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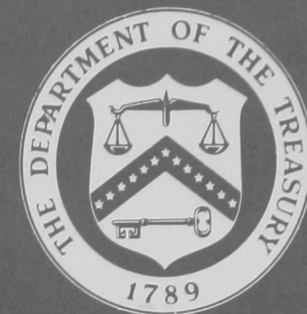

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STATEMENT OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY FOR DOMESTIC FINANCE
BEFORE THE SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE COMMITTEE ON BANKING, FINANCE AND
URBAN AFFAIRS OF THE HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I appear before you today to present the President's proposal for a National Development Bank, which is embodied in H.R. 13295. This innovative proposal is the product of extensive work within Treasury, HUD, Commerce, and other agencies, and of consultations over more than a year with representatives of State and local governments, local development authorities, financial institutions, businesses and the academic community. This project has been one of the Administration's highest priorities during that time. These are the reasons why we are proposing this legislation:

1. The key to this country's economic future is our private sector. Four of every five jobs are private jobs. The primary reason that national unemployment fell from 7.4% to 5.7% in the period from January 1977 to June 1978 is that more than 5.5 million new private jobs were created.

2. Many areas of this country, urban and rural, have not fully participated in this recent growth. Particularly during the 1970's, certain areas have lost population, jobs and important parts of their tax base.

3. These trends are costly for those places. They experience high unemployment, unused public facilities,

B-1078

a growing concentration of less skilled and less educated groups, and increasing welfare and other social support costs. At the same time, their fiscal bases shrink, and their ability to maintain an appropriate level of social services becomes strained.

4. Land, construction and operating costs in distressed cities are disproportionately high and have led American businessmen to invest elsewhere. Furthermore, small and medium-sized businesses already located in distressed urban and rural areas frequently cannot obtain long-term financing to expand or rehabilitate.

5. In the past, the Federal government has influenced, directly and indirectly, these business and job location trends.

6. The National Development Bank represents a private jobs strategy. It is aimed at increasing private investment and related jobs in distressed areas. We believe that a new economic development tool of this type is needed. It does not presently exist.

7. Specifically, the National Development Bank will provide a combination of grants, loan guarantees and interest subsidies to reduce financing costs for business in distressed areas. These reduced financing costs will relate to acquiring, constructing and rehabilitating facilities. The combination of Development Bank incentives can lower the cash invested in such projects, on a present value basis, by over 60%.

In addition, the Bank also will provide a liquidity facility to increase the flow of private credit to small and medium-sized companies located there.

8. It would be inefficient to give the Bank's powers to existing agencies. This would mean building a separate long-term, private financing staff in each agency -- two or more staffs instead of one.

CHRONIC ECONOMIC DISTRESS

Numerous rural and urban areas are experiencing chronic economic distress -- low levels of investment, a lack of jobs,

loss of population, poverty and a shrinking tax base. The health of most central cities has declined relative to the suburbs. The cities of the Northeast and Midwest have not shared in the growth of the South and West. And many rural areas in all parts of the nation continue to be isolated from growth.

There is no single cause of this distress -- firms leave an area or go out of business; the loss of jobs and skilled people increases the concentration of unemployment and poverty among those who remain; a greater proportion of the unemployed are structurally unemployed persons; the physical and social environment deteriorates; crime increases, insurance costs rise and the cost of attracting and retaining skilled workers increases; the tax base deteriorates and taxes rise; and then investment declines more and there is a further loss of jobs and skilled workers. The resulting social cost grows at the very time the local government's tax base is eroding -- so services deteriorate further, which accelerates the trend. The nation's level of economic activity may pick up, but it does not reverse the long-term decline in these places.

Rural distress is less visible than urban distress -- because it is not geographically concentrated -- but it is no less serious. Low incomes and chronic poverty caused both by unemployment and underemployment characterize economically weak rural areas.

Rural America may need infrastructure beyond what now exists to successfully attract the private investment necessary to diversify its economy. In addition, rural development needs should be planned across geographic areas large enough to provide sufficient labor for a variety of basic economic activities.

URBAN DISTRESS

The characteristics of chronic distress in urban areas can be highlighted by comparing the economic indicators for distressed places with those of healthy places.

Employment and Unemployment

It is well known that many of our larger cities have not shared in national growth. During the period 1970 to 1975, overall growth in employment was 7.8%. In contrast,

in St. Louis, employment fell during that period by over 19%, and in New York City by 16%.

As indicated in Table 1, central cities showed major declines in manufacturing jobs between 1970 and 1975. Jobs lost, largely through ordinary attrition, were not being replaced. In addition, looking at the ten American cities with the largest number of headquarters of "Fortune 500" companies in 1956, we find that the number of headquarters had declined from 293 to 236 in 1971. In large measure, the cities' loss has been the suburbs' gain, as shown in Table 2.

Looking at the unemployment side of the equation, we again see clear geographical disparities, as in Table 3. One study has compared the average unemployment rates of fourteen declining cities with those of eight growing cities. On an unweighted basis, the rate of unemployment in the declining cities was 41% greater in 1976 than in the growing cities (see Table 4). Within regions, there are further disparities between central cities and their suburbs.

Investment

The imbalance among different regions and cities is also highlighted by differences in investment per employee, as set forth in Tables 5 and 6. According to a recent Urban Institute study, the average capital investment per production employee during 1970-1976 was 66.7% greater in a group of growing cities as compared to distressed cities. For the same distressed cities, the ratio of wages to value added per production worker was 35% less favorable than in the group of growing cities.

Shifts in Population

Population loss is also both a cause and an effect of chronic distress. During the 1960's, the nation's central cities lost 3.5 million residents through population movements; in the first half of this decade the pace quadrupled. In some individual cases, this loss has been staggering. Detroit has shrunk from a city of 1.85 million in 1950 to a city of 1.3 million in 1975. The population of St. Louis has declined by more than 15% since 1970.

Those who leave tend to be young and have above-average skills and income. Employers find the relatively more unskilled job pool less attractive than before. Thus, it is even more difficult to find jobs for those who remain. Between 1970 and 1976, 1.2 million skilled workers left the central cities for the surrounding suburbs, while only a half million skilled workers moved in the opposite direction.

In addition, the more affluent tend to leave distressed cities. For example, 25 percent of the households that moved from the Pittsburgh area between 1965 and 1970 had 1970 incomes of $15,000 or more, while only 18% of all Pittsburgh area households had incomes at that level. Individuals who left Pittsburgh also tended to be young, with a median age of 24 compared to the city's median age of 35.

RURAL DISTRESS

Rural areas have consistently had a lower standard of living and a larger share of poverty-stricken residents than urban areas. While rural America has shown signs of some turnaround in its economic prospects since 1970, nationwide data conceals the continuing decline in population which some rural areas are experiencing, notably in the Mississippi Delta and the Corn Belt.

In the most rural counties, the incidence of poverty is high. Housing is more often substandard and medical care often unavailable. These problems are continuing despite some positive trends in rural economies. For example, Appalachia has benefited from the boom in the coal industry, but its 1975 per capita income was still only 84% of the national average.

Frequently, the root of a rural area's economic problems is the lack of diversification in its economy. In many agricultural areas, farm employment is declining, and nonfarm opportunities are not available to fill the gap. Other rural areas are dependent on a single manufacturing industry. The recent problems of the American shoe industry have severely harmed some undiversified rural areas in Arkansas and Missouri.

In many areas the problem of attracting new business to rural America is aggravated by the lack of a public infrastructure, a lack of capital, and other symptoms of underdeveloped economies.

IS IT APPROPRIATE FOR THE GOVERNMENT TO INFLUENCE LOCATIONAL DECISIONS?

The foregoing demonstrates that there is a need for action. Nevertheless, some argue that the Federal government should not "distort" the locational decisions of private firms and that such programs merely subsidize inefficiency. We do not find these arguments convincing. Let me explain.

The Effect of Federal Policies on Regional Economic Trends

Throughout the history of this country, Federal policy has influenced certain patterns of settlement and development. Sometimes the effect on the geographic dispersion of people and economic activity has been intentional. Sometimes it has not. Important examples in the expansion of the West include land grants to railroads, public universities and individual homesteaders. More recent actions are the construction of the interstate highway system, tax and mortgage credit policies that encourage home ownership, electrical power pricing policies, and water and sewage system grants to new areas.

The Federal government thus bears some responsibility for current disparities in the locations of jobs and people, and in some respects, it still supports policies that encourage the movement of new investment and jobs from central cities. It is unfair, therefore, to argue that the Federal government should not now play a role in fostering economic development in distressed areas.

Efficiency

Efficiency cannot be measured by looking only at the economics of a particular business that is offered the incentives. We must also take into account the overall social costs of permitting deterioration to continue in economically distressed areas. The costs of public medical services, welfare, police and fire protection, among other things, rise as these places decline. Tables 7 and 8 indicate that the expense levels experienced by economically distressed cities, for example, is higher than those in the suburbs and other cities. If the Bank's incentives create new permanent jobs in an area, there can be substantial savings in many of these costs. In addition, declining investment causes the revenue

base of distressed areas to shrink sharply, while expenses rise. These localities are forced to increase their tax rates (see Table 9) or reduce services. Most have tried the former course, which increases the disincentives to new investment.

FEDERAL ECONOMIC DEVELOPMENT PROGRAMS

These reasons and others have given rise to substantial Federal programs aimed at helping to aid our economically distressed urban and rural areas. First, in certain cases, aid has been directed to selected local governments. Examples include the countercyclical revenue sharing program, the Emergency Local Public Works Act of 1977, the proposed Supplementary Fiscal Assistance program, and the Comprehensive Employment and Training Act. Second, EDA's programs have provided grants and loans for public infrastructure and technical and planning assistance. The President's proposed Labor-Intensive Public Works program will improve the quality of public facilities, while providing jobs for the structurally unemployed. Third, HUD's Community Development Block Grant program provides grants to local governments, which have until recently been used primarily to revitalize older neighborhoods. With changes in this legislation, these funds can be used increasingly for economic development. HUD's UDAG program provides a flexible economic development and revitalization tool for many distressed cities.

A fourth focus of activity has been special training programs for the structurally unemployed, principally through the Comprehensive Employment and Training Act. In addition, many programs under the Department of Health, Education and Welfare deal with the impact on people of chronic economic distress.

Finally, a different set of initiatives focuses on the private sector economic base itself. The Departments of Commerce, Housing and Urban Development and Agriculture each have programs designed to promote economic development in distressed areas. What is lacking, however, is a program of long-term financing for relatively large private projects. The Bank will fill this void in a way which will complement the existing development efforts mentioned above.

WHY USE CAPITAL INCENTIVES?

The most important disincentive to new investment in economically distressed areas is higher costs -- land acquisition, construction, property taxes, labor, insurance, security, transportation and the like. The Bank's programs respond directly to the higher costs of land acquisition and construction by providing significant cash flow savings -- in excess of 60% of the cost of capital. They respond indirectly to higher costs of operations because the savings from the Bank's financial assistance will partly offset higher costs of operation.

Capital financing subsidies have been the traditional method of governmental aid to private business. There is good reason for that choice.

Financing incentives permit the degree of assistance to be frozen at the time the investment is made, leaving the business free to make operating choices without regard to the impact on government subsidies. By contrast, operating subsidies give the government a direct interest in wages, salaries and other subsidized expenses of private businessmen. They are also administratively complex. The government's involvement in financing transactions is far more limited in time and scope. Accordingly, we think that a capital subsidy is the most appropriate method of increasing jobs and investment in economically distressed areas.

Moreover, it is an effective response in this case because it is a very substantial subsidy. While its value will vary from project to project, on the basis of our discussions with bankers and businessmen, we believe that the savings will be significant in many cases.

THE FOREIGN EXPERIENCE

The United States is not alone among the industrialized democracies in its desire to promote balanced economic growth among its regions. The Western European countries, Canada, and Japan have all had substantial experience with their own regional development programs.

In Europe, the initial policies took the form of subsidies to labor but later shifted to business loans, capital grants, direct controls over the location of private industry and the

deliberate location of government facilities and government-controlled industry in order to achieve more lasting success. Japan has provided long-term funds for "economic reconstruction, industrial development, and socio-economic progress" through the Japan Development Bank since 1951. More than two-thirds of all Japan Development Bank loans in fiscal 1976 went to urban development, regional development, improvement of the quality of life and the relocation of industries to underdeveloped areas. Loans are made to private firms for acquisition or reclamation of land and for construction or improvement of plant and equipment. The total amount of debt outstanding as of the end of fiscal year 1976 was $13.9 billion.

STRUCTURE AND RELATION TO OTHER FEDERAL PROGRAMS

The Bank is designed to complement, not compete with, existing programs. Indeed, we have explicitly structured it to maximize cooperation with existing economic and community development activities at HUD and Commerce.

Let me be specific. The Bank will not have a field staff. It will not set economic development policies for an eligible area. Funds for the Bank's grants are proposed to be appropriated through existing HUD and Commerce grant programs. The Bank will have the final decision-making authority over its grants, and HUD and Commerce will participate fully in the grant process. In short, the Bank will not be an entity acting independently of other federal agencies and programs.

We do not view the Bank as duplicating existing programs. Some of its incentives, such as the interest subsidy for taxable development bonds and the liquidity facility for non-guaranteed loans, simply are not offered by any agency today. And there is no program offering these combined incentives for large private projects.

For example, the HUD UDAG program provides only grants. EDA has both grant and loan guarantee authority, but they are not usually offered in combination. Moreover, the average EDA business loan ranges between $1 million and $1.5 million. The average Small Business Administration loan or loan guarantee is under $150,000. In contrast, the Bank's loan guarantee authority extends up to $15 million per project.

We propose establishing the Bank as an independent agency in the Executive Branch under the direction of the President of the United States. Its Board will be composed of the Secretaries of the Departments of Housing and Urban Development, Commerce and Treasury. The Board will have the power to exercise all of the powers granted to the Bank, including the powers to issue regulations, fix policy and review investments. It may, of course, delegate those functions where appropriate.

The staff will be headed by a President and an Executive Vice President, each appointed by the President of the United States with the advice and consent of the Senate.

In addition, the Bank will have a nine-member advisory committee composed of individuals knowledgeable about or representative of state and local government, commerce, finance, labor, community development and consumer interests. Two members of the advisory committee may be Federal government officials.

The Bank will submit annual reports to the President of the United States and the Congress.

THE BANK'S PROGRAM

I would like to summarize the major provisions of the Bank proposal and then to discuss them in detail.

Program - The Bank's basic program is to provide long-term financing assistance to viable businesses for the acquisition, construction or rehabilitation of physical facilities in economically distressed areas.

Objective - Its objective is to increase the number of permanent, private sector jobs in these distressed places that would not otherwise have been located there and to increase the economic and fiscal base of the areas.

Powers - The Bank will have five basic tools at its disposal, which may be used singly or in combination:

- equity grants
- loan guarantees

- interest subsidies on guaranteed loans
- interest subsidies on taxable development bonds
- a liquidity facility to increase the flow of credit to economically distressed areas.

Role of Local Government - The basic governmental decisions about which projects have priority and which are consistent with local development plans, as well as post-financing monitoring, will remain with the local elected officials or their designated local development authorities.

Eligible Projects

The Bank will assist those businesses -- small, medium and large -- which will provide permanent private sector jobs in eligible localities. In each case, the Bank must find that the facility financed would not have remained, expanded or been located in the distressed area unless the Bank provided financing assistance -- or that Bank assistance was a dominant factor in the decision to do so. The justification for that finding must be put in writing, and it will be subject to audit. The Bank will make a separate decision on the appropriate combination of incentives in each case.

In selecting among projects, the Bank will give primary consideration to two factors: (1) the permanent jobs to be provided by the project; and (2) the project's contribution to the economic and tax base of the distressed area, including the extent to which it provides employment opportunities to the area's long-term unemployed and low-income residents.

The Bank will also consider additional factors. These include the opportunities provided by the project to expand minority business; companion actions undertaken by the locality to encourage economic development in the area; and the ability of the area's labor force, public facilities and services to accommodate the project.

The Bank will not provide financing assistance to relocate a facility or private sector jobs from one area to another unless it finds that that relocation does not significantly or adversely affect the area from which the business is relocating.

Examples

I would like to give you a few examples of projects that might be appropriate for the Bank. Each of these is drawn from conversations with local officials who have requested that the areas and companies remain confidential. First, one Midwestern city would like National Development Bank assistance in retaining a major manufacturer in the city. The firm is a division of a large U.S. company which does not have a strong commitment to the area. The manufacturer employs 6,000 skilled and semi-skilled laborers and is located on the fringe of one of the lowest income neighborhoods in the city.

It needs one-story plant facilities. Local environmental problems and the unavailablity of suitable land for expansion have already forced the firm to move some of its operations to another country.

To accommodate some of its operations, the manufacturer is considering an old plant in the city that had been vacant for the past ten years. It needs $25 million to prepare the facility. A local bank has been involved in the city's negotiations with the firm and is likely to help finance the project if National Development Bank aid is also provided.

Second, the mayor of a small, Northeastern city would like to use the Bank's assistance to help a local manufacturer to expand and another firm to locate on an industrial site in the city. The firms would provide 800 jobs, including 300 new ones.

A nine-and-a-half-acre site has recently become available for approximately $1 million. The city would like to purchase the land for the two companies. A combination of local capital and combined local and National Development Bank incentives could persuade the companies to use the site.

Financing Assistance Provided by the Bank

The Bank will offer a unique combination of long-term financing incentives, which in each case will be conditioned on a substantial commitment from private sector lenders -- either private institutions or the public markets. Specifically, no grant will be made or loan guaranteed unless at least 25% of the long-term debt associated with the project is provided by a

private financial institution or the public credit markets. This "private market test" is intended to differentiate between projects which, if financed, have a reasonable chance of long-term economic viability and those where the risk of loss is too high to attract any private capital, even when three-quarters of the total debt is guaranteed by the Bank. Economic viability is important not only to protect against waste of government funds and credit but also to help assure the permanence of the new jobs and the investment.

Some ask why a project which can raise 25% of its required long-term debt cannot raise all of it. In certain cases, businesses may have adequate access to capital but avoid distressed areas because of high costs. The basic purpose of the Bank's financial incentives is to lower the cost of capital to the private firm -- by providing an infusion of equity and inexpensive long-term debt -- to offset the higher capital and operating costs of doing business in economically distressed areas. It is an incentive to private firms to locate in the area. It is not intended, as a general matter, to make "bankable" a project which is not expected to be self-sustaining. Of course, in some cases the availability of credit will be adversely affected when a proposed project plans to locate in an economically distressed area. In those cases, the Bank's guarantee will aid in making credit available.

The Bank will have at its command five basic tools -- grants, loan guarantees, interest rate subsidies on guaranteed loans, interest rate subsidies on taxable development bonds and a new liquidity facility.

Grants

The Bank may provide equity grants in amounts up to 15% of the eligible capital costs of a project, but not more than $3 million for each project. A grant may be combined with loans guaranteed by the Bank, with tax-exempt industrial revenue bonds, or with subsidized taxable development bonds.

These grants are a crucial part of the Bank's incentives, representing approximately 45% of the savings that a total package of Bank financing can offer to a company. A grant will substitute for an equivalent amount of equity investment, reducing sharply the amount of cash that a company must invest

at the front end of a project. We propose that the Bank have authority to provide $1.65 billion in grants over the first three years of its life.

Grants are not speculative seed money. A grant will be made only after the full financing for the project has been made or irrevocably committed, or after appropriate provision has been made for its return to the Bank if the project does not go forward.

Loan Guarantees

The Bank may guarantee up to 75% of the long-term loans incurred to finance the eligible capital costs of a project. The amount guaranteed for each project may not exceed $15 million.

We have gone to special lengths to ensure that the terms other than the interest rate of the guaranteed long-term debt and the nonguaranteed long-term debt are equivalent, including conditions, covenants, maturity, security and application of payments in the event of default. This parity has two advantages. It protects the interests of the United States as a creditor. It also assures that the considerations supporting the private credit decision are equally applicable to the portion guaranteed by the government.

Before guaranteeing any debt, the Bank must find that there is a reasonable prospect of repayment. The Bank thus retains responsibility for its own credit decisions. Nevertheless, the fact that at least 25% of the long-term debt has been extended by a private financial institution or by the public credit markets will help to confirm the Bank's judgment. The guarantee will apply to taxable debt issued by local development authorities or by the business itself.

We have proposed authority for the Bank to guarantee up to $8 billion of long-term loans for fiscal years 1979, 1980 and 1981.

Interest Subsidies on Guaranteed Loans

The Federal guarantee will have the effect of lowering interest costs to the business on the portion of the long-term debt which is guaranteed. The rate must be approved by the

Bank and will bear a relationship to the rates carried by other U.S. guaranteed debt securities, which are just above the rates applicable to Treasury securities.

The Bank may further reduce the effective interest on the guaranteed portion through a direct interest cost subsidy. The effective rate to the borrower may be reduced to 2-1/2% per annum. We do not expect, however, that every loan would be subsidized and that every subsidy would reduce the effective rate to 2-1/2%. When a subsidy commitment is made, the amount of subsidy must be fixed. It cannot vary with future fluctuations in interest rates.

We have proposed $3.795 billion in budget authority for interest rate subsidy commitments in fiscal years 1979, 1980 and 1981. The total subsidy payable over the full life of a guarantee will be counted against the Bank's budget authority in the year of the commitment.

Interest Rate Subsidies on Development Bonds

The Bank may also provide an interest rate subsidy on up to $20 million of nonguaranteed taxable development bonds for eligible projects. The subsidy is fixed at 35% in fiscal years 1979 and 1980 and 40% in the following years. Interest subsidies on taxable development bonds are an alternative to a loan guarantee for a company that has the credit to finance in the public markets.

The Bank's subsidies on taxable development bonds would not be subject to the capital expenditure limitation imposed by Section 103 of the Internal Revenue Code. The amount of outstanding tax exempt or subsidized industrial development bonds, plus the outstanding amount of taxable bonds subsidized by the Bank, may not exceed $20 million in one eligible area.

We have proposed $934 million in budget authority for interest rate subsidy commitments in fiscal years 1978, 1980 and 1981. The total subsidy payable over the full life of the taxable development bonds will be counted against the Bank's budget authority in the year of the commitment.

Liquidity Facility

Our extensive consultations revealed that banks and other financial institutions are reluctant to make the large,

long-term commitments which a Bank project may require because of the impact on their liquidity. In addition, many medium-sized and small businesses have difficulty in securing long-term financing because traditional long-term lenders, such as insurance companies and pension funds, prefer to deal with larger companies. The Bank's liquidity facility addresses this need. By providing liquidity and some incentives to lenders, it will increase the flow of long-term capital to distressed areas.

The Bank would be authorized to purchase existing long-term loans made to businesses to finance capital projects in distressed areas, provided that the selling bank or other financial institution re-lends the proceeds only in the form of capital improvement loans in distressed places. The local development authority must also certify that the new investment is consistent with the Bank's job creation and economic development goals. The Bank may not purchase a loan which is either tax exempt or guaranteed by the Bank or by any other Federal, State, or local government entity.

The Bank will finance these loan purchases by selling the loans, with its guarantee, to the Federal Financing Bank. The Development Bank would have the power to purchase loans at a premium created by the difference between the interest rate on the loans and the Federal borrowing rate, which will determine the sale price to the Federal Financing Bank.

The private financial institution will continue to service each loan. Let me emphasize that the Bank will have full recourse to the selling institution in the event of a default, which would also require forfeiture of any unamortized premium. The Development Bank may require the seller to provide collateral to secure its obligation to repurchase the loan. We have proposed budget authority of $3 billion for the liquidity facility in Fiscal Years 1979, 1980 and 1981.

<u>Definition of Distressed Areas</u>

Since the primary objectives of the Bank are to provide jobs and income to distressed localities, the Bank's incentives should be targeted to those areas suffering from chronic economic decline.

We believe that we have arrived at a fair and effective formula. It is the product of months of effort to choose criteria that reflect economic distress in an appropriate way. These factors take into consideration the absolute wealth of a community, the level of unemployment and three growth factors over a five-year period. In combination, they provide a good profile of chronic economic decline. A list of eligible areas prepared on the basis of current information has been requested by the Chairman and has been furnished for the record.

It is important to remember that the purpose of these criteria is to define geographic areas which are eligible under the Bank's programs. The actual number of assisted projects will be far fewer than the number of eligible distressed areas.

Distressed areas will be defined by the boundaries of local governments and will include the unincorporated areas within county jurisdictions. To be eligible, an area must exhibit three of the following four conditions:

(1) An unemployment rate above the national average for the most recent five-year period.

(2) A population growth rate below the national average for the most recent five-year period.

(3) A growth rate in total employment below the national average for the most recent five-year period.

(4) An increase in absolute dollars in per capita income less than the national average for the most recent five-year period.

In addition, no area is eligible if, in the most recent year for which data is available, its per capita income is 125% or more of the national average.

We have developed separate national averages for "Standard Metropolitan Statistical Areas (SMSA)" and "non-SMSA" areas. This feature makes the Bank's eligibility standards sensitive to the differences between urban and rural economies. It allows urban areas to be judged against other urban areas and rural areas to be compared to other rural areas.

Of about 40,000 local jurisdictions in this country, almost 12,000 are eligible, comprising approximately one-third of the American population. Approximately three-quarters of the people in eligible areas reside in urban areas and one-quarter in rural areas.

Eligible areas with populations in excess of 10,000 can apply directly to the Bank for assistance. Smaller areas may apply with the concurrence of other eligible areas if their combined population is 10,000 or more.

If an area with a population of 50,000 or more does not qualify on the basis of eligibility criteria, it may still receive assistance under the "pockets of poverty" provision. Ten percent of the Bank's assistance will be set aside for pockets of poverty in areas that, taken as a whole, do not meet the Bank's eligibility criteria. A pocket of poverty must have a population of at least 10,000 in a contiguous area within the jurisdiction. The local jurisdiction will furnish evidence through its local economic development authority showing that this particular area would probably be eligible under the Bank's tests if it were a separate jurisdiction.

Each year the Bank will publish a list of eligible areas. Once the Bank determines that an area is eligible, it may provide financial assistance to projects in that area during any time in the next two years, even if the Bank determines during the second year that the area is ineligible.

Local Development Authorities

Successful local economic development requires public and private cooperation and careful planning at the local level. Hence, the National Development Bank legislation requires local development authorities to play an important role in formulating the projects. Applications for all forms of Bank assistance, with the exception of the liquidity facility, must be submitted by a local development authority. The latter is responsible for ensuring that the project is consistent with the area's economic and community development policies and for assessing the economic value of the project to the community. It must also concur in the purchase of any loans by the liquidity facility.

The bill provides flexibility as to which local government body can qualify as a local development authority. The authority could be a city economic or development entity, a county development authority, an economic development district, a non-profit private development corporation or a State department or development authority. In most cases, these functions are already assigned to an existing local or county agency. Only a simple designation is required.

Only one local development authority will be designated in each area. Units of State or local government with wider responsibilities (i.e., counties and States), however, can carry out specific projects in the economically distressed area, even if the State or county is not the designated authority, provided that the elected officials of the eligible locality agree. If the municipality itself does not act as the local development authority, then the municipality must redesignate one every two years.

SUMMARY OF PROPOSED FUNDING

Following is a table showing the requested authority and anticipated outlays for fiscal years 1979, 1980 and 1981.

NATIONAL DEVELOPMENT BANK
GUARANTEE AND BUDGET AUTHORITY, OUTLAYS

	1979	1980	1981
	(dollars in millions)		
Formation of Bank, initial organizing expenses and operating expenses			
Budget authority	$ 25	$ 25	$ 25
Outlay	5	17	23
Loan guarantee authority pursuant to Title VII -- subject to appropriations control	(2,175)	(2,900)	(2,900)
Reserve for contingencies to honor guarantees, pursuant to Section 706			
Budget authority	543.75	725	725
Outlay*	46	166	272
Interest rate subsidies for guaranteed loans pursuant to Section 801			
Budget authority	1,035	1,380	1,380
Outlay	9	73	144
Interest rate subsidies for long-term debt (taxable development bonds) pursuant to Section 802			
Budget authority	234	324	376
Outlay	2	21	43
Title IX of the Public Works and Economic Development Act, as amended, for grants pursuant to Title IX			
Budget authority	275	275	275
Outlay	70	255	275
Title I of the Housing and Community Development Act, as amended for grants pursuant to Title IX			
Budget authority	275	275	275
Outlay	8	109	211
Loan purchases to carry out the purposes of Title X			
Budgetary authority	810	1,095	1,095
Outlay	-0-	-0-	-0-
Reserve for contingencies to honor guarantees, pursuant to Section 1009			
Budget authority	202.5	273.75	273.7
Outlay	18	65	104
Less: Recoveries	-11	-47	-83
Net Outlay Effect	7	18	21
Total			
Budget authority	$3,400.25	$4,372.75	$4,424.7
Outlay	158	706	1,072
Less: Recoveries	-11	-47	-83
Net Outlay Effect	147	659	989

*These amounts do not include recoveries from loans that default.

CONCLUSION

In conclusion, Mr. Chairman, the Administration believes the National Development Bank will fill a significant void in the existing array of Federal economic development tools and that it will do so efficiently.

MANUFACTURING EMPLOYMENT IN
CENTRAL CITIES AND URBAN COUNTIES BY REGION

Region	City					Balance of Urban County a/		
	Number of Cities	Total Employment (In thousands)		Percent Change		Number of Counties	Total Employment (In thousands)	Percent Change
		1975	1976	1970 - 1975	1975-76		1975	1970 - 1975
New England	5	160	157	-21%	-2%	5	242	-10%
Middle Atlantic	10	1092	1066	-27%	-2%	8	379	- 4%
East N. Central	19	1396	1398	-18%	0	19	890	- 1%
West N. Central	6	325	305	-19%	-6%	5	69	-12%
South Atlantic	10	338	336	- 6%	0	9	104	-11%
South East	5	199	199	-10%	0	5	73	4%
South West	8	431	447	- 2%	4%	7	107	15%
West	12	716	724	5%	1%	10	630	1%
All Cities/ Urban Counties	75	4657	4632	-17%	-1%	68	2463	-1%

a/ Balance of urban county is urban county less its central city. For example, Cook County less Chicago, or Wayne County less Detroit.

Source: U.S. Department of Commerce, Bureau of the Census, 1972 and 1976 Census of Manufacturing.

Table reproduced from Muller, Thomas, "Central City Business Retention: Jobs, Taxes, and Investment Trends", Urban Institute, February 22, 1978, revised June 1978, p. 6.

TABLE I

TABLE 2

NUMBER OF FORTUNE "500" COMPANIES IN TEN CITIES, BY CITY, SUBURB, AND REGION, 1956 and 1971

City a/	Central City			Suburbs			Region		
	1956	1971	Change	1956	1971	Change	1956	1971	Cha
New York	140	116	-24	16	40	+24	156	156	0
Chicago	47	37	-10	4	15	+11	51	52	+1
Pittsburgh	22	15	- 7	2	0	- 2	24	15	-9
Detroit	18	8	-10	2	4	+ 2	20	12	-8
Cleveland	16	14	- 2	0	2	+ 2	16	16	0
Philadelphia	14	9	- 5	8	4	- 4	22	13	-9
St. Louis	11	10	- 1	1	0	- 1	12	10	-2
Los Angeles	10	15	+ 5	5	6	+ 1	15	21	+6
San Francisco	8	7	- 1	4	8	+ 4	12	15	+3
Boston	7	5	- 2	2	2	0	9	7	-2
Total	293	236	-57	44	81	+37	337	317	-20

Source: Wolfgang Quante, "The Relocation of Corporate Headquarters from New York City", Ph.D. dissertation, Columbia University, 1974.

a/ The ten cities are ranked in the order of number of headquarters in 1956.

Table reproduced from Vaughan, Roger J., The Urban Impacts of Federal Policies: Vol. 2, Economic Development, Santa Monica, CA: Rand Corporation, June 1977, p. 19.

TABLE 3

UNEMPLOYMENT RATE 1975, BY REGION

Region[a]	Unemployment Rate 1975
New England	10.3
Mid-Atlantic	9.3
East North Central	9.0
West North Central	5.8
South Atlantic	7.9
South Central	6.9
Mountain	7.5
Pacific	9.8
Nation	8.5

Source: The National Journal, June 26, 1976, p. 887.
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[a]The Regional definitions correspond to census definitions of divisions except in the case of the South Central region, which includes both the East and West South Central divisions.

Table reproduced from Vaughan, Roger J., The Urban Impacts of Federal Policies: Vol. 2, Economic Development, Santa Monica, CA: Rand Corporation, June 1977, p. 21.

TABLE 4

14 Cities Declining in Population*

	Rate of Unemployment	
	1970	1977
Chicago	4.4	7.4
Philadelphia	4.6	9.7
Detroit	7.2	9.9
Baltimore	4.6	8.7
Cleveland	5.2	8.7
Milwaukee	4.1	5.1
San Francisco	6.4	8.3
Boston	4.3	9.6
St. Louis	6.4	7.8
New Orleans	5.8	7.7
Seattle	8.3	8.4
Pittsburgh	5.3	8.2
Buffalo	6.0	12.0
Cincinnati	4.8	7.3
Unweighted Average	5.5	8.5

8 Cities Growing in Population*

	Rate of Unemployment	
	1970	1977
Houston	3.1	4.7
Dallas	3.1	4.7
San Diego	6.6	9.1
San Antonio	4.3	7.2
Memphis	4.7	6.2
Phoenix	3.9	7.4
Jacksonville	3.3	6.8
Denver	4.1	7.0
Unweighted Average	4.1	6.6

Sources: 1970, data provided by George Reigeluth of the Urban Institute

1977, data provided by Bureau of Labor Statistics

* Population change measured during period 1960-1973.

TABLE 5

CAPITAL INVESTMENT PER PRODUCTION EMPLOYEE BY REGION 1970 - 1975

Region	Central City	Balance of Urban County	Percent Difference
New England	$5467	$6952	27%
Middle Atlantic	6197	11480	85%
North Central	9796	14528	49%
South Atlantic	11626	9594	-18%
South Central	12206	32043	163%
West	8395	11774	40%
Average, U.S.	8910	$12064	35%

Table reproduced from Muller, Thomas, "Central City Business Retention: Jobs, Taxes, and Investment Trends", The Urban Institute, February 1978, revised June 1978, p. 4.

TABLE 6

CITIES	CAPITAL INVESTMENT (1970 - 1976) PER PRODUCTION WORKER
MOST DISTRESSED	
Newark	$12,700
Buffalo	12,400
Bridgeport	7,800
New York	8,200
Detroit	18,800
Boston	10,700
New Bedford	5,600
Philadelphia	11,000
St. Louis	11,700
Dayton	14,700
Average	11,400
LEAST DISTRESSED	
Cedar Rapids	$19,500
Winston Salem	15,900
Memphis	18,400
Houston	30,000
San Jose	19,600
Tulsa	13,100
Denver	15,200
Omaha	15,600
Charlotte	14,900
Richmond	27,400
Average	$19,000

Source: Bureau of Census, Survey of Manufacturers

Table reproduced from Muller, Thomas, materials provided to Treasury, The Urban Institute, June 1978, table 4.

Table 7

Costs of Police Protection 1972-73

	Central City Expenditure Per Capita	Expenditure Per Capita Rest of SMSA
Declining Cities		
Baltimore	$65	$21
Boston	83	29
Buffalo	51	21
Chicago	68	26
Cincinnati	56	27
Cleveland	60	23
Detroit	72	60
Milwaukee	56	27
New Orleans	38	17
Philadelphia	71	18
Pittsburgh	44	15
St. Louis	64	20
San Francisco	42	33
Seattle	52	19
Previously Growing, Now Declining Cities		
Columbus	$34	$18
Dallas	38	19
Denver	39	17
Indianapolis	27	9
Kansas City	51	22
Los Angeles	59	49
Growing Cities		
Honolulu	$37	--*
Houston	24	$22
Jacksonville	22	--*
Memphis	27	18
Phoenix	46	27
San Antonio	18	12
San Diego	25	28
New York City	$70	$35

*These cities comprise 100 percent of their SMSA's.

Data from Bureau of the Census, Local Government Finances in Selected Metropolitan Areas and Large Counties: 1972-73, table 3.

Table reproduced from The Urban Predicament, William Gorham and Natnan Glazer, eds., Chapter 2, "Finance", by George Peterson, Washington, D.C., The Urban Institute, 1976, p. 76.

TABLE 8

Per capita expenditures on all city services excluding health, education, and welfare

	1950	1973
13 cities growing in population from 1960 to 1973*	$26	$154
14 cities declining in population from 1960 to 1973*	$38	$249

Source: Reigeluth, George, "Economic Base," Chapter 4 of Urban Economic and Fiscal Indicators, Urban Institute Public Finance Staff, 1978, p. 23.

*Growing Cities

Columbus
Dallas
Denver
Honolulu
Houston
Indianapolis
Jacksonville
Kansas City
Los Angeles
Memphis
Phoenix
San Antonio
San Diego

*Declining Cities

Baltimore
Boston
Buffalo
Chicago
Cincinnati
Cleveland
Detroit
Milwaukee
New Orleans
Philadelphia
Pittsburgh
St. Louis
San Francisco
Seattle

TABLE 9

LOCAL TAX BURDENS

City Type *	Mean Effective Property Tax Rate		Total Tax Effort As Percent of Household Income	
	1967	1972	1967	1972
Growing Cities	1.85%	1.33%	3.5%	4.0%
Growing to 1970, Declining Thereafter	1.89%	1.98%	4.9%	6.2%
Declining Cities	2.05%	2.54%	5.1%	6.7%

Source: Effective property tax rates: computed from data in 1967 Census of Governments, vol. 2, Taxable Property Values and 1972 Census of Governments, vol. 2, Part 2, Taxable Property Values and Assessment-Sales Price Ratios; Total tax effort from Census of Governments data.

