred to in the Code as "limited entrepreneurs").

Accordingly, the accounting rules for farm corporations and farm syndicates are similar with respect to limited categories of farm assets. Specifically, both corporations and syndicates are required to capitalize the cost of poultry, whether used for egg-laying or sold for meat. Both are required to capitalize the preproductive period costs of groves, orchards or vineyards, even though there are variations in the respective rules relating to the time over which capitalized amounts can be recovered. With respect to all other farm products, however, the accounting requirements relating to corporations are substantially more restrictive than the syndicate rules. Current law does not require that the feed, seed or fertilizer expenses of syndicates be matched with the income produced from such assets as field crops and cattle. As long as a syndicate actually uses the farm supplies during the taxable year, a current deduction is permitted. Corporations, on the other hand, are subject to the general requirement that all preproductive period expenses be matched with related income through use of the accrual accounting method and the capitalization of expenses incurred before the realization of income.

Reasons for Change

In enacting the Tax Reform Act of 1976, Congress recognized instances where the rationale for farmers' cash accounting privilege is no longer applicable. Large farming corporations cannot fairly claim that they lack access to the sophisticated accounting and recordkeeping procedures involved in the accrual method of accounting. In fact, most large companies are already required to keep financial records on the accrual basis in order to obtain certification of financial statements by an accountant. As a result, the cash method of accounting serves not to relieve large corporations from recordkeeping burdens, but rather to misstate substantially the taxable income of those enterprises.

The 1976 Act did not go far enough in its application of the accrual requirement. During consideration of the Tax Reduction and Simplification Act of 1977, Congress was presented with claims that the "one-family corporation" exception to the accrual accounting requirement arbitrarily granted a substantial competitive advantage to several multimillion dollar farming operations at the expense of other large farm corporations that failed to fall within the definition of a family corporation. The approach taken by Congress in the 1977 Act was to extend for one year the family corporation exemption to cover at least two additional corporations that allegedly had been placed at a competitive disadvantage in spite of the fact that these corporations each had annual gross sales in excess of $50 million. The 1977 Act did not address the fundamental cause of the inequity; the fact that a distinction between family and non-family corporations bears no relationship to the rationale of preserving simple bookkeeping methods for small farmers who truly lack access to the necessary accounting and recordkeeping procedures involved in the accrual method of accounting.

By eliminating the family corporation exemption, the Administration's proposal will result in the application of the accrual method requirement to all large farming corporations (aside from subchapter S corporations, which are treated for tax purposes essentially like partnerships). Farming corporations with annual gross receipts of $1 million or less will still be exempted in order to preserve the availability of the cash method of accounting for those corporate farms that may lack access to accounting and recordkeeping expertise. Moreover, the Administration's proposal will extend the accrual accounting requirement to all farming syndicates, regardless of size. In those instances where interests in farming operations are required to be registered with Federal or State securities officials or where a substantial portion of the enterprise is owned by

passive investors, the rationale for cash accounting is also inapplicable. Persons who are involved in farming as outside investors, whether for tax shelter opportunities or for positive economic return, should not share in a cash accounting privilege designed for farmers unaccustomed to sophisticated financial transactions.

One additional change is desirable in order to remove an exception to the accrual accounting requirements that no longer seems warranted. The Administration has proposed that state and local taxes, aside from income taxes and real property taxes, not be deductible as taxes. Sales taxes, personal property taxes and other miscellaneous taxes will instead be expensed or capitalized by a taxpayer in accordance with the rules relating to other business expenditures. Following this general treatment of state and local taxes, the taxes of a farmer (aside from income taxes and real property taxes) will be treated like any other expenditures incurred in raising farm products.

General Explanation

The Administration proposal will delete the exception for family corporations from the requirement that corporations engaged in farming compute taxable income on an accrual method of accounting and with the capitalization of preproductive period expenses. The proposal will also extend those accounting requirements to "farming syndicates" as defined in the Tax Reform Act of 1976.

Therefore, under the Administration's proposal, the following farming operations will be required to use an accrual method of accounting and to capitalize preproductive period expenses:

(1) All farming syndicates (as defined under current law);

(2) All corporations (and partnerships with a corporate partner) engaged in farming, with the exception of (a) nurseries or other farming operations that raise or harvest trees (other than fruit and nut trees), (b) subchapter S corporations, and (c) corporations which do not have annual gross receipts exceeding $1 million.3/

As under present law, the "preproductive period expenses" required to be capitalized will not include interest or expenditures incurred on account of casualties. However, taxes, aside from income taxes and real property taxes, will no longer be excluded from the definition of "preproductive period expenses."