Table reproduced from The Urban Predicament, William Gorham and Nathan Glazer, eds., Chapter 2, "Finance", by George Peterson, Washington, D.C., The Urban Institute, 1976, p. 56.

*See Table 7 for a list of cities in each category stated above.

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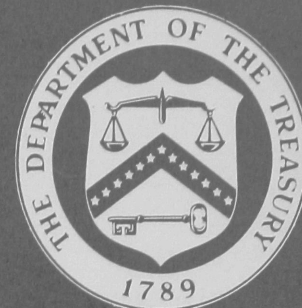

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STATEMENT BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE
THE INTERNATIONAL TRADE, INVESTMENT
AND MONETARY POLICY SUBCOMMITTEE
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

I am delighted to be here today to discuss current issues in international trade policy. As you indicated so well Mr. Chairman, in your recent editorial in the Washington Post, continued movement toward more open trade and resistance to calls for increased protectionism are more vital than ever to our economic welfare and the health of the world economy.

There are three basic issues surrounding U.S. trade policy today: the status and outlook for our trade balance, the prospects for developing a more aggressive and effective U.S. export policy, and the completion of the Multilateral Trade Negotiations (MTN). I will address each briefly in my opening remarks.

B-1079

U.S. Trade Policy Objectives in the MTN

At the outset, I reiterate that we continue to pursue a policy of open trade, and trade liberalization, for three simple reasons -- though some here at home have called for higher protective barriers instead.

First, imports are of great benefit to the United States. They lower prices in the US market, allowing the consumer to stretch his dollar farther. They make available a greater range of consumption choices. Where imported goods can be used as inputs by a domestic producer, U.S. production costs can be lowered. Competition from imports has frequently spurred U.S. producers to develop more efficient methods and new products. Particularly as long as inflation remains the priority concern of U.S. economic policy, continued movement toward trade liberalization is essential.

By contrast, import restrictions add to inflation. Tariffs raise domestic prices directly and harm consumers. Quotas cut supply and indirectly achieve the same effect. Import restrictions generate resource misallocations, imposing permanent losses on the United States economy.

Second, millions of U.S. jobs depend on the preservation of an open trading system. Those who would seek a solution to our trade deficit and import-impacted industries by erecting new barriers to imports forget that others will emulate

us if we impose import restraints, choking off U.S. exports -- and American jobs. Consider the following facts:

-- Somewhere between one of six, and one of eight, manufacturing jobs in the United States produces for export. For some of the states represented on this Subcommittee, direct export-related manufacturing employment, and exports, are as follows (FY 1976 data - Bureau of Census):

	Employment	Exports ($ billions)
Ohio	86,800	5.8
California	123,700	8.1
New York	84,000	5.3
New Jersey	34,900	2.7
Oregon	13,000	0.8
Massachusetts	48,200	2.5
Indiana	40,000	2.8
Iowa	19,800	1.5
Georgia	21,100	1.4
Minnesota	23,200	1.6
Nebraska	3,700	.3

-- Exports take 39% by value of all U.S. production of construction machinery, for example, and about 40% by value of our aerospace output.

-- Every third acre of American farmland produces for export. More than half our wheat, soybeans and rice is sold abroad.

-- Nearly one-third of U.S. corporate profits now come from the international activities of U.S.

companies, including both their exports and their foreign investments (which also rely heavily on open international trading arrangements).

-- The share of trade in our GNP has doubled over the past decade.

In short, we believe that the United States has far more to gain from negotiating more open markets abroad than from closing off our own markets to imports.

Foreign Trade in First Half 1978

The major cause of the $45 billion annual-rate trade deficit in the first quarter was an extraordinary surge of nonpetroleum imports, which were 27% higher than in the first quarter of 1977. This upsurge was led by sharply higher purchases of machinery, autos, and steel, but most other products were also up. The dollar depreciation was a major factor causing import prices to rise over 10% and encouraging buyers to accelerate shipments. Steel import tonnage was up 75% compared to last year as importers rushed to beat the trigger price deadline.

The trade deficit in the second quarter declined to an annual rate of $32 billion due to a very strong increase in exports, and only a slight rise in imports. Led by major shipments of corn, wheat, and soybeans, agricultural exports

increased 23%. The sharpest gains were with Eastern Europe and the developing countries. Very encouraging has been the steady growth of nonagricultural exports over the four months, March through June, following a long period of stagnation. All major categories of nonagricultural exports have shown significant increases, especially machinery, automotive, and consumer goods. The two major factors in this increase have been foreign growth and the initial effects of dollar depreciation, both of which should continue to encourage strong U.S. export growth during the remainder of 1978 and 1979.

In the second quarter nonpetroleum imports leveled off. In May and June steel import tonnage was down about 20% from last year, as the trigger-price program began to take effect. There was also a slowdown in the rise of import prices, which suggests that the price effects of the dollar depreciation already have been realized.

Petroleum imports on a balance-of-payments basis averaged only 8.6 mb/d in the first half of 1978 -- down about 1 mb/d from 9.6 mb/d in the first half of last year.

However, a rundown of private stocks and a one-time buildup of Alaskan production fully accounted for the decline. Alaskan oil, which began to flow in June 1977, was approaching the capacity pipeline flow of 1.2 mb/d in the

second quarter of this year. In contrast, crude production in the lower 48 states was down almost 3% from last year, while domestic petroleum consumption was up about 2.4%.

With petroluem consumption expected to continue to grow moderately, crude production declining without the benefit of any additional Alaskan oil, and imports for our strategic stockpile amounting to about 1/2 mb/d in the second half of this year, petroleum imports are expected to increase in the second half of 1978 and continue to rise through 1979.

Export Policy

In April, the President established an interagency Export Policy Task Force chaired by Secretary Kreps to develop ways of increasing U.S. exports. The Treasury Department participated actively in the task force, which completed its work and sent its recommendations to the President last week.

The recommended package focuses on several important areas. First, the Task Force looked at possible incentives to help firms overcome the greater difficulties associated with exporting as compared to selling in the U.S.

Second, the Task Force has made recommendations to reduce the disincentives to exports resulting from U.S. Government-imposed requirements. This is a fertile area of conflicting policy objectives, confusing regulations,

and slow licensing procedures. Examples are the application of U.S. environmental requirements to foreign trade, export controls, antitrust policy, and illicit payments to foreign agents. Reducing government disincentives affords many opportunities for increasing exports at no additional cost.

Third, we examined direct government assistance programs to help U.S. firms develop new export markets and to help overcome the factors which deter small- and medium-sized firms from exporting.

While the specific recommendations of the task force will help to improve our export performance, equally important is the need for both government and private business to develop an awareness of the increasing importance of exports to the overall health of our economy. We must weigh carefully the impact on exports of our policies and actions in non-trade areas.

Status of the MTN

Ambassador Strauss has been ably working to conclude the MTN in Geneva, and I was privileged to join him there for the last ten days of the latest negotiations -- which produced the "framework of understanding" released on July 13. We did not achieve final agreement, and many difficult issues remain, but I believe that remarkable progress has been made toward

attaining agreements which seemed impossible just a few months ago.

Most of the major issues are now clearly defined in a way which makes them amenable to political resolution. The Súmmit has mandated completion of the negotiations by December 15. I believe that we can succeed in that task, and that we should therefore now review where we are and how much further we have to go.

I was particularly heartened by the great progress made over the past few months on a subsidy/countervailing duty code -- one of the top MTN priorities of the United States. This issue was dead in the water as late as last February. But we have worked with our major trading partners to fashion a detailed proposal that has recently been circulated to other MTN participants, and -- to quote the "framework of understanding" already endorsed by 20 nations -- provides a "substantial basis for developing agreement in this area".

We believe that subsidies represent one of the most critical problems for the world trading system in the decade ahead, because governments are increasingly tempted to export their problems to others through direct financial and other types of help to favored industries. At the same time, we recognize that the present U.S. countervailing duty statute -- alone among major countries -- includes no injury test,

which many countries view as disruptive to their trade. We also recognize that the temporary waiver authority in the statute will expire next January, with possibly dire consequences for world trade unless an effective new regime has been negotiated by that time. Hence we seek three basic objectives in any new code:

- -- effective discipline on the use of subsidies themselves
- -- recognition of the need for an injury test in the U.S. countervailing duty law
- -- effective procedures, both domestically and in the GATT, to ensure faithful and timely implementation of the new arrangements.

Two current problems illustrate the critical importance of developing new understandings with regard to the use of subsidies affecting international trade, through either the MTN or other avenues such as the International Arrangement on Export Credits.

One was an example of aggressive financing of exports, under which the British offered highly concessional terms to induce Pan American Airways to select the Rolls Royce engine for its purchase of 12 L-1011s. While aircraft are not included in the International Arrangement, there is a limited OECD Aircraft Standstill and there is an OECD

agreement on local cost financing. The British credit offer violated international understandings by failing to require any down payment, exceeding the agreed-on ten year maximum term, and providing local cost financing. The British, while acknowledging that this was an unusual financing offer, argued that they were only matching financing terms offered by a private U.S. firm. Our view is quite clear, and we have made it abundantly clear to the British at the highest level -- the UK action constituted a triple derogation from existing understandings.

The second instance relates to several steps taken by the Government of Canada which seek to induce U.S. and other automobile companies to locate a significant part of their new production north of the border. Sizeable cash grants have reportedly been offered by the Federal government, along with certain provincial authorities, to persuade the companies to do so. Duty reductions have been negotiated for Canadian imports of Volkswagens made in the United States, conditioned on larger purchases of Canadian auto parts by Vokswagen plants located throughout the world. Similar arrangements are contemplated with other non-U.S. firms.

We fully recognize that several U.S. states have also offered substantial incentives for the location of auto plants, but so have the Canadian provinces. We simply cannot sit by while these interventionist practices are escalated to the

Federal level. We have so informed Cabinet officials of the Government of Canada and we have called for urgent consultations under the terms of both the U.S.-Canadian Automotive Products Agreement and the 1976 decision of the OECD Council on international investment incentives and disincentives. Assistant Secretary of State Katz and I will travel to Canada on Friday to launch these discussions, which we hope will prevent the opening of another front of international subsidy competition.

The Subsidy/Countervail Code

The draft subsidy/countervail text would establish a comprehensive discipline on the use of government subsidies, and set strict standards to limit the effect of subsidies on world trade. The text also incorporates the "two-track" approach proposed by the United States, which lays out procedures whereby countries can take countermeasures to offset the impact of foreign subsidies in both their domestic market and third country markets as well. This will provide the means to protect our exporters from subsidized competition in foreign markets.

As part of the proposed agreement on subsidies and countervailing duties, we are prepared to recommend to the Congress that it accept inclusion of an injury test in the U.S. countervailing duty law. This is an issue of major importance for our trading partners, for understandable and

justifiable reasons. Only the United States now operates without an injury test, and our continued failure to adopt one places us in clear violation of the spirit of the GATT. Our willingness to recommend this change -- within the context of an agreement containing effective discipline on the use of subsidies themselves -- demonstrates our great interest and sincere desire to avoid trade disputes in this area in the future.

The injury test would be incorporated within the framework of the two-track approach. If a country granted a subsidy in violation of specific commitments not to use certain practices, then the importing country could apply countermeasures along one track without having to demonstrate injury. This is fully consistent with the GATT approach to tariffs: retaliation is authorized whenever a member country violates its tariff bindings, with no need to demonstrate injury. Indeed, the MTN seeks to extend such a network of rights and responsibilities from the traditional area of tariffs into several non-tariff areas.

The other track provides for countermeasures against subsidies after a finding of injury. With the two-track approach, we will be able to provide expeditious and appropriate relief for industries facing subsidized competition.

The subsidy/countervail code also provides an excellent opportunity to engage the advanced developing countries (ADCs)

more actively in the international trading system. We recognize that subsidies can contribute to development in poorer countries, but also believe that ADCs should assume responsibilities commensurate with their level of development and should accept increased obligations as their industries become internationally competitive. The current proposal affirms this principle, and seeks to provide a flexible basis for the adoption of obligations on subsidies which are appropriate for individual developing countries.

There are still three key issues that have yet to be resolved in the subsidies code, without which there can be no agreement:

-- Agriculture. We will not accept an agreement that does not tackle the thorny problem of limiting subsidized competition in world agricultural export markets.

-- Provisional Measures. We have not agreed on some of the mechanics of the second track, in particular whether a country can have recourse to provisional measures while international review of a case is pending. We favor expeditious international resolution of disputes but, where this is not possible, we need to maintain the right to act against the most blatant of subsidy practices -- those which countries have already agreed to avoid.

-- Domestic Subsidies. We need to include an illustrative list of domestic subsidies in the code. Direct government financial assistance to industrial development is often introduced in the name of laudable domestic economic goals: increased employment, industrial efficiency, farm income security, long-term research and development efforts. But it also tends to forestall needed structural adjustment at home, while exporting problems abroad. We believe that international guidelines and an illustrative list are needed to guide the application of such subsidies, and should be valuable in preventing (or at least helping to resolve) disputes over their use in the future.

These three issues, and the details for applying the code to the ADCs, are tough both intellectually and politically. But they are not insurmountable obstacles. The foundation for a comprehensive agreement exists in the text prepared by our negotiators over the past few weeks. I believe that agreement can be reached -- indeed must be reached -- by the end of the year.

Framework

Subsidy/countervail is but one, albeit perhaps the most important, area where the MTN seeks to create new rules to govern international trade for the 1980s and beyond. Recognizing the tremendous changes which have occurred in trade

practice and international circumstances since the founding of the GATT in 1948, the Trade Act called on the President to negotiate changes in GATT rules and procedures in the MTN. Originally dubbed "GATT Reform", this effort is now being carried forward in the MTN's "Framework Group." In addition, it applies to other parts of the MTN, particularly the various code negotiations.

The Framework Group concerns itself with the following topics:

a) special and differential treatment for developing countries, including LDC reciprocity for trade concessions by developed countries and the related issue of graduation from LDC status;

b) trade restrictions for balance of payments reasons;

c) consultation, surveillance, and management of disputes;

d) export restrictions.

Many developing countries have come to regard the Framework Group as the "LDC Group" in the MTN. They are pushing hard for GATT amendments which would provide a permanent "legal" basis for special and more favorable treatment of LDCs by developed countries in future trade negotiations, and enshrine the principle that LDCs owe less than full reciprocity for trade concessions by developed countries. The

developing countries believe that present GATT rules give insufficient consideration to development problems, and that deviations from the rules to take account of such problems require "waivers" which are complicated and difficult to obtain.

This is one of the most politically sensitive issues in the MTN. We are sympathetic to the special problems of LDCs. At the same time, we cannot agree to a change in GATT rules which might result in a permanent two-tier trading system and less than fair treatment of our own trade interests by a large bloc of other countries. We also believe that any solution must provide for "graduation" -- the phasing out of special treatment, and acceptance by the more advanced developing countries of the increasing obligations of the trading system as the status of their development warrants it.

The GATT sanctions use by its members of import quotas and licensing restrictions to remedy serious <u>balance of payments</u> difficulties. However, it does not adress the issue of import surcharges and prior import deposits -- which have been much more commonly used in recent years. More generally, this provision was adopted under a regime of fixed exchange rates whereas the new system of flexible rates provides for a whole new balance of payments adjustment device.

Clearly, "GATT reform" is needed here. When the GATT rules are manifestly inadequate to deal with common practice

in a major area like this, the entire Agreement loses credibility. More important, better coverage of these practices by GATT would limit their use to situations which are fully justifiable.

An essential element of a final MTN agreement will be an improved dispute settlement package. It should apply specifically in the non-tariff measure codes, as well as to disputes under the GATT generally. We believe it should provide:

-- maximum inducement for the parties to a dispute to reach agreement directly;

-- means for impartial establishment of the facts of a dispute;

-- a means of arbitration and conciliation;

-- a record of the disposition of disputes.

We believe that existing GATT practice is useful in this regard, but could be improved upon. The GATT now provides for the use of impartial panels of experts to help resolve questions of fact and law related to a dispute. Such findings then can form the basis for efforts at reconciliation, either directly between the parties or with the help of mediators. We would like to spell out more fully how this system would work, improve GATT procedures to restore the system's efficacy, and provide for time limits on the various steps in the process.

Finally, we need improvements in GATT provisions governing export restrictions, to balance existing GATT restraints

on import restrictions. The former can be just as trade-distorting, and can also be used to export one country's economic problems to its trading partners -- as experience has demonstrated in recent years.

The general rules of the GATT apply to exports in much the same manner as to imports. Restrictions on quantity -- such as quotas and licensing systems -- are generally prohibited, but duties or taxes on exports may be imposed so long as:

-- they do not discriminate among trading partners, and

-- the contracting country has not agreed to "bind", or set a limit on, the amount of such duties or taxes.

However, the GATT clauses dealing with export restrictions are in several ways less complete than those dealing with import restrictions. When the GATT was written in 1948, import restrictions were a serious issue but export restraints were not. Thus the Agreement permits export restraints to prevent or relieve critical shortages of essential commodities in the restricting country, to conserve "exhaustible natural resources", or when domestic prices of inputs are being held below world levels as part of a government stabilization program.

But the GATT provisions dealing with binding of duties and taxes need to be made more clearly and specifically applicable to exports. The general rule of nondiscrimination among trading partners needs to be made as clearly relevant to exports as it is to imports. The status under GATT of export restraints imposed by state trading enterprises, rather than governments themselves, needs to be clarified. And we need more specific provision for notification, consultation, and dispute resolution with respect to export restraints, reflecting the increasing importance of this issue in world trade.

Export Credits

Although it is not being negotiated in the MTN, I would like to comment finally on a closely related topic -- the new International Arrangement on Official Export Credits, concluded by twenty countries and the Commission of the European Communities earlier this year. You will recall that, when I last appeared here last March, I pointed out that the Arrangement is intended to head off the possibility of a self-defeating export credit war, a very real danger in this time of increased government intervention in trade.

You may recall that I expressed hope that the new Arrangement would form the basis for cooperation among the major trading nations to curb excessive competition in export credits. It was a welcome first step, but further action was

needed to restrain aggressive government financing practices and reduce the element of subsidy in official export credit financing.

We are especially concerned about practices such as those of the British in the aircraft sector, which I mentioned earlier, because they create a kind of competitive trade atmosphere that brings forth counter actions tending to produce a general export credit war. To avoid these dangers, we will seek to strengthen the International Arrangement on Export Credits. At the OECD Ministerial in June, Secretary Blumenthal emphasized the need for further negotiations this year. Such negotiations will be formally initiated at the review meeting of the Participants in October.

While we pursue a more rigorous international agreement, we are also taking action to maintain our ability to compete in the highly competitive export credit market. The Export-Import Bank is increasing its financing activities, with an anticipated budget authority increase of 30 percent for fiscal 1979 (from $2.9 to $3.8 billion). And we could of course respond to excessive foreign export subsidies by using our own countervailing duty law or even Section 301 of the Trade Act, which gives the President authority to retaliate against foreign subsidies of exports both to the U.S. and to third country markets.

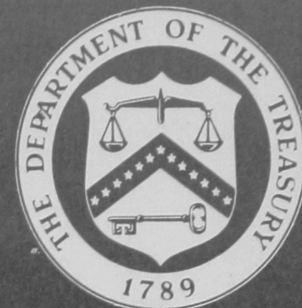
Conclusion

The goal of U.S. trade policy is to maintain, and further liberalize, the open trading system which has played such a major role in the postwar prosperity of the United States and the entire world. We thus seek further freedom for trade via the MTN.

But we feel just as strongly that all industrialized countries, and increasingly the advanced developing countries as well, must play by agreed rules of the game. In some areas, new rules are needed. In all areas, closer adherence to the rules is maandatory. It is an old, but true, cliche that "trade must be fair to be free".

Hence we are trying to negotiate, simultaneously, a further opening for trade flows and a more effective international regime within which trade takes place. I believe that we will achieve such a two-fold result before the end of 1978.

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



FOR RELEASE AT 4:00 P.M. August 1, 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 August 10, 1978. If final action on the debt ceiling legislation has not been completed by August 10, the issue date of these bills, the bills delivered on that date will be those issued on July 31 to Government accounts. The auctions will be held as scheduled and the bills will have the CUSIP numbers and due dates specified in this announcement. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,808 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 May 11, 1978, and to mature November 9, 1978 (CUSIP No. 912793 U3 8), originally issued in the amount of $3,403 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,500 million to be dated August 10, 1978, and to mature February 8, 1979 (CUSIP No. 912793 W7 7).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing August 10, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,482 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 Daylight Saving time, Monday, August 7, 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-1080

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.

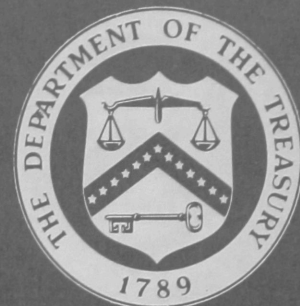
Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in 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 August 10, 1978, in cash or other immediately available funds or in Treasury bills maturing August 10, 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.

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



August 1, 1978

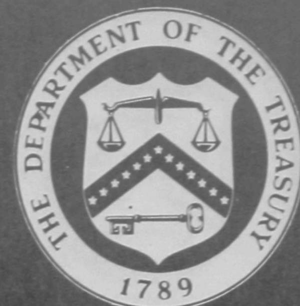
Immediate Release

The Treasury Department today suspended sales of U.S. Savings Bonds until the public debt limit is increased. Without new legislation to increase the public debt limit, the government lacks authority to issue new debt obligations. Notice of the suspension is being given to about 40,000 issuing agents throughout the country.

Until the debt ceiling is raised, the Treasury Department will also be unable to complete transactions involving special nonmarketable securities which are issued in connection with the financing of tax-exempt bond issues by state and local governments.

B-1081

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



FOR IMMEDIATE RELEASE August 1, 1978

RESULTS OF AUCTION OF 3-YEAR NOTES

The Department of the Treasury has accepted $2,503 million of $5,384 million of tenders received from the public for the 3-year notes, Series N-1981, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	8.44% 1/
Highest yield	8.47%
Average yield	8.46%

The interest rate on the notes will be 8-3/8%. At the 8-3/8% rate, the above yields result in the following prices:

Low-yield price	99.831
High-yield price	99.753
Average-yield price	99.779

The $2,503 million of accepted tenders includes $1,124 million of noncompetitive tenders and $1,379 million of competitive tenders from private investors, including 16% of the amount of notes bid for at the high yield.

In addition to the $2,503 million of tenders accepted in the auction process, $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 August 15, 1978, and $320 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorites for new cash.

1/ Excepting 6 tenders totaling $155,000

B-1082

partment of the TREASURY NEWS
HINGTON, D.C. 20220 TELEPHONE 566-2041

FOR IMMEDIATE RELEASE August 2, 1978

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $3,000 million of $4,078 million of tenders received from the public for the 7-year notes, Series B-1985, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	8.28%
Highest yield	8.41%
Average yield	8.36%

The interest rate on the notes will be 8-1/4%. At the 8-1/4% rate, the above yields result in the following prices:

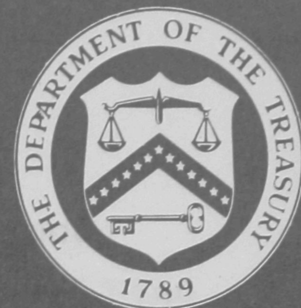
Low-yield price	99.843
High-yield price	99.166
Average-yield price	99.426

The $3,000 million of accepted tenders includes $ 715 million of noncompetitive tenders and $2,286 million of competitive tenders from private investors, including 57% of the amount of notes bid for at the high yield.

In addition to the $3,000 million of tenders accepted in the auction process, $1,434 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 August 15, 1978, and $330 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash.

B-1083

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



Release on Delivery
Expected 7 p.m. CDT,
August 7, 1978

REMARKS BY THE HONORABLE
BETTE B. ANDERSON
UNDER SECRETARY OF THE TREASURY
BEFORE THE
SCHOOL FOR BANK ADMINISTRATION
MADISON, WISCONSIN
AUGUST 7, 1978

THE BANK SECRECY ACT: CHALLENGE FOR AMERICAN BANKING

I am very pleased to have this opportunity to participate in your program. As a career banker, I hold the School for Bank Administration in high esteem for the role it plays in furthering the development of bankers who have audit, controllership, administrative, and operations responsibilities.

Tonight I would like to talk about the Bank Secrecy Act, and its role to help law enforcement officers overcome foreign bank secrecy laws which were, and still are, being used to frustrate investigations of tax evasion and other crimes. I want also to explain why its success is a challenge to American banking.

As many of you are aware, the statute requires that:

-- banks and other financial institutions report unusual currency transactions in excess of $10,000 and maintain certain basic records;

-- travelers and others report the importation or exportation of currency and other bearer instruments in excess of $5,000; and

-- all U.S. persons file reports concerning the ownership or control of foreign financial accounts.

The Act assigns the responsibilities for compliance to the Secretary of the Treasury, and he has delegated them, in turn, to my office.

For many years prior to 1969, when the Act was introduced, Federal law enforcement agencies were well aware of the problems in prosecuting persons who use foreign transactions and foreign financial facilities to conceal or shield their violations of U.S. law.

Some of the abuses of foreign bank accounts then included:

-- The use of foreign bank accounts to hide income not reported for tax purposes. Since U.S. investigators rarely have access to them, such accounts can be used very much like a safe deposit box. However, the funds on deposit in a foreign bank have an added advantage; they can be invested through the bank and earn additional, untaxed income without disclosing the identity of the depositor.

-- The use of a foreign bank as a conduit to permit a U.S. depositor to "borrow" the funds from his own secret foreign account without disclosing the actual source of the funds. In this way, the depositor could overtly use his hidden funds and take a tax deduction for the "interest" the foreign bank charges him.

-- The use of foreign banks as a front in conducting securities transactions, which were frequently executed through U.S. brokers. Some of those transactions were for the purpose of concealing dividend income and capital gains; others were used to facilitate the violation of the margin limitations on security purchases.

Of course, in some instances, the banking system was by-passed. Currency was simply packed in an attache case, carried out of the country and deposited in a foreign bank. Even though law enforcement officers may have had accurate information concerning some of these shipments, they usually had no legal basis for stopping or taking other action against the courier. Unfortunately, once the money was deposited, undetected, in a foreign bank governed by bank secrecy laws, there was little likelihood that U.S. law enforcement officials would learn about it.

Even when bank information came from informants or was obtained from foreign governments, its use was usually restricted because of problems of admissibility in U.S. courts or limitations imposed by the foreign government.

Congress recognized these obstacles and attempted to alleviate them by passing a statute which has become known as the Bank Secrecy Act.

Public Law 91-508, which included the Bank Secrecy Act, was enacted in October, 1970, and the Treasury implementing regulations became effective two years later.

Although the Act gave Treasury extremely broad powers to require recordkeeping and reporting of financial transactions, the Department has chosen a moderate course, striving to accomplish the goals of the statute without imposing unnecessary

burdens. The regulations apply mainly to the banking and securities industries and set standards which reflect prevailing industry practices. They include the following provisions:

Banks, savings and loans, securities brokers, dealers in foreign exchange, agents of foreign banks, and other institutions are required to retain the original or a copy of:

-- Each extension of credit in excess of $5,000 except for those secured by real estate, and

-- Records of instructions for the transmission of credit, funds, currency or other instrument, check, or securities of more than $10,000 out of the United States.

Banks and bank-type institutions such as savings and loans, and credit unions, must also retain a variety of records for each deposit or share account, especially those pertaining to transactions with foreign financial institutions.

Also, securities brokers supervised by the SEC must obtain a signature card or similar document establishing trading authority over an account and make a reasonable effort to obtain a Social Security Number for each account.

There are a number of other provisions which you should know about.

First, financial institutions must report to the IRS any unusual domestic currency transaction in excess of $10,000. This only modifies a similar requirement in effect for more than 25 years which required banks to report any unusual customer transaction involving more than $2,500.

Second, except for certain shipments made by banks, the international transportation of currency, bearer checks and other monetary instruments in excess of $5,000 must be reported to the Customs Service.

Finally, the regulations require all U.S. persons to report their foreign financial accounts. The regulations also specify that certain records of such accounts be maintained in the United States.

To enforce this act, the Treasury Secretary delegated responsibilities to several agencies which already regulate groups of financial institutions: the Comptroller of the Currency, the Federal Reserve Bank, the Federal Home Loan Bank Board, the National Credit Union Administration, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Commissioner of Customs, and the Commissioner of Internal Revenue.

Overall responsibility for coordination and compliance with

the regulations remains in my office.

We believe that the regulations, which are relatively uncomplicated, have already helped fight white collar crime, political and commercial corruption, and organized crime.

For example, during the 12 month period which ended June 30 of this year, the Treasury Department provided Federal drug enforcement agents with more than 1,700 currency transaction reports covering more than $200 million.

Last year, the Miami Herald credited these reports with helping to identify a widespread drug operation in the Miami area. One of the transactions was in excess of $900,000, and most of it was in denominations of less than $100. Some of the deposits involved such large volumes of currency that it took three tellers three or four hours to count the money. Someone familiar with the investigation commented that the currency had to be converted into some other form because otherwise "you'd need a DC-6 to fly it to your holding bank."

The currency transaction reports have been valuable in other ways. Every one of them is screened by the IRS. Also, they have been used by the Department of Justice and Congressional subcommittees in connection with specific investigations.

The Customs Service has had increasing success in utilizing currency transaction reports against drug dealers and other violators.

For example, in one case, a joint investigation by Customs, the Drug Enforcement Administration, and foreign police, Customs seized 2,000 pounds of hashish, $19,000 in currency, and $130,000 in bank drafts. Further investigation disclosed other reporting violations and resulted in freezing more than $800,000 in various bank accounts. In December, three of the defendants were fined $500,000 each, the maximum amount possible under the Bank Secrecy Act, and given substantial jail terms.

Customs also is investigating with the Department of Justice possible violations of the reporting requirement by a number of large corporations in connection with the maintenance of slush funds. The first case completed resulted in the assessment of a $229,000 penalty against Gulf Oil last year. Earlier this year, Control Data Corporation was fined $1,000,000 for a violation of the reporting requirement.

Even a financial institution has been affected. In May, the San Francisco subsidiary of Deak & Company, the international foreign exchange dealer, was fined $20,000 for failing to report several million dollars in shipments.

Customs makes several hundred seizures of currency and monetary instruments each year under a variety of circumstances. In one case last month, agents seized some currency that a

traveler had concealed in his wooden leg.

Although these successes are very significant and we are proud of them, I believe that we have only scratched the surface.

Consider, for example, the huge amounts of money that flows through criminal enterprises. Legitimate businesses that gross far less have very high visibility in our communities. For example, in 1977 K Mart Corporation required more than $1 billion in working capital to generate approximately $10 billion in sales. Yet that is less than the estimated value of illegal drugs sold in the United States each year.

Can you imagine trying to conceal the cash generated from those operations? I can't. But still the huge cash flow from drugs, illegal gambling, and other large scale criminal activities remains, for the most part, undetected.

The fact that there is a comparatively large volume of currency in circulation today has become the basis for estimates of the subterranean economy -- the new name for economic activity not reported for tax purposes.

According to one observer it amounts to $200 billion annually based on the changes in the ratio of currency in circulation to demand deposits. For example, in 1961, there was $249 in currency circulating for every $1,000 in demand deposits. By 1976, the ratio increased to $344 and led one economist to estimate that $28.7 billion of the currency in circulation then was used for illegal purposes -- the subterranean economy.

While the size of the subterranean economy is subject to dispute, the increase in currency in circulation is not. The figures clearly indicate that while we may talk about a checkless and cashless society, the public uses a much larger amount of currency than ever before.

The fact that criminals continue to generate and use large volumes of currency in their illegal activities is the reason that the Bank Secrecy Act is an opportunity and a real challenge to bankers to help discourage criminals from using cash. Although we had very broad authority to require in-depth reporting of currency transactions, Treasury decided to limit reporting to large, unusual transactions.

The reasoning was that bankers are in the best position to know their customers and to decide what is normal activity in a customer's account. Therefore, you and your associates have a key role in our program to combat crime in America.

Is the job getting done? Frankly, I don't know.

Part of the problem has been that Treasury needs to improve its analysis of the reports. We recognized that and have established a Reports Analysis Unit in our Office of Law Enforcement. With improved computerization and collation of the

reports, we should be more sensitive to the data and better able to identify persons who habitually deal in relatively large amounts of currency, as well as banks which file an unusual number of reports or no reports at all.

The other part of the job is to develop greater awareness of banks' responsibilities under the Act. Last year, one of the major New York banks was fined $222,500 in connection with the failure to report 445 currency transactions amounting to several million dollars. The case came to light as the result of a narcotics investigation. Several bank employees admitted receiving commissions on drug related transactions which involved the exchange of $1.8 million in small bills for larger bills, and no reports were filed. The activity took place at several branches of the bank. It is my understanding, however, that no senior executives were implicated and that the internal auditors were unaware of the situation.

Yet all of our investigations have been initiated as a result of complaints by law enforcement agencies. Not one resulted from information from bank management. We intend, however, to work with the bank supervisory agencies to overcome this deficiency.

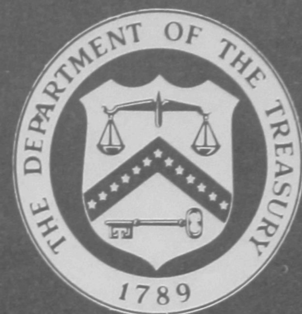
We also plan to work with more of you, in groups and individually, to answer questions you may have about the reporting requirements and to listen to any suggestions you may have.

I am confident in the ability of the banking community to help us make these regulations work, and we are looking forward to a more successful program.

Thank you.

oOOo

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



FOR IMMEDIATE RELEASE August 3, 1978

RESULTS OF AUCTION OF 30-YEAR TREASURY BONDS
AND SUMMARY RESULTS OF AUGUST FINANCING

The Department of the Treasury has accepted $1,501 million of $2,588 million of tenders received from the public for the 30-year bonds auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	8.37%
Highest yield	8.46%
Average yield	8.43%

The interest rate on the bonds will be 8-3/8%. At the 8-3/8% rate, the above yields result in the following prices:

Low-yield price	100.055
High-yield price	99.079
Average-yield price	99.402

The $1,501 million of accepted tenders includes $148 million of noncompetitive tenders and $1,353 million of competitive tenders from private investors, including 4% of the amount of bonds bid for at the high yield.

In addition to the $1,501 million of tenders accepted in the auction process, $600 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 August 15, 1978.

SUMMARY RESULTS OF AUGUST FINANCING

Through the sale of the three issues offered in the August financing, the Treasury raised approximately $3.3 billion of new money and refunded $7.6 billion of securities maturing August 15, 1978. The following table summarizes the results:

	New Issues						
	8-3/8% Notes 8-15-81	8-1/4% Notes 8-15-85	8-3/8% Bonds 8-15-03-2008	Nonmarketable Special Issues	Total	Maturing Securities Held	Net New Money Raised
Public...............	$2.5	$3.0	$1.5	$ -	$7.0	$4.4	$2.6
Government Accounts and Federal Reserve Banks...............	1.2	1.4	0.6	(*)	3.2	3.2	-
Foreign Accounts for Cash.................	0.3	0.3	-	-	0.6	-	0.6
TOTAL.........	$4.0	$4.8	$2.1	(*)	$10.9	$7.6	$3.3

*$50 million or less.
Details may not add to total due to rounding.

B-1085

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

NEWS

TELEPHONE 634-5248

FOR IMMEDIATE RELEASE
FRIDAY, AUGUST 4, 1978
CONTACT: ROBERT W. CHILDERS (202) 634-5248

ALLOCATIONS OF REVENUE SHARING FUNDS ANNOUNCED

The Department of the Treasury's Office of Revenue Sharing today announced the amounts of general revenue sharing funds which each of approximately 39,000 units of state and local government is entitled to receive for the 1979 fiscal year.

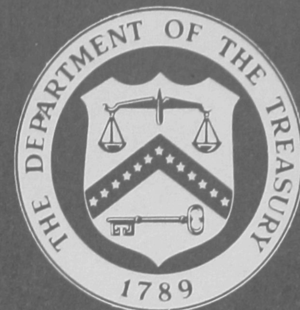
More than $6.8 billion has been allocated nationally for the period. The money is scheduled to be paid in four quarterly installments, in January, April, July and October of 1979.

General revenue sharing funds are allocated periodically, as specified in the revenue sharing law. The law requires that the Office of Revenue Sharing calculate the allocations using such factors as per capita income, local tax effort and inter-governmental transfers and population for each recipient unit of government. These data are applied to formulas set forth in the revenue sharing law in order to arrive at individual recipients' allocations.

B-1086

- 30 -

epartment of the TREASURY
NEWS
ASHINGTON, D.C. 20220 TELEPHONE 566-2041



For Release Upon Delivery
Expected at 9:30 a.m., E.D.T.

STATEMENT OF
DANIEL I. HALPERIN
ACTING DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
AUGUST 4, 1978

Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity to appear before you today to discuss S. 2266, a bill which reforms the law of bankruptcy.

S. 2266, and its counterpart on the House side, H.R. 8200, embody the first major attempt in forty years to revise the bankruptcy laws of the United States. Since the United States Government, as a result of its role as tax collector, is a frequent creditor in bankruptcy, many of the provisions of these bills have an important impact on the tax collection process. Questions of priority, dischargeability, and collection of tax claims in bankruptcy have a direct impact on the integrity of our Federal tax system. The Federal tax system, based on voluntary assessment, can only work as well as it does today if the majority of taxpayers think it is

fair. This presumption of fairness is an asset which must be protected. A modernized bankruptcy law may well allow more debtors to avail themselves of bankruptcy relief. Provisions which reduce or minimize tax liabilities in bankruptcy will inevitably increase the attractiveness of bankruptcy for both debtors and creditors (other than the Federal Government), and thus may undermine taxpayer confidence in the equity of our tax system. It is very important, in protecting the integrity of the Federal tax system, that any increased use of the bankruptcy laws not be viewed by taxpayers at large as providing a loophole for other taxpayers to avoid their tax debts unfairly by going into bankruptcy.

The competing considerations of tax policy and bankruptcy policy express themselves in a number of provisions in S. 2266, the bill before you today. Several solutions suggested in S. 2266 differ from those advanced in its counterpart, H.R. 8200. On occasion, a third solution is suggested by the proposed amendments before you. These proposed amendments were developed by the staff of the Joint Committee on Taxation. We appreciate the opportunity we were given to work with the staff in the development of the amendments. Although the result is not always the one we would have chosen, we believe that S. 2266, if modified by the proposed amendments, would generally follow a reasonable middle ground between protecting the integrity of the tax system and yet allowing for the policy of the bankruptcy laws.

In our testimony, we will review some of the important issues raised in the various sections which have been referred to you by the Committee on the Judiciary1/; discuss various issues raised in other sections which affect tax claims and raise issues which invite amendments; explain differences between S. 2266 and its counterpart, H.R. 8200, to make clear why we favor the provisions in the Senate version; and express our reservations on one of the provisions in S. 2266 for your further consideration.

1/ All references to sections in S. 2266 and H.R. 8200 are to sections of the proposed new Title 11 of the United States Code, which is embodied in section 101 of each bill.

I. SECTIONS REFERRED TO THIS COMMITTEE BY THE COMMITTEE ON THE JUDICIARY

The Treasury, with the exception noted below with respect to section 505, supports the proposed amendments to the seven sections referred to the Finance Committee. A discussion of the issues raised by the amendments to these sections follows.

1. Section 346. Special tax provisions. The provisions in this section deal with certain substantive tax issues which must be resolved in bankruptcy for Federal, State, and local purposes, such as the allocation of tax attributes between a debtor and the debtor's estate. However, section 346 generally applies only to State and local tax issues. The resolution for Federal tax purposes is left to another bill now being considered by the Ways and Means Committee. Since we believe the same rules should apply for Federal, State and local purposes, we think it is premature to legislate in these areas before the Federal rules are finally determined. Thus, we agree with the proposed amendment which would delete all the rules in section 346 of the bill, except for the rule concerning withholding or collection of taxes, such as employment taxes withheld from wages. The rules governing withholding must be integrated with the principles of priority and dischargeability of liabilities, principles which are determined in other sections of S. 2266. For this reason, it is appropriate to deal with those provisions, for Federal as well as State and local purposes, in this bill.

2. Section 505. Determination of tax liability. This section follows present law and authorizes the Bankruptcy Court to determine the tax liability of the debtor where no court has previously ruled on the debtor's liability. The section also requires the trustee to request a prompt tax audit from any Federal, State, or local taxing authority. Under the bill, the Governmental unit would be required to respond to the request for a quick audit within specified time periods. This would apply to tax returns filed by the trustee in the proceeding.

One aspect of the procedure for quick audits under S. 2266 creates unnecessary paperwork, contrary to the needs of a streamlined bankruptcy policy and efficient tax administration. The vast majority of bankruptcy cases are cases in which there are little or no assets in the debtor's estate. Once this is determined, the trustee would have no reason to keep the estate open for purposes of obtaining a quick tax audit. Although in some situations there is a theoretical possibility of personal liability for the trustee, in the absence of an audit, there would be no such liability as a practical matter. Accordingly, it is appropriate (as the proposed amendments provide) to allow the trustee to determine by election whether he wishes to request a prompt audit. If the quick audit is made elective with the trustee, rather than mandatory, it will significantly reduce the amount of paperwork required in many cases both for the trustee and for the taxing authority.

The proposed amendments also revise the procedures for choice of forum for litigating the tax liability of the debtor and the debtor's estate, in cases where the tax liability is not dischargeable in bankruptcy. Under current law, upon bankruptcy, a debtor is generally denied entry into the Tax Court. The issue of the debtor's tax liability may be raised by the debtor without prepayment of the tax if the debtor institutes a proceeding in the Bankruptcy Court under section 17c of the Bankruptcy Act. If the debtor chooses not to contest personal tax liability in the Bankruptcy Court, and the Federal government asserts a tax liability against the debtor individually, the debtor can litigate only by paying the tax and suing for a refund in the District Court or the Court of Claims. Some have argued that the decision of the Bankruptcy Court in determining the liability of the estate may have binding effect only on the Government in a subsequent refund suit.

Under the proposed amendment, the debtor would be given a choice of prepayment forums. If the debtor so chose, the debtor could ask the Bankruptcy Court to determine individual tax liability for prepetition taxes, a determination which the Bankruptcy Court would, in any event, normally make in measuring the liability of the debtor's estate.

If the bankrupt did not choose to have personal liability determined in the Bankruptcy Court, the amendments would allow the debtor to bring a separate suit in the Tax Court. The bill makes clear that neither the government nor the debtor could rely on the decision of the Bankruptcy Court in the Tax Court action. The Tax Court would be free to reach a contrary result. Thus, the debtor could formally choose to stay out of the Bankruptcy Court in order to be free to relitigate the claim in the event the Government succeeds in the Bankruptcy Court. The debtor will follow this course in every case unless by doing so the debtor runs the risk of further liability even if the Government loses in the Bankruptcy Court. This risk is not real unless the Internal Revenue Service will actually relitigate cases it does not win in the Bankruptcy Court.

The structure embodied in the amendment to S. 2266 thus raises a significant possibility of duplicative litigation for the IRS in its determination of a single taxpayer's tax liability. The effect of current law is, in almost all cases, to consolidate all determinations of the debtor's tax liability for prepetition years in the Bankruptcy Court. Since identical facts and legal issues apply in determining the debtor's tax liability and the tax liability of the debtor's estate, we would prefer that current law be continued. The basis for the proposed amendment is concern that present law deprives the debtor of the opportunity to make a presentation in the Tax Court. We believe that taxpayers are allowed a hearing in Tax Court so that they will have a prepayment forum. The debtor in bankruptcy has such a forum in the Bankruptcy Court. Also, we believe that the structure of current law could be retained while granting to most debtors -- those whose estates have little or no assets -- the right to go into Tax Court.

3. Section 507. Priorities. S. 2266 provides a significant advance over current law by indicating more clearly the priority which various tax liabilities will be given in bankruptcy. The proposed amendments in this section are important because they eliminate various devices which taxpayers have used to thwart the purposes of the priority rules in bankruptcy. In general, the priority of taxes depends on their age -- many old taxes (those that are more than 3 years old) do not receive priority and, under the general rule

which coordinates priority and discharge, are discharged through bankruptcy. Very often a tax becomes "stale" because the Government and the taxpayer are negotiating the taxpayer's potential liability. Taxpayers who wish to take advantage of this rule have entered into such negotiations for the purpose of transforming their liability into a "stale" tax liability. Once the tax has been sufficiently aged, the taxpayer is able to go into bankruptcy to discharge the tax liability.

The proposed amendment would preclude that possibility. Under the amendment, if an offer in compromise is withdrawn by the debtor, or rejected by a Governmental unit, within 240 days before the petition date, the tax involved will receive sixth priority as long as the tax would have been entitled to priority had the bankruptcy case begun when the offer was originally submitted. This is a useful addition to the rules in order to prevent abuse.

4. Section 523. Nondischargeable taxes. This section of S. 2266 provides that priority taxes will not be discharged. However, proper exceptions are made to the general rule coordinating priority and discharge of tax liabilities. These exceptions are for taxes as to which the debtor had not filed a required return as of the date the bankruptcy petition was filed, for certain taxes as to which a late return was filed within three years before the petition, and for taxes with respect to which the debtor filed a fraudulent return or as to which the debtor fraudulently attempted to evade or defeat any tax. A proposed amendment to this section, coupled with a proposed amendment to section 507, will help determine in a reasonable fashion the proper treatment of liabilities for taxes as to which a deferred payment plan had been negotiated between the debtor and a taxing authority prior to bankruptcy.

The proposed amendments add a rule that if the Service fails to file a timely proof of claim for a prepetition tax liability of the debtor, any later collection which the Service makes from the debtor's after-acquired assets and exempt and abandoned property must be reduced by the amount of that debt that could have been paid from property of the debtor's estate if the tax authority had filed a timely claim. In general, the Service will fail to file a proof of claim only in a "no asset" case. It should be stressed that

the rule provides an exception to its application where the taxpayer's nondischarged liability results from fraud or the failure to file, or late filing of, a return.

5. Section 728. Special tax provisions in liquidations. This section provides special tax provisions concerning the treatment of debt liquidation cases under State and local tax laws. For the reasons stated in connection with section 346, this provision should be deleted at this time. Comparable provisions which would also apply to Federal taxes will be dealt with in later legislation.

6. Section 1146. Special tax provisions in reorganizations. To the extent the provisions of S. 2266 deal with the tax rules under State and local law, they should be deleted for the reasons discussed in connection with sections 346 and 728.

The proposed amendments would delete provisions in S. 2266 which permit the Bankruptcy Court to "declare" the tax effects of a reorganization plan following a request for a private ruling made to the taxing authority. We support this deletion. The provision would have created serious administrative problems because the IRS could have been required to respond to many alternative proposed plans in a single reorganization. It would also have allowed creditors in a bankruptcy reorganization to have the tax effects of a plan determined by a court before the plan went into effect. Under the amendment, creditors participating in a bankruptcy reorganization will simply make the same kinds of business decisions that other businessmen make outside the bankruptcy context.

7. Section 1331. Special tax provisions in wage earner plans. We agree with the proposed amendments to this section, which subject the collection of nondischargeable taxes after bankruptcy to the normal restrictions on assessment and collection of taxes, and which indicate that the payment of nondischargeable taxes under a wage earner plan are generally subject to other rules for wage earner plans.

II. OTHER PROPOSED AMENDMENTS

Before this Subcommittee for consideration are several amendments on tax-related matters which appear in sections of the bill which have not been referred specifically to the Finance Committee. Because the Finance Committee may want to suggest further amendments to the bill in these areas, we would like to offer our comments on these proposals.

As in the case of the amendments to the seven sections which were specifically referred to the Finance Committee, we believe the amendments before you reach appropriate positions reconciling the conflicting purposes of tax and bankruptcy law.

1. Section 108. Extensions of the statute of limitations. The amendment here is a technical one, making clear in the statute what the Judiciary Committee in its report on S. 2266 indicates should be the rule regarding the effect of bankruptcy on the running of the statute of limitations with respect to the collection of assessed taxes by levy or suit.

2. Section 506. Avoidance of certain liens. Under S. 2266, tax liens would be automatically voided if the Internal Revenue Service fails to file a proof of claim and the claim is therefore not allowed (unless the Service had no notice or knowledge of the case). Under the proposed amendment, failure of the Service to file a proof of claim would not cause a tax lien securing the claim to be void if the tax claim is nondischargeable. As indicated before, the Service will often fail to file a proof of claim in a "no asset" case. If the rule in S. 2266 were adopted, the Service would be required to file a proof of claim in all these cases in order to maintain its liens. This would be nothing more than useless paperwork. Accordingly, we support the proposed amendment.

3. Section 511. Federal unemployment tax (FUTA) credit. Under the Internal Revenue Code, the tax credit against the Federal unemployment tax for payments into a State compensation fund is normally reduced in the case of a late contribution to the State fund. S. 2266 provides that the credit will not be reduced if a trustee in bankruptcy makes a late payment, since the trustee may be barred by the

bankruptcy proceedings from making a timely payment of the State contribution. The amendment to S. 2266 would expand this rule so that in the case of a prepetition FUTA credit which would have been available to the debtor absent late payment, the Federal Government's claim attributable to a reduction of such credit because of a late payment would be treated as a tax claim which is not entitled to priority. Although we might have preferred a more stringent rule in this area, we defer to the bankruptcy policy considerations which have led to the expansion of this rule as embodied in the amendment.

4. Section 522. Collection of taxes from exempt assets. The proposed amendment would make it clear that taxes may be collected out of exempt property, even if the property had been subject to a lien for taxes that was avoided by the debtor or the trustee. The authority to collect taxes out of exempt property is an important one, and this clarification supports the general structure which allows for such collections.

5. Section 541. Property of the estate. One proposed amendment to this section would make clear that property of the estate includes a refund of any tax arising from the carryback of a loss or a credit of the debtor to a taxable year before the first taxable year of the estate. This is a useful clarification of the statute.

This section would also be amended to state specifically that property of the estate does not include certain "trust fund taxes," including amounts withheld from the wages of employees and sales taxes collected by a retailer. It seems inappropriate for other creditors to collect their debts from such amounts, which the debtor does not receive for the debtor's own account. If S. 2266 is amended as proposed there will be a conflict between S. 2266 and H.R. 8200 in this area. We would hope that, at least in a case where these amounts are placed in a segregated trust account, the amounts would not be considered property of the estate.

6. Section 1325(c). Payment of taxes in wage earner plans. The proposed amendment would require that tax debts be paid in cash under a wage earner plan. As a general rule, it is very important for the proper administration of the tax laws that taxes be paid in cash rather than in kind. The

debtor or the trustee is in a better position than the Internal Revenue Service to dispose efficiently of property in the estate, and payments in kind to the IRS should not be encouraged in the bankruptcy context. Accordingly, we strongly support this amendment.

III. DIFFERENCES BETWEEN H.R. 8200 AND S. 2266

In a number of tax-related areas, S. 2266 differs significantly from H.R. 8200. We think it is important for the Committee to be cognizant of these areas, and to understand why we prefer the approach taken in S. 2266.

1. Section 507. Priorities. Under S. 2266, like current law, any taxes that a debtor was required to withhold from wages or collect from customers and turn over to the Government would be entitled to priority and be nondischargeable regardless of age. In contrast, H.R. 8200 would deny priority for, and make dischargeable, liabilities for such "trust fund" taxes if the accompanying return was due more than two years before bankruptcy.

Withheld taxes differ from other taxes payable by a debtor, and by law they must be held in special trust for the Government. Nevertheless, delinquency in this area is continually increasing and represents a serious problem. The Senate bill's treatment of the priority and dischargeability of trust fund taxes appropriately reflects the special nature of this form of liability and the serious breach of public trust which results when such funds are used to pay other creditors prior to bankruptcy. Accordingly, the Treasury Department supports the approach taken in the Senate bill.

Another difference between the Senate and House bills is that the former recognizes that collection efforts generally do not commence until a liability is assessed. Absent an extension of the statute of limitations, the assessment must usually be made within three years of the filing of the return. But under current law and under the House bill, a tax may lose priority and be dischargeable although the Service never had any realistic opportunity to collect. The Senate bill ameliorates this problem by affording priority to a tax and forbidding its discharge when the tax assessment was made within 240 days before the bankruptcy petition was

filed, but only if the assessment was made within three years of the due date of the return. This relatively modest change of current law will be helpful in curing present abuses and we strongly endorse this provision.

2. Section 522. Exemptions. Under current law, tax authorities are permitted to collect both nondischargeable and dischargeable taxes from exempt property. Under H.R. 8200, only nondischargeable taxes are collectable from a debtor's exempt property. Under both the Senate and the House bills, the debtor is permitted to elect exemptions under state laws which may be quite generous. There is no reason to restrict the rule of present law which allows collection of all taxes from exempt property. Accordingly, we support the version in S. 2266.

3. Section 547. Preferences. Under H.R. 8200, it is not stated explicitly that pre-petition tax payments are not preferential transfers which can be avoided by the trustee. S. 2266 makes clear that the preference rules may not be applied to tax payments. Since the Government is an involuntary creditor that must continue to extend credit regardless of past non-payment by the debtor, the general evil at which the preference rules are addressed does not apply to a taxing authority. Accordingly, it is appropriate that the preference rules not be applied to tax payments. It is important that this issue be made clear in the statute itself, as S. 2266 does.

4. Section 1130 (section 1129 of H.R. 8200). Confirmation of plan. Under H.R. 8200, a taxing authority could be paid in property other than cash on its claims. As indicated before, the trustee is in a better position than the Internal Revenue Service to dispose of property in the estate. It would be extremely difficult for the Government to monitor and properly dispose of such property at full value. S. 2266 makes clear that the Government is to be paid in cash for its priority taxes. This is an important and appropriate result, which we strongly support.

IV. OTHER POSSIBLE AREAS FOR AMENDMENT OF S. 2266

There are a number of sections in S. 2266 which may profit from further technical improvements. We are discussing these issues with the staffs of your Committee and of the Joint Committee on Taxation, and expect to resolve them.

There is one issue which we would bring to your attention at this time, however. Under S. 2266, the Government may receive property in kind in payment of its non-priority taxes. As indicated above, the trustee of an estate is generally in a better position than the Internal Revenue Service to dispose of property in the estate. Because of restrictions on the flexibility granted to the Government in its disposition of property, the Internal Revenue Service may not be able to obtain full fair market value for property it receives. Moreover, when the property it receives consists of stock or securities of a newly reorganized corporation, the Government may be placed in the inappropriate position of owning an equity interest (or a creditor's interest which is, in effect, an equity interest) in a private enterprise. Such a position could lead to the appearance of impropriety in the Government's dealings with the newly-reorganized debtor and its competitors. This result must be avoided. Accordingly, we would recommend that S. 2266 provide that all tax payments be made in cash rather than in kind.

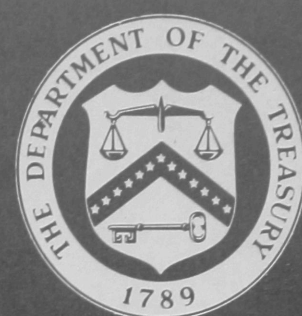
V. CONCLUSION

In summary, we believe that the tax-related provisions in S. 2266, if amended in the manner suggested by the proposed amendments before you, will provide a reasonable and appropriate compromise between the conflicting policies of tax and bankruptcy law. We believe the amendments before you, taken as a whole, represent a useful improvement to S. 2266 in those areas where the tax and bankruptcy laws interact in the administration of a debtor's estate.

I am authorized to say that the Justice Department agrees with the views expressed in this statement.

I would be pleased to try to answer any questions that you might have.

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



FOR IMMEDIATE RELEASE
August 3, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY STARTS ANTIDUMPING INVESTIGATION OF HOUSEHOLD LIGHT BULBS FROM HUNGARY

The Treasury Department today announced it has started an antidumping investigation of imports of household light bulbs from Hungary.

Treasury's action followed a summary investigation conducted by the U. S. Customs Service after receipt of a petition filed by Westinghouse Electric Co. alleging that the Hungarian manufacturer is dumping household light bulbs in the United States. The petitioner claims that Hungarian light bulbs are sold in this country at lower prices than in the home market.

Although the petitioner also claimed injury from these imports, the Treasury has expressed "substantial doubt" of the injury and has referred the case to the U. S. International Trade Commission for a determination within 30 days of whether there is any reasonable indication of injury from these imports. If the Commission finds there is no reasonable indication of injury, the antidumping investigation will be terminated immediately; otherwise, the investigation will continue.

If, after a full investigation, the Treasury finds sales at "less than fair value," the Commission will again consider the question of injury in a full 90-day investigation of that issue. Both sales at "less than fair value" and "injury" must be determined before a dumping finding is reached.

Notice of the start of this investigation will appear in the Federal Register of August 7, 1978.

Imports of household light bulbs from Hungary during calendar year 1977 were valued at approximately $4 million.

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B-1088

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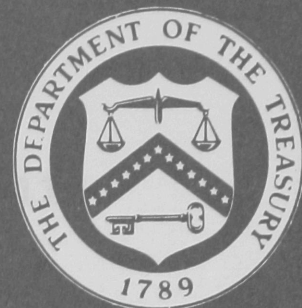


FOR IMMEDIATE RELEASE
August 3, 1978

Contact: Alvin Hattal
566-8381

TREASURY DEPARTMENT FINDS MOTORCYCLES
FROM JAPAN SOLD HERE AT LESS
THAN FAIR VALUE

The Treasury Department announced today that it has determined that motorcycles imported from Japan are being sold in the United States at "less than fair value" as defined by the Antidumping Act. For purposes of this action, the term "motorcycles" means those motorcycles having engines with total piston displacement over 90 cubic centimeters (cc), whether for use on or off the road.

This affirmative determination affects all Japanese motorcycle manufacturers except Suzuki Motor Co., Ltd. Suzuki was excluded from the determination on the basis that its sales to the U.S. were at margins below home market prices that are legally de minimis, or insignificant. Virtually all other motorcycle imports from Japan are produced by Honda, Kawasaki and Yamaha, and weighted average margins of sales below fair value in their cases were, respectively 2.9, 7.26 and 1.98.

(over)

B-1089

The case is being referred to the U.S. International Trade Commission, which must decide, within 90 days, whether a U.S. industry is being, or is likely to be, injured by these sales. If the ITC's decision is affirmative, dumping duties will be collected on those sales found to be at "less than fair value".

Sales at less than fair value generally occur when the prices of the merchandise sold for export to the United States are less than the prices of the same merchandise sold in the home market. Interested persons were offered the opportunity to present oral and written views prior to this determination.

Notice of this action will appear in the Federal Register of August 8, 1978.

Imports of motorcycles from Japan were valued at $484 million during calendar year 1977.

* * *

APP-2-04-O:D:T-RR-11f

DEPARTMENT OF THE TREASURY
OFFICE OF THE SECRETARY

MOTORCYCLES FROM JAPAN

ANTIDUMPING

DETERMINATION OF SALES AT LESS THAN FAIR VALUE AND EXCLUSION FROM INVESTIGATION

AGENCY: United States Treasury Department

ACTION: Determination of Sales at Less Than Fair Value and Exclusion from Investigation

SUMMARY:

This notice is to advise the public that an antidumping investigation has resulted in a determination that motorcycles from Japan are being sold at less than fair value. Sales at less than fair value generally occur when the price of merchandise for exportation to the United States is less than the price of such or similar merchandise sold in the home market or to third countries. This case is being referred to the United States International Trade Commission for a determination whether such sales have caused or are likely to cause injury to an industry in the United States.

EFFECTIVE DATE:

(Date of publication in the Federal Register.)

FOR FURTHER INFORMATION CONTACT:

Richard Rimlinger, U.S. Customs Service, Office of Operations, Duty Assessment Division, Technical Branch,

1301 Constitution Avenue, N.W., Washington, D.C., 20229, telephone (202) 566-5492.

SUPPLEMENTARY INFORMATION:

On June 8, 1977, information was received in proper form pursuant to sections 153.26 and 153.27, Customs Regulations (19 CFR 153.26 and 153.27), indicating that motorcycles from Japan are being, or are likely to be, sold at less than fair value within the meaning of the Antidumping Act, 1921, as amended (19 U.S.C. 160 et seq.) (referred to in this notice as "the Act"). This information was submitted by counsel acting on behalf of the Harley-Davidson Motor Co., Inc., a subsidiary of AMF, Inc. On the basis of this information and subsequent preliminary investigation by the Customs Service, an "Antidumping Proceeding Notice" was published in the Federal Register of July 15, 1977 (42 F.R. 36584).

Pursuant to section 201(b)(2) of the Act (19 U.S.C. 160(b)(2)), notice was published in the Federal Register of January 20, 1978 (43 F.R. 3968), stating that the Secretary had concluded that the determination provided for in section 201(b)(1) of the Act (19 U.S.C. 160(b)), could not reasonably be made within 6 months. The determination under section 201(b)(1) of the Act (19 U.S.C. 160(b)(1)) was, therefore to be made within no more than 9 months.

A "Withholding of Appraisement Notice" was published in the Federal Register of April 26, 1978 (42 F.R. 17900-02).

For purposes of this notice, the term "motorcycles" means motorcycles having engines with total piston displacement over 90 cubic centimeters, whether for use on or off the road.

FINAL DETERMINATION OF SALES AT LESS THAN FAIR VALUE

On the basis of information developed in Customs' investigation and for the reasons noted below, I hereby determine that motorcycles from Japan, other than those produced and sold by Suzuki Motor Co., Ltd., are being sold at less than fair value within the meaning of section 201(a) of the Act (19 U.S.C. 160(a)). In the case of motorcycles from Japan produced and sold by Suzuki Motor Co., Ltd., I hereby exclude such merchandise from this determination.

STATEMENT OF REASONS ON WHICH THIS DETERMINATION IS BASED

The reasons and bases for the above final determination are as follows:

a. Scope of the Investigation. It appears that virtually all imports of the subject merchandise from Japan were manufactured by Honda Motor Company, Ltd., Yamaha Motor Co., Ltd., Kawasaki Heavy Industries, Ltd., and Suzuki Motor Co., Ltd. Therefore, the investigation was limited to these manufacturers.

B. Basis of Comparison. For the purpose of considering whether the merchandise in question is being, or is likely to be, sold at less than fair value within the meaning of the Act, the proper basis of comparison, with the exception of one model sold by Honda Motor Co., Ltd. (the GL 1000 K2), is between exporter's sales price and the home market price of such or similar merchandise on all sales.

In the case of Honda model GL 1000 K2, the proper basis of comparison was between exporter's sales price and sales of such merchandise sold in a third country. Exporter's sales price as defined in section 204 of the Act (19 U.S.C. 163) was used since sales by all four manufacturers were made to U.S. firms related to those manufacturers within the meaning of section 207 of the Act (19 U.S.C. 166).

Home market price, as defined in section 153.2, Customs Regulations (19 CFR 153.2), was used since such or similar merchandise, with one exception, was sold in the home market in sufficient quantities to provide a basis for fair value comparisons. Third country sales, as defined in section 153.3, Customs Regulations (19 CFR 153.3), were used for Honda model GL 1000 K2 since, upon advice of an independent technical consultant, the Treasury Department has determined that there were no sales in the Japanese home market of such or similar merchandise within the meaning of section 212(3) fo the Act (19 U.S.C. 171(3)).

Sales of the GL 1000 K2 to Canada were selected for fair value comparisons, since the Canadian model was virtually identical to the United States model and was, thus, considered to be "such or similar " within the meaning of section 212(3)(A) of the Act. Accordingly, no comparisons were made under section 212(3)(B) with merchandise sold in other third countries.

In accordance with section 153.31(b), Customs Regulations (19 CFR 153.31(b)), pricing information was obtained concerning imports from Japan sold in the United States during the 8-month period November 1, 1976, through June 30, 1977, and Canadian and home market sales of motorcycles during the period corresponding to the dates of export of those motorcycles sold in the United States during the above 8-month period.

c. Exporter's sales price. For the purposes of this determination of sales at less than fair value, all of the merchandise was sold or agreed to be sold in the United States, before or after the time of importation, by or for the account of the exporter, within the meaning of section 207 of the Act. Accordingly, the exporter's sales price was calculated based on prices to unrelated U.S. dealers with deductions for Japanese inland freight and insurance, U.S. duty, U.S. port handling, U.S. inland freight, set-up and preparation, tires and tubes excise tax, direct advertising, co-op advertising,

discounts, rebates, selling expenses and sales promotion, as appropriate. An addition was made for the Japanese commodity tax incurred with respect to home market sales but not collected or rebated by reason of exportation to the United States, in accordance with section 204 of the Act (19 U.S.C. 163).

After the Tentative Determination, information was presented indicating that respondents might have paid rebates after the investigatory period in connection with motorcycles sold during the period, in addition to the rebates disclosed to the Customs Service in the course of its investigation. Respondents were requested to supplement their responses to report any such additional rebates. Some supplementary information has been received, and taken into consideration in the calculation of exporter's sales price. A further Customs verification effort directed to the question of unreported rebates is underway. Should it reveal the existence of additional unreported rebates, this Final Determination of Sales at Less than Fair Value will be amended, as appropriate.

d. Home Market Price. For the purposes of this determination of sales at less than fair value, the home market prices have been calculated on the basis of the weighted-average prices to unrelated dealers. Adjustments were made for inland freight, owners'

manuals, rebates, discounts, warranty costs, financing expenses, selling expenses, sales promotion, and direct advertising, with an addition for cost of export packing, as appropriate, in accordance with section 153.10, Customs Regulations (19 CFR 153.10). Adjustment was made for differences in merchandise sold in the two markets, as appropriate, in accordance with section 153.11, Customs Regulations (19 CFR 153.11).

(i) Model Year Adjustment. It has been claimed by counsel for certain of the respondents that, with respect to 1974, 1975 and 1976 model year motorcycles sold during the investigatory period, an adjustment should be made to account for the fact that these motorcycles were considered "current" when sold in Japan, where motorcycles are not marketed by model year designations, but were not considered "current" when sold in the United States, where this merchandise is sold by model year designation.

Counsel for petitioner has claimed that discounts given in connection with sales of certain prior model year Japanese motorcycles are not "customary" in the United States market, and that such a "custom", if it existed, was established by respondents in order to sell excess inventory and was unrelated to the fact that these motorcycles were of a prior model year.

An adjustment of the type here claimed by respondents must be predicated upon a practice of discounting prior model year motorcycles. This practice must be shown to be consistent, both as to timing of the discount to coincide with the introduction of new model year motorcycles and as to the amount of the discount. Further, such a practice must be shown to be carried out in response to consumer perception that prior model year motorcycles will be discounted. However, the recent introduction of such a practice or custom will not prevent its recognition.

Based on the evidence presented on the above points, it has been concluded that the adjustment must be denied. The introduction of new models did not result in an automatic reduction of prices on prior models as part of the alleged custom. Older models were discounted at varying times and in varying amounts and in connection with various promotional programs unrelated to the introduction of new models. Further, when older models constitute a substantial portion of sales (in this case for some exporters from 26 to 58 percent of all sales made in the period of investigation) and, in some cases, continue to be shipped after the introduction of new models, the sales of prior model year motorcycles may not be disregarded in assessing the exporter's sales policies.

(ii) <u>Valuation of "differences" in merchandise</u>. Section 153.11, Customs Regulations (19 CFR 153.11), provides that in making comparisons between similar merchandise, due allowance shall be made for differences in

the merchandise. Primarily, such allowance will be based upon differences in the cost of manufacture, including differences in the costs of materials, labor and direct factory overhead. Counsel for petitioner has claimed that such adjustment must be made based on the costs of producing differences in the merchandise which have been previously identified. Counsel for certain of the respondents have urged that the adjustment may be determined by simply comparing the total of all costs of producing the two similar products.

It has been concluded that the methodology urged by the respondents may distort the adjustment by introducing cost differences totally extraneous to, and which do not result from, the objective differences in the merchandise. The adjustments for differences in the merchandise have, therefore, been based on those cost differences directly attributable to the objective differences in the merchandise.

During the extended investigatory period, information was requested concerning direct factory overhead expenses applicable to the cost of manufacture of motorcycles sold to the United States and similar merchandise sold in the home market, and if applicable, third countries. This information has been analyzed prior to the Final Determination and has been utilized in determining differences in cost of manufacture of similar merchandise in the two markets, under Section 153.11.

(iii) Advertising Adjustment.

The Withholding of Appraisement Notice in this case stated:

> Petitioner has claimed that advertising expenses directed to the promotion of sales of a particular motorcycle should be deducted form the price of that particular model, rather than allocated over the entire class or kind of merchandise subject to the investigation. While it has been concluded that this claim is well-founded, it has not been possible to perform the necessary recalculations in time for this Tentative Determination. This will be done prior to the Final Determination.

This statement was intended to reflect the dual concepts of section 153.10(b), Customs Regulations (19 CFR 153.10(b)), relating to adjustments for differences in circumstances of sale: First, allowable expenses under that provision must bear a direct relationship to the sales which are under consideration, and may not be items of general overhead attributable to all of a company's sales; second, allowable advertising expenses under that provision must be attributable to a later sale of the merchandise by a purchaser.

The concepts in section 153.10(b) have been interpreted in previous Treasury practice to mean:

1. The expense must have been incurred with respect to the particular product in question, rather than benefiting the sales of more than one product, the company's entire product line or its institutional image.

2. The expense must have been incurred with respect to the particular geographic market in question, rather than benefiting sales in all markets or markets not under consideration.

3. The expense must relate to materials or advertising media directed to purchasers in later sales; in effect, they must represent an assumption of a cost by the producer that would otherwise be borne by the customer of the producer.

In the instant case, each respondent has stated that it does not maintain records of expenditures in a way which would enable a determination of the advertising expenses incurred with respect to each model of motorcycle sold. Rather respondents' evidence establishes that funds were expended in respect of sales of "motorcycles", and then allocated by value of sales to types of motorcycles. In this case, the allocations of such expenses to models and markets made by each respondent, have been determined to be appropriate.

(iv) Adjustment for currency value changes

Counsel for petitioner has requested that Treasury examine whether prices of the subject merchandise have been revised to reflect fully increases in the value of

the Japanese yen during the time subsequent to the conclusion of the investigatory period, i.e., June 30, 1977. It is not normally possible, nor generally is it Treasury policy, to examine pricing behavior subsequent to the investigatory period, other than in the context of considering a request for a discontinuance of investigation under section 153.33, Customs Regulations (19 CFR 153.33). Under that section, an investigation may be discontinued if no more than "minimal" margins are found, if assurances of no further sales at less than fair value are received, and if the exporter has, in fact, revised prices so as to eliminate sales at less than fair value. None of the three companies, with respect to which sales at less than fair value in more than a de minimis amount have been found, have margins which would be considered "minimal" under existing Treasury practice. Should, however, information be received which would necessitate a revision of the findings of margins set forth in this notice to a level considered minimal, it will be necessary, in view of the significant change in the value of the yen since June 1977, to scrutinize closely the evidence submitted by respondents of the current pricing in the two relevant markets.

e. Third Country Sales. During our extended investigatory period, additional information was obtained in connection with the comparability of merchandise sold to the United States with that sold in the home market. This information has been reviewed and analyzed by a

special consultant selected by the U.S. Customs Service for this purpose. As a result of his analyses, the determination was made that there were no sales of motorcycles in the home market which were considered to be "such or similar" to Honda Model GL 1000 K2 within the meaning of section 212(3) of the Act. Therefore, third country sales of this model were examined.

Since the GL 1000 K2 sold to Canada was virtually identical to the United States model, Canadian sales information was obtained and verified. For the purposes of this determination of sales at less than fair value, third country sales price has been calculated on the weighted-average prices to unrelated Canadian dealers. Adjustments were made for: Japanese inland freight, in-transit storage costs, Japanese brokerage and handling, ocean freight, marine insurance, Canadian duty, Canadian customs brokerage, Canadian inland freight, Canadian harbor charges, Canadian local delivery and miscellaneous charges, Canadian federal sales and excise taxes, cash and early payment discounts, and an offset to U.S. selling expenses deducted from exporter's sales price. Also, an adjustment

was made for a *de minimis* difference in the merchandise sold in the two markets, in accordance with section 153.11, Customs Regulations (19 CFR 153.11). However, so minor an adjustment on a product of such value does not prevent the consideration of the merchandise under section 212(3)(A) of the Act and obviates

the need to consider merchandise in other countries under section 212(3)(B).

f. Result of Fair Value Comparisons. Using the above criteria, exporter's sales price was found to be lower than the home market and third country price of such or similar merchandise. Comparisons were made on approximately 90 percent of the total sales of the subject merchandise to the United States by all manufacturers investigated for the period under investigation. Margins were found on approximately 18.8 percent of the sales ranging from 0.9 to 54 percent resulting in a weighted-average margin of 2.59 percent on all sales compared. Weighted-average margins found with respect to the companies under investigation, computed over all sales compared, were as follows: Honda, 2.9 percent; Kawasaki, 7.26 percent; Yamaha, 1.9%; and Suzuki, 0.28 percent.

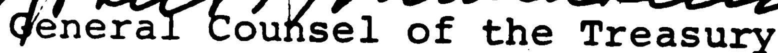
In the case of Suzuki, the weighted-average margin is considered to be *de minimis*.

The Secretary has provided an opportunity to known interested persons to present written and oral views pursuant to section 153.40, Customs Regulations (19 CFR 153.40).

The U.S. International Trade Commission is being advised of this determination.

The order issued April 26, 1978, to withhold appraisment on the subject merchandise from Japan, the notice of which is cited above, is hereby terminated with respect to Suzuki, effective upon publication of this notice.

This determination is being published pursuant to section 201(d) of the Act (19 U.S.C. 160(d)).