Analysis of Impact

Approximately 94 percent of all corporate farms have annual gross receipts under $1 million and will thereby remain eligible to use the cash receipts and disbursements method of accounting. In most instances, farming syndicates and the large corporations with receipts above $1 million already use accrual accounting for financial purposes. Therefore, it is unlikely that the Administration proposal will create any substantial recordkeeping problems for the large, family corporations and syndicates formerly exempted from the accrual method requirement.

Since the exemption for ordinary corporations will be based solely on the amount of gross receipts, equity among comparably situated taxpayers will be increased. The Administration proposal will eliminate the competitive disadvantage incurred by large farm corporations, using the accrual method, which must compete with other large corporations entitled to use the cash method because the latter happen to fall within the definition of "family corporation."

Effective Date

The proposed change will be effective for taxable years beginning after December 31, 1978.

Revenue Estimate

Change In Tax Liability

($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-	40	25	10	5	7

Technical Explanation

For the purpose of the accrual rules, a "farming syndicate" will be defined as it is in the Tax Reform Act of 1976. Accordingly, a "farming syndicate" will include any enterprise (other than a non-subchapter S corporation) engaged in the trade or business of farming if any offering of interests in the enterprise were required to be registered with any federal or state securities agency, or an enterprise (other than a non-subchapter S corporation) engaged in the trade or business of farming if more than 35 percent of the losses during any period are allocable to limited partners or

other limited entrepreneurs not actively participating in the management of the enterprise. The statutory definition of "farming syndicate" will also preserve the provisions that treat interests meeting the following requirements as interests not held by a limited partner or limited entrepreneur: (a) where an individual has an interest attributable to his active participation in the management of any trade or business of farming for a period of not less than 5 years; (b) where an interest is held in an enterprise engaged in operating a farm which serves as the principal residence of the individual who owns that interest; (c) where an individual has a participating interest in the further processing of livestock raised in a farming operation covered by the above provisions or in whose management that individual actively participates; (d) where the interest is owned by an individual whose principal business activity involves active participation in the management of a trade or business of farming; and (e) where an individual is a member of the family of a grandparent of an individual who would be excepted under any of the four situations listed above, and his interest is attributable to the active participation of such individual.

With respect to both farming corporations and syndicates, "preproductive period expenses" will refer to expenditures attributable to crops, animals or other property having a crop or yield during the period of time (a) prior to the disposition of the first marketable crop or yield of property having a useful life of more than one year, or (b) before disposition of any property having a useful life of one year or less. 4/ Exceptions from the definition will be retained for interest and expenses incurred on account of casualties, disease or drought; but taxes, aside from income taxes and real property taxes, will not be excepted. Also, in applying the definition, the use of self-produced supplies of the farm will be considered a disposition of those supplies.

Finally, any taxpayer required by this provision to change its method of accounting will treat such a change as having been made with the consent of the Secretary of the Treasury, will consider the change as not having been initiated by the taxpayer, and will generally be given a ten year period to take into account the net amount of adjustments required in the computation of taxable income. The Secretary will prescribe regulations indicating those situations in which less than a ten year period is appropriate (e.g., the taxpayer was in existence for less than ten years).

Footnotes

1/ Under the cash receipts and disbursements method, gross income items are to be included for the taxable year in which actually or constructively received; and expenses are to be deducted for the taxable year in which actually paid. Under the accrual method, income is to be included for the taxable year in which all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy; deductions are permitted for the taxable year in which all the events have occurred which establish the fact of liability and the amount thereof can be determined with reasonable accuracy.

2/ Under the Tax Reduction and Simplification Act of 1977, another exemption until taxable years beginning after December 31, 1977 was granted where two families own at least 65 percent of the stock or where three families own at least 50 percent of the stock and substantially all of the remaining stock is owned by corporate employees, their families or exempt retirement trusts established for the benefit of the employees.

3/ These exceptions will not apply if the entity is a "farm syndicate."

4/ Under present law, a farming syndicate must capitalize those expenditures incurred in developing a grove, orchard or vineyard prior to the first taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. This special rule will be eliminated, and farming syndicates raising fruit or nuts will be subject to the general provision described above. However, all taxpayers will continue to be covered by a special Code provision for citrus and almond groves (section 278). That provision requires capitalization of the developmental expenditures of a citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. Accordingly, a farming corporation or syndicate will be required to capitalize expenditures during the first four years after planting a citrus or almond grove even though the dispostion of the first marketable crop or yield might have occurred prior to the expiration of that four-year period.