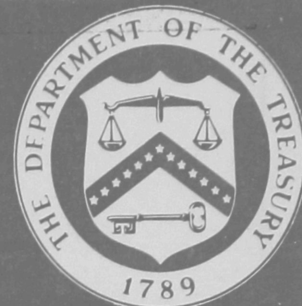


General Counsel of the Treasury

AUG 3 1978

Robert H. Mundheim

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



FOR IMMEDIATE RELEASE
August 4, 1978

Contact: Charles Arnold
202/566-2041

TREASURY RESUMES SALES OF SAVINGS BONDS

The Treasury Department today authorized the resumption of sales of U.S. Savings Bonds, state and local series securities-- so-called special arbitrage securities-- and other types of Treasury securities, effective August 3, 1978. This action was made possible by the passage of legislation providing a temporary increase in the public debt limit.

In the absence of legislation to increase the public debt limit, the government had lacked authority to issue new debt obligations. Notice of the resumption of sales is being given to all Federal Reserve banks and 40,000 other issuing agents throughout the country.

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CORMAN-FISHER AMENDMENT TO WAYS AND MEANS BILL

This amendment to the Ways and Means tax bill contains the following features:

- The Committee bill cuts individual taxes through bracket widening, an increase in the standard deduction, selected rate cuts, and an increase in the personal exemption to $1,000. The amendment would replace these changes with a modified rate schedule and an increase in the general credit from $35 to $100 per exemption.

- The amendment would preserve the provisions of the Committee bill that set a 35 percent maximum rate on capital gains, exclude gains on home sales, and eliminate the existing minimum tax on capital gains. But in place of the Committee's micro-mini tax on capital gains, the amendment would place a new limitation on the amount of capital gains that could be deducted from the regular tax base.

  One-half of total capital gains can now be excluded from income even though the remaining half may be sheltered by ordinary losses. Under the proposal, the special exclusion for capital gains would generally be limited to the amount of capital gains subject to tax. This new limitation could never reduce the amount of excluded gains below $5,000 nor would it apply in a manner to reduce the benefits of charitable deductions.

Advantages of Amendment

The bill, as amended, would have a revenue cost similar to the original Ways and Means bill ($18.0 billion in CY 1979 compared to $16.1 billion in the Committee bill). The proposed changes would improve the bill in the following respects:

- The amendment would provide greater tax relief than the Committee bill for all income classes through $50,000.

- The amendment would provide the same capital gains relief to unsheltered taxpayers as the Committee bill, but at a revenue cost $300 million less. Taxpayers who have ordinary income exceeding ordinary losses would be unaffected by the amendment and would pay no minimum tax.

- At the same time, the amendment would build upon the Committee bill to provide a true alternative minimum tax. Under the Committee bill, individuals with millions of dollars of capital gains and no regular tax liability would pay a micro-mini tax of no more than 5 percent on their gains. The capital gains tax for these persons might rise to 17-1/2 percent under the true alternative tax (although the usual rate in such cases would be 10-12 percent).

- In contrast to the micro-mini tax approach in the Committee bill, this amendment would have no negative impact on incentives for charitable giving.

Income Tax Burdens under Present Law, the Ways and Means Committee Bill and the Corman-Fisher Amendment 1/

Four-person, One-earner Families

(dollars)

Wage income	Present law income tax	Changes in Income Tax: Under Ways and Means Committee Bill	Changes in Income Tax: Under Corman-Fisher Amendment
$ 7,200 2/	0	0	0
10,000	446	-62	-260
15,000	1,330	-77	-229
20,000	2,180	-146	-228
25,000	3,150	-232	-308
30,000	4,232	-304	-423
40,000	6,848	-486	-654
50,000	9,950	-654	-700
100,000	28,880	-924	-700
Addendum:			
Tax-free income levels	7,200	7,400	8,888

Office of the Secretary of the Treasury
Office of Tax Analysis

August 4, 1978

1/ Tax burdens assume deductible expenses equal to 23 percent of income.

2/ Excludes the earned income credit.

Ten Examples of High Income Taxpayers Who Presently Pay No Regular Tax

	1	2	3	4	5	6	7	8	9	10
Capital gains before 50% exclusion	2,336,914	2,184,982	2,634,860	793,076	1,603,953	1,117,313	1,347,515	876,746	558,994	1,631,290
Adjusted gross income	-327,290	-2,566	-328,709	-48,100	-288,633	-93,051	32,865	23,242	-68,273	-177,724
Capital gains after 50% exclusion	1,168,457	1,092,491	1,354,155	396,538	801,977	558,657	673,758	438,135	279,497	815,645
All other income	-1,495,747	-1,095,057	-1,682,864	-444,638	-1,090,610	-651,708	-640,892	-414,893	-347,770	-993,369
Preference income:										
Excluded capital gains	835,315	1,079,075	947,499	172,316	491,813	393,236	673,758	239,387	206,523	256,382
Other preference income	0	0	0	0	0	0	0	0	0	0
Current law tax:										
Regular tax	0	0	0	0	0	0	0	0	0	-133 a/
Minimum tax	123,832	160,984	140,278	23,659	72,092	57,305	99,564	34,408	29,408	36,777
Total	123,832	160,984	140,278	23,659	72,092	57,305	99,564	34,408	29,408	36,644
Effective tax rate b/	5.3%	7.4%	5.3%	3.0%	4.5%	5.1%	7.4%	3.9%	5.3%	2.2%
Tax under Committee Bill:										
Regular tax	0	0	0	0	0	0	0	0	0	0
Micro-Mini Tax (10 percent)	82,531	106,907	93,750	15,544	48,001	38,144	66,376	22,939	19,582	24,458
Total	82,531	106,907	93,750	15,544	48,001	38,144	66,376	22,939	19,582	24,325
Effective tax rate	3.5%	4.9%	3.6%	2.0%	3.0%	3.4%	4.9%	2.6%	3.5%	1.5%
Tax under Corman/Fisher:										
Regular tax	144,833	345,628	325,110	35,236	139,630	90,396	204,917	38,646	44,736	59,145
Minimum tax	0	0	0	0	0	0	0	0	0	0
Total	144,833	345,628	325,110	35,236	139,630	90,396	204,917	38,646	44,736	59,145
Effective tax rate	6.2%	15.8%	12.3%	4.4%	8.7%	8.1%	15.2%	4.4%	8.0%	3.6%
Change in tax over current law tax:										
Committee Bill	-41,301	-54,077	-46,528	-8,115	-24,091	-19,161	-33,188	-11,469	-9,826	-12,319
Corman/Fisher	21,001	184,644	184,832	11,577	67,538	33,091	105,353	4,238	15,328	22,501

Office of the Secretary of the Treasury, Office of Tax Analysis — August 7, 1978

a/ Taxpayer qualified for earned income credit.
b/ Tax as percent of capital gains before 50 percent exclusion.

DESIRABILITY OF A TRUE ALTERNATIVE MINIMUM TAX APPROACH

Question: The existing minimum tax on capital gains has been widely criticized. The Ways and Means Committee eliminated the existing minimum tax on capital gains and substituted a new micro-mini tax provision. Why didn't the Ways and Means bill solve the problems?

Answer: The Committee bill solves one problem and exacerbates another. The Corman-Fisher amendment solves both problems.

Impact on persons with significant tax liability. Since the current minimum tax can be imposed on capital gains even when an individual has a significant regular tax liability, it has increased the capital gains taxes for many individuals who are already paying a relatively high rate of tax. For some persons, the minimum tax can now raise the effective capital gains tax rate from 35 percent to 39-7/8 percent.

- The Committee bill and the Corman-Fisher amendment both eliminate the minimum tax for these individuals and lower the top capital gains rate to 35 percent.

Tax-sheltered individuals. The current minimum tax has little impact on persons who use tax losses to shelter capital gains from all regular tax liability. Many individuals now have a total tax liability of 7-1/2 percent or less on millions of dollars of capital gains.

- The Committee bill has the undesirable effect of reducing the capital gains tax still further for many tax-sheltered individuals. For a person with no regular tax liability, the maximum capital gains rate under the micro-mini tax approach would be no higher than 5 percent regardless of whether he had $50,000 or $5,000,000 of capital gains.

- Under the Corman-Fisher proposal, a true alternative minimum tax would be applied to the capital gains of tax-sheltered individuals. The capital gains tax for these persons who now have no regular tax liability would vary in accordance with the amount of gain, with a top rate of 17-1/2 percent under the true alternative minimum tax.

IMPACT ON MIDDLE-CLASS TAXPAYERS

Question: How would the Corman-Fisher amendment affect middle-class taxpayers?

Answer: The Corman-Fisher amendment would be much more beneficial to middle-income taxpayers than would the Committee bill.

- ° Taxpayers in all income brackets through $50,000 would receive greater tax relief under the amendment.
- ° A typical family of four with income of $20,000 would save $228 under the amendment, as compared to $146 under the Committee bill. A family at the $30,000 income level would save $423 under the amendment, as compared to $304 under the Committee bill. For a family making $50,000, the amendment would increase the tax relief in the Committee bill from $654 to $700.
- ° 87 percent of the total individual relief under the Corman-Fisher proposal would go to persons with less than $50,000 of income; almost one-fourth of the relief under the Committee bill goes to taxpayers with incomes over $50,000.

IMPACT ON HOMEOWNERS

Question: What impact will the Corman-Fisher amendment have on gain realized on the sale of a home?

Answer: The Corman-Fisher amendment would retain the Committee bill's generous capital gains exclusion for homeowers.

- Taxpayers would be permitted a one-time exclusion of up to $100,000 of the gain on the sale of a home used as a principal residence for 2 years.

IMPACT ON CHARITIES

Question: Isn't the Corman-Fisher amendment very similar to other alternative minimum tax proposals that are estimated to have a substantial adverse impact on charitable giving?

Answer: The Corman-Fisher proposal has been carefully drawn to avoid any adverse impact on charities.

- Under present law, a taxpayer with $200 of capital gain can completely eliminate tax liability with $100 of ordinary deductions. Our proposal is designed to prevent tax avoidance in this manner. Such a taxpayer would offset $100 of capital gain with the deduction and would pay tax on one-half of the remaining $100 gain. However, we have kept present law with respect to charity; a $100 charitable contribution could continue to offset $200 of income from capital gain.

We have also avoided another adverse impact of some minimum tax proposals, such as the one in the Committee bill.

- Under the Committee bill, a taxpayer pays the micro-mini tax if it is higher than the regular tax. Once the taxpayer has enough deductions so that the regular tax has been reduced below the micro-mini tax, further charitable deductions will not affect his tax liability. (See attached example 5.) Corman-Fisher avoids this adverse impact on the incentive for charitable giving.

In addition, the Corman-Fisher amendment would delete the increased standard deduction from the Committee bill--a Committee provision that might have a negative effect on charities.

COMPARISON TO CORPORATE CAPITAL GAIN TREATMENT

Question: Why are you introducing such a novel system of taxing capital gains at this point?

Answer: This system is not novel. It is very similar to the current treatment of a corporation's capital gains.

- Individual taxpayers can now completely avoid tax on capital gain by excluding one-half through the capital gains deduction and sheltering the remaining half with ordinary deductions. On the other hand, corporations pay an alternative tax of 30 percent on total capital gain without regard to other deductions; corporate capital gains are taxed at a preferential rate without permitting special capital gain treatment to turn into a complete exclusion.

- Like the current corporate capital gain structure, the Corman-Fisher amendment would place some meaningful limits on the extent to which taxes can be avoided by combining the capital gains preference with shelter losses. In contrast to the Committee bill, this amendment would not permit millions of dollars of capital gains to escape all but token taxation.

- The limitation on the exclusion from capital gain as a percentage of taxable income is patterned after the limit on percentage depletion (65 percent of taxable income) adopted by the Congress in 1975.

Application of Capital Gain Proposals*

1. High Income Taxpayer With Shelter Losses

Under present law a taxpayer with capital gains of $1,600,000 and tax shelter losses of $1,000,000 pays a tax of $90,000 on capital gains. This represents less than a 6 percent rate on capital gains. The Committee bill would reduce the taxpayer's liability to $60,000 or less than a 4 percent rate on capital gains. The Corman-Fisher amendment would result in a tax liability of $178,740, about an 11 percent rate on capital gains.

	Tax Impact		
	Present Law	Committee Bill	Corman-Fisher
1. Capital gain before 50% exclusion	1,600,000	1,600,000	1,600,000
2. All other income	-1,000,000	-1,000,000	-1,000,000
3. Income before capital gain exclusion (1 and 2)	600,000	600,000	600,000
4. Capital gain exclusion	800,000	800,000	300,000
5. Taxable income (3 minus 4)	-0-	-0-	300,000
6. Regular tax	-0-	-0-	178,740
7. Minimum tax**	90,000		
8. Micro-mini tax**		60,000	
9. Total tax (6 plus 7 or 8)	90,000	60,000	178,740

---

* All calculations are made on the basis of present law rates applicable to married taxpayers filing joint returns in order to permit a comparative analysis of the capital gain changes.

** These calculations assume a tax benefit rule so that minimum tax at 15 percent (present law) or 10 percent (Committee bill) is applied only to the amount of capital gain exclusion ($600,000) necessary to reduce taxable income to zero.

2. High-Income Taxpayer Without Shelter Losses

Under present law a taxpayer with capital gains of $1,600,000 and other income of $1,000,000 pays a tax of $1,256,418. The Committee bill would reduce the taxpayer's liability to $1,228,560 by eliminating the minimum tax on the excluded portion of capital gains. The Corman-Fisher proposal would also reduce the taxpayer's liability to $1,228,560.

	Present Law	Committee Bill	Corman-Fisher
1. Capital gain before 50% exclusion	1,600,000	1,600,000	1,600,000
2. All other income	+1,000,000	+1,000,000	+1,000,000
3. Income before capital gain exclusion (1 and 2)	2,600,000	2,600,000	2,600,000
4. Capital gain exclusion	800,000	800,000	800,000
5. Taxable income (3 minus 4)	1,800,000	1,800,000	1,800,000
6. Regular tax	1,228,560	1,228,560	1,228,560
7. Minimum tax	27,858		
8. Micro-mini tax		-0-	
9. Total tax (6 plus 7 or 8)	1,256,418	1,228,560	1,228,560

3. Taxpayer With Gain on Stock

Under present law a taxpayer who has ordinary income of $30,000 and a capital gain of $40,000 from the sale of stock would pay a total tax of $16,780. Under both the Committee bill and the Corman-Fisher amendment the taxpayer would pay a tax of $15,280 and would not be subject to the minimum tax.

	Tax Impact		
	Present Law	Committee Bill	Corman-Fisher
1. Capital gain before 50% exclusion	40,000	40,000	40,000
2. Net ordinary income (salary less itemized deductions and exemptions)	30,000	30,000	30,000
3. Income before capital gain exclusion (1 and 2)	70,000	70,000	70,000
4. Capital gain exclusion	20,000	20,000	20,000
5. Taxable Income (3 minus 4)	50,000	50,000	50,000
6. Regular Tax	15,280	15,280	15,280
7. Minimum Tax	1,500		
8. Micro-mini tax		-0-	
9. Total tax	16,780	15,280	15,280

4. Taxpayer With Gain on Residence

Under present law, an individual with ordinary income of $30,000 and a capital gain of $40,000 from the sale of a residence would pay a tax of $16,780. Under both the Committee bill and the Corman-Fisher proposal, he is allowed to exclude from income the gain on the residence and would pay only a $6,488 tax.

	Tax Impact		
	Present Law	Committee Bill	Corman-Fisher
1. Capital gain before 50% exclusion	40,000	--	--
2. Net Ordinary income (salary less itemized deductions and exemptions)	30,000	30,000	30,000
3. Income before capital gain exclusion (1 and 2)	70,000	30,000	30,000
4. Capital gain exclusion	20,000	--	--
5. Taxable income (3 minus 4)	50,000	30,000	30,000
6. Regular tax	15,280	6,488	6,488
7. Minimum tax	1,500		
8. Micro-mini tax		-0-	
9. Total tax (6 plus 7 or 8)	16,780	6,488	6,488

5. Taxpayer With Charitable Contributions

Under present law, an individual with a $100,000 capital gain and losses from his business of $28,500 who makes a $15,000 contribution to charity pays a tax of $6,889. $4,250 of the charitable contribution yields no current tax deduction, and the taxpayer would receive no tax benefit in the current year if he made additional charitable contributions. Under the Committee bill, he would pay a tax of $4,000, and would receive no current tax benefit from the charitable contribution. Under the Corman-Fisher proposal he would pay only $3,304 in tax. The full $15,000 charitable contribution would reduce his tax liability in the current year, and he would receive additional current tax benefits if he increased his charitable contribution this year.

	Tax Impact		
	Present Law	Committee Bill	Corman-Fisher
1. Capital gain before 50% exclusion	100,000	100,000	100,000
2. Business Losses (other than charitable deductions)	-28,500	-28,500	-28,500
3. Income before capital gain exclusion, exemptions, and charitable deductions (1 minus 2)	71,500	71,500	71,500
4. Exemptions	1,500	1,500	1,500
5. Income before capital gain exclusion and charitable deduction (3 minus 4)	70,000	70,000	70,000
6. Capital gain exclusion	50,000	50,000	35,000
7. Adjusted Gross Income (3 minus 6)	21,500	21,500	36,500
8. Contributions actually made	15,000	15,000	15,000
9. Contributions allowed	10,750	10,750	15,000
10. Taxable income (7 minus 4 and 9)	9,250	9,250	20,000
11. Regular tax	889	889	3,304
12. Minimum tax	6,000		
13. Micro-mini tax		4,000	
14. Total tax (11 plus 12 or 13)	6,889	4,000	3,304

6. Taxpayer Aided by <u>De Minimus</u> Rule

An individual with total capital gains of $15,000 and deductions and exemptions which total $7,000 would pay no tax either under present law or under the proposals. Under present law and under the Committee bill, the capital gain exclusion would be $7,500, taxable income would be $500, and no tax would be owed. Under the Corman-Fisher proposal, the capital gain exclusion would be $5,000, taxable income would be $3,000, and no tax would be owed. Although the Corman-Fisher proposal normally limits the capital gain exclusion to one-half of income before the exclusion, which would yield an exclusion of only $4,000 in this example, the proposal never operates to limit the exclusion to less than $5,000, and the $5,000 minimum applies in this example.

	Tax Impact		
	Present Law	Committee Bill	Corman-Fisher
1. Capital gain before 50% exclusion	15,000	15,000	15,000
2. Deductions (exemptions and itemized deductions other than charitable contributions)	7,000	7,000	7,000
3. Income before capital gain exclusion (1 minus 2)	8,000	8,000	8,000
4. Capital gain exclusion	7,500	7,500	5,000
5. Taxable income (3 minus 4)	500	500	3,000
6. Regular tax	-0-	-0-	-0-
7. Minimum tax	-0-		
8. Micro-mini tax		-0-	
9. Total tax (6 plus 7 or 8)	-0-	-0-	-0-

Table 1

Comparison of Tax Liability Changes in Calendar Year 1979

($ billions)

	Ways & Means Bill	Alternative
Personal..............	-10.4	-12.7
Business..............	-3.8 1/	-3.8 1/
Capital gains.........	-1.9	-1.6
Total.........	-16.1	-18.1

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Includes revenue attributed to repeal of the general jobs credit, elsewhere included in the President's budget.

Table 2

Individual Income Tax Liabilities by Expanded Income Class
Present Law, Committee Tax Bill, and Alternative Tax Bill

(1978 Levels)

Expanded income class	Present Law		H.R. 13511			Alternative		
	Tax liability	Percentage distribution	Tax liability	Percentage distribution	Change in tax	Tax liability	Percentage distribution	Change in tax
($000)	($ millions)	(percent)	($ millions)	(percent)	($ millions)	($ millions)	(percent)	($ millions)
Less than 10	8,110	4.4%	-7,620	4.4%	-490	6,608	3.9%	-1,502
10 - 15	17,067	9.3	16,217	9.3	-849	15,406	9.0	-1,661
15 - 20	24,055	13.1	22,716	13.1	-1,339	22,309	13.0	-1,746
20 - 30	44,774	24.3	41,830	24.1	-2,944	41,345	24.2	-3,429
30 - 40	26,007	14.2	24,405	14.1	-1,672	24,005	14.0	-2,072
40 - 50	13,182	7.2	12,304	7.1	-878	12,264	7.2	-918
50 - 100	24,009	13.0	22,637	13.1	-1,372	22,998	13.4	-1,011
100 - 200	13,130	7.1	12,624	7.3	-506	12,827	7.5	-303
200 and over	13.743	7.5	13,053	7.5	-690	13,378	7.8	-365
Total	$184,148	100.0%	$173,405	100.0%	$-10,743	$171,144	100.0%	$-13,004

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 197

Note: Details may not add to totals due to rounding.

1/ Excludes basis adjustment for inflation.

Table 3

Individual Tax Change as Percent of Present Law Tax
by Expanded Income Class:
Committee Tax Bill 1/ and Alternative Tax Bill

(1978 Levels)

Expanded income class	H.R. 13511 1/	Alternative
($000)	(.................percent.................)	
Less than 10	-6.0%	-18.5%
10 - 15	-5.0	-9.7
15 - 20	-5.6	-7.3
20 - 30	-6.6	-7.7
30 - 40	-6.4	-7.9
40 - 50	-6.7	-7.0
50 - 100	-5.7	-4.2
100 - 200	-3.9	-2.3
200 and over	-5.0	-2.7
Total	-5.8%	-7.1%

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Excludes basis adjustment for inflation.

Table 4

Alternative to the Ways and Means Committee Tax Bill
Estimated Effect on Calendar Year Liabilities of Personal Income Taxes

(1978 Levels of Income)

($ millions)

Expanded income class	Repeal alternative tax	Delete capital gains as item of preference: For maximum tax	Delete capital gains as item of preference: For minimum tax	$100 thousand personal residence exclusion	Sale of personal residence within 18 months	Limit capital gains exclusion to ½ taxable income	Technical changes to earned income credit	Repeal gasoline tax deduction	Repeal political contribution deductions	Simplified medical deduction	$100 general tax credit	Reduce tax rates	Tax unemployment benefits	Total
($000)														
Less than 10	--	--	-6	- 9	*	5	-4	28	--	- 3	-1,500	- 9	*	-1,502
10 - 15	--	--	-*	-33	*	8	--	90	*	- 8	-1,544	-180	6	-1,661
15 - 20	--	--	-3	-48	*	13	--	151	*	-13	-1,521	-334	8	-1,746
20 - 30	--	--	-14	-228	-2	18	--	328	*	- 8	-2,046	-1,582	105	-3,429
30 - 40	*	--	-31	-163	-1	15	--	196	1	17	- 714	-1,470	77	-2,072
40 - 50	*	--	-35	-108	-1	8	--	79	*	13	- 260	-640	26	- 918
50 -100	14	-2	-225	-67	*	40	--	81	2	25	- 260	-636	17	-1,011
100 -200	55	-14	-208	-32	*	53	--	18	1	8	- 56	-133	6	-303
200 and over	55	-32	-636	-21	*	307	--	5	1	2	- 13	- 34	1	-365
Total	124	-47	-1,158	-709	-5	466	-4	976	5	34	-7,915	-5,016	246	-13,004

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

* Less than $500 thousand.

Table 5

Comparison of 10% Micro-Mini Tax and Corman-Fisher True Alternative Capital Gains Tax

(1978 levels of income)

	10% Micro-Mini Tax	Corman-Fisher True Alternative Tax
Revenue Gains ($ million)	148	466
Number of Taxpayers Affected (000)	49	168
Nontaxable Returns Made Taxable (000)	16	31
Impact on Charitable Giving	Yes	No

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

Table 6

Alternative to the Ways and Means Committee Tax Bill

($ millions)

	Full year 1978	1979	1980	1981	1982	1983
		Calendar Years				
I. Personal income taxes:						
Reduce tax rates	-5,016	-6,019	-7,223	-8,668	-10,401	-12,481
$100 general tax credit	-7,915	-8,152	-8,397	-8,649	-8,908	-9,176
Repeal deduction for gasoline tax and political contributions	981	1,157	1,369	1,609	1,897	2,238
Simplify medical deduction	34	37	41	45	50	55
Tax unemployment compensation starting at $20,000 of income for single taxpayers, $25,000 for married	246	251	261	259	263	268
Technical changes to earned income credit 1/	-4	-4	-4	-4	-3	-3
Subtotal	-11,674	-12,730	-13,953	-15,408	-17,102	-19,099
II. Business income:						
Reduce rates to 17 percent of first $25,000, 20 percent of next $25,000, 30 percent of next $25,000, 40 percent of next $25,000, 46 percent above $100,000..	-4,493	-5,033	-5,536	-6,008	-6,514	-7,089
90 percent limit for investment credit (phase in at 10 percent a year)	-201	-287	-629	-1,169	-826	-728
Tighten tax shelter provisions (at risk, partnership audit).	12	14	10	8	5	6
10 percent investment tax credit for pollution control facilities	-120	-8	-25	-53	-91	-112
$10 million limitation for IDB.	-14	-2	-10	-18	-26	-34
Targeted unemployment	-679	-299	-638	-760	-841	-887
Small business proposals	-145	-379	-322	-277	-242	-216
Investment tax credit for rehabilitation of structures ..	-227	-237	-276	-300	-328	-355
Extend rapid write-off for low-income housing	--	-1	-7	-15	-22	-26
Repeal general jobs credit 2/ .	2,458	2,458	2,458	2,458	2,458	2,458
Subtotal	-3,409	-3,774	-4,975	-6,134	-6,427	-6,983

Table 6 continued

($ millions)

	Full year 1978	1979	1980	1981	1982	1983
		Calendar Years				
:I. Capital gains:						
Repeal alternative tax (individuals)	124	133	143	154	166	178
Delete capital gains as item of tax preference from minimum and maximum tax (individuals and corporations)	-1,279	-1,414	-1,560	-1,716	-1,888	-2,076
Limit capital gains exclusion one-half taxable income (individuals)	466	513	564	620	682	750
$100 thousand personal residence exclusion	-709	-780	-858	-944	-1,038	-1,142
Sale of personal residence within 18 months	-5	-5	-5	-5	-5	-5
Subtotal	-1,403	-1,553	-1,716	-1,891	-2,083	-2,295
Total	-16,486	-18,057	-20,644	-23,433	-25,612	-28,377

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Office of Tax Analysis

August 4, 1978

Excludes increased outlays (-).	-13	-12	-12	-11	-11	-11

Elsewhere included in the President's budget.

ess than $500 thousand.

Table 7

Alternative to the Ways and Means Committee Tax Bill

($ millions)

	Full year 1978	Fiscal Years 1979	1980	1981	1982	1983
I. Personal income taxes:						
Reduce tax rates	-5,016	-3,724	-6,764	-8,117	-9,740	-11,688
$100 general tax credit	-7,915	-5,044	-8,304	-8,553	-8,809	-9,074
Repeal deduction for gasoline tax and political contributions	981	473	1,244	1,467	1,727	2,036
Simplify medical deduction	34	15	39	43	47	52
Tax unemployment compensation starting at $20,000 of income for single taxpayers, $25,000 for married	246	--	251	261	259	263
Technical changes to earned income credit 1/	-4	-4	-4	-4	-3	-3
Subtotal	-11,674	-8,284	-13,538	-14,903	-16,519	-18,414
II. Business income:						
Reduce rates to 17 percent of first $25,000, 20 percent of next $25,000, 30 percent of next $25,000, 40 percent of next $25,000, 46 percent above $100,000..	-4,493	-2,265	-5,259	-5,748	-6,236	-6,773
90 percent limit for investment credit (phase in at 10 percent a year)	-201	-129	-441	-872	-1,015	-782
Tighten tax shelter provisions (at risk, partnership audit).	12	2	14	10	8	5
10 percent investment tax credit for pollution control facilities	-120	-6	-18	-42	-76	-104
$10 million limitation for IDB.	-14	*	-3	-13	-22	-30
Targeted unemployment	-679	-108	-436	-702	-812	-862
Small business proposals	-145	-148	-357	-305	-263	-232
Investment tax credit for rehabilitation of structures ..	-227	-84	-259	-292	-318	-340
Extend rapid write-off for low-income housing	--	-1	-4	-11	-19	-24
Repeal general jobs credit 2/ .	2,458	689	2,458	2,458	2,458	2,458
Subtotal	-3,409	-2,050	-4,305	-5,517	-6,295	-6,684

Table 7 continued

($ millions)

	Full year 1978	Fiscal Years 1979	1980	1981	1982	1983
[I. Capital gains:						
Repeal alternative tax (individuals)	124	--	133	143	154	165
Delete capital gains as item of tax preference from minimum and maximum tax (individuals and corporations)	-1,279	--	-1,414	-1,560	-1,716	-1,888
Limit capital gains exclusion one-half taxable income (individuals)	466	--	513	564	620	682
$100 thousand personal residence exclusion	-709	--	-780	-858	-944	-1,038
Sale of personal residence within 18 months	-5	-2	-5	-5	-5	-5
Subtotal	-1,403	-2	-1,553	-1,716	-1,891	-2,084
Total	-16,486	-10,336	-19,396	-22,136	-24,705	-27,182

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Office of Tax Analysis

August 4, 1978

' Excludes increased outlays (-).	-13	--	-12	-12	-11	-11

' Elsewhere included in the President's budget.

.ess than $500 thousand.

Table 8-A

Alternative Tax Bill

Individual Tax Rate Schedules for Joint Returns

Taxable income bracket	Present law: Tax at low end of bracket	Present law: Tax rate on income in bracket	Alternative tax bill: Tax at low end of bracket	Alternative tax bill: Tax rate on income in bracket
$ 0 - 3,200	$ 0	0%	$ 0	0%
3,200 - 4,200	0	14	0	14
4,200 - 5,200	140	15	140	15
5,200 - 6,200	290	16	290	16
6,200 - 7,200	450	17	450	17
7,200 - 11,200	620	19	620	19
11,200 - 15,200	1,380	22	1,380	22
15,200 - 19,200	2,260	25	2,260	23
19,200 - 23,200	3,260	28	3,180	25
23,200 - 27,200	4,380	32	4,180	29
27,200 - 31,200	5,660	36	5,340	33
31,200 - 35,200	7,100	39	6,660	38
35,200 - 39,200	8,660	42	8,180	42
39,200 - 43,200	10,340	45	9,860	45
43,200 - 47,200	12,140	48	11,660	48
47,200 - 55,200	14,060	50	13,580	50
55,200 - 67,200	18,060	53	17,580	53
67,200 - 79,200	24,420	55	23,940	55
79,200 - 91,200	31,020	58	30,540	58
91,200 - 103,200	37,980	60	37,500	60
103,200 - 123,200	45,180	62	44,700	62
123,200 - 143,200	57,580	64	57,100	64
143,200 - 163,200	70,380	66	69,900	66
163,200 - 183,200	83,580	68	83,100	68
183,200 - 203,200	97,180	69	96,700	69
203,200 and over	110,980	70	110,500	70

Office of the Secretary of the Treasury
Office of Tax Analysis

August 4, 1978

Table 8-B

Alternative Tax Bill

Individual Tax Rate Schedules for Single Returns

Taxable income bracket	Present law: Tax at low end of bracket	Present law: Tax rate on income in bracket	Alternative tax bill: Tax at low end of bracket	Alternative tax bill: Tax rate on income in bracket
$ 0 - 2,200	$ 0	0%	$ 0	0%
2,200 - 2,700	0	14	0	14
2,700 - 3,200	70	15	70	15
3,200 - 3,700	145	16	145	16
3,700 - 4,200	225	17	225	17
4,200 - 6,200	310	19	310	19
6,200 - 8,200	690	21	690	21
8,200 - 10,200	1,110	24	1,110	23
10,200 - 12,200	1,590	25	1,570	24
12,200 - 14,200	2,090	27	2,050	25
14,200 - 16,200	2,630	29	2,550	28
16,200 - 18,200	3,210	31	3,110	31
18,200 - 20,200	3,830	34	3,730	34
20,200 - 22,200	4,510	36	4,410	36
22,200 - 24,200	5,230	38	5,130	38
24,200 - 28,200	5,990	40	5,890	40
28,200 - 34,200	7,590	45	7,490	45
34,200 - 40,200	10,290	50	10,190	50
40,200 - 46,200	13,290	55	13,190	55
46,200 - 52,200	16,590	60	16,490	60
52,200 - 62,200	20,190	62	20,090	62
62,200 - 72,200	26,390	64	26,290	64
72,200 - 82,200	32,790	66	32,690	66
82,200 - 92,200	39,390	68	39,290	68
92,200 - 102,200	46,190	69	46,090	69
102,200 and over	53,090	70	52,990	70

Office of the Secretary of the Treasury
Office of Tax Analysis

August 4, 1978

Table 9-A

Ways and Means Committee Tax Bill

Individual Tax Rate Schedules for Joint Returns

Taxable income bracket	Tax at low end of bracket	Tax rate on income in bracket
$ 0 - 3,400	$ 0	0%
3,400 - 4,460	0	14
4,460 - 5,520	148	15
5,520 - 6,580	307	16
6,580 - 7,640	477	17
7,640 - 11,880	657	18
11,880 - 16,120	1,420	21
16,120 - 20,360	2,311	24
20,360 - 24,600	3,328	28
24,600 - 28,840	4,516	32
28,840 - 33,080	5,872	36
33,080 - 37,320	7,399	39
37,320 - 41,560	9,052	42
41,560 - 45,800	10,833	45
45,800 - 50,040	12,741	48
50,040 - 58,520	14,776	50
58,520 - 71,240	19,016	53
71,240 - 83,960	25,758	55
83,960 - 96,680	32,754	58
96,680 - 109,400	40,132	60
109,400 - 130,600	47,764	62
130,600 - 151,800	60,908	64
151,800 - 173,000	74,776	66
173,000 - 194,200	88,468	68
194,200 - 215,400	102,884	69
215,400 and over	117,512	70

Office of the Secretary of the Treasury
Office of Tax Analysis

August 4, 1978

Table 9-B

Ways and Means Committee Tax Bill

Individual Tax Rate Schedules for Single Returns

Taxable income bracket	Tax at low end of bracket	Tax rate on income in bracket
$ 0 - 2,300	$ 0	0%
2,300 - 2,830	0	14
2,830 - 3,360	74	15
3,360 - 3,890	154	16
3,890 - 4,420	238	17
4,420 - 6,540	329	18
6,540 - 8,660	710	19
8,660 - 10,780	1,113	21
10,780 - 12,900	1,558	24
12,900 - 15,020	2,067	27
15,020 - 17,140	2,639	29
17,140 - 19,260	3,254	31
19,260 - 21,380	3,911	34
21,380 - 23,500	4,632	36
23,500 - 25,620	5,395	38
25,620 - 29,860	6,201	40
29,860 - 36,220	7,897	45
36,220 - 42,580	10,759	50
42,580 - 48,940	13,939	55
48,940 - 55,300	17,437	60
55,300 - 65,900	21,253	62
65,900 - 76,500	27,825	64
76,500 - 87,100	34,609	66
87,100 - 97,700	41,605	68
97,700 - 108,300	48,813	69
108,300 and over	56,127	70

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Office of Tax Analysis

August 4, 1978

Table 10

Comparison of Changes in the Combined Income and Social Security Taxes Resulting from H.R. 13511 and the Alternative Compared with 1977 Law Taxes 1/

Wage income	Four-person, one-earner families		Four-person, two-earner families 2/		Single individuals	
	H.R. 13511	Alternative	H.R. 13511	Alternative	H.R. 13511	Alternative
$ 5,000	14	14	14	14	-7	-44
10,000	-34	-232	-34	-232	13	19
15,000	-35	-187	-35	-187	-29	-14
20,000	115	33	-90	-172	157	162
25,000	207	131	-162	-237	279	339
30,000	135	16	-220	-339	226	339
40,000	-47	-215	35	-133	112	339
50,000	-215	-261	223	177	3	339
100,000	-485	-261	-47	177	3	339

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Assumes deductible expenses equal to 23 percent of income.

2/ Assumes each spouse earns 50 percent of total family income.

Table 11

Combined Income and Social Security Tax Burdens

1977 **Law vs H.R. 13511**

Four Person, One-earner Families

(dollars)

Wage income	1977 law tax			1979 tax under H.R. 13511			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
$ 5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	384	613	997	-62	28	-34
15,000	1,330	878	2,208	1,253	920	2,172	-77	42	-35
20,000	2,180	965	3,145	2,034	1,226	3,260	-146	261	115
25,000	3,150	965	4,115	2,918	1,404	4,322	-232	439	207
30,000	4,232	965	5,197	3,928	1,404	5,332	-304	439	135
40,000	6,848	965	7,813	6,362	1,404	7,766	-486	439	-47
50,000	9,950	965	10,915	9,296	1,404	10,700	-654	439	-215
100,000	28,880	965	29,845	27,956	1,404	29,360	-924	439	-485

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Assumes deductible expenses equal to 23 percent of income.

2/ FICA calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ FICA calculated under present law rates and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 12

Combined Income and Social Security Tax Burdens

1977 Law vs H.R. 13511

Four Person, Two-earner Families 1/

(dollars)

Wage income	1977 law tax			1979 tax under H.R. 13511			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
$ 5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	384	613	997	-62	28	-34
15,000	1,330	878	2,208	1,253	920	2,172	-77	42	-35
20,000	2,180	1,170	3,350	2,034	1,226	3,260	-146	56	-90
25,000	3,150	1,463	4,613	2,918	1,533	4,451	-232	70	-162
30,000	4,232	1,755	5,987	3,928	1,839	5,767	-304	84	-220
40,000	6,848	1,931	8,779	6,362	2,452	8,814	-486	521	35
50,000	9,950	1,931	11,881	9,296	2,808	12,104	-654	877	223
100,000	28,880	1,931	30,811	27,956	2,808	30,764	-924	877	-47

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Assumes each spouse earns 50 percent of total family income.

2/ Assumes deductible expenses equal to 23 percent of income.

3/ FICA calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees share only.

4/ FICA calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 13

Combined Income and Social Security Tax Burdens

1977 Law vs Alternative Tax Bill

Single Individuals

(dollars)

Wage income	1977 law tax			1979 tax under Alternative			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
$ 5,000	278	292	570	220	306	526	-58	14	-44
10,000	1,199	585	1,784	1,190	613	1,803	-9	28	19
15,000	2,126	878	3,004	2,070	920	2,990	-56	42	-14
20,000	3,231	965	4,196	3,132	1,226	4,358	-100	261	162
25,000	4,510	965	5,475	4,410	1,404	5,814	-100	439	339
30,000	5,950	965	6,915	5,850	1,404	7,254	-100	439	339
40,000	9,232	965	10,197	9,132	1,404	10,536	-100	439	339
50,000	12,985	965	13,950	12,885	1,404	14,289	-100	439	339
100,000	32,235	965	33,200	32,135	1,404	33,539	-100	439	339

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 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/ FICA calculated under present law rates and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 14

Combined Income and Social Security Tax Burdens

1977 Law vs Alternative Tax Bill

Four Person, One-earner Families

(dollars)

Wage income	1977 law tax			1979 tax under Alternative			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
$ 5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	186	613	799	-260	28	-232
15,000	1,330	878	2,208	1,101	920	2,021	-229	42	-187
20,000	2,180	965	3,145	1,952	1,226	3,178	-228	261	33
25,000	3,150	965	4,115	2,843	1,404	4,246	-308	439	131
30,000	4,232	965	5,197	3,809	1,404	5,213	-423	439	16
40,000	6,848	965	7,813	6,194	1,404	7,598	-654	439	-215
50,000	9,950	965	10,915	9,250	1,404	10,654	-700	439	-261
100,000	28,880	965	29,845	28,180	1,404	29,584	-700	439	-261

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Assumes deductible expenses equal to 23 percent of income.

2/ FICA calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees' share only.

3/ FICA calculated under present law rates and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 15

Combined Income and Social Security Tax Burdens

1977 Law vs Alternative Tax Bill

Four Person, Two-earner Families 1/

(dollars)

Wage income	1977 law tax			1979 tax under Alternative			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
$ 5,000	-300	292	-8	-300	306	6	0	14	14
10,000	446	585	1,031	186	613	799	-260	28	-232
15,000	1,330	878	2,208	1,101	920	2,021	-229	42	-187
20,000	2,180	1,170	3,350	1,952	1,226	3,178	-228	56	-172
25,000	3,150	1,463	4,613	2,843	1,533	4,376	-308	70	-237
30,000	4,232	1,755	5,987	3,809	1,839	5,648	-423	84	-339
40,000	6,848	1,931	8,779	6,194	2,452	8,646	-654	521	-133
50,000	9,950	1,931	11,881	9,250	2,808	12,058	-700	877	177
100,000	28,880	1,931	30,811	28,180	2,808	30,988	-700	877	177

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 1978

1/ Assumes each spouse earns 50 percent of total family income.

2/ Assumes deductible expenses equal to 23 percent of income.

3/ FICA calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 ($16,500), employees share only.

4/ FICA calculated under present law rate and base for 1979 (6.13 percent and $22,900), employees' share only.

Table 16

Combined Income and Social Security Tax Burdens

1977 Law vs H.R. 13511

Single Individuals

(dollars)

Wage income	1977 law tax			1979 tax under H.R. 13511			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
$ 5,000	278	292	570	257	306	563	-21	14	-7
10,000	1,199	585	1,784	1,184	613	1,797	-15	28	13
15,000	2,126	878	3,004	2,055	920	2,975	-71	42	-29
20,000	3,231	965	4,196	3,127	1,226	4,353	-105	261	157
25,000	4,510	965	5,475	4,350	1,404	5,457	-160	439	279
30,000	5,950	965	6,915	5,737	1,404	7,141	-213	439	226
40,000	9,232	965	10,197	8,905	1,404	10,309	-327	439	112
50,000	12,985	965	13,950	12,549	1,404	13,953	-436	439	3
100,000	32,235	965	33,200	31,799	1,404	33,203	-436	439	3

Office of the Secretary of the Treasury
Office of Tax Analysis

August 3, 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/ FICA calculated under present law rates and base for 1979 (6.13 percent and $22,900), employees' share only.

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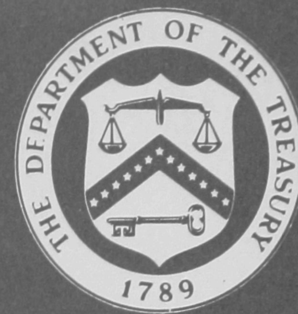

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TREASURY DEPARTMENT

FOR IMMEDIATE RELEASE
AUGUST 4, 1978

CONTACT: Robert E. Nipp
202/566-5328

TREASURY ANNOUNCES REVISED ANTIDUMPING REGULATIONS FOR VALUING MERCHANDISE FROM STATE-CONTROLLED ECONOMIES

The Treasury Department announced today a revised regulation for the valuation of merchandise from state-controlled economies under the Antidumping Act.

Under the new regulation, products imported from countries considered "state-controlled" will be valued for the purposes of the Antidumping Act by comparing them to similar products made and sold in a non-state-controlled economy that is at a comparable stage of economic development.

If similar products are not actually made and sold in such a free market economy, a "contructed value" for the merchandise will be calculated based on the physical inputs (labor, material, energy, etc.) in the state-controlled economy, valued in a non-state-controlled economy at a comparable stage of economic development.

If neither of these procedures provides data that can be verified to the satisfaction of the Secretary of the Treasury, domestic prices and costs may be used to establish the "fair value" of the merchandise.

Under the Antidumping Act, a special dumping duty is applied to products imported at "less than fair value" if the International Trade Commission determines that such sales cause or threaten injury to a U.S. industry. "Fair value" is generally based on the prices or costs of the foreign producer in its home market or sales to third countries.

However, because the prices and costs in state-controlled economies are generally not reflective of market supply and demand, but are arbitrarily determined, they cannot be used to establish "fair value" under the Antidumping Act.

The new regulation provides a basis for establishing "fair value" for a producer in a state-controlled economy that takes into account any advantages (and disadvantages) in its production abilities, and allows the resources used to be valued in a market economy that is approximately comparable to the economy in which the goods are produced.

The new method for calculating "fair value" might be applied, for example, to the case of golf carts from Poland. Golf carts are not sold in Poland and appear not to be produced in commercial quantities in any other country outside the United States. The cost of producing golf carts (plus statutory minimums for general expenses and profit) may now be calculated by obtaining the verified physical inputs from the Polish producer and valuing them in a non-state-controlled economy such as Spain or Portugal.

The regulation was first proposed in January 1978 and has been intensively studied since then. It is being adopted on a trial basis and will be reconsidered in the light of experience.

A copy of the revised regulations is attached.

###

(T.D. 78-)

Antidumping--Customs Regulations amended

Part 153, Customs Regulations, relating to procedures under the Antidumping Act, 1921, amended

DEPARTMENT OF THE TREASURY
OFFICE OF THE COMMISSIONER OF CUSTOMS
Washington, D. C.

TITLE 19--CUSTOMS DUTIES

CHAPTER I -- UNITED STATES CUSTOMS SERVICE

PART 153--ANTIDUMPING

AGENCY: United States Customs Service, Department of the Treasury.

ACTION: Final Rule.

SUMMARY: This document amends the Customs Regulations relating to antidumping investigations which involve merchandise from countries whose economies are determined to be "state-controlled" for the purposes of the Antidumping Act, 1921, as amended. The amended regulations provide that in determining the fair value of merchandise from a state-controlled-economy country through comparisons with prices or the constructed value of merchandise in a country or countries not regarded as having a state-controlled-economy, the Secretary of the Treasury may give recognition to the level of economic development and to relative efficiencies or natural advantages in the state-controlled-economy country. In addition, the amended regulations provide that antidumping petitions which involve merchandise from a state-controlled-economy country should contain information pertinent to the new procedures.

EFFECTIVE DATE: The amendments will become effective as noted below under that part of the document entitled "Effective Date".

FOR FURTHER INFORMATION CONTACT:

Theodore Hume, Office of the Chief Counsel, U.S. Customs Service, 1301 Constitution Avenue, N.W., Washington, D. C. 20229, 202-566-5476.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On January 9, 1978, notice was published in the FEDERAL REGISTER (43 FR 1356) of a proposal to amend sections 153.7 and 153.27 Customs

Regulations (19 CFR 153.7 and 153.27), concerning investigations under the Antidumping Act, 1921, as amended (19 U.S.C. 160 et seq.) ("the Act"), which involve merchandise imported from a "state-controlled-economy country." Section 205(c) of the Act (19 U.S.C. 164(c)), as added by the Trade Act of 1974, provides that the Secretary of the Treasury ("the Secretary") may determine the foreign market value of merchandise exported from a state-controlled-economy country on the basis of the normal costs, expenses, and profits for the merchandise, as reflected by the prices or the constructed value of such or similar merchandise from a non-state-controlled-economy country or countries. Based on its experience in administering this provision and in an effort to make comparisons on a more equivalent and realistic basis, it was concluded that when the foreign market value, and thereby the fair value, of merchandise from a state-controlled-economy country is being determined based upon the prices or the constructed value of such or similar merchandise in a non-state-controlled-economy country or countries, the latter country or countries should be comparable in terms of economic development to the state-controlled-economy country in which the merchandise under investigation is produced.

Accordingly, it was proposed to amend section 153.7 to provide that prices shall be used as a basis of comparison if they are available from a non-state-controlled-economy country of comparable economic development. Where such or similar merchandise is not produced and sold in sufficient quantities in a non-state-controlled-economy country comparable in terms of economic development to the state-controlled-economy country from which the merchandise is exported, a constructed value could be used. When constructed value is used as the basis for fair value, it would be determined based upon the actual factors of production in the state-controlled-economy country as valued in a non-state-controlled-economy country of comparable economic development. If such factors and values cannot be adequately verified, then prices of such or similar merchandise sold or produced by any other non-state-controlled-economy country including, if necessary, the United States would be used.

It also was proposed to amend sections 153.27(a)(3)(i), (ii), and (iii) to distinguish clearly certain types of information required in any petition involving merchandise from a state-controlled-economy country, as well as to require that such petitions include information pertinent to the comparability of the state-controlled-economy country with a non-state-controlled-economy country from which prices or constructed value are to be determined.

Interested persons were invited to submit comments on the proposed amendments on or before February 8, 1978. By notice published in the FEDERAL REGISTER on February 6, 1978 (43 FR 4871), the comment period was extended to February 22, 1978.

DISCUSSION OF COMMENTS

USE OF PRICES OR CONSTRUCTED VALUE

IN DETERMINING FAIR VALUE

A number of commenters argued that the proposed amendments would depart from the statutory requirements for determining the fair value of merchandise from a state-controlled-economy country. Some commenters interpreted the proposed amendments as giving preference to prices over constructed value in determining fair value. Others believed the amendments would make the constructed value of such or similar merchandise in a non-state-controlled-economy country the primary determinant of fair value.

Section 205(c) provides that the Secretary shall determine the foreign market value in antidumping investigations of merchandise from a state-controlled-economy country on the basis of the normal costs, expenses, and profits as reflected by either--

(1) the prices at which such or similar merchandise of a non-state-controlled-ecomony country or countries is sold either (A) for consumption in the home market, of that country or countries, or (B) to other countries, including the United States; or

(2) the constructed value of such or similar merchandise in a non-state-controlled-economy country or countries.

It is the position of the Treasury Department that section 205(c) provides that either prices or constructed value may be used by the Secretary in determining the foreign market value and thereby the fair value, depending uponthe information available in the particular case under consideration. To indicate more clearly that the regulations are intended to follow the statutory standards, section 153.7(a) retains the statutory structure.

AUTHORITY FOR APPLYING A STANDARD

OF COMPARABILITY OF ECONOMIES

Some commenters questioned the authority of the Treasury Department to make adjustments in determining fair value based on differences in the level of economic development between the non-state-controlled-economy country or countries and the state-controlled economy country, or to determine fair value on the basis of prices for such or similar merchandise in a non-state-controlled-economy country of comparable economic development.

One commenter objected that the proposed regulations would provide for examination of economic criteria and factors of production in the state-controlled-economy country whose merchandise is under investigation even though, in his view, the intent of the law is that information concerning markets and products in state-controlled-economy countries must be disregarded altogether.

Section 205(c) of the Act provides that the Secretary shall determine the foreign market value, and thereby the fair value, of merchandise from a state-controlled-economy country on the basis of the normal costs, expenses, and profits as reflected by the prices or constructed value of such or similar merchandise in a non-state-controlled-economy country or countries, as set forth in sections 205(c)(1) and (c)(2) of the Act. This provision reflects Congressional concern that state control of an economy renders inherently suspect the prices and costs of producers in such countries. Therefore, the prices (or costs, if appropriate) are to be determined from a non-state-controlled economy country. In selecting a non-state-controlled-economy country as a surrogate for the country from which the products, in fact are being exported to the United States, the Treasury in the past has attempted to select a country that is most like the exporting country. The standard for selection, however, has not been articulated clearly. The present regulation seeks to provide such a standard, consistent with the principles of the Antidumping Act which attempt generally to establish the "fair value" of merchandise from the practices of the foreign producer or, in the instant case, of the surrogate producer.

One commenter argued that the most suitable non-state-controlled-economy country to be selected is the one with a market for sales most like the United States. This, however, is, not the usual priority established by the Act. Under section 205(a) of the Act and section 153.2(a) Customs Regulations (19 CFR 153.2(a)), it is the home market that is the preferred reference for establishing the foreign market value, and thereby the fair value. The proposed regulation attempts to follow that concept by using data from another country, but not a state-controlled-economy country, most like the unavailable home market. The prices in such a country will be the preferred reference, but costs may be used if sales in a non-state-controlled economy country are insufficient or data is unavailable.

Even though the prices and costs in the state-controlled-economy country are not regarded as sufficiently reliable to establish the foreign market value, and thereby the fair value, of merchandise, the actual physical inputs in such a country can be recorded and verified. If adequately recorded and verified, they should provide a reliable measure of the capabilities of the producer to make and sell the merchandise in question. These inputs then can be valued in a non-state-controlled economy country, and the appropriate value established, which recognizes both the natural advantages and po ssible disadvantages of production for the producer. This method should accord most closely with the statutory requirement

of section 205(c) of the Act that the "normal costs" be found. Based on past experience and practice -- which the Congress sought to incorporate into the Act -- the regulatory provisions hereby adopted seem best suited to achieving the purposes of the Act as a whole in the unique circumstances to which they are addressed.

The Treasury Department believes that the new procedures are necessary for fulfilling properly its responsibilities under the Act and are consistent with both its past practices and the law that adopted those practices. For example, the Treasury Department has based, in part, its selection of a non-state-controlled-economy country or countries for price comparison purposes on the comparabilities of that country's or countries' level of economic development with that of the state-controlled-economy country from which the merchandise under investigation was exported.

COMMENTS ON PROPOSED COMPARISON PROCEDURES

Some commenters argued that the fact that the proposed regulations require examination and comparison of production costs in various countries introduces elements of unreliability and speculation in determinations of fair value. Similarly, it was contended that there is no reliable basis for applying a standard of comparability between state-controlled-economy countries and non-state-controlled-economy countries. Further, it was suggested that without detailed guidelines and definitions in the regulations, persons affected will not be able to make informed judgments as to whether they are in compliance with the statute.

The regulations as adopted should make clear that costs of production in a non-state-controlled-economy country of comparable economic development will be used only if (1) price information is unavailable, and (2) verified information is made available by the state-controlled economy country producer concerning the specific factors actually used in producing the merchandise exported to the United States. As stated in the amended regulations, these specific factors include, but are not limited to, hours of labor required, quantity of materials employed, and amounts of energy consumed. The valuation of these components and factors in a comparable non-state-controlled economy country also would be required to be subject to verification.

The basis for the use of constructed value in fair value determinations under the Act generally is that the components and factors of production can usually be ascertained, for any given type of merchandise and, if verified, provide a reliable basis for determining fair value. Similarly, comparability

in ecomonic development will be determined from per capita gross national product, the level of infrastructure (particularly in the sectors of the economy at issue), and other widely used criteria for which generally reliable information is publicly available.

Proposed section 153.7(b)(i) is not being adopted. This section provided for adjustments for differences in economic factors between (1) a non-state-controlled-economy country or countries actually producing such or similar merchandise, and (2) a non-state-controlled-economy country or countries determined to be comparable in terms of economic development to the state-controlled-economy country whose merchandise was under investigation. Upon further consideration, it has been concluded that adop tion of this provision would, as the commenters argued, be relatively speculative and unreliable, and would create an unnecessary burden upon persons involved in an investigation, without significantly improving the Treasury Department's ability to ascertain the normal costs, expenses, and profits.

USE OF UNITED STATES

PRICES OR CONSTRUCTED VALUE

Some conmmenters contended that section 205(c) of the Act does not authorize the use of prices or constructed value of such or similar merchandise in the United States.

The Treasury Department does not agree with this interpretation of the statutory language. Proposed section 153.7(b)(3) is not new, but merely restates the provision for the use of prices or constructed value of United States produced merchandise in the existing section 153.7 and, indeed, in section 153.5 of the Customs Regulations in effect prior to the Trade Act of 1974. Specifically, former section 153.5 provided for the use of "prices at which such or similar merchandise is sold by a non-state-controlled-economy country." The Treasury Department considers that this language clearly authorized, and continues to authorize, the use of U.S. prices in appropriate situations.

EDITORIAL CHANGES

In addition to the change in format and deletion of proposed section 153.7(b)(i), the last sentence of proposed section 153.7(b)(ii), which is being adopted as the last sentence of section 153.7(c), is revised to read as follows:

> To the constructed value thus obtained, there shall be added an amount for general expenses and profit, as required by section 206(a)(2) of the Act (19 U.S.C. 165(a)(2)), and the cost of all containers and coverings and other expenses, as required by section 206(a)(3) of the Act.

After consideration of all comments received and further review of the matter, it has been determined that the amendments should be adopted as proposed, except for the noted changes.

EFFECTIVE DATE

These amendments will take effect 30 days after publication with respect to investigations initiated on or after that date, and to the extent practicable, will be applied to any investigations pending on the effective date. Similarly, the Department intends to adopt the procedures set forth in these amendments for the purposes of determining whether special dumping duties should be assessed on any merchandise entered for consumption or withdrawn from warehouse for consumption on or after the effective date. Recognizing the need to assess the effects of these amendments, the Department will evaluate the impact of these amendments as soon as sufficient experience has been acquired, with a view to making further revisions if deemed appropriate.

DRAFTING INFORMATION

The principal author of this document was Edward T. Rosse, Regulations and Legal Publications Division, U.S. Customs Service. However, other personnel in the Customs Service and the Treasury Department assisted in its development.

AMENDMENTS TO THE REGULATIONS

Part 153 of the Customs Regulations (19 CFR Part 153) is amended as set forth below.

(Signed) LEONARD LEHMAN
Acting Commissioner of Customs

Approved: 3 AUG 1978
(signed) Robert H. Mundheim
General Counsel of the Treasury

PART 153 - ANTIDUMPING

1. Section 153.7 is amended to read as follows:

153.7 Merchandise from state-controlled-economy country.

(a) General. If the information available indicates to the Secretary that the economy of the country from which the merchandise is exported is state-controlled to an extent that sales or offers of sales of such or similar merchandise in that country or to countries other than the United States do not permit a determination of fair value under section 153.2, 153.3, or 153.4, the Secretary shall determine fair value on the basis of the normal costs, expenses, and profits as reflected by either:

(1) The prices, determined in accordance with subsection 205(a) and section 202 of the Act (19 U.S.C. 164(a), 161) at which such or similar merchandise of a non-state-controlled economy country or countries is sold either: (A) for consumption in the home market of that country or countries, or (B) to other countries, including the United States; or

(2) The constructed value of such or similar merchandise in a non-state-controlled-economy country of countries,

(b) Comparability of economies. (1) The prices as determined under section 153.7(a)(1), or the constructed value as determined under section 153.7(a)(2), shall be determined, to the extent possible, from the prices or costs in a non-state-controlled-economy country or countries at a stage of economic development comparable to the state-controlled-economy country from which the merchandise is exported. Comparability of economic development shall be determined from generally recognized criteria, including per capita gross national product and infrastructure development (particularly in the industry producing such or similar merchandise).

(2) If no non-state-controlled-economy country of comparable economic development can be identified, then the prices or constructed value as determined from another non-state-controlled-economy country or countries other than the United States shall be used.

(3) If neither section 153.7(b)(1) nor (b)(2) provides an adequate basis for determining the price or constructed value of such or similar merchandise, then the prices or constructed value, as determined from the sales or production of such or similar merchandise in the United States, shall be used.

(c) Use of constructed value. If such or similar merchandise is not produced in a non-state-controlled-economy country which is concluded to be comparable in terms of economic development to the state-controlled-economy country from which the merchandise is exported, the constructed value of such or similar merchandise may be determined from the costs of specific objective components or factors of production incurred in producing the merchandise in question, including, but not limited to, hours of labor required, quantities of raw materials employed, and amounts of energy consumed, if such information is obtained from the producer of the merchandise in the state-controlled-economy country under investigation, and verification of such information in the state-controlled-economy country is concluded to the satisfaction of the Secretary. Such components or factors shall be valued and such values verified in a non-state-controlled-economy country determined to be reasonably comparable in economic development to the state-controlled-economy country under investigation. To the values thus obtained, there shall be added an amount for general expenses and profits, as required by section 206(a)(2) of the Act (19 U.S.C. 165(a)(2)), and the cost of all containers and coverings and other expenses, as required by section 206(a)(3) of the Act (19 U.S.C. 165(a)(2)).

* * * * *

2. Paragraph (a)(3)(i-iii) of section 153.27 is amended by deleting subparagraph (iii) and revising subparagraph (i) and (ii) to read as follows:

153.27 Suspected dumping; nature of information to be made available.

(a) General.

*   *   *   *   *

(3) Price information; fair value.

(i) If the merchandise is being exported from a country other than one considered to be a "state-controlled-economy country" within the meaning of section 205(c) of the Act (19 U.S.C. 164(c)):

(A) The home market price of such or similar merchandise in the country of exportation;

(B) If such information is unavailable, the price at which such or similar merchandise is sold to a third country from the country of exportation; or

(C) If the information required under section (a)(3)(i)(A) or (a)(3)(i)(B) is unavailable, the constructed value (as defined in section 206 of the Act (19 U.S.C. 165)) of such merchandise produced in the country of exportation.

(ii) If the merchandise is being exported from a country considered to be a "state-controlled-economy country":

(A) The price or prices at which such or similar merchandise of a non-state-controlled-economy country or countries, considered to be comparable in terms of economic development to the state-controlled-economy country, is sold for consumption in the home market of that country or countries or to other countries (including the United States);

(B) The constructed value of such or similar merchandise in a non-state-controlled-economy country, determined in accordance with sections 153.7(b) and (c).

(iii) Deleted.

*   *   *   *   *

(Sec. 201-212, 407, 42 Stat. 11 et seq., as amended, sec. 5, 72 Stat. 585, secs. 406, 407, 42 Stat. 18 (5 U.S.C. 301, 19 U.S.C. 160-173))

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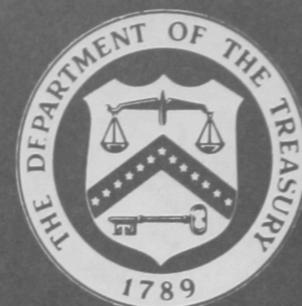

FOR IMMEDIATE RELEASE August 7, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,301 million of 13-week Treasury bills and for $3,500 million of 26-week Treasury bills, both series to be issued on August 10, 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 November 9, 1978			26-week bills maturing February 8, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.283	6.793%	7.01%	96.380	7.160%	7.53%
Low	98.278	6.812%	7.03%	96.370	7.180%	7.55%
Average	98.279	6.808%	7.02%	96.374	7.172%	7.55%

Tenders at the low price for the 13-week bills were allotted 74%.
Tenders at the low price for the 26-week bills were allotted 22%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 21,580,000	$ 21,580,000	$ 47,965,000	$ 32,965,000
New York	3,678,530,000	2,015,405,000	5,248,745,000	3,181,590,000
Philadelphia	19,450,000	19,400,000	9,860,000	9,860,000
Cleveland	62,145,000	31,755,000	25,790,000	15,790,000
Richmond	21,180,000	17,920,000	13,600,000	11,600,000
Atlanta	24,750,000	23,750,000	16,375,000	16,375,000
Chicago	280,705,000	30,845,000	249,160,000	48,160,000
St. Louis	79,125,000	57,875,000	37,445,000	21,445,000
Minneapolis	20,345,000	14,045,000	21,150,000	21,150,000
Kansas City	18,745,000	18,745,000	23,955,000	21,780,000
Dallas	18,470,000	9,950,000	12,510,000	7,950,000
San Francisco	225,455,000	31,825,000	386,405,000	101,645,000
Treasury	8,380,000	8,380,000	10,160,000	10,160,000
TOTALS	$4,478,860,000	$2,301,475,000a/	$6,103,120,000	$3,500,470,000b/

a/ Includes $ 311,965,000 noncompetitive tenders from the public.
b/ Includes $195,145,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

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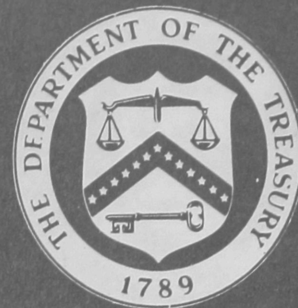

FOR IMMEDIATE RELEASE
August 7, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES START OF ANTIDUMPING INVESTIGATIONS ON CONDENSER PAPER FROM FINLAND AND FRANCE

The Treasury Department said today that it will begin antidumping investigations of imports of condenser paper from Finland and France.

Treasury's announcement followed summary investigations conducted by the U. S. Customs Service after receipt of a petition filed by counsel on behalf of Crocker Technical Papers, Inc., Kimberly-Clark Corp. and Stevens Paper Mill, Inc. alleging that firms in those two countries are dumping condenser paper in the United States.

The petition alleges that imports of condenser paper are being sold in the United States at "less than fair value." Fair value was based on the foreign producers' prices to a market other than the United States because petitioners presented information indicating that there was no home market for this merchandise. The Customs Service will investigate the matter and make a tentative determination by February 8, 1979.

If sales at less than fair value are determined by Treasury, the U. S. International Trade Commission will subsequently decide whether there is injury, or the likelihood of injury, or a domestic industry. Both sales at less than fair value and injury must be determined before a dumping finding is reached. If dumping is found, a special antidumping duty is imposed equal to the difference between the price of the merchandise at home (or in third countries) and the price to the United States.

Notice of the start of this investigation will appear in the Federal Register of August 8, 1978.

Imports of condenser paper in 1977 were valued at $401,000 for France and $263,000 for Finland.

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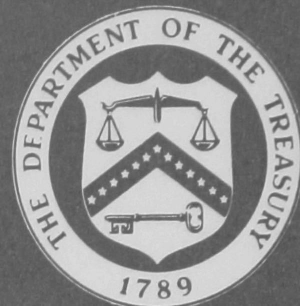

FOR IMMEDIATE RELEASE
August 7, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES START OF ANTIDUMPING INVESTIGATION OF AUTOMOTIVE AND MOTORCYCLE REPAIR MANUALS FROM THE UNITED KINGDOM

The Treasury Department said today that it will begin an antidumping investigation of automotive and motorcycle repair manuals from the United Kingdom.

Treasury's announcement followed a summary investigation conducted by the U. S. Customs Service after receipt of a petition filed by counsel on behalf of Clymer Publications alleging that this merchandise is being sold in the United States at "less than fair value."

Sales at "less than fair value" generally occur when imported merchandise is sold in the United States for less than in the home market.

This case is simultaneously being referred to the U. S. International Trade Commission. Should the Commission find, within 30 days, that there is no reasonable indication of injury or likelihood of injury to a domestic industry, the investigation will be terminated; otherwise, the Treasury will continue its investigation. A tentative determination would then be made by February 8, 1979.

Dumping occurs when there are both sales at less than fair value and injury to a U. S. industry. If dumping is found, a special antidumping duty is imposed equal to the difference between the price of the merchandise at home and the price in the United States.

Notice of this action will appear in the Federal Register of August 8, 1978.

Imports of these manuals from the United Kingdom during 1977 were estimated to be valued at approximately $1 million.

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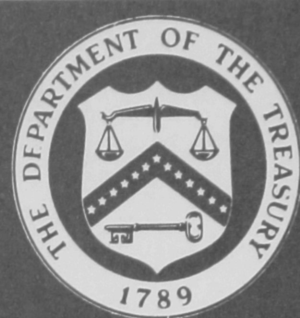

FOR RELEASE AT 4:00 P.M. August 8, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,700 million, to be issued August 17, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,716 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 May 18, 1978, and to mature November 16, 1978 (CUSIP No. 912793 U4 6), originally issued in the amount of $3,405 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,400 million to be dated August 17, 1978, and to mature February 15, 1979 (CUSIP No. 912793 W8 5).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing August 17, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,502 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 Daylight Saving time, Monday, August 14, 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-1095

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 August 17, 1978, in cash or other immediately available funds or in Treasury bills maturing August 17, 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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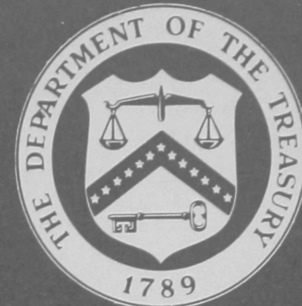
SHINGTON, D.C. 20220 TELEPHONE 566-2041



FOR RELEASE ON DELIVERY
EXPECTED 9:30 A.M.
AUGUST 10, 1978

TESTIMONY OF STEPHEN J. FRIEDMAN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
HOUSE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of this distinguished Subcommittee:

I appreciate this opportunity to testify on behalf of the Administration on H.R. 11310, the National Credit Union Liquidity Facility Act. Assistant Secretary Lawrence P. Simons has already presented the views of the Administration on the other issues under consideration at these hearings.

The Congress has been concerned with the liquidity needs of our nation's credit unions for many years. Authorizing legislation has been introduced in eight successive sessions of Congress. We agree that the Congress should act on this matter now. The Administration enthusiastically supports the creation of a central liquidity fund for credit unions. We have a few technical suggestions in the language of the bill, and we recommend a different and more limited borrowing authority.

Credit Union Liquidity Needs

Credit unions are increasingly experiencing the type of cyclical liquidity crises that long have characterized other depository financial institutions. There is a growing imbalance between the uses and sources of credit union funds -- a rapid and sustained growth in the demand for loans of increasing maturities combined with a relatively volatile flow of share capital.

B-1096

Loans have grown faster than deposits. The loan-to-share ratio of federal credit unions was 0.76 in 1955. By 1965 the loan-to-share ratio was 0.85; at the end of 1977 it was 0.87. As the loan-to-share ratios have been drifting upward, their liquid asset ratios* have been declining, down to 0.33 in 1977 for federal credit unions. This is largely attributable to the growing proportion of shares represented by large accounts, and the growing reliance on borrowings as a source of funds. At the end of 1977, more than half of the total share capital at federal credit unions was held in accounts larger than $5,000; and notes payable accounted for 5.5% of total liabilities, up from 1.8% in 1965.

This imbalance may deepen as credit unions implement recently-gained powers such as mortgage loans, share drafts and preauthorized lines of credit.

Until recently, the credit union industry was able to deal with its liquidity needs. Credit unions lend only to members. When members' deposits became insufficient to fund new loans, further loan commitments were curtailed, reducing the need for liquidity. Using the cooperative form, they organized to help meet their liquidity needs through the corporate central system. This program has made an important contribution. For example, for the 10-month period September 1977 through June 1978, the total share capital of corporate central members of the U.S. Central averaged about $1.2 billion, while loans outstanding averaged about $664 million.

The U.S. Central Credit Union specializes in offering loan and investment services to its 41 member corporate centrals to help maintain their liquidity. Over the same 10-month period, the total share capital of the U.S. Central averaged $279 million while loans outstanding averaged $79 million.

Nevertheless, it must be recognized that the structural pyramiding of the internal capital base of the credit union industry at the corporate central and U.S. Central levels introduces an element of weakness in this privately funded liquidity system. This system is least able to maintain liquidity when the need for it is widely experienced, since

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* The liquid asset ratio represents the sum of U.S. Government obligations, common trust investments, shares and deposits in other credit unions, and savings and loan association shares as a percentage of the sum of notes and other accounts payable, other liabilities and share accounts larger than $5,000.

the members tend to draw down their deposits to meet liquidity needs. Accordingly, we agree upon the need for an external source of funds to help meet credit union liquidity needs.

The Central Liquidity Facility

H.R. 11310 would establish a Central Liquidity Facility (CLF) within the National Credit Union Administration. The CLF would be managed by the Administrator.

Membership in the CLF would be open to any credit union serving individuals that invests at least 1/2 of 1 percent of its capital and surplus in CLF shares. A corporate central credit union may also become a member with the approval of the Administrator.

Lending Powers

The CLF would be authorized to meet the liquidity needs of its members for (1) short-term adjustment credit, (2) seasonal credit, and (3) protracted adjustment credit. Those catagories are drawn from the Federal Reserve's Regulation A, which defines the lending operations of its discount window.

In general, the Administration agrees that the present practices of the Federal Reserve System in administering its discount window operations are a good model for CLF operations. That is, the facility should be used to help credit unions satisfy their deposit and other liability obligations. Advances should not be used to maintain or expand the level of loans except in the case of a short run and unusual decrease in available funds. We would be pleased to submit to the Subcommittee staff suggestions for changes in the language of the bill that would make that purpose more clear.

Financing

The National Credit Union Administration has estimated that if all insured credit unions became members of the CLF its capitalization would be about $150 million. H.R. 11310 would authorize the CLF to sell its own debt securities, with or without guarantee by the United States, in the public credit markets. The face value of those obligations guaranteed by the United States may not exceed twenty times the subscribed capital stock and surplus of

the Facility. In addition, the Administrator would be authorized to borrow up to $500 million under a Treasury line of credit.

If the $500 million line of credit is added to the subscribed capital and the maximum borrowing, the CLF would have funding capacity of over $3.6 billion. This sum is in addition to the credit union share insurance fund of approximately $100 million, a back-up Treasury line of credit for that fund of $100 million and the resources of the corporate central system. We suggest that a smaller amount would be more appropriate for the needs of the credit union industry.

The Federal Reserve and FHLB Systems

Consideration of the Federal Reserve System and the Federal Home Loan Bank System is instructive in this respect. The Federal Reserve has no limit on the funds it makes available to member banks through the discount window. The System creates (rather than borrows) these funds. The size of its "fund" is a by-product of its monetary policy functions rather than the needs of its discount window. As a matter of fact, the level of discount window advances has been modest. For example, since the beginning of December 1977, outstanding loans to member banks have averaged about $500 million; in more recent months they have averaged about $750 million. Since 1965, the amount outstanding has never been higher than about $3.4 billion, or about 36/100 of 1 percent of insured banking assets.

Unlike the Federal Reserve, the Federal Home Loan Bank System obtains funds for its program of advances by borrowing in the private market. It may borrow up to 12 times the total paid-in capital and retained earnings of its regional banks.

As of June 1978, the paid-in capital and retained earnings of the FHLB System were about $4.7 billion. Thus, the FHLB System can borrow up to $56 billion in the private market. That ceiling greatly exceeds the historical level of advances by the System.

In the last period of severe disintermediation, 1974, the level of advances outstanding reached $22 billion. Currently, loans outstanding are approaching a new high

in excess of $26 billion. These large amounts are a result of the mandate of the FHLB System to maintain and expand mortgage lending, rather than merely to provide liquidity.

The CLF Size

As noted above, since 1965 the largest proportion of outstanding Federal Reserve discount window balances in relation to the size of the insured deposit base has been about 36/100 of 1 percent. If that relationship is applied to a credit union deposit base of even $100 billion -- which is twice the size of the present industry -- the result is a fund of about $360 million. That result is generally consistent with statements by the National Credit Union Administrator as to the likely level of advances in the near future.

Accordingly, we suggest that the capitalization of the Facility should be smaller than that contemplated by the bill. We recommend that the borrowing authority be limited to ten times the capital and surplus of the CLF or $400 million, whichever is less. For the same reasons, we suggest that the Subcommittee consider a smaller line of credit from the Treasury, perhaps in the area of $100 million.

These amounts, added to capital of about $150 million, would generate a potential fund of $650 million, which should be more than adequate in the near future.

Method of Financing

In recent years, the Treasury has consistently taken the position that borrowing by agencies of the Federal government should not be conducted directly in the credit markets.