SIMPLIFICATION OF ADR DEPRECIATION

Present Law

Under present law, a taxpayer generally may claim depreciation either on the basis of the particular "facts and circumstances" bearing on his anticipated use of the property or under the asset depreciation range and class life system ("ADR").

A taxpayer claiming depreciation on the basis of facts and circumstances must estimate the useful life and salvage value for each item of depreciable property used in his trade or business. This can be a cumbersome and inexact process for the taxpayer. Moreover, the taxpayer's estimates are frequently reexamined by auditing agents of the Internal Revenue Service, and any discrepancies between their estimates and the taxpayer's will result in further time and attention being devoted to these factual matters.

In 1971 Congress authorized the Secretary of the Treasury to promulgate regulations establishing the ADR system. Under the ADR system, the Treasury Department establishes useful lives for classes of assets based upon the activity in which the assets are used (e.g., mining or agriculture) or the type of asset (e.g., automobiles or office furniture). A taxpayer is permitted to compute depreciation on the basis of these lives without any showing of facts and circumstances.

Since the class lives are set so that 70 percent of all assets in a class have actual useful lives which are as long or longer than the prescribed class life, the use of class lives in itself is a benefit to the average taxpayer. Moreover, taxpayers are permitted to set useful lives within a range extending from 20 percent below to 20 percent above the established class lives.

Taxpayers who adopt the ADR system obtain other advantages in the treatment of salvage value and retirements of assets. On the other hand, the regulations require taxpayers who adopt the ADR system to comply with a number of formal accounting and reporting requirements.

Reasons for Change

The presence of many attractive features in the ADR system has led to its adoption by taxpayers holding more than half of all corporate assets. In 1974, 64 percent of all depreciable corporate assets were held by taxpayers who

elected ADR. 1/ The largest corporations appreciate the advantages of the ADR system. In 1974, nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR. In contrast, little more than half of the corporate taxpayers with more than $100 million in depreciable assets elected ADR; only 0.36 percent of corporate taxpayers with $500,000 or less in depreciable assets elected ADR in that year. Thus, many corporations have not been sharing in the benefits of ADR to the same extent as the largest corporations. While it is not clear why these businesses have not elected ADR, it would appear that the mechanics of asset classification and the application of prescribed accounting procedures intimidate many businessmen and their accountants.

The Treasury Department has been studying ways to simplify the ADR system. It is expected that a simplified ADR system would lead to the use of ADR by additional taxpayers. However, because the Congress enacted the legislation which authorizes the existing ADR system with a particular set of regulations in mind, it is not clear that present law would authorize the Secretary of the Treasury to promulgate regulations substantially different from those contemplated when the statute was enacted.

A simplified ADR system could reflect a number of changes which experience with the existing ADR system suggests would be beneficial. For example, the current regulations set forth rules for the treatment of salvage value (section 1.167(a)-11(d)(1)). If a taxpayer does not follow "the practice of understating his estimates of gross salvage value," no change will be made to the taxpayer's estimate of salvage value unless the change would exceed 10 percent of unadjusted basis. In the case of most personal property, the taxpayer is allowed to decrease salvage value by an additional 10 percent (section 167(f) of the code). Thus, while the importance of salvage value has been significantly diluted, the Internal Revenue Service still must reexamine a taxpayer's choice of salvage values to determine whether it complies with the tests described above. A rule which eliminated this factual determination would be more consistent with the goals of ADR.

The existing regulations permit taxpayers to choose one of two conventions to determine the date from which they can begin claiming depreciation for property placed in service during the year (section 1.167(a)-11(c)(2)). Under the half-year convention, all assets placed in service during the year are deemed to have been placed in service on the first day of the second half of the taxable year (July 1 for calendar year taxpayers). Under the modified half-year convention, assets placed in service in the first half of the year are deemed to have been placed in service on the first day of the year (January 1 for calendar year taxpayers);

those placed in service in the second half of the year are deemed placed in service on the first day of the succeeding year (January 1 of the next year for calendar year taxpayers). These alternative conventions add complexity to both the operation of the ADR system and its description in the regulations. Moreover, one of the conventions--the half-year convention--offers a number of practical and theoretical advantages in the operation of the ADR system. The half-year convention does not require a taxpayer to determine exactly when the second half of his taxable year begins, a task which may not be simple if the taxpayer's taxable year has fewer than twelve months or if the taxpayer is on a 52-53 week year. The half-year convention also requires the taxpayer to create only one set of vintage accounts each year, rather than the two sets required under the modified half-year convention.