Securities issued by Federal agencies, particularly new agencies, can be marketed only at interest rates which are significantly higher than the rates on Treasury securities. In order to issue its securities directly in the market, a Federal agency would be required to develop a highly sophisticated debt management staff with the necessary market expertise. Even with that expertise, agencies are required to pay excessive rates of interest because the agencies are not widely known or accepted by various investor groups, they must borrow in relatively

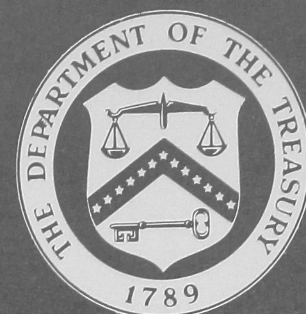
small amounts, they have little flexibility as to the timing of their issues, and they have a limited secondary market. Also, permitting such agency securities to be issued in direct competition with Treasury's own securities, and at higher interest rates, is counterproductive to Treasury debt management goals.

Accordingly, we strongly recommend that the CLF borrow the $400 million directly from the Treasury and that it be held in a revolving fund. In order to assure the fund's continued availability in time of need, the bill should provide for a one-time appropriation without fiscal year limitation. As advances by the CLF are repaid, they will be available to be advanced again.

***

Mr. Chairman, this concludes my formal testimony. I would be pleased to answer any questions that you or the members of this Subcommittee may have.

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



FOR IMMEDIATE RELEASE
EXPECTED AT 2:00 P.M. EDT
THURSDAY, AUGUST 10, 1978

STATEMENT BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL ECONOMIC
POLICY AND TRADE
AND THE SUBCOMMITTEE ON AFRICA
OF THE
HOUSE COMMITTEE ON
INTERNATIONAL RELATIONS

I appreciate the opportunity to testify before the Subcommittee regarding the three bills, H.R. 12463, H.R. 13262 and H.R. 13273, which would restrict U.S. investment in South Africa.

H.R. 13273 would prohibit additional U.S. investment in South Africa until "The President determines that the Government of South Africa has made substantial progress towards the full participation of all the people of South Africa in the social, political and economic life in that country and toward an end to discrimination based on race or ethnic origin." H.R. 12463 and H.R. 13262 have similar goals but are somewhat less restrictive. Both of these

bills would prohibit all new investment, except for reinvested earnings. H.R. 12463 would deny tax credits, export licenses, Government contracts, and Ex-Im facilities. H.R. 13262 would permit new investment in existing or new enterprises that did not engage in unfair employment practices.

The Administration is of course strongly opposed to the practice of apartheid in South Africa and elsewhere. We have adopted policies to promote peaceful change in South Africa, as indicated by the representative of the Department of State, and we will continue to do so.

As the State Department has already testified, however, the Administration believes that bills such as those under consideration today would not represent a productive approach to the problem of apartheid. Accordingly, the Administration opposes passage of these bills.

There are several reasons why we believe that passage of any of these bills would be contrary to the national interest. First, such legislation might be totally ineffective in achieving its stated objective of limiting U.S. investment in South Africa. Second, the implementation of such legislation would be difficult and burdensome on both the Government and business firms. Third, it could provoke retaliatory actions by the Government of South Africa that would be harmful to U.S. economic interests.

Fourth, it would be inconsistent with basic U.S. policy on foreign investment, which is to avoid intervening in the activities of U.S. companies in regard to their activities abroad. Fifth, such legislation would conflict with two objectives of U.S. foreign investment policy regarding national treatment of foreign-owned companies and government intervention in these activities.

Administrative Considerations

Let me begin by stating the serious problems we would foresee regarding implementation of these bills.

One problem is that companies could frustrate the intent of the law by simply reinvesting more and hence obviating the need for new capital flows from the United States or elsewhere. If reinvested earnings were also prohibited, the Government of South Africa could counter the U.S. law by prohibiting U.S. affiliates operating under the jurisdiction of South Africa from remitting their profits.

In regard to the provision in H.R. 12463 denying the foreign tax credit, the effect of this provision would be mitigated in part or entirely by other provisions of U.S. tax law.

First, in computing the foreign tax credit, a U.S. taxpayer is required to aggregate all his foreign source

income and all foreign taxes levied against that income. He then uses the foreign tax as a credit against the U.S. tax levied on the foreign source income. Thus, any taxes in excess of the applicable U.S. tax on income from the rest of the world are used to offset the U.S. tax on South African income.

Second, South African taxes are deductible against the income that would otherwise be subject to U.S. taxes if they are not eligible for the foreign tax credit. H.R. 12463 does not prohibit this result.

Finally, U.S. taxes are not levied against the earnings of foreign subsidiaries until the income is repatriated. U.S. parent companies could therefore postpone indefinitely, or until such time as they have sufficient excess foreign tax credits from third countries, any U.S. taxes that might otherwise be due because of the enactment of H.R. 12463.

This bill would also prohibit the use of Eximbank services for transactions with South Africa made by U.S. persons with major investments there. The U.S. Government some time ago took action to express its disapproval of South Africa's racial policies: direct loans by Ex-Im to finance exports to South Africa have been prohibited since 1964.

The constraint in H.R. 12463 on Ex-Im loan guarantees and insurance would have little effect. Total outstanding

Eximbank exposure in South Africa as of May 1978 was $197 million, of which $100 million was in long-term financial guarantees, $67 million in medium-term insurance and guarantees, and $30 million in short-term insurance and guarantees. Thus, cessation of Eximbank authorizations would be economically insignificant to South Africa, whose merchandise imports totaled $8.5 billion in 1976.

We should also recognize that enforcement of this kind of legislation would necessitate the establishment of an exchange control regime which would require detailed regulation and close monitoring of business transactions between U.S. parent companies and their affiliates in South Africa. The distinction between investment flows, which would be prohibited, and money flows on account of trade and service transactions, which would not be prohibited, might be difficult to maintain in the actual operation of a regulatory program. We should also weigh this cost to the firms and to the Government against the prospective benefits of the legislation.

Implications of Retaliation

We do not want to exaggerate the consequences of these bills, which we realize are quite limited in their intended

effect. But we are talking here about legislation designed to force companies operating in South Africa to conform to U.S. standards, an action which would be viewed as hostile by the Government of South Africa. Thus, it is only prudent to carefully assess the possible implications of this action if the Government of South Africa chose not to remain passive and to retaliate against U.S. trade and investment.

The value of U.S. direct investment assets in South Africa is about $1.8 billion. In addition, U.S. persons hold investments in South Africa in the form of securities and bank loans of about $2.8 billion. The total assets of residents of South Africa in the United States are only about $200 million. In other words, U.S. assets subject to South African control and expropriation outweigh South African assets subject to U.S. control and expropriation by more than $4 billion. If we decide to use investment as an instrument for imposing sanctions, or even for making a symbolic statement, the hard fact is that South Africa has more cards to play than we do in this area.

Any response by South Africa need not be limited to the investment area. If they chose to respond on trade, they could cause considerable pain to many people in the United States. South Africa provides a significant

portion of several critical mineral imports to the United States including chromium, manganese, industrial diamonds, vanadium, platinum group metals and antimony. If supplies of South African chromium were to stop, there would be sharp price increases and shortages in the U.S. specialty steel industries. These shortages would be felt in industries consuming these steels. The United States could adjust to a cutoff in supplies of the other minerals from South Africa by switching to other sources of supply where available, by using substitutes, by drawing down private inventories, and by releasing materials from the excesses in the strategic stockpile. There would, however, be serious economic dislocations in attempting to adjust to the loss of these minerals which would compromise achievement of our policy objectives in the fields of environment, energy, and employment.

U.S. Policy on Foreign Investment

In addition to our objections to the likely economic effects of these bills, we also believe that they run counter to U.S. foreign investment policy.

Shortly after taking office, this Administration undertook a review of U.S. policy on foreign investment. The conclusions of that review, which were announced in July 1977,

rested on the long-standing U.S. principle of not intervening in foreign investment transactions. Specifically, the policy statement said:

> The fundamental policy of the U.S. Government toward international investment is to neither promote nor discourage inward or outward investment flows or activities.
>
> <u>and</u>
>
> The Government, therefore, should normally avoid measures which would give special incentives or disincentives to investment flows or activities and should not normally intervene in the activities of individual companies regarding international investment.

The reasons given for this conclusion were quite pragmatic. The first two reasons were, in essence, that the investment process is economically more efficient in the absence of government intervention. A third reason was:

> Unilateral U.S. Government intervention in the international investment process could prompt counteractions by other governments with adverse effects on the U.S. economy and U.S. foreign policy.

In addition to possible counteractions by South Africa, we should also be aware of the implications of

the measures proposed in these bills for the attitudes of other governments and for the climate for international investment in general. Too many governments are now intervening in the international investment process, in an effort to increase the economic benefits accruing to their countries from the activities of multinational companies. Because these interventions often redound to the detriment of the United States, one of our basic policy objectives, as stated in the July 1977 policy statement, is to:

> Strengthen multilateral discipline and restraint over government actions which affect investment decisions, when such actions might adversely affect other countries.

While it may be argued that U.S. Government intervention in the case at hand is morally justified, the fact remains that it would be a unilateral intervention for U.S. political purposes. Other governments view their interventions, although not aimed at international political objectives, as being at least equal in moral justification. For example, the most important reason for intervention in the investment process by other governments is to increase domestic employment. In

countries where poverty and wide-scale unemployment are endemic, it is hard to argue that the objectives of government interventions are not on sound moral grounds. If everyone plays this game, however, we will be in a downward spiral of beggar-thy-neighbor actions reminiscent of what happened to international trade in the 1930's.

A fourth reason given for the July 1977 conclusion was:

> The United States has an important interest in seeking to assure that established investors receive equitable and non-discriminatory treatment from host governments.

In other words, we seek for our companies operating abroad treatment which is no less favorable than that accorded to domestically-owned companies and companies owned by other foreign nationals. When the United States takes the position that U.S.-owned companies which are located and operating in other political jurisdictions are also subject to U.S. laws, we can hardly expect them to be viewed as nationals entitled to the same treatment as other companies. In effect, such action suggests that U.S.-owned companies have all the rights of domestic companies in the host country and in addition

are subject to U.S. laws and policies where we deem the local laws and policies as insufficient or simply wrong.

We should also ask ourselves if we are prepared to accept political intervention by foreign governments in the activities of U.S. companies operating in the United States in cases where such companies happen to be owned or controlled by foreign nationals. If the answer to that is a unanimous "no," which I am sure it is, regardless of any moral imperatives which might motivate foreign governments, then it is obviously difficult for us to justify unilateral interventions on our part in the activities of U.S.-owned companies operating in other countries.

It might be argued that the actual economic effect of these bills is secondary to the symbolic effect of the United States' taking a concrete step to express disapproval of South Africa's apartheid policy. The Administration of course shares that sense of disapproval. Nevertheless, it is clearly bad public policy to put a law on the books which is ineffective, is difficult and burdensome to enforce, could trigger retaliation against important U.S. economic interests, and is inconsistent with several key aspects of our own national policy toward international investment.

We appreciate the laudable objectives of the sponsors of these bills and I am sure they are put forth under the impression that the effect would be relatively limited and essentially benign. However, the costs of such a symbolic action could be very high, and we strongly urge that these bills not be passed.

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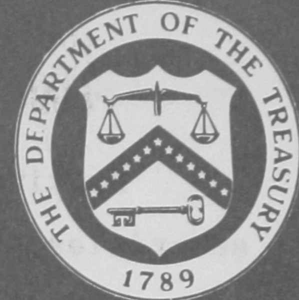

FOR RELEASE AT 4:00 P.M. August 10, 1978

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for $3,500 million, or thereabouts, of 364-day Treasury bills to be dated August 22, 1978, and to mature August 21, 1979 (CUSIP No. 912793 Z5 8). 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 August 22, 1978.

This issue will provide $495 million new money for the Treasury as the maturing issue is outstanding in the amount of $3,005 million, of which $1,891 million is held by the public and $1,114 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 1:30 p.m., Eastern Daylight Saving time, Wednesday, August 16, 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.

(OVER)

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 August 22, 1978, in cash or other immediately available funds or in Treasury bills maturing August 22, 1978. 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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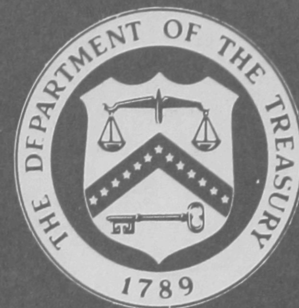

FOR IMMEDIATE RELEASE
August 10, 1978

Contact: Charles Arnold
566-2041

TREASURY ANNOUNCES TENTATIVELY THAT STEEL
WIRE ROPE FROM KOREA IS NOT BEING "DUMPED"

The Treasury Department today announced its preliminary determination that steel wire rope from the Republic of Korea is not being sold in the United States at less than fair value.

"Sales at less than fair value" generally occur when merchandise is sold in the United States for less than in the home market or third countries.

In this case, the petitioner alleged the possibility of sales in the home market, or to third countries, at prices below the cost of producing steel wire rope in Korea. However, cost information received from the Korean manufacturers covered by this investigation could not be analyzed in sufficient time for this tentative determination. Before a final determination is made, which is due in this case by November 15, 1978, Treasury will make a decision as to whether there were in fact sales in the home market below cost. If sales below costs are found and insufficient sales remain at prices above the cost of producing the merchandise, then the "fair value" of Korean steel wire rope will be calculated based upon the verified cost information submitted by the Korean manufacturers.

Notice of this action will appear in the Federal Register of August 15, 1978.

Imports of steel wire rope from the Republic of Korea were valued at $9.7 million during the period May-October 1977.

* * *

B-1099

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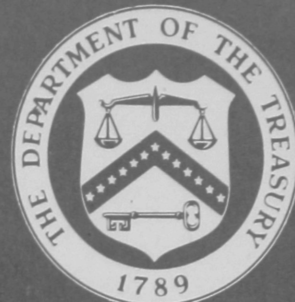

RELEASE ON DELIVERY
EXPECTED 1:30 P.M. EDST
AUGUST 12, 1978

REMARKS OF THE HONORABLE
BETTE ANDERSON
UNDER SECRETARY OF THE TREASURY
BEFORE THE
AMERICAN INSTITUTE OF BANKING
SAVANNAH, GEORGIA

It's a pleasure to be here to discuss the economic and tax policies of the Carter Administration.

We've clearly come a long way since President Carter took office. Since November, 1976 we reduced the unemployment rate by about two points -- from 8 percent to 6.2 percent. Last year, we added more than four million jobs to the economy. And so far this year, we have added 1.8 million more new jobs. We now have almost 59 percent of working-age Americans in civilian jobs -- higher than at any time in our history.

In the last three years, the utilization rate of our nation's industrial plant rose from 72 percent in early 1975 to 84 percent recently. Real per capita disposable income has risen by 13 percent in the same period, and business profits have increased substantially.

This year our economy has grown by about 3-3/4 percent in real terms during the first half of the year. The first quarter, of course, was depressed by the severe weather and the coal strike. But the economy came back strongly, with real growth of close to 7-1/2 percent in the second quarter, based on preliminary figures.

We have only to look around us -- at the city of Savannah, its port, its historical district, its industries -- at the State of Georgia and the rest of the nation -- to see the tangible results of an economy that is strong, vital and growing.

Now that we are well into the fourth year of this recovery, some business executives and analysts have questioned whether it can last much longer. Some have even predicted a recession next year.

B-1100

In our postwar business cycles, the expansion phase has lasted an average of about four years, so some have suggested that we cannot expect a fifth year of expansion in this cycle.

Past patterns, however, have a way of not repeating themselves, and we do not see any fundamental reasons for an end to this expansion in the fifth year.

Fortunately, we have avoided the kinds of major imbalances that brought previous recoveries to an end. Inventories are lean. The ratio of inventories to final sales are at their lowest level in over a decade.

The surplus of apartments and offices that glutted the market four or five years ago has largely disappeared, and vacancy rates for apartments today are unusually low.

While nonfinancial corporations are less liquid today than a year or two ago, they do not have the distortions in balance sheets that undermined business in the early 1970's.

Aside from some building materials, there are no signs of major bottlenecks or shortages that could boost prices for materials and finished goods. The rise in unfilled orders for durable goods has been moderate.

Moreover, we expect business investment to help sustain growth. While it is not high enough to be completely satisfactory, new orders and contracts for new plant and equipment have been 11 percent above a year ago, adjusted for inflation.

We expect consumer spending to continue to rise by close to four percent next year, about the same as our overall growth rate. Personal savings have returned to about normal rates by historical standards, and we see no major shift in consumer patterns in the near future.

Finally, we can foresee some decline in housing starts and construction later this year and in 1979 because of high interest rates. But lending institutions have much stronger financial positions now than in previous cycles, and the demand for housing remains strong -- so we do not foresee a sharp decline in this important segment of the economy.

All in all, we can continue on a path of moderate growth of 3-1/2 to 4 percent through 1978 and 1979 -- _if_ we follow sensible, balanced policies to attack our economic problems.

The dark cloud in the picture, of course, is inflation.

Although we've nearly cut in half the double-digit inflation of three years ago, we still have an unacceptably high underlying rate of about 7 percent.

At this level, inflation is the most serious economic problem we face today. It has created major inequities, hitting some groups of people hard, while others have kept pace with rising prices. It has impaired the competitiveness of American exports and helped erode the exchange value of the dollar. Most important, it jeopardizes our continued economic expansion.

While prices increased in the first half of 1978 by almost 11 percent -- to a major extent because of food prices -- we can expect moderation in those increases during this half.

We expect, for example, food price increases to slacken. A more stable dollar should contribute less to inflation. And the payroll cost increases resulting from the scheduled rise in the minimum wage will be less in 1979 than this year.

But these factors, while significant, are not at the heart of our problem. The central problem in inflation is that pressures on costs of production are mounting.

We simply are not investing enough in new tools of production. At this stage in previous expansions, investment had exceeded its previous peak by an average of 18 percent. This time, investment has exceeded the previous peak level by less than five percent.

Yet we urgently need more investment to increase productivity and keep down costs.

In the past four years, our manufacturing capacity has increased at an annual rate of less than 3 percent, down 1-1/2 percentage points from the growth rate in the postwar period through 1973. And since 1973, productivity growth in manufacturing has fallen by almost half, compared to its average for 1948 to 1973.

We must contain the wage-price spiral that is underway -- as workers seek to catch up with prices, and companies raise prices to catch up with costs. It's the proverbial vicious cycle, and it calls for cooperation and coordination to wind down this spiral.

The Carter Administration takes the inflation problem seriously, and we are carrying out a policy to reduce the rate of inflation without slowing down our economic growth to an unacceptable level.

First, we are exercising budget restraint to contain budget deficits and avoid creating an overheated economy.

While the 1979 deficit will be large, we have already cut the deficit projections we made in January by $12 billion. And the President has encouraged Congress to trim the deficit even further by reducing outlays by another $5 billion.

We are now drawing up the fiscal year 1980 budget with the same restraint that we exercised earlier -- and we expect the 1980 deficit to be substantially smaller than 1979. This will permit sustained growth, without generating undue inflationary pressures.

In recent months, we have heard some voices advocating even slower growth targets -- under three percent, for example -- to help fight inflation.

Unfortunately, the likely result would be only a small drop in wage and price increases and a large increase in unemployment. In fact, only massive unemployment for a very long time would have a significant impact on this inflation -- a cost that is clearly unacceptable, and as we have seen recently, not necessarily guaranteed to keep inflation down.

Consider the impact on business of such a slowdown. As capacity utilization fell, profits would fall. Combined with depressed consumer demand, these would discourage investments needed to improve productivity and restore jobs. We have already been through such a period in this decade, and our lagging growth in productivity is directly attributable to that.

In other words, we cannot afford deliberately to slow economic growth below our long-term potential.

We must instead encourage investment through direct business tax cuts and broader cuts that sustain consumer demand.

That's why we continue to work with Congress for a moderate tax cut. Only with greater incentives to invest will we begin to hold down the rising costs of production.

In view of the overriding public concern about inflation, it is ironic that Congress is seriously considering a massive income tax cut contained in the Kemp-Roth bill.

Instead of working toward a balanced budget, as President Carter's tax proposals would, Kemp-Roth proposes to cut Federal income taxes by one-third over three years -- increasing the deficit by $12 billion the first year and $38 billion by the third year -- figures, I might add, that were developed by supporters of Roth-Kemp.

We do not quarrel with the use of tax reductions, in a slack economy, to stimulate growth. But huge tax cuts in an economy already plagued by inflation is irresponsible. Such cuts would push consumer demand far beyond our capacity to produce goods that could satisfy demand. The inflation that would result would simply undo all the benefits envisioned by the promoters of the Kemp-Roth bill.

Budget restraint and moderate tax cuts, however, are not our only economic policies.

To bring down the wage-price spiral, we are continuing President Carter's deceleration program, seeking voluntary restraint from both business and labor.

In the early months of this program we received considerable support from the business community, and we are seeking to sustain that cooperative spirit.

Also, we are proceeding with specific programs to relieve the very serious problem of structural unemployment. Besides the obvious personal hardships these programs can relieve, we can help ease inflation by training the hard-core unemployed, expanding the pool of skilled labor available to businesses, thereby reducing inflationary pressures caused by tight labor markets.

Finally, we are continuing to push for Congressional approval of the President's energy program. An effective energy program for this nation is the single most important step we can take to reduce our balance of payments deficit.

Last year, about $45 billion went overseas to pay for imported oil -- an unprecedented drain on our domestic income stream -- and an unnecessary burden on our economy. While we can expect some easing of that payments deficit in coming months, we can restore stability to the dollar only when we significantly curb our appetite for imported oil.

That, briefly, is the shape of the Administration's economic program. We consider it an important fulfillment of the pledge we made last fall -- that we would put in place a clear, consistent economic game plan -- and that business leaders would participate in forming that plan.

We've set our priorities, and made clear that our first priority is to fight inflation, for without control of inflation we cannot have a healthy, growing private sector.

So now it is largely up to you. If we are to succeed, these policies need and deserve your strong support. You, as the leaders most concerned about your community's economic needs and the impact of proper handling of resources on those needs, are the logical people to assure the success of a reasonable economic plan.

oOOo

For Release Upon Delivery
Expected at 10:00 a.m.

STATEMENT OF
DANIEL I. HALPERIN, ACTING DEPUTY ASSISTANT SECRETARY
DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY
BEFORE THE
SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES
OF THE COMMITTEE ON WAYS AND MEANS
August 11, 1978

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the eleven miscellaneous bills under current consideration by the Subcommittee. The Treasury Department position on each of these bills is summarized in Exhibit A to this statement.

In our testimony to this Subcommittee we have urged extreme caution in the use of the Subcommittee as a vehicle through which special exceptions to generally applicable rules are created for particular taxpayers. All such claims must be carefully examined and reasonable people may reach opposite conclusions on the merits. However, we must all recognize that *ad hoc* solutions inevitably increase the complexity of the Code, invite other taxpayers to seek similar relief and, unless scrupulously drafted, may create new potentials for abuse.

<u>H.R. 12846</u> (Investment tax credit for poultry structures)

H.R. 12846 is an example of this situation. This bill would amend Code section 48(a)(1) to make eligible for the investment credit buildings used solely for the raising of poultry and for related work and maintenance space. The provision would be effective for taxable years ending on or after August 15, 1971.

Under current law, buildings and their structural components are generally not eligible for the investment credit. Certain special purpose structures are eligible for the credit but only if the structure houses property used as an integral part of a production activity and the structure is so closely related to the use of such property that it is clearly expected to be replaced at the same time as the property that it houses is replaced. Thus, H.R. 12846 would treat poultry structures as eligible for the credit even though under current law they are generally ineligible.

We have proposed expanding the investment credit to all industrial structures. Under our proposal these poultry structures would be eligible for the credit. However, we do not support H.R. 12846 since we believe that extension of the credit to industrial structures should be done on a general, rather than a piecemeal basis. Also, from the standpoint of equity, we do not consider it appropriate to favor investments in buildings used to house poultry raising facilities, over investments in other industrial structures. Finally, H.R. 12846 would apply retroactively to August 15, 1971. This presumably is to resolve in taxpayers' favor pending disputes between taxpayers and the Internal Revenue Service. We oppose this retroactive effective date.

<u>H.R. 12395</u> ("Independent Local Newspapers Act of 1978")

H.R. 12395, designed to provide tax relief to those who own independent "local" newspapers, is another example of specific relief legislation.

The bill is divided into two principal parts. The first permits the establishment of a trust by an independent "local" newspaper for the purpose of paying the estate tax attributable to any owner's interest in the business. The trust must have an independent trustee and its corpus may be invested only in United States obligations. The value of the trust cannot exceed 70 percent of the value of the owner's interest in the business. The income earned on the trusteed

assets will be exempt from tax. The transfer of assets to the trust is deductible by the newspaper business, but is also excluded from the taxable income of the owner. The corpus of the trust is excluded from the owner's gross estate and the estate does not realize income when its estate tax liability is discharged by the trust.

The newspaper must have all its publishing offices located in a single state, and if it is a partnership or corporation, it cannot be traded on an established securities market. Deductions for transfers from the business to the trust are limited to 50 percent of the business profits.

The second part of the bill provides for an elective deferral of the estate tax attributable to the newspaper interest not otherwise paid from the assets of the estate tax payment trust essentially on the same terms as Code section 6166, with the same preferential 4 percent interest rate but without regard to the size of the interest in relation to the owner's estate.

I would like to take a few moments to examine the major aspects of the bill. First, the bill permits a deduction for earnings diverted to the estate tax payment trust. Although the bill provides that such a deduction is allowable under section 162, the payment in no way can be said to meet the "ordinary and necessary" business expense criteria of that section. Nor, is there in the tax law any other provision similarly allowing a deduction for amounts to be used to pay death taxes.

Second, the bill provides that the funds transferred to the estate tax payment trust will not be included in taxable income by the owner. To the extent that the newspaper business is held in corporate form, this payment would in all other cases be treated as a taxable dividend.

Third, the exemption of trust earnings is contrary to existing law which would normally, in this case, treat the beneficiary as the owner of the trust and taxable on its income.

Fourth, exclusion of the corpus of the trust from the owner's gross estate violates existing principles which would include in a decedent's estate any asset in which the decedent or his estate had an interest.

Finally, if it was appropriate to exclude the funding and earnings of the trust from the decedent's income, then the exclusion from estate income of the amount paid by the trust to relieve the estate of its estate tax liability contravenes the basic income tax rule that discharge of an obligation to another results in income to the party whose obligation has been discharged.

The proponents of this bill may argue that many of its provisions are analogous to provisions of existing law. For instance, there are provisions in the deferred compensation area dealing with business deductions, exclusions from income, tax-exempt trusts, and estate tax exclusions. But this is a poor analogy. First, in the employee plan area the law does not discriminate between industries or businesses. Second, although deductions are allowed at the business level, these deductions are allowed only insofar as they meet the "ordinary and necessary" standards of sections 162 or 212. Third, although the employee participating in a retirement plan is not taxed currently as contributions are set aside for him by his employer, those amounts and their accumulated earnings are taxed to the employee, or his heirs, when received. Finally, the estate tax exclusion for certain employee benefits is limited to benefits payable as annuities and does not extend to lump-sum payments. Furthermore, this exclusion is specifically not applicable to the extent the payment is made to or for the benefit of the decedent's estate.

Apart from its significant departure from accepted tax principles the bill has other deficiencies. The benefits are available to any shareholder of an independent "local" newspaper, no matter how many shares are owned and without regard to whether such ownership creates an estate tax liquidity problem. Moreover, there is no provision for the recapture of benefits if the family of the owner does not continue the operation of the local newspaper.

While we are sympathetic to the plight of some owners of small businesses in planning the payment of estate taxes while retaining control of their business in the heirs, we oppose this special relief for one group of "small businessmen." We well understand that these problems have in some cases increased following the enactment of the Tax Reform Act of 1976. In particular, there is now a greater likelihood of a significant income tax liability in the event that a business interest is sold to provide funds for the payment of estate taxes.

It must be noted, however, that present law already provides relief for small business owners and their heirs. Section 303 provides that in certain cases the redemption of stock by a corporation to pay estate taxes will be treated as a redemption and thus subject to capital gains tax rather than as a dividend subject to ordinary income tax. Also, if a portion of the business must be sold to generate funds to pay estate taxes, the gain realized will generally be taxed at the capital gains rate. Further, the transaction can often be structured as an installment sale, in which case the payment of the income tax is deferred over the installment payment period.

In computing the estate tax, there are special relief provisions. In the 1976 Act, the amount of property which may be passed without being subject to the estate tax was increased from $60,000 to $175,000. Also, the marital deduction for transfers to surviving spouses, which before the 1976 Act was limited to one-half the estate, was changed to a limit of the greater of 50 percent of the value of the gross estate or $250,000.

Finally, the payment of the estate tax may be deferred where a business interest constitutes a major part of the estate. Under section 6161(a) the time for payment of the estate tax may be extended for up to 10 years upon a showing of reasonable cause. Reasonable cause exists when an estate consists largely of a closely held business and does not have sufficient funds to pay the tax on time, or must sell assets to pay the tax at a sacrifice price. In section 6166 a five-year deferral and 10-year installment payment is allowed if the value of an interest in a closely held business exceeds 65 percent of the adjusted gross estate. Finally, section 6166A is applicable to a broader number of situations, those in which the value of the closely held business interest is either 35 percent of the gross estate or 50 percent of the taxable estate. Under that section the estate tax attributable to the closely held business interest may be paid in up to 10 annual installments. As valuable as a free and vigorous press is to this nation, we do not believe that an ownership interest in such business should be entirely free from tax. If the independent local newspaper industry has particular problems arising from its economic circumstances, the tax expenditure method may be one of the least controllable method of dealing with them. Consideration should be given to other means of relieving the burdens of payment outside of the framework of the tax laws. For instance, special loan programs might be considered. To

the extent the value of these businesses is being artificially escalated by takeover bids from larger newspapers, consideration might be given to the remedies available under anti-trust law.

The adoption of this bill would provide a wedge to be used again and again by other segments of society, each arguing its own importance. We do not believe in this piecemeal approach to legislation. There are existing provisions intended to minimize the problems inherent in the payment of taxes. If they are inadequate they should be reviewed in a comprehensive and not an ad hoc manner.

H.R. 8533 (Exemptions for income received by certain tax-exempt organizations from bingo and similar games)

These four bills deal with the tax treatment of income from the conduct of bingo and similar games of chance by certain tax-exempt organizations. Under H.R. 7460 and H.R. 13405 the unrelated business income tax would not be applicable to the income from such games conducted by organizations exempt under Code section 501(a) if wagers are placed, winners determined and prizes distributed in the presence of the participants. The bills also require that such games not be "ordinarily carried on a commercial hbasis;" and that the conduct of the activity not violate applicable local law. H.R. 8533, H.R. 9429 and H.R. 13405 would exempt from tax income from bingo and similar games when conducted by political organizations subject to Code section 527.

The Treasury generally is opposed to the creation of special exceptions from the unrelated business income tax. One policy underlying the unrelated business income tax is to insure that exempt organizations do not compete on an unfair competitive advantage with commercial enterprises. Also, bingo and similar games are not substantially related, apart from the need of tax-exempt organizations for funds, to the purpose or function constituting the basis for the organization's exemption. In this context, the conduct of bingo is unrelated, may compete with commercial enterprises and thus should be taxable.

There is an exception under current law, Code section 513(a)(1), which exempts income from these games from the unrelated business income tax if the activity is carried on with volunteer labor. We do not regard this exception as inappropriate since an organization is not likely to engage in large scale, commercial activities where they are conducted through volunteers. Thus, we would not object to a similar exception in the case of political organizations.

If the Committee believes that the tax exemption for income from certain games should be extended, we would urge that the exception be limited to bingo and should not be extended to other games of chance which are essentially casino activities. Furthermore, we would limit the exemption to situations where the conduct of bingo games by exempt organizations is specifically sanctioned by applicable State or local law and, under such law, may not be carried on by taxable enterprises. If the legislation were restricted in this fashion it would be more consistent with the underlying policy of the unrelated business income tax. Finally, the bills to extend the exemption from unrelated business income tax to tax-exempt organizations which carry on the activity with paid employees would apply retroactively to 1969 and subsequent years. This would have the effect of overturning two Court decisions, which we oppose.

H.R. 8615 (Income averaging for certain taxpayers who have changed marital status)

We understand that the bill is directed at the situation in which a taxpayer is attributed base period income earned by a former spouse for purposes of determining his eligibility for income averaging. Under Code section 1304(c)(2), during any base period year unless a taxpayer and spouse filed a joint return and the taxpayer had no other spouse in that year, that base period year income is the greatest of (1) the individual's separate income and deductions for that year; (2) 50 percent of the total of both his and his former spouse's separate income and deductions for that year; or (3) 50 percent of the total of his and his present spouse's separate income and deductions for that year. Thus, even if the taxpayer's former spouse earned 100 percent of the taxable income for a base period year, the taxpayer's base period income would be 50 percent of such taxable income. This will generally result in the lower income taxpayer failing to qualify for the benefits of income averaging, because his current income will not exceed by $3,000 120 percent of his base period income.

We believe that present law operates properly in the situation described above. The low-income spouse received a benefit during the base period years from filing a joint return with the high-income spouse, since the household enjoyed greater after-tax income in those years as a result of the joint return. Thus, we are opposed to the bill.

H.R. 13047 (Tax accounting rules for trading stamps and coupons redeemed after the close of the taxable year)

The last bill, on which I will comment, concerns the proper tax accounting treatment of certain trading stamps and coupons redeemed after the close of a taxable year. Specifically, since 1918 the income tax regulations have allowed taxpayers who issue certain trading stamps and premium coupons to exclude from gross receipts the estimated redemption cost of stamps and coupons outstanding at the end of the year. The regulation (Treasury Regulation section 1.451-4) applies only to trading stamps and premium coupons issued "with sales" and which are "redeemable in cash, merchandise, or other property." H.R. 13047 would codify the regulation and extend its application to discount coupons which allow "cents-off" on the purchase price of merchandise or property.

The Treasury is opposed to this bill. We are currently studying the problem of the proper accounting rules for discount coupons and expect shortly to propose an alternative solution. However, I would like to discuss with you the various issues and the considerations involved.

In 1973 the Internal Revenue Service ruled that the trading stamp and premium coupon regulation does not apply to so-called "media" type discount coupons. "Media" coupons are those which are distributed gratuitously through the mail or in newspaper or magazine advertisements. In June of this year the Internal Revenue Service ruled that the regulation also does not apply to so-called "in pak/on pak" discount coupons. These are coupons which are either inside the package of the product or on the outside of the package. The IRS ruling regarding "media" coupons relied on the fact that they are not issued "with sales" as required by the regulations. Both rulings were based on the underlying intent of the regulation that the use of property, such as trading stamps and premium coupons, not be conditioned on a future event. The issuer of discount coupons has no obligation to redeem them unless and until the consumer purchases the requisite product. Trading stamps and premium coupons, on the other hand, are subject to redemption immediately.

We believe that the IRS's rulings are proper. We acknowledge, however, that there may not appear to be a great difference between trading stamps and premium coupons on one hand and discount coupons on the other. In fact, we

understand that a number of discount coupon issuers have relied on the trading stamp and premium coupon regulation in creating a reserve for their future redemptions, while taking a current tax deduction. Thus, we believe that any confusion in the tax treatment of discount coupons should be promptly resolved. However, we do not believe that the proper result is simply to add discount coupons to the trading stamp and premium coupon rules. A reserve for discount coupons, in our view, raises a number of far-reaching tax policy issues concerning the proper measure of gross income and the allowability of reserves for estimated future expenses.

The rationale of the trading stamps and premium coupons regulation is that when the consumer has purchased the product and has received the stamps or coupons, he has purchased two things -- the product and the stamps or coupons. Conversely, the seller has sold the product and the stamps or coupons. When a taxpayer sells property, his gross income is not the revenue he receives, but is the revenue less his cost of the product. With respect to the portion of the sale that relates to the trading stamps or premium coupons, were we to tax the full amount, we would be taxing the gross receipt. However, consistent with general tax concepts the seller offsets the gross receipt with the estimated cost of the goods he is selling. This cost is the estimated cost of redemptions. This is consistent with current tax accounting rules.

The case of trading stamp companies is clearer. What they are selling is the merchandise consumers turn their stamps in for. Revenue is received when they sell the stamps to retail stores. When that sale takes place, they have sold property and the gain on the sale is the difference between the revenue and the cost of the merchandise that will be used when the stamps are redeemed.

Discount coupons, however, are a different matter. I will first discuss "media" coupons, i.e., those that are issued directly or in the print media. When an issuer mails out thousands of cents-off coupons, he has no fixed immediate obligation to redeem them. The consumer must purchase the product first. These discount coupons are in the nature of promotion expenses and we understand that it is in this manner that most issuers include them in their financial statements. General tax rules provide that an expense does not accrue until all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy.* We understand that the issuer may not have a legal obligation to redeem discount coupons until

the redemption center has verified their validity and compliance with the applicable coupon agreement. The earliest time for accrual may be when the consumer has used the coupon to purchase the product. However, since these media coupons are not issued with the sales of the product, there is no issue of proper determination of gross income on these sales. It is strictly a question of a reserve for future expenses, which as a general rule is not allowed by the Internal Revenue Code.

The issue presented by this bill is whether these transactions should be given a special accrual rule. Currently there are areas within the tax law where reserves are allowed; most notably, the bad debt reserve and the reserve for accrued vacation pay. However, it should be noted that in 1954 Congress enacted Code sections 452 and 462 which changed the accrual rules by allowing deferral of prepaid income and accrual of reserves for estimated future expenses and, less than a year later, repealed these sections retroactively. In large part the repeal was due to the unanticipated large revenue loss for the adjustment on the change of method of accounting for these items. Since that time, the reserve issue has been raised periodically and Congress has been very cautious about allowing such rules. Thus, we believe that very careful consideration should be given before a reserve for future expenses is allowed with respect to media type discount coupons.

With respect to in pak/on pak coupons, the issues are slightly different. We recognize that there is a reasonable argument that like trading stamps and unlike media coupons, they are issued with sales and part of the cost of the product relates to the coupon. However, to which sale do they relate -- the current one or the future one? We do not believe there is a definite answer. If it is the latter -- the future sale, in pak/on pak coupons are no more acceptable than media coupons. In any event, like media coupons and unlike trading stamps the obligation to redeem them is contingent on a future purchase.

I would like to discuss one more specific issue presented in the bill. The current trading stamp and premium coupon regulation allows an exclusion only for the cost of the cash or merchandise of the future redemption of the stamp or coupon. No accrual of related expenses incurred to service such redemptions, such as service center costs, is allowed. These expenses clearly do not accrue until later, when the service has been performed. However, with respect to discount coupons, this bill would allow the accrual of the

service fee paid to the retailer and the redemption center. This would allow a current deduction for services to be rendered and paid for in the future. We strongly oppose such an accrual.

As I previously stated, we are presently studying these issues concerning the proper treatment of discount coupons. We believe they are economically different than trading stamps and premium coupons and under current rules of tax accounting should not be treated the same. We believe we can resolve the problem shortly with a fair and equitable rule consistent with current tax law.

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* Treasury Regulation section 1.461-1(a)(2).

Exhibit A

Summary of Treasury Positions

1. H.R. 8533 (Exemption from income received by certain tax-exempt organizations from bingo and similar games)

The Treasury supports these bills only on a prospective basis and only with respect to bingo games where they are conducted in accordance with State and local law and pursuant to such law may not be conducted by profit-making businesses.

2. H.R. 8615 (Income averaging for certain taxpayers who have changed marital status)

The Treasury opposes this bill.

3. H.R. 8696 (Tax treatment of retroactive determination of eligibility for disability compensation from the Veteran's Administration)

The Treasury has no objection to this bill.

4. H.R. 12395 ("Independent Local Newspaper Act")

The Treasury opposes this bill.

5. H.R. 12845 (Investment credit for poultry structures)

The Treasury opposes this bill.

6. H.R. 12950 (Nonrecognition of gain on the sale of residence for certain members of the Armed Forces)

The Treasury has no objection to this bill.

7. H.R. 13047 (Tax accounting rules for trading stamps and coupons redeemed after the close of the taxable year)

The Treasury opposes this bill. We are currently studying the problem and expect shortly to propose an alternative solution.

8. H.R. 13092 (Small tax case procedures of the Tax Court)

The Treasury supports this bill. However, we recommend that it be made clear that the Government will have the right in appropriate circumstances to remove cases from the small tax case category.

Exhibit B

Treasury Comments on H.R. 13092, 8696 and 12950

H.R. 13092 (Small tax case procedures of the Tax Court and authority of Tax Court commissioners)

The Treasury Department supports this bill which would increase the jurisdictional limits for small tax cases from $1,500 to $5,000. This is a desirable step to help relieve the Tax Court judges of the need to deal with mainly routine factual cases. At the same time, however, it is important that the Government have the right to insure the removal of appropriate cases from the small tax case category. We recommend that the legislative history recognize the authority of the Tax Court to remove a case from the small case category when the orderly conduct of the work of the Court or the administration of the revenue laws call for a regular trial of the case. We will be glad to consult with the staff of the Joint Committee and the Tax Court in drafting appropriate language.

H.R. 8696 (Tax treatment of retroactive determination of eligibility for disability compensation from the Veteran's Administration)

The Treasury has no objection to this bill. On March 18, 1978 the Internal Revenue Service published a ruling which would interpret existing law in a manner substantially similar to the provisions of this bill. In addition, the bill has two desirable provisions not in Rev. Rul. 78-161: it would allow taxpayers a one-year period during which to apply for refunds after a retroactive determination had been made with respect to a closed tax year and also would limit the interest due on any refund allowed by the bill to the period commencing after the Veteran's Administration determination.

H.R. 12950 (Nonrecognition of gain on sale of residence for certain members of the Armed Forces)

The Treasury Department does not oppose this bill which would extend the nonrecognition of gain period on the sale of a principal residence by a members of the Armed Forces who are stationed outside of the United States or who are required to reside in Government-owned quarters for at least a one-year period after the date on which the taxpayer is no longer stationed outside the United States or is no longer required to reside in Government-owned quarters.

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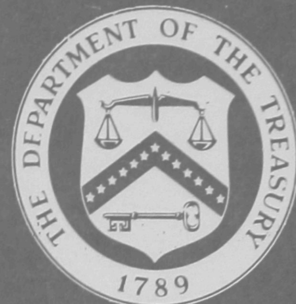

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.

STATEMENT OF
DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE
TASK FORCE ON EMPLOYEE FRINGE BENEFITS
OF THE WAYS AND MEANS COMMITTEE
August 14, 1978

Mr. Chairman and Members of this Task Force:

I am pleased to appear here today to comment on the tax treatment of employee fringe benefits.

The income tax treatment of most types of fringe benefits is clear. Unless specifically exempted from tax by statute, the Internal Revenue Code requires that fringe benefits be included in income, and the courts have upheld this requirement over many years in many different circumstances.

The uncertainty which exists under present law is limited primarily to two types of fringe benefits. One type is the fringe benefit which is a product of the employer's business -- such as transportation provided by a transportation company, education provided by a university, and discounts provided by a company which produces or sells the discounted goods. Another type is the fringe benefit which is indirectly related to the employee's job, such as limousines for commuting and "supper money".

The primary question before this Task Force, then, is whether these two types of fringe benefits should be taxable. The answer to this question will turn on identification of the true nature of the particular benefit and the administrative feasibility of subjecting it to tax. I shall, at a later point, suggest some principles to be applied in deciding these issues. However, I would like first to discuss the considerations of equity and economic efficiency which demonstrate that these issues must be squarely faced.

B-1102

Inequity and Economic Inefficiency Caused by Exempting Fringe Benefits From Tax

Fringe benefits come in a wide variety of shapes and sizes. They also vary widely in their patterns of distribution. As the Commissioner has pointed out, the nature and extent of fringe benefits vary from industry to industry, from employer to employer within industries, and from employee to employee in the case of a single employer. For these reasons, exempting fringe benefits from tax or valuing them at less than real value creates substantial tax inequities among employees.

Fairness requires that taxpayers with equal incomes be treated equally for income tax purposes. Compensation received in kind may be just as valuable as compensation received in cash. When fringe benefits are exempted from tax, taxpayers with equal incomes pay unequal taxes.

Exempting fringe benefits from tax produces unfairness not only among employees at the same income level, but also among employees at different income levels. When a fringe benefit is exempted from tax, the exemption is of greater value to a high-income taxpayer than to a low-income taxpayer. For a person in the highest tax bracket, an exemption provides 70 cents in tax savings for every dollar's worth of fringe benefits received. For a person in the lowest tax bracket, the exemption is worth only 14 cents. For a person with income too low to be taxed, the exemption is worth nothing.

There may be a social welfare purpose which justifies these horizontal and vertical inequities for the statutory exclusions, such as for pensions or life insurance, which already exist. No such purpose exists with respect to the cases which have become controversial.

When a fringe benefit is exempted from tax, the resulting tax savings to the employee makes the fringe benefit worth more than cash compensation of equal value. Suppose, for example, that an employee in the 50 percent tax bracket receives as a fringe benefit an item worth $100. In order to purchase that benefit out of after-tax dollars, the employee would have to earn $200 in wages, pay tax on the wages, and then use the remainder to purchase the item. It is true that the item may not be worth $100 to the employee; that is, the employee may only be willing to pay $80 in after-tax wages for the item. Still, since that would require $160 in before-tax wages, the employee would prefer

the $100 fringe benefit to any amount of wages up to $160. Thus, exempting fringe benefits from tax creates a strong incentive to convert cash compensation into tax-free fringe benefits.

This incentive to provide tax-free fringe benefits instead of cash has unfortunate effects. First, it is likely to result in significant erosion of the tax base. This, in turn, would make it necessary to increase tax rates for items of income which are not exempt, exacerbating tax inequities among employees which resulted from exempting fringe benefits in the first place.

As taxpayers perceive themselves as being treated unfairly in comparison to other taxpayers, they may begin to lose confidence in the income tax system and in government. In a tax system that is dependent upon self-reporting, such a decline in confidence may lead to a decline in compliance.

Second, an incentive to provide tax-free fringe benefits instead of cash reduces economic efficiency. When fringe benefits are exempted from tax, employees demand and employers provide more compensation in the form of those benefits than they would if the benefits were taxed. This shift in demand causes a distortion in the economy. The tax law is interfering with free choice in the allocation of economic resources.

Third, exempting fringe benefits from tax leads to distortions in labor markets and creates inequities among employers. Employees accept less total compensation if a portion is in tax-free fringe benefits than if the entire compensation is in cash. In the example I gave before, an employer offering less than $160 in wages could not compete with an employer offering the $100 fringe benefit. Thus, employers who are able to provide compensation in the form of tax-free fringe benefits are given a competitive advantage over employers who are not. When fringe benefits are exempted from tax, employees shift to the tax-preferred industries. Employers who do not want to play these games, who want to pay cash compensation, who want to concentrate on increasing production rather than finding ways to take advantage of tax subsidies, or who simply are limited in the extent to which they can offer fringe benefits, are heavily penalized.

In sum, exempting fringe benefits from tax leads to inequities among employees and employers and distortions in demand and in labor markets. These inequities and distortions imply added complexity in the economy and loss of welfare to individuals.

Practical Problems in Taxing Fringe Benefits

Despite these compelling policy reasons for taxing fringe benefits, some claim that practical problems make it impossible to do so. They point to difficulties in distinguishing between fringe benefits and working conditions. They point to problems in valuing fringe benefits. And they point to the administrative burdens of accounting for many benefits of small value.

While these obstacles to taxing fringe benefits may be significant, they should not be insurmountable. However, problems in identifying, valuing, and reporting fringe benefits are an appropriate subject for public comment before this Task Force. We can suggest some general guidelines.

Working Conditions Distinguished

Some noncash items provided by employers to employees are so closely connected with the employee's performance of his job that the items would not be considered compensation and therefore would not be taxed. Items provided to enable the employee to perform the job, rather than to compensate him for performing it, are commonly called working conditions.

The basic factor in distinguishing between working conditions and other noncash items is the relationship between the item and the employee's performance of his job. Generally, items which are used by the employee in performing his job should be considered working conditions, at least to the extent of that use.

Many working conditions are easy to recognize. For example, tools provided by an employer for an employee's use on the job are working conditions. Offices also are working conditions, even if they have features designed to make work more pleasant, such as air conditioning and piped-in music. Even if those features do, in fact, make work more pleasant, the office still is a working condition.

Many items which are not working conditions also are easy to recognize. An all-expenses-paid vacation at a luxurious resort may improve an employee's attitude toward his job, but that vacation is no more a working condition than is a $5,000 bonus.

In determining whether an item is used by the employee in performing his job, it is relevant to look at where and when the item is used. Items are more likely to be working conditions if they are used by the employee at his place of employment during normal working hours. For example, if an automobile manufacturer provides one of its executives with a new car for personal use and requires that the executive report his reaction to the car, the use of the car is not likely to be a working condition even though it must be used in order to write the report.

Even if an item is not used in performing the employee's job, it still may be appropriate to consider it a working condition if it plays an essential role in enabling the employee to perform the job. For example, lodging provided at the job site because the employee is required to be available for duty at all times, is excludable from income under Code section 119.

The relationship between an item and the employee's job should be scrutinized with particular care if the item is essentially personal in nature. By "essentially personal" items, I mean those which individuals ordinarily pay for out of after-tax dollars, such as food, clothing, shelter, and any item provided to a member of the employee's family.

Items which are essentially personal are likely to be compensatory. If exempted from tax, they are also likely to be a primary source of inequity among taxpayers. In developing rules to determine which essentially personal benefits are to be subject to tax, it would seem appropriate to focus on whether the cost of an item would be deductible if paid for by the employee. Since personal expenses such as meals and commuting are not deductible, the creation of rules of inclusion which deviate too far from the rules regarding employee deductibility could result in substantial inequity.

Even when use of an item is noncompensatory at a particular time, allocation between periods of compensatory and noncompensatory use should be made where it is feasible to do so. Such allocation often is possible where personal and business use of an item do not occur simultaneously. For example, a salesperson may use an employer-provided automobile during the day to travel to customers, and may use the same automobile during the evening for personal purposes. In such a case, allocation of value should be made between compensatory and noncompensatory use.

Valuation

The next question is how taxable fringe benefits should be valued. As the Commissioner has said, the regulations under section 61 require the recipient of compensation paid in any form other than cash to include in income the "fair market value" of the compensation. In addition, a specific statutory provision, section 83 of the Code, provides that where "property" has been transferred in connection with the performance of services, the recipient is required to include in income the excess of the fair market value of the property over the amount paid for it. For these purposes, "fair market value" is the price which would be paid for the benefit if it were purchased in an informed marketplace transaction. This standard has been generally applied by the courts in determining the value of in-kind benefits and was specifically adopted by the Staff of the Joint Committee on Taxation in determining the amount of income President Nixon realized on account of the personal use of government aircraft by his family and friends.

Some assert that it is unfair to treat a fringe benefit as having a value equal to its market price because fringe benefits are generally nontransferable and are substituted for cash in a process which depends upon the relative bargaining strengths of the employer and the employee. They conclude that the value of the benefit should be equal to the cash payment the employee would demand if the benefit were not available. In other words, they assert that subjective value is the appropriate income measure.

Subjective value is a superficially appealing choice. Indeed, it was adopted once by the Tax Court in determining the value of first class steamship tickets won as a prize on a radio quiz. Assuming accurate measurement of the personal value of the benefit, a system based on personal value would achieve a type of tax neutrality. It would avoid establishing a tax incentive to provide benefits in kind, without creating an offsetting tax disincentive. By definition, tax treatment would not determine whether compensation is received in cash or in kind because tax liability would not vary according to the form of the payment.

Unfortunately, however, it would be administratively impossible to tax fringe benefits on the basis of their subjective value to the recipient. It is unreasonable to expect a self-assessment tax system to function effectively if income is subjectively determined on a case-by-case basis. Problems of accurate withholding and information reporting under such a system are virtually insoluble.

Of course, even if it is agreed that fringe benefits should be taxed on the basis of objective fair market value, a number of important questions remain. An item may have more than one objective fair market value. For example, when the Joint Committee Staff determined the value of the economic benefit to President Nixon of personal use of government aircraft, it had to choose between two "fair market" values -- the per-passenger cost of first class air fare on a commercial airline, or an allocated portion of the cost of renting a comparable plane. It chose the former.

The same issue arises in other contexts. For example, if an employee discount is treated as a taxable fringe benefit, should the value of the discount be determined by reference to the price of the discounted item at the time of purchase, or the lowest price at which the item has been offered to the public within a defined time period?

Further, notwithstanding the fact that the objective fair market value standard is consistent with generally accepted valuation standards, it may be appropriate to consider other alternatives. For example, some suggest that the objective fair market value standard be adopted as the base for income inclusion but that the base value be discounted by some percentage to reflect individual utility.

Administrative difficulties of valuation, particularly those involving withholding, may be alleviated by the creation of generally applicable guidelines or safe harbor rules regarding either the value of the benefit or the amount to be withheld. As an illustration of the former, the value of a personal flight on a company airplane could be determined by reference to first class airfare bewteen the points. As to the latter, an employer who allows an employee to use, in nonworking hours, a company car usually used for business could be deemed to have satisfied his withholding obligation by withholding based on a fixed dollar amount.

Accounting and Reporting

The taxability of noncash items provided by employers to employees should depend not only on the nature of the item, but also on the administrative implications of taxing it. Tax simplicity is as important as tax equity. Unreasonably expensive recordkeeping requirements should not be imposed on employers. Nor should Internal Revenue Service audit resources be frittered away.

Compensation in kind should not be taxed if it would be administratively impractical to do so. If the total combined costs of an employer in accounting for an item and of the government in collecting tax on it would be unreasonably large in relation to the value of the item, the item should not be subject to tax.

When looking at specific, isolated examples of employer-provided items, it is not difficult to suggest some which should be exempt from tax for administrative reasons. For example, Revenue Ruling 59-58, 1959-1 C.B. 17, holds that the value of a turkey or ham provided by an employer to each of his employees at Christmas or a comparable holiday should be excludable from income. Similarly, employees should not be taxed on the value of attending their employer's annual company picnic.

Rules for determining which benefits should be excluded for administrative reasons (*de minimis* rules) could apply on an item-by-item basis. For example, an item whose value did not exceed a specified dollar amount could be excludable from income. A discount on an employee purchase could be excludable if the sales price of the item purchased did not exceed a specified dollar amount, or if the discount did not exceed a specified percentage of the sales price. We are not suggesting that we have decided upon these rules. Rather, we raise them as examples of the types of solutions the public may wish to address in its comments.

We note that applying *de minimis* rules solely on an item-by-item basis could allow large total amounts to be excluded from income. A Christmas dinner may be *de minimis*, but a year of free meals in an executive dining room may not be. A set of china may not be *de minimis*, and every piece of china in the set can be purchased separately.

To avoid becoming a sieve, ideally *de minimis* rules should take into account in some way the aggregate value of noncash items provided by an employer to an employee during the year. We recognize the potential difficulty of accounting for numerous small items, but we believe this difficulty can be avoided. Reasonable approximation of value may well be appropriate for some types of items. We also note that employers already keep records of the amounts and recipients of many types of fringe benefits. They may do so for purposes of tax deductibility, internal cost accounting, or disclosure required by the Securities and Exchange Commission.

In conclusion, we note that most types of fringe benefits are clearly subject to tax and that an exemption for others would create serious inequities and economic distortions. We recognize that there are potential administrative problems in taxing some types of fringe benefits. However, we believe these problems can be solved. Hearings before this Task Force could provide the information needed to do so.

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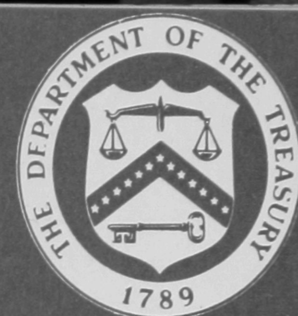

FOR IMMEDIATE RELEASE
August 11, 1978

Contact: George G. Ross
202/566-2356

TREASURY RELEASES RESULTS OF
NATIONAL ASSOCIATES STUDY OF PENSION PLAN

The Treasury Department today released the results of a study designed to assist in evaluating the impact on small pension and profit-sharing plans of the Administration's proposal to change the present pension-social security integration rules in the Internal Revenue Code.

Plans which reduce private pension benefits or contributions based roughly on an employee's anticipated benefits from social security are said to be "integrated." Under present law, it is possible for employees whose earnings are lower than the social security wage base ($17,700 in 1978) to receive little or nothing from an integrated private pension plan.

The study was conducted by National Associates, an actuarial and consulting firm which services small and large plans. At the request of the Treasury, and without commitment to the Treasury's position, National Associates undertook the study of its plans voluntarily in the public interest and at no cost to the government.

On April 25, 1978, the Treasury released the A. S. Hansen study which surveyed defined benefit plans only. That study represented mainly larger plans. The National Associates study, however, has a good representation both of defined contribution plans and of smaller plans. The study is based on a survey of 2,155 plans (1,205 defined benefit plans and 950 defined contribution plans) selected at random. Thirteen offices affiliated with National Associates participated in the survey. The participating offices are located in Atlanta, Baltimore, Chicago, Cleveland, Detroit, Honolulu, Houston, Los Angeles, New York, Philadelphia, Providence, San Francisco, and Seattle.

A defined benefit plan may be described as one for which the monthly pension is determined by a formula usually involving the employee's pay and service. In a defined contribution plan, the benefit depends on the amount in the employee's account at retirement.

B-1103

The Administration's proposal, part of the President's 1978 tax program, would provide at least some benefits to those who now are not receiving any benefits, and would improve the benefits of other participants who are also affected by present integration rules. In large part, employees who would benefit most from the proposed change range from low to moderately paid. They would range from those with wages considerably below the social security wage base to those with wages somewhat above that wage base.

The Administration's proposal generally is that plans can provide pensions based on pay in excess of the social security wage base no greater than 1.8 times the pensions based on pay below the social security wage base.

Alternatively, the Administration's proposal will allow plans integrated by the social security offset method to use as a maximum offset the same portion of social security benefits as the portion of pay provided by the plan formula. For example, a plan could provide a pension of 50 percent of final average pay reduced by 50 percent of Social Security; or, 60 percent of final average pay reduced by 60 percent of Social Security.

The National Associates study found that nearly half of the plans were not integrated and therefore clearly would not be affected by the President's proposal. Of the 2,155 plans analyzed 1,182 were integrated, or 55 percent. Furthermore, of these 55 percent, more than 200, when tested without reference to any other employer plans, would clearly meet the Administration's guidelines.

Evidently a substantial number of integrated pension plans are maintained by employers who also maintain a non-integrated defined contribution plan. If those plans were tested together, as the Administration proposal permits, even a higher percentage of plans would meet the Administration test. A number of additional plans would also meet a more liberalized rule--2.0 instead of 1.8--that has been suggested by the Administration as a modification to its original proposal.

The 2,155 plans included in the National Associates study are sorted into categories of: (1) non-integrated plans, (2) pure excess plans, (3) step-rate excess plans, and (4) offset plans.

The 1,182 integrated pension plans include 17 percent which are offset plans and 67 percent which are step-rate excess plans. Fourteen percent are pure excess plans. Two percent have frozen benefits.

For further information, contact:

Gabriel Rudney (Treasury)	202/566-5911
Howard Neal (National Associates)	213/626-5542

The National Associates study, "Analysis of the Effect of Proposed Integration Rules on Small Pension and Profit-Sharing Plans," is attached.

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ANALYSIS

OF THE EFFECT OF PROPOSED INTEGRATION RULES

ON SMALL PENSION AND PROFIT SHARING PLANS

Prepared at the Request of the

United States Department of the Treasury

By

NATIONAL ASSOCIATES, INC.

I. Total plans analyzed:

Defined benefit plans	1,205
Defined contribution plans	950
Total	2,155

II. Offices participating are located in the following cities:

Atlanta, Baltimore, Chicago, Cleveland, Detroit, Honolulu, Houston, Los Angeles, New York, Philadelphia, Providence, San Francisco, and Seattle.

III. Plans analyzed by type and size (active participants):

Number of Active Participants	Defined Benefit	Defined Contribution	Total
Under 10	675	536	1,211
10 - 25	294	221	515
26 - 100	182	146	328
101 - 1,000	54	47	101
TOTAL	1,205	950	2,155

Plans with more than 1,000 participants were omitted from the analysis; 80% of the surveyed plans and 80% of the integrated plans analyzed covered 25 or fewer participants.

IV. Plans analyzed, breakdown by type of integration formula:

Integration Formula	Defined Benefit	Defined Contribution	Total
Not Integrated	252	721	973
Integrated	952	229	1,182
Benefits frozen	5	6	11
Excess only	155	12	167
Step-rate	596	211	807
Offset	197	-0-	197
TOTAL	1,205	950	2,155

54% of all plans analyzed are integrated, 79% of the defined benefit plans are integrated, 23% of the defined contribution plans are integrated.

V. Plans analyzed in terms of compliance with the Treasury Department's proposed integration guidelines (generally the proposal provides that pensions based on pay in excess of the integration level can be no greater than 1.8 times pensions based on pay below the integration level; Social Security "offsets" could be no more than the portion of pay provided by the plan formula).

Effect of Proposal	Defined Benefit	Defined Contribution	Total
Integrates	123	80	203
Fails to integrate	830	137	967
Unable to determine	-0-	12	12
TOTAL integrated now	953	229	1,182

If the Treasury Department's original recommendations were adopted, 87% of the integrated defined benefit plans would require revision, 60% of the integrated defined contribution plans would require revision, and 82% of all integrated plans would have to be amended.

I. Detailed analysis, defined benefit plans:

	Under 10	10 - 25	26 - 100	100 - 1000	Total
Not Integrated	178	30	35	9	252
Integrated	497	264	147	45	953
Frozen Benefits	-0-	1	2	2	5
Excess only	92	44	16	3	155
Step-rate (Integrates)	53	18	8	3	82
Step-rate (Fails to Integrate)	253	157	82	22	514
Offset (Integrates)	24	3	9	5	41
Offset (Fails to Integrate)	75	41	30	10	156
TOTAL	675	294	182	54	1,205

II. Detailed analysis, defined contribution plans:

	Under 10	10 - 25	26 - 100	100 - 1000	Total
Not Integrated	424	144	114	39	721
Integrated	112	77	32	8	229
Frozen accounts	3	1	1	1	6
Excess only	6	5	1	0	12
Step-rate (Integrates)	44	23	12	1	80
Step-rate (Fails to Integrate)	51	46	17	5	119
Step-rate (Unable to Determine)	8	2	1	1	12
TOTAL	536	221	146	47	950

VIII. Detailed analysis of excess and step-rate plans, by integration level:

Integration Level	Defined Benefit 1/	Defined Contribution	Total
Under $6000 per year	96	4	100
$6000 - $8400	304	25	329
$8400 - $12,000	38	61	99
Over $12,000	36	133	169
Table I - fixed 2/	227	-0-	227
Table I - current 2/	50	-0-	50
TOTAL	751	223	974

20% of the defined benefit plans adjust automatically as Social Security benefits adjust (4% step-rate, 16% offset). 14% of the defined contribution plans adjust automatically as the Social Security wage base changes.

1/ These are almost exclusively flat benefit plans. Excluded are 197 integrated offset plans and 5 integrated plans with frozen benefits.

2/ Integration level was $8400 per year for employees retiring in 1978 under current IRS rulings.

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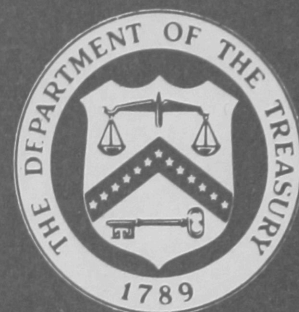

FOR IMMEDIATE RELEASE August 14, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,300 million of 13-week Treasury bills and for $3,401 million of 26-week Treasury bills, both series to be issued on August 17, 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 November 16, 1978			26-week bills maturing February 15, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.265	6.864%	7.08%	96.338	7.244%	7.62%
Low	98.255	6.903%	7.12%	96.328	7.263%	7.64%
Average	98.259	6.887%	7.11%	96.330	7.259%	7.64%

Tenders at the low price for the 13-week bills were allotted 77%.
Tenders at the low price for the 26-week bills were allotted 47%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 23,435,000	$ 23,435,000	$ 23,360,000	$ 7,360,000
New York	3,130,015,000	1,836,615,000	5,356,010,000	3,120,405,000
Philadelphia	16,325,000	16,325,000	12,615,000	12,615,000
Cleveland	26,760,000	26,760,000	38,420,000	13,420,000
Richmond	25,050,000	25,050,000	14,525,000	11,575,000
Atlanta	48,825,000	46,525,000	25,605,000	25,605,000
Chicago	271,570,000	125,340,000	211,845,000	59,195,000
St. Louis	28,180,000	12,180,000	25,965,000	9,965,000
Minneapolis	18,580,000	17,430,000	19,790,000	12,140,000
Kansas City	37,010,000	37,010,000	24,280,000	16,405,000
Dallas	10,835,000	10,835,000	7,385,000	7,385,000
San Francisco	306,445,000	115,295,000	337,215,000	97,865,000
Treasury	7,210,000	7,210,000	7,480,000	7,480,000
TOTALS	$3,950,240,000	$2,300,010,000a/	$6,104,495,000	$3,401,415,000b/

a/ Includes $332,175,000 noncompetitive tenders from the public.
b/ Includes $174,675,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

B-1104

epartment of the TREASURY NEWS
SHINGTON, D.C. 20220 TELEPHONE 566-2041

For Release Upon Delivery
Expected at 10:00 a.m.

STATEMENT OF
DANIEL I. HALPERIN, ACTING DEPUTY ASSISTANT SECRETARY
OF THE TREASURY (TAX LEGISLATION)
BEFORE THE SUBCOMMITTEE ON LABOR OF THE SENATE
HUMAN RESOURCES COMMITTEE AND THE SUBCOMMITTEE ON PRIVATE
PENSION PLANS AND EMPLOYEE FRINGE BENEFITS OF THE
SENATE FINANCE COMMITTEE
August 15, 1978

Messrs. Chairmen and Members of the Subcommittees:

I am pleased to have the opportunity to appear before you today to discuss the several bills you are addressing concerning the private pension system.

The broad policy issues I will address today include those proposals concerning the jurisdiction of the administration of the Employee Retirement Income Security Act of 1974 ("ERISA").

A second area of proposed major change is in ERISA reporting and disclosure requirements. My testimony focuses on those proposed changes affecting requirements specified by the Internal Revenue Code.

The third major area encompasses changes in the rules designed to prevent those persons connected with a plan from engaging in transactions that are likely to lead to conflicts of interest and consequently impairment of plan assets--fiduciary responsibility and prohibited transactions.

The fourth area of broad policy proposals I will address are those designed to encourage more savings for retirement: by the employee through deductions for contributions to employer plans; by the employer through a credit for new and improved plans; and by the development of special master and prototype plans. The denial of IRA deductions in certain cases also furthers this goal.

Finally, I will outline the basic policy issues that are inherent in the changes S. 3017 proposes to ERISA's joint and survivor annuity rules.

We plan to submit shortly a brief analysis and the position of the Department on the less far reaching changes also proposed by S. 3017.

B-1105

The Treasury Department will not comment on those issues that fall outside its administration: for example, S. 260 relating to reductions in disability payments; S. 1383 regarding preemption of health plans; and those areas of reporting and disclosure administered solely by the Labor Department.

Dual Jurisdiction

As you know, the President announced last week his Reorganization Plan Number 4. This proposal to divide rulemaking jurisdiction between the Departments of Treasury and Labor is described in the testimony of the Department of Labor. We are confident that this plan will reduce substantially the difficulties caused by the current, overlapping rulemaking authority. The plan is designed to be evaluated in early 1980. Based on that evaluation, the Administration will submit legislative proposals for a long term administrative structure for ERISA. This interim plan does not prevent adopting a single agency approach in the future.

We have not supported the single agency concept to date in part because we are reluctant to thrust a new administrative system on the pension industry before there has been a more in-depth analysis of the problems it raises. There are two major areas of concern to the Treasury Department. First, a single agency will not eliminate the need to coordinate with the Internal Revenue Service; the agencies will have to begin again to learn to cooperate on a different basis. Second, reducing the role of the IRS in determining eligibility for tax benefits may impair equity in the tax system.

The first concern I stated arises because the private pension system is now based on tax incentives and penalties. Like other single agency proposals, S. 3017 uses these incentives and penalties, recognizing that the potential loss of tax benefits may be a more effective deterrent than the threat of injunctive relief or other action by an agency other than the IRS. Under S. 3017, the new agency would certify the tax qualification or disqualification of a plan to the Service. Such qualification affects issues left to the Service, including taxation of participants on distributions and the employer's deduction.

A few, isolated precedents exist for certification by another agency to the IRS for tax purposes. In general, however, these cases involve a single factual determination made at a single point in time. 1/ In contrast, in the area of tax-qualified pension plans, tax qualification must be based on the plan in operation. The result must be continued certification of operational facts as affecting tax liability; initial qualification does not suffice.

This procedure requires coordination of tax audits with the other agency or, if all functions are transferred, presumably an entirely separate audit of pension issues with IRS auditors instructed not to raise such matters. If the IRS is required to await determinations by another agency, its ability to conclude audits of the employer and all plan participants would be impaired. In other words, new types of dual jurisdiction would exist.

Furthermore, the more "certification" one places in a single agency, the more likely it is that tax equity may be compromised. S. 3017 would transfer the Code's qualification standards (including nondiscrimination and limits on benefits for the highly compensated) to the new agency. Discriminatory treatment and excessive contributions may seriously compromise tax equity and yet may have little to do with retirement security, as evidenced by the fact that they are not presently a concern of the Department of Labor. Therefore, continued IRS authority over these issues seems appropriate.

I would also point out that even S. 3017 does not cleanly divide jurisdiction. It does not make all plans subject to the single agency through the certification process. S. 3017 retains jurisdiction in the Service over, among other provisions, individual retirement accounts and the excess contributions tax on Keogh plans. Furthermore, the Code provisions would apply to governmental and church plans and nonqualified plans.

The total division of authority proposed by S. 2352 raises some of these same issues. Employers could be faced with more duplicative jurisdiction if the Labor Department audited a pension plan for violations of prohibited transactions and the Service for tax qualification. Even more important, we believe that the use of the IRS audit force is critical to adequate enforcement of the prohibited transactions rules.

To reiterate, the dual jurisdiction reorganization plan developed within the Administration has important and immediate benefits; it does not develop new problems, nor does it weaken enforcement of employee rights. Nonetheless, we recognize the importance of, and encourage, this dialogue to fully examine the issues before the pension community may again be subjected to a new form of administration.

Reporting and Disclosure

The Internal Revenue Service recently has testified concerning its efforts in the area of reporting and disclosure. Specifically on June 27, the Assistant Commissioner for Employee

Plans and Exempt Orgainzations testified before the Senate Finance Subcommittee on one of the bills considered here, S. 3193. I will briefly address three of the proposals made by that bill and several others considered here.

First, the proposal has been made that the Labor Department's plan description (EBS-1) and the Service's application for a determination letter (5300 series) should be combined into one form. Because the Labor Department is now considering elimination of the EBS-1, concern over it may have dissipated. We believe that further consideration should be given to consolidating IRS and Labor forms, but that consolidation issues can best be pursued administratively.

Second, the bills propose a single form for annual reports by the three agencies. This already has been accomplished through administrative action.

Third, cyclical filing--every five years--is proposed for the annual reports, with staggered filings of the major report every five years and a simplified report in the other years. The Service has agreed in principle with the Labor Department for filing of a compliance-oriented annual report every three years by plans covering fewer than 100 participants. There will be an abbreviated filing in the other years. The three-year cycle is essential considering the statutory assessment period of three years from the date of filing a tax return.

One bill, S. 2992, proposes uniform acounting standards for various purposes for pension plans. The Treasury Department is commenting in detail on S. 2992 in a bill report. That report states that we do not believe legislation is appropriate at this time. First, Treasury is opposed to the requiring of a single funding method for purposes of sections 404 and 412 of the Code (relating to the limitations on deductions and the minimum required contribution). We believe that with respect to reports to plan participants, section 103(d) of ERISA contains adequate statutory authority for the determination of appropriate information for their benefit. The Labor Department is considering this problem and it does not appear essential to mandate a single funding method at this time.

Second, Treasury is concerned that prescribing a uniform method for some purposes will cause it to be used in other areas where it may not be apppropriate; and that uniform data may not be produced at a reasonable cost to plans which are using other actuarial methods for other purposes such as the calculation of actual contributions.

Fiduciary Responsibility and Prohibited Transactions

In changing to a single agency, S. 3017 would also delete the excise tax that is now used to deter plan officials from entering into prohibited transactions. Similarly, it would delete the 100% correction penalty. In lieu of these provisions, civil litigation is left as the sole remedy.

It is our belief that the annual excise tax is an effective deterrent to persons engaging in the enumerated transactions. If the only relief available were in equity, the plan often could easily (and basically without cost) undo its transaction. There could be no downside risk to engaging in these transactions. Under the current system, the tax is coordinated with the Labor Department's seeking equitable relief so that participants are made whole, but persons connected with plans also are deterred from ever engaging in the transactions.

Another bill under consideration, S. 1745, also would change the rules applying to fiduciaries. We concur in the Labor Department's analysis of the prudence standard and consequently of their position on this bill.

Deductible Employee Contributions to Qualified Plans

Provisions of S. 3017. -- Under section 303 of S. 3017, an employee who is an active participant in any one of a number of types of tax-favored plans may make a deductible contribution to the plan. The deductible contribution is limited to the lesser of 10% of compensation for the taxable year or $1,000. However, if the indiviudal's adjusted gross income (AGI) exceeds $30,000 ($15,000 in the case of a married individual filing a separate return), the deductible limitation is reduced by 20% of the amount by which that AGI exceeds $30,000 (or $15,000). Thus, for example, a single individual having AGI of $31,000 would have the maximum deductible contribution reduced by $200 (i.e., 20% of the $1,000 excess over AGI of $30,000), and the limitation would be reduced to zero at AGI of $35,000.

The plans to which deductible contributions can be made include plans qualified under section 401 and similar provisions of the Code, governmental plans (whether or not qualified), and tax-deferred annuities maintained by tax-exempt institutions under section 403(b). Thus, self-employed individuals and participants in government plans could benefit under this provision of the bill.