The ADR system simplifies depreciation by establishing a limited number of rules which, on the average, provide a reasonably accurate measurement of income, and which can be readily applied both by the taxpayer and by the Internal Revenue Service. It is inconsistent with that goal to allow complicated options and variations, such as the use of the double declining balance method followed by the sum of the years-digits method for the same asset. Moreover, with the sanction of Congress, the ADR system provides a favorable pattern of tax depreciation for the average taxpayer by setting the useful lives of assets below average lives and then permitting these lives to be reduced by up to 20 percent. Thus, it is unnecessary to allow taxpayers to overlay this guideline system with optional combinations of depreciation methods that further accelerate depreciation deductions.

At present, taxpayers electing ADR are subject to detailed reporting requirements (section 1.167(a)-11(f) of the regulations). The purpose of these reporting requirements is to enable the Treasury Department to determine and refine appropriate lives for different classes of assets. In practice, the reporting requirements are both ineffective and costly to taxpayers and the government. Their purpose can be more efficiently accomplished through survey techniques involving controlled sampling procedures.

General Explanation

Under the proposal, the Secretary of the Treasury will be authorized to issue new regulations governing the ADR system. It is intended that the new regulations will be shorter and simpler than the present regulations. These regulations--which should encourage more taxpayers to adopt

the ADR system--will differ from the present regulations in several respects, including the following:

1. Salvage value will be disregarded for purposes of computing depreciation.

2. All assets will be governed by the "half-year convention," under which they will be deemed to be placed in service in the middle of the taxable year.

3. Taxpayers will be restricted to the straight-line and declining balance methods of depreciation.

4. The annual reporting requirements will be eliminated. Taxpayers will be required to respond to survey requests to be used in calculating ADR standards. It is expected that no industry will be subject to the survey procedures more often than once every five years, and thus most taxpayers electing ADR will rarely be required to respond to such surveys.

The result of these changes will be a simpler system for taxpayers who elect to depreciate assets under ADR.

Effective Date

The simplified ADR system provided by the proposal will be applicable with respect to property placed in service by the taxpayer in taxable years beginning after December 31, 1978. It is expected that regulations will be promulgated under this section before March 1, 1980, so that taxpayers filing returns for taxable years ending on or after December 31, 1979 will have sufficient time to determine whether to elect the new simplified ADR system.

Revenue Estimate

The proposal will have a negligible effect on tax liability.

Footnote

1/ Because assets placed in service before January 1, 1971 cannot be depreciated under ADR, only 25 percent of the assets of these corporations were depreciated under the ADR system. This percentage should increase over time.

V

Excise Taxes

COMMUNICATIONS TAX REPEAL

Present Law

Amounts paid for certain communication services are subject to a communications excise tax. The rate of this tax for 1978 is 4 percent. The tax is being phased out by reducing the rate by one percentage point a year. As of January 1, 1982 the tax will be repealed.

Services subject to tax are local telephone service, long distance toll telephone service including WATS, and teletypewriter exchange service. Private communication services which are charged for separately are exempted from the tax.

Reasons for Change

In the Excise Tax Reduction Act of 1965, Congress instituted a comprehensive overhaul of the excise tax system. The only uncompleted step in this overhaul is repeal of the communications tax.

In addition to completing the overhaul of the excise tax system planned in 1965, repeal of the communications tax will help to reduce inflation. Repeal of the tax will reduce the cost of living both directly and by lowering business costs. As the resulting reductions in business costs are passed through in the form of price cuts, they will reduce inflation through lower consumer prices and through the effect of these lower prices on cost-of-living adjustments in wages. Repeal of the communications tax will be particularly beneficial to lower and middle income persons, who bear a disproportionately heavy share of the tax.

Between 40 and 50 percent of this tax reduction will be reflected in lower prices of communications services paid by business firms. The rest will be reflected in lower prices paid by individual telephone users.

General Explanation

The Administration proposes to repeal the communications tax as of October 1, 1978. Repeal will be effective for service for which bills are first rendered on or after such date, except that the tax will continue to apply to services supplied before August 1, 1978 even though a bill is first rendered on or after October 1.

Revenue Estimate

Change In Tax Liability

($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
-355	-1,200	-900	-500	--	--

UNEMPLOYMENT TAX RATE REDUCTION

Present Law

The unemployment compensation program is financed by a combination of Federal and State employer payroll taxes. In general, the Federal tax effectively is equal to 0.7 percent of the first $6,000 of each worker's annual earnings. The nominal Federal tax rate is 3.4 percent; it is generally offset by a credit of 2.7 percent for State unemployment tax payments.

Unemployment benefits can be provided for up to 65 weeks. The first 26 weeks is referred to as "regular coverage," the next 13 weeks is referred to as "extended benefit coverage," and the final 26 weeks is referred to as "supplemental benefit coverage." State unemployment taxes are used to finance the regular coverage plus half of the extended benefit coverage. The Federal government through the Federal Unemployment Insurance Fund ("FUIF") finances the other half of extended benefit coverage plus all of the supplemental benefit coverage. In addition, States which have run out of money to pay unemployment benefits may borrow from the FUIF.

Federal unemployment taxes are deposited in the FUIF. Federal general revenues are loaned to the FUIF to the extent it does not otherwise have sufficient funds to meet its obligations.

Reasons for Change

The 1974-1975 recession had a severe impact on the unemployment insurance system. As shown in the following table, as of December 1977 the Trust Fund had borrowed about $8.9 billion from general revenues to finance those unemployment benefits which are a Federal responsibility.

Table VB-1

	Federal UI Costs			Costs Met By	
	Extended Benefits	Federal Supplemental Benefits	Total	Payroll Tax	Loans from General Revenue
		($ millions)			
Prior to CY 1975	661		661		661
CY 1975	1,306	2,271	3,577	130	3,447
CY 1976	1,237	2,946	4,183	160	4,023
CY 1977 Estimate	946	620	1,566	750	816
	4,150	5,837	9,987	1,040	8,947

Office of the Secretary of the Treasury
Office of Tax Analysis
January 18, 1978

Moreover, about half the States have exhausted their insurance reserves and have borrowed an additional $4.4 billion from the Trust Fund. The Trust Fund in turn has borrowed this money from the general revenues. Further, between 1979 and 1981, Federal unemployment tax revenues are expected to fall short of outlays by $600 million.

Congress has taken two steps in response to this extraordinary financing problem. The rate of Federal unemployment tax was effectively increased from 0.5 to 0.7 percent as of January 1, 1977. This increased rate is scheduled to remain in effect until the FUIF has repaid all general revenue advances other than those which financed loans to the States. Also, costs of the Federal supplemental benefit program incurred after April 1, 1977, are being funded directly out of general revenues.

The January 1977 increase in the rate of Federal unemployment tax has raised business costs, thereby increasing inflationary pressures. The Administration is committed to financing normal unemployment benefits out of employer payroll taxes. However, the Administration believes it is inappropriate for the extraordinary expenses resulting from the severe 1974-1975 recession and the continuing rate of high unemployment to be financed solely out of payroll taxes.

General Explanation

The Administration proposes to restore the Federal unemployment payroll tax to its normal effective rate of 0.5 percent, a reduction of 0.2 percentage points.

In addition, the Administration plans to consider whether further use of general revenues is necessary to strengthen the present financial position of the FUIF, or to ensure the financial strength of the FUIF for the future.

Analysis of Impact

The reduction in the effective rate of Federal unemployment tax will assist in reducing inflation. As the resulting reductions in employer wage costs are passed through in the form of price cuts, they will reduce inflation directly through lower consumer prices and, indirectly, as the lower prices result in lower cost-of-living wage adjustments. (As the employer cost reductions are passed through in the form of price cuts, the reduction in wage costs will eventually translate into a reduction in the GNP deflator of approximately 0.1 percent.)

The impact of the rate reduction, in terms of percentage of wages, will be greatest for costs associated with the employment of low-wage workers. Thus, the reduction will partially offset the increased employer costs associated with recent minimum wage legislation and will increase the demand for low-skilled labor.

Effective Date

The reduction in the rate of Federal unemployment tax will be effective as of January 1, 1979.

Revenue Estimate

Change in Tax Liability
($ millions)

Calendar Years					
1978	1979	1980	1981	1982	1983
--	-850	-900	-950	-1,000	-1,050

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