Under a separate provision of this section, a plan could not be qualified under section 401 of the Code unless it accepts deductible employee contributions up to $1,000 per calendar year for each employee.

Problems Affected by the Bill. -- Present law creates two problems which would be affected by S. 3017. S. 3017 seems to be concerned with the ability of a participant in a tax-favored retirement plan to make deductible contributions to an individual retirement arrangement, but it also affects the broader problem of the tax teatment of employee contributions to retirement and fringe benefit programs.

(a) IRA contributions. -- An individual who is entitled to make deductible contributions to an individual retirement acount (IRA) may generally make a contribution up to the lesser of $1,500 or 15 percent of compensation for the year. However, an individual may not make a deductible contribution for a taxable year to an IRA if he or she is an active participant during any part of the taxable year in a qualified plan, a tax-deferred annuity maintained by a tax-exempt institution, or a governmental plan (whether or not qualified). As a result, an active participant in such a plan may not make a deductible contribution, even though the employer's contribution to the plan on his or her behalf might be quite small or the individual might never vest in a retirement benefit because of frequent changes in jobs.

In an extreme example of this disparity, an individual earning $10,000 and not participating in any retirement plan could make a deductible IRA contribution of $1,500, whereas a second individual with the same income who receives an allocation of a minimal amount under an employer-maintained plan would not be able to make an IRA contribution.

There is no easy answer to this dilemma once the decision to create IRAs has been made. Allowing all participants in qualified plans to make deductible contributions to IRAs is unacceptable. IRAs already are inherently discriminatory in that there is much greater utilization by eligible individuals at higher income levels. Opening IRAs to participants in qualified plans will substantially increase this disparity. However, a solution to the problem which remains solely within the current IRA structure and limitations is necessarily complex. For example, efforts to develop procedures to reduce the IRA deduction limitation by the amount of employer contributions allocable to a particular employee under a defined benefit plan have not been successful.

Because of the complexity inherent in an IRA approach, it can be argued that the inequity, if any, should be accepted without further solution. Moreover, although allowing IRAs to individuals who participate in modest retirement plans may mitigate employee objections to establishment of such plans, it

is possible that those employees who establish IRAs will resist plan improvements. Therefore, although pressure against the establishment of qualified plans might be reduced, attempts to meld qualified plans with partial IRA deductions within the framework of the current IRA rules could still have an adverse effect on qualified plans. We discussed these concerns at greater length in testimony before the Subcommittee on Oversight of the House Ways and Means Committee on February 16, 1978. In general, the better approach may be to retain IRAs only for employees who do not participate in employer-maintained plans.

(b) Treatment of employee contributions generally.

(1) Present law: The broader problem is the question of the tax treatment of employee contributions to tax-favored employee benefit plans. The law on this point now goes in many directions, due to the variety of types of employee benefit plans in existence and the varying approaches to the treatment of employee contributions to them. These plans include traditional types of qualified retirement plans, so-called "cash or deferred" profit sharing plans, unfunded salary reduction arrangements maintained by State and local governments, and a number of others. In testimony before the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Finance Committee on March 15, 1978, we suggested that Congress and the Treasury together begin to give serious consideration to the possibility of deductions and exclusions for employee contributions to all types of tax-favored deferred compensation arrangements and fringe benefit plans. We pointed out that it seems to us that a unified system could be developed under which amounts set aside at the employee's election are deductible or excludable if the arrangements are nondiscriminatory with respect to both coverage of employees and benefits (or contributions) actually provided and where excessive deferral is not created. However, care must be taken to prevent undue revenue costs. We indicated in March that a possible starting point would be an expansion of the proposal concerning cafeteria plans contained in the President's tax reform program to both cash or deferred profit sharing plans and salary reduction arrangements for government employees. On May 4 we submitted to the Finance Committee and the House Ways and Means Committee a proposal to establish uniform, favorable treatment of salary reduction contributions to those types of plans.

(2) H.R. 13511: H.R. 13511, the Revenue Act of 1978 as adopted by the House of Representatives, deals with three types of arrangements which, as a result of that bill, would continue to receive tax-favored treatment.

(A) Cafeteria plans. -- The bill adopts a provision which is substantially the same as was contained in the Administration's Tax Reform Proposal. The rules for cafeteria plans 2/ would result in nondiscriminatory plan coverage and nondiscrimination in operation of the plan. In measuring nondiscrimination in operation, the plan would have to be nondiscriminatory with respect to both total contributions or benefits and nontaxable benefits elected by participants. The provisions of the bill will allow for the continuance or establishment of an attractive type of employee benefit plan and will incorporate meaningful anti-discrimination features.

(B) Cash or deferred profit sharing plans. -- Cash or deferred profit sharing plans are similar in concept to cafeteria plans, except that they involve qualified retirement plans rather than other types of fringe benefits. Under such an arrangement, an employer offers an employee an election between immediate payment of an amount of compensation in cash or contribution of that amount to a qualified profit sharing plan. For a number of years these arrangements were subject to discrimination rules prescribed under Internal Revenue Service revenue rulings. These rulings generally held that a cash or deferred plan would not be discriminatory if one-half the participation in the plan came from among the lower paid two-thirds of employees eligible to participate. ERISA limited the effect of these rulings to previously existing plans. 3/ H.R. 13511 would essentially apply the rules of the prior revenue rulings to all cash or deferred plans and would make those rules permanent.

The problem with the prior revenue rulings is that they do not assure any degree of participation from the lowest ranking group of eligible employees. Since one-half of the actual participation must come from the lowest paid two-thirds of eligible employees, this requirement can be met by having that degree of participation come from the middle third. Thus, the lower third of the eligible group might have no actual participation, but the plan could be held not to be discriminatory. We believe that there should be stricter discrimination rules which would result in substantial participation from the lowest paid group.

(C) Government salary reduction arrangements. -- For several years, State and local governments were able to establish sucessfully nonqualified, unfunded deferred compensation arrangements on a salary reduction basis. Since the exception under ERISA for governmental plans allowed these plans to be unfunded, an employee participating in one of these arrangements was able to defer tax on the amount of withheld compensation until that amount was paid. Thus, employees of State and local

governments were in effect allowed to make deductible contributions to IRAs without any ceiling and despite their participation in another qualified plan. Put another way, they obtained the deferral benefit of qualified plans without any of the restrictions. Except as might be unilaterally imposed under the arrangement, there were no requirements regarding the amounts of salary which could be deferred, offering of the program to a nondiscriminatory group of employees, or nondiscriminatory actual participation in the plan. Proposed regulations published earlier this year would reverse the Internal Revenue Service's position on these arrangements and would result in current taxation of deferred amounts.

H.R. 13511 would basically accord the same treatment to State and local government salary reduction arangements as existed prior to the proposed regulations, except that a limitation equal to the lesser of $7,500 or 33-1/3% of net compensation would be imposed upon annual salary reduction contributions. These limitations can be well in excess of the limitations which are imposed upon the deferral inherent in a qualified retirement plan. Moreover, as in the past, there would be no discrimination requirements in connection with these arrangements.

Our May 4 legislative proposal would have subjected State and local government salary reduction arrangements to the same requirements as would be applied to privately maintained plans in order for all employees to obtain deferral. However, we recognize that there may be legitimate reasons for treating the governmental arrangements separately, since State and local government employees typically work at lower compensation levels than their counterparts in the private sector. Thus, we do not object to the creation of separate rules for these arrangements. However, we do not believe that favorable tax treatment should be available for these plans in the absence of meaningful discrimination rules and deferral limitations appropriate to the nature of the plans and employers.

Methods of Dealing with Discrimination. -- Although attempts have been made to limit it, section 303 of S. 3017 can still result in discriminatory utilization of the tax benefits which would be accorded to employee contributions under the bill. The phase-out of the deductible limitation for higher paid employees does not begin until the individual reaches adjusted gross income of $30,000. Thus, an individual well above the median income level could make a full $1,000 contribution. Because such a person is in a better position to save for retirement, tax benefits from deductible contributions would tend to cluster around the group of employees at that income level.

Another approach to this problem which we have supported is contained in S. 3140. Under that bill, deductible employee contributions would be permitted to an employer plan which is in essence an employer-maintained IRA which, unlike IRAs under the current rules, could also receive employer contributions. The employee's deductible limit would be the amount equal to the difference between the employer's contribtions and the individual's usual IRA deductible limitation. To illustrate the difference, assume that an individual has compensation from an employer of $30,000 for a year (also assumed to be adjusted gross income), and the employer contributes 10 percent of the compensation to an employer-maintained plan for the benefit of that individual. Under section 303 of the bill, the taxpayer could deduct a full $1,000 for an employee contribution in addition to the employer's $3,000 contribution. Under S. 3140, the employer's $3,000 contribution would completely eliminate the possibility of a deductible contribution by that employee.

The most effective method of handling discrimination is a direct approach, such as is contained in the cafeteria plan provisions under H.R. 13511. This is also the result under S. 3288, which is very similar to section 303 of the bill, except that it contains a much more effective discrimination feature. Under S. 3288, deductible employee contributions made to the employer's plan are treated as an employer contribution for purposes of measuring discrimination under the plan. Thus, the employee contributions automatically enter into the traditional measurement of discrimination in employer-derived benefits.

Revenue considerations. -- We have emphasized revenue considerations in the past in connection with proposals dealing with employee contributions to retirement plans. We think it is particularly important to bear the cost implications of section 303 of the bill in mind. We estimate that the annual revenue cost of this section of the bill is between $2 billion and $2.2 billion.

Credits for New and Improved Plans

S. 3017 provides a tax credit in the case of new qualified plans. The credit begins at 5 percent in the first plan year and ends with 1 percent in the fifth year, and is applied to the employer's total plan contribution, up to the deductible limit. The new plan credit is available to employers which are "small businesses" as determined by the administrator of the Small Business Administration. No credit is allowed if the employer terminated another qualified plan at any time after January 1, 1978. The credit is not allowed for contributions to an ESOP. It is, however, available for contributions to Keogh plans.

The improved plan credit of section 305 is available without regard to the small business restriction, but is not applicable to Keogh type plans described in Code section 401(d). The credit applies for all years during which an improved plan is maintained. The bill provides that an improved plan is one which is certified by the Employee Benefits Commission created in Title I of the bill. This certification is dependent on the meeting of one of two alternatives. The first alternative is that both the participation and vesting rules of the plan are significantly more liberal than the minimum requirements of ERISA. The second alternative is that there is some other significant improvement at least equivalent to the vesting and participation improvement possibilities.

According to a study appearing in the November, 1975 Social Security Bulletin, the portion of the nongovernmental labor force covered by a retirement plan was 46.2 percent in 1975. Although that percentage has increased from 42.1 percent in 1970, we have no reason to believe that much more than one-half of the nation's labor force is now covered by private pension plans. Employees working for small employers tend to be among those who are least likely to be covered by a private pension plan. The purpose of the bill is the encouragement of such small employers in the establishment of plans for their employees. The further purpose of the bill is to improve the level of benefits for all plans.

It is probably true that a major improvement in coverage by private plans will not be accomplished within the present framework of incentives. However, there is not to our knowledge sufficient information about the gap in coverage so as to be able to target tax benefits narrowly enough to provide a substantial increase in coverage without an unacceptably large revenue cost. Although the percentage of the work force covered by retirement plans has grown slowly, employer contributions grew from $15 billion in 1971, to $28 billion in 1975. It has been estimated that over the next 10 years contributions could reach $176 billion. Because of the number of plans already in existence or which will be established by employers in any event, there will be a substantial tax cost under the bill even if no employer changes his or her mind as a result of the offered credit. If by 1985 as many as 50 percent of the contribution dollars were to "improved" plans, the tax cost of the improved plan credit would be $4.4 billion.

Perhaps the credit could be made effective if it were more narrowly focused, such as to employers whose work force has a low average pay, those whose income is below specified levels, or those who have a relatively small amount of assets. Without clearer information as to the gap in coverage, we cannot evaluate these possibilities.

We are also concerned over the administrability of the power to certify an "improved plan". Certification requires that the plan be more generous than required by ERISA's minimum standards with respect to the age and service and vesting requirements. Should the change in participation and vesting rights be factually as well as legally significant? For instance, some employers with a very low rate of employee turnover can change from ten-year "cliff" vesting to five-year vesting at little or no cost. If the test is to be one of economic significance under the facts and circumstances, there will be complex actuarial problems to resolve. If the test is that any plan is eligible if by its terms it appears better, there will be many employers receiving the credit at little or no additional cost.

There is an even more difficult administrative aspect of the proposal. As an alternative to "significantly better participation and vesting rights", the bill directs the Commission to look for "some other significant improvement in a participant's benefits and rights under the plan, which is at least equivalent to an improvement which would satisfy the required participation and vesting improvements." The difficulty here is the relative nature of the term improvement. There is no standard. There is no minimum standard under ERISA regarding the amount of benefit granted by the employer.

If the improvement refers to what was done by the employer in some prior year, there will be statutory encouragement to the starting up of very small plans, so that a measurable increase may be granted. If, as suggested by the bill, the maintenance of an improved plan can begin with the first year of a plan (merely by satisfying the participation and vesting side of the test), there will be no prior year's level of contributions or benefits against which to measure.

Master and Prototype Plans

In addition to the preceding measures designed to encourage more savings for retirement, S. 3017 would establish mechanisms for special master plans.

The bill proposes that the master sponsor--the bank, insurance company, or other investment manager--be considered the

plan administrator and named fiduciary for purposes of Title I of ERISA. We concur in the Labor Department's support of this part of the proposal.

As you know, the Internal Revenue Service is an enthusiastic supporter of, and has developed several different types of, master and prototype plans. The major difference between S. 3017 and existing IRS procedures for master plans for corporate employers--from the perspective of the tax law--is that under the bill there would be no need for an employer to apply for a letter demonstrating that the plan is qualified. The IRS does not believe such a provision is workable unless a plan covers all employees and has full and immediate vesting. In the absence of this requirement, a determination of qualification cannot be made without examination of the employer's workforce.

Although we do not support such a plan, if a master plan with potentially discriminatory standards were permitted to be qualified without individual examination, appropriate sanctions for marketing and establishing discriminatory plans would have to be developed. Questions must be addressed concerning the type of sanction, the effective date of the sanction, and the party on whom the sanction is to be imposed.

<u>Denial of IRA Benefits to Certain Individuals</u>

Another means of encouraging plans covering more members of the workforce is through denial of IRA deductions where they compete with nondiscriminatory plans. S. 3017 would deny IRA deductions to individuals who are owner-employees in partnerships or sole proprietorships or who are officers or 10%-or-more shareholders of corporations. We support this amendment.

A serious problem in connection with IRAs is that an individual in control of a business can elect to forego a Keogh plan in favor of an IRA. Although the direct tax benefits for that individual may be less under an IRA than under a Keogh plan, the overall cost of the IRA may be substantially less, since the establishment of a Keogh plan would require the provision of benefits for a nondiscriminatory group of employees. Thus, IRAs constitute a serious disincentive to the establishment of qualified plans in many cases. Section 306 of the bill will reduce this disincentive. However, we would not preclude an individual from having an IRA if he or she (or the relevant corporation) has no other employees.

<u>Joint and Survivor Annuity</u>

The changes proposed in S. 3017 to ERISA's joint and survivor annuity rules are highly technical. Yet they raise

broad and significant policy issues that must be addressed before any changes are effected. Under both Title I of ERISA and section 401(a) of the Internal Revenue Code, special rules apply if a plan provides for the payment of benefits in the form of an annuity. 4/ Under those rules, the annuity benefits must be paid in the form of a qualifying joint and survivor annuity to the participant and his or her spouse unless the participant elects not to receive payment of the benefit in that form. These rules apply generally where the participant has begun to receive benefit payments at or after reaching normal retirement age, or a plan's early retirement age if it has one. The vesting rules of ERISA and the Code provide that employer-derived benefits may be forfeited upon the death of a participant (before or after retirement), except in the case of a survivor annuity payable under the joint and survivor annuity rules. Thus, the employer-derived benefits (other than the survivor annuity) can be forfeited even where a participant is fully vested and dies prior to the commencement of any benefit payments.

Section 238 of S. 3017 would, in substance, change the vesting and joint and survivor annuity rules in two situations. In either case, the surviving spouse of a participant would be entitled to a survivor benefit where the participant is at least 50% vested in employer contributions or benefits and dies before receiving the vested percentage of his or her employer-derived account balance or benefits.

The provisions of this section of S. 3017 are technical responses to limited problems within the scope of the joint and survivor annuity provision. As such, they contain their own technical problems. More important, the amendments proposed in the bill do not directly address several important questions which we believe need to be considered over a longer period of time. We do not yet have answers to these questions ourselves, but we would hope to work with the Committees to arrive at proper results.

The fundamental question is whether the vesting rule which allows forfeiture of employer-derived benefits upon death is a correct approach. The existence of any retirement plan implies that employees have received reduced immediate compensation in favor of the diversion of that compensation into the retirement plan. It can be argued that death should not result in the loss of the diverted compensation. On the other hand, at least in the context of a defined benefit plan, the diversion can be viewed as something like the purchase of an annuity. It is not illogical to accept the loss of future annuity payments on death, even if the annuitant dies before any payments have been made.

The second question follows only if, as a result of examination of the first question, the possibility of forfeiture upon death still remains. The question then is whether the death to be focused upon is solely that of the plan participant or the death of the survivor of the participant and his or her spouse. The current joint and survivor annuity rules, in effect, mean that both deaths must be taken into account in some situations. However, the current rules deal with the problem in a very confused and somewhat arbitrary manner.

The third question is whether, assuming there should be survivor benefit requirements of some sort, the participant should be allowed to elect against benefits for the surviving spouse. If the proper policy is that the law should at least favor survivor benefits, subsidiary issues arise regarding the degree of flexibility which should be involved. For example, would it be appropriate to make survivor benefits mandatory where, at the time of a participant's retirement, the participant is healthy but his or her spouse is terminally ill? Similarly, should the actuarial reductions implicit in the provision of survivor benefits be mandated where the participant's spouse is receiving, or will receive, full retirement benefits resulting from his or her own employment?

FOOTNOTES

1/ Examples of certification include, under prior law, the Department of Commerce certifying import injury for purposes of determining a taxpayer's entitlement to a special five-year loss carryback established under the Trade Expansion Act; the War Production Board certifying facilities as war emergency facilities in connection with the special amortization rules applicable to those facilities. Under present law, there is a similar certification procedure with respect to the amortization of pollution control facilities (I.R.C. Section 169); there is also special treatment for gain or loss under SEC orders (I.R.C. Section 1081) or FCC policy changes for radio stations (I.R.C. Section 1071).

2/ A cafeteria plan is an arrangement under which a participating employee elects the types of fringe benefits to which employer contributions will be applied on his or her behalf. These plans usually include benefits, such as health and accident insurance or group-term life insurance under $50,000, which would be nontaxable under current Code provisions if provided under a non-elective plan. A cafeteria plan usually also includes elective benefits which are taxable, such as current cash distributions. Under H.R. 13511, if a cafeteria plan is nondiscriminatory, a highly compensated employee will be currently taxed only to the extent that he or she elects taxable benefits. If the plan is discriminatory, a highly compensated employee will be currently taxed on the total amount of taxable benefits which could have been elected, regardless of the actual election made by the employee.

3/ The ERISA provision was only a temporary measure. The original freeze was until the end of 1976. It was extended until the end of 1977 by the Tax Reform Act of 1976, and it would be extended further until the end of 1979 by H.R. 9251 which has been approved in different versions by the House of Representatives and the Senate.

4/ Under the Internal Revenue Service regulations interpreting this provision, the special rules apply only where the annuity is a life annuity. Thus, a plan's provision for the payment of an annuity for a term certain or for a term measured by the life expectancy of the recipient would not, in itself, result in application of the special rules.

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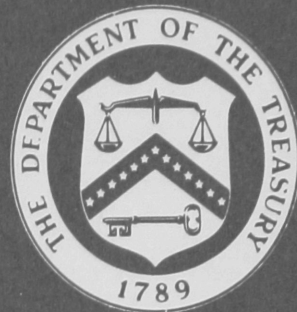

FOR RELEASE AT 4:00 P.M. August 15, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,700 million, to be issued August 24, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,706 million. The two series offered are as follows:

92-day bills (to maturity date) for approximately $2,300 million, representing an additional amount of bills dated May 25, 1978, and to mature November 24, 1978 (CUSIP No. 912793 U5 3), originally issued in the amount of $3,407 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,400 million to be dated August 24, 1978, and to mature February 22, 1979 (CUSIP No. 912793 W9 3).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing August 24, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $ 3,355 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 Daylight Saving time, Monday, August 21, 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-1106

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 August 24, 1978, in cash or other immediately available funds or in Treasury bills maturing August 24, 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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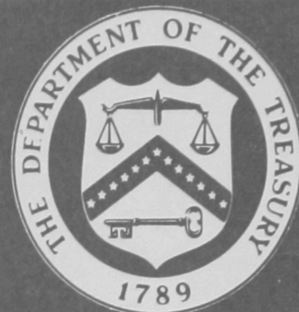
HINGTON, D.C. 20220 TELEPHONE 566-2041



FOR RELEASE ON DELIVERY
EXPECTED AT 10 A.M.
AUGUST 16, 1978

TESTIMONY OF ROBERT CARSWELL
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

I am pleased to present the views of the Administration on S. 3304, introduced at the request of the Federal Reserve Board. That bill authorizes actions to eliminate the incentive for commercial banks to withdraw from the Federal Reserve System.

In June of last year, this Committee considered S. 1664, which had the dual purpose (1) of authorizing financial institutions to maintain NOW accounts and (2) of reducing the cost of Federal Reserve membership by lowering the range of statutory reserve ratios and by permitting the Federal Reserve to pay interest on required reserves. This Committee acted promptly, and favorably, on that legislative proposal, which the Administration supported, and reported out a bill in mid-August of last year. No further action has been taken.

Since that time, the trend toward lower Federal Reserve membership has continued. In the last 12 months, more than 60 commercial banks have voluntarily withdrawn from the System. We understand that additional member banks are considering doing so, but have delayed their decision until after the Congress responds to the bills, such as S. 3304, that are presently before it in this area.

B-1107

Previous witnesses have reviewed the burden imposed on National and state chartered member banks by the requirement that they hold non-interest bearing reserves in the Federal Reserve System. The burden has been heightened by the advent of high interest rates, which have increased the opportunity cost to member banks of reserves that cannot be employed to generate income. As a result, the effective cost of deposits to member banks is higher than for nonmembers.

Summary of Conclusions

The Administration believes that the continuing attrition in Federal Reserve System membership will endanger the pivotal role in our financal system played by the Federal Reserve. The Treasury believes that requiring mandatory reserves for all but the smaller depository institutions is the preferable method of dealing with that problem.

If the Congress does not adopt that approach, the Administration supports the enactment of legislation that would (1) lower reserve requirements and (2) explicitly grant to the Federal Reserve the authority to pay interest on member bank reserve balances. The legislation should limit the potential revenue loss to the Treasury and provide standards for the Federal Reserve to follow in setting the appropriate levels of interest payments and reserve requirements.

The Administration also agrees that the Federal Reserve should move to impose explicit charges for each of its services, with appropriate safeguards to provide for an orderly transition from the present system.

The Impact of a Declining Membership on the Federal Reserve

In the aftermath of the banking reforms that began with the Federal Reserve Act in 1913 and continued after the Depression, the financial system of the United States has become the strongest in the world. Bank regulators at the Federal and state levels have played an important part in that development. The role of the Federal Reserve System as the central bank has been critical -- as the overseer of the money supply and discount window; as an institution that maintains close relations with, and provides counsel to, a large spectrum of the banking community through its regional Federal Reserve Banks; and through the extension of its services to members.

Each of these functions plays a part in fulfilling the Federal Reserve's responsibility for the integrity and control of the monetary system. Each is eroded by the continuing decline in membership. We cannot pinpoint the moment when a worrisome trend becomes an alarming event. In all likelihood, there is no such single point. But the stature and power of the central bank will become more attenuated as the trend proceeds. This weakening of the role of the Federal Reserve in our banking system should be arrested.

I would now like to turn to the specific legislative issues before this Committee.

Universal Reserves

The Federal Reserve has proposed legislation that would require all depository institutions -- whether or not members -- to comply with Federal Reserve requirements for reserves against transaction accounts. Nonmember reserves would be held at the Federal Reserve Banks or at other member banks which would, in turn, hold the reserves at a Federal Reserve Bank.

The Treasury supports, in principle, the imposition of uniform reserve requirements on similar types of deposits at institutions of comparable size regardless of the type of depository institution holding the deposits. The Federal Reserve's effectiveness in the conduct of monetary control would be strengthened by requiring universal reserves.

This approach will provide a permanent solution to the impact of the membership problem on the conduct of monetary policy. It severs the link between Federal Reserve membership and the separate issue of the appropriate level of reserve requirements necessary for the conduct of monetary policy. It avoids the necessity -- which arises if the problem is to be met by the payment of interest on reserves -- of requiring the Federal Reserve to compute the differing burdens of membership for different banks to insure that the interest payments and other benefits are properly targeted.

Another advantage of a universal reserve requirement is that this approach is significantly less costly to the Treasury than the alternatives. Nevertheless, even under a universal reserve structure, a substantial reduction in

reserve requirements (or even the payment of interest) may be required to reduce the impact on smaller nonmembers of meeting reserve requirements.

Finally, it would eliminate the present inequities between treatment of members and nonmembers with respect to reserves while continuing to vest responsibility for supervision and regulation of nonmembers with the FDIC and State bank supervisors.

Of course, there are a number of issues that remain to be resolved. One very important question is the extent to which smaller institutions may be exempted from reserve requirements in order to avoid the adverse impact on earnings that would flow from a charge. Another is whether the "universal" reserve requirement should extend to deposits other than transaction accounts. In addition, the interaction of this proposal with the separate questions of Federal Reserve membership and access to Federal Reserve services must be closely examined.

Other issues include the place at which reserve balances should be held, the form in which the reserves are held (some have argued in favor of permitting Treasury securities to be used as reserves), the degree of reduction in reserve requirements, the degree of uniformity in reserve ratios, and the amount of interest, if any, paid on required reserves.

Despite these unanswered questions, this is a straightforward and workable approach to a complex problem. We would be glad to assist you and your staff in seeking answers to these difficult questions.

Payment of Interest on Reserves and Reduction in Reserve Requirements

If the Congress should decide that nonmember banks and thrift institutions should continue to be exempted from reserve requirements of the Federal Reserve, then the Administration supports legislation to reduce the financial burden of membership on those banks that would otherwise leave the System. One approach, contained in S. 3304, is to lower reserve requirements and to permit the Federal Reserve to pay interest on its required reserves.

This approach will initially be more costly than universal reserves. There is no reason to believe that the precise level of interest payments and reserve requirements which serve to stabilize Federal Reserve membership can be readily identified and it is likely that pressures for additional payments or reserve changes will build in the future.

The Federal Reserve's proposal is similar in design and cost to the program contained in Title II of the Administration's NOW account bill introduced last summer. The Federal Reserve Banks would begin paying interest on required reserves and reserve requirements on demand deposits would be simplified and reduced. Services now provided at no cost to member banks would begin to be sold to members -- and perhaps eventually to others -- at prices set by the Federal Reserve.

During the first phase, reserve requirements would be reduced to release approximately $3 billion in reserves. The Federal Reserve Banks would also begin paying an interest rate of 2 percent on all required reserve balances held by them. At present deposit levels, these payments would equal approximately $430 million.

As the program becomes fully implemented, the interest rate paid on the first $25 million of a bank's reserves will be raised to a level equal to 1/2 of 1 percent below the yield on the Federal Reserve's securities portfolio. Reserve requirements will be further reduced to release an additional $2 billion in reserves to member banks.

Under present conditions, the Federal Reserve estimates that total interest payments to member banks under the fully phased-in program would equal about $765 million annually. The increased member bank earnings from the released reserves will provide an additional $320 million in earnings, but member banks will probably pay about $410 million to the Federal Reserve in service charges. The net benefit to banks is therefore estimated to be approximately $675 million. Interest payments would be limited to not more than the sum of the System's receipts from charges for services purchased by members plus 7 percent of its annual net earnings.

To reduce the initial impact of the program on the Treasury and the Federal deficit during the transition period, the Federal Reserve will finance the program's estimated after-tax cost by paying the Treasury about $575 million from its accumulated surplus.

The Cost to the Federal Government

Any payment by the Federal Reserve of interest on reserves, and any reduced earnings from lower reserve balances, result in a reduction of payments to the Treasury. On the other hand, the increased income received by member banks as a result of such a program will lead to their paying additional taxes to the Treasury. We estimate that over time the Treasury will recapture approximately one-half of these benefits. Based on the estimated cost of the Federal Reserve proposal of $675 million, we estimate that the net cost to the Treasury, after tax recapture, will be about $335 million per year.

When Secretary Blumenthal testified last year on S. 1664, he stated that the Administration would accept a net revenue loss of some $200-300 million in order to solve the membership problem of the Federal Reserve. As I noted, approaching the problem through the requirement of universal reserves will reduce the cost to the Federal government, but we continue to believe that incurrence of a significant cost is warranted to solve this problem.

The aggregate cost to the Treasury should, however, be subject to an appropriate limit and should also take into account that the loss of revenue to Treasury can accrue from a reduction in reserve requirements just as easily as from the payment of interest on the reserves. We also believe that any plan based on the payment of interest on reserves should take into account that different classes of banks receive differing benefits from Federal Reserve membership. Thus use of the discount window may well be more important to a larger than to a smaller bank that may borrow in an emergency situation from its larger correspondent.

There is considerable room for debate about the appropriate amount necessary to stem the membership loss and whether payments should be the same to all banks or targeted to that class of bank where membership attrition is most probable. We would be pleased to discuss with your staff further possible ways to target payments to reduce the cost to the Treasury.

Pricing of Federal Reserve Services

Imposing explicit charges for services rendered by the System will impose a useful discipline on the users of the services. It will also permit private vendors of these services to compete on an equal basis. At the present time, private participation has been constrained by the difficulty of competing with a government agency offering free services. We would suggest, however, that the Committee consider alternative methods by which such pricing may be phased-in so that unnecessary disruption in the system can be avoided.

The Administration is, in principle, in favor of open access to Federal Reserve services for all non-members at nondiscriminatory prices. That issue must be resolved, however, in the context of the effectiveness of the steps taken to stem the reduction in membership. If access to services is no longer an advantage of membership, then this change may increase the outflow of members unless the other disadvantages have been fully offset.

That concludes my formal testimony, Mr. Chairman. I would be pleased to answer any questions the Committee may have.

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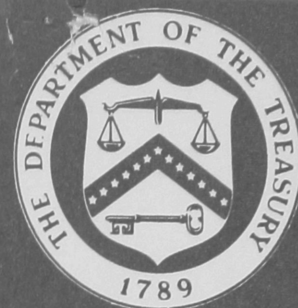

FOR IMMEDIATE RELEASE
August 17, 1978

Contact: George G. Ross
202/566-2356

TREASURY PUBLISHES 2ND ANNUAL REPORT ON HIGH INCOME TAX RETURNS

The Treasury Department today made available the second annual report on high income taxpayers. The report, "High Income Tax Returns - 1975 and 1976," was prepared as required by Section 2123 of the Tax Reform Act of 1976.

The report contains the first data reflecting the changes made by the Tax Reform Act of 1976. For high income individuals, a major change was the strengthening of the minimum tax including an increase in the rate from 10 to 15 percent and the provision of new tax preference items for intangible drilling expenses and for itemized deductions (other than casualty losses and medical expenses) exceeding 60 percent of adjusted gross income (AGI).

The report highlights the fact that the Tax Reform Act of 1976 was "extraordinarily successful" in reducing the number of high-income nontaxable income tax returns. The number of nontaxable high-AGI returns fell from 260 in 1975 to 22 in 1976, a decline of 92 percent. In proportion, the nontaxables fell from 1 out of 130 high-income returns in 1975 to about 1 out of every 2,000 returns in 1976.

As measured by the more comprehensive expanded income, the decrease was similar although less dramatic. The number of nontaxable high expanded income returns fell by 75 percent, from 215 in 1975 to 53 in 1976. By either measure, there were far fewer high income nontaxable returns than in any year since data first became available in 1966.

In testimony today before the Senate Finance Committee, Secretary of the Treasury W. Michael Blumenthal urged passage of tax legislation that would "avoid a serious setback to important minimum tax reform efforts." He asked adoption of a "true alternative tax" approach that would provide a "much more reasonable minimum tax liability" for individuals with tax sheltered capital gains.

The report also highlights the fact that despite the sharp decline in the number of high income nontaxable returns there is still a significant number of high income taxpayers who, while paying some tax, fail to pay a fair share of the tax burden. For every nontaxable high-income return, there are about 10 or more nearly nontaxable returns where income has been reduced by more than 80 percent by use of preferences, deductions, and tax credits. The nontaxables, and these so-called nearly nontaxables, whose effective tax rates are lower than those of a typical middle or lower-middle income family, totaled nearly 500 in 1976. This is about twice the number of high-income nontaxables there were in the late 1960's, whose existence prompted the Treasury Department to focus on this problem and the Congress to enact the minimum tax.

The report finds that while the Tax Reform Act of 1976 reduced the number of nontaxables and nearly nontaxables and raised the average effective tax rate modestly for the remaining nearly non-taxables, it did not significantly change the average effective tax rate for other individuals with incomes of $200,000 or more. In fact, the tax rate on all high expanded income returns other than nontaxables and nearly nontaxables actually declined from 36 percent in 1975 to 35 percent in 1976.

Even the expanded income measure, which is broader than AGI, does not include income from some sources which are very valuable to high-income taxpayers. Thus, expanded income understates economic income because taxpayers are allowed deductions for real estate and agriculture expenses in excess of economic costs and because income such as interest on tax-exempt state and local bonds is omitted. This understatement of economic income results in some high-income individuals being omitted from the report. The actual number of individuals omitted, however, is not known. In addition, the understatement of income makes the effective tax rate for all high income returns appear higher than it actually is.

Presented in the report are data for all individuals with AGI of $200,000 or more, as well as similar data based on three other income measures specified in the 1976 Act. These include the broader-based "expanded income" (AGI plus preferences less investment interest), "AGI plus preferences," and "AGI less investment interest." In 1976, there were 53,587 high income taxpayers, as measured by expanded income. They paid an average tax of $144,942 or 35.0 percent of expanded income. Similarly, the 41,761 returns with AGI of $200,000 or more had an average tax of $167,656, or 44.5 percent of AGI.

The 122 page report includes 57 statistical tables and 2 charts, which contain virtually all of the basic data about high income returns currently available for 1975 and 1976 tax returns.

Copies of the report are available from the Office of Tax Analysis, U. S. Department of the Treasury, Washington, D. C. 20020. Copies also are available from the Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402.

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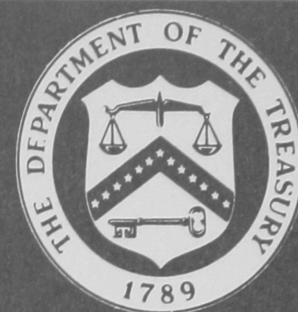

FOR IMMEDIATE RELEASE
August 15, 1978

Contact: Robert E. Nipp
202/566-5328

TREASURY ANNOUNCES RESULTS
OF GOLD AUCTION

The Department of the Treasury announced that 300,000 ounces of fine gold were sold today to 12 successful bidders at prices from $213.23 to $216.17 per ounce, yielding an average price of $213.53 per ounce.

Gross proceeds from this sale were $64.1 million. Of the proceeds, $12.7 million will be used to retire Gold Certificates held by Federal Reserve banks. The remaining $51.4 million will be deposited into the Treasury as a miscellaneous receipt.

These sales were made as the fourth in a series of monthly auctions being conducted by the General Services Administration on behalf of the Department of the Treasury. The next auction, at which another 300,000 ounces will be offered, will be held on September 19.

A total of 50 eligible bids were submitted by 17 bidders for a total amount of 564,400 ounces at prices ranging from $192.80 to $216.17 per ounce.

The General Services Administration will release additional information, including the list of successful bidders and the amounts of gold awarded to each, after those bidders have been notified that their bids have been accepted.

B-1108

Stockpile Information

August 16, 1978
FOR IMMEDIATE RELEASE

GSA #P2365

The General Services Administration, in consultation with the Department of the Treasury, today announced the award of 300,000 fine troy ounces of gold from U.S. Treasury stocks. The total proceeds of the sales were $64,060,440, averaging $213.54 per ounce.

The sale of this material resulted from the sealed bid offering of U.S. Treasury gold conducted at 11 a.m., Washington, D.C. time on August 15, 1978. The gold was available from the U.S. Assay Office, New York, New York.

The acceptable bids are as follows:

Firm	Approximate Fine Troy Ounces	Price Per Fine Troy Ounces
Bank Leu, Ltd. Zurich, Switzerland	1,200	$216.17
Credit Suisse Zurich, Switzerland	4,000	214.07
Dresdner Bank AG Frankfurt, West Germany	32,000	213.73
	32,000	213.61
	64,000	213.56
	32,000	213.51
	32,000	213.47
	32,000	213.41
Edward P. Cawley Westlake, Ohio	1,200	214.26
Exchange National Bank and Trust Company Atchison, Kansas	1,200	214.00
Gold Standard Corporation Kansas City, MO.	400	213.95

more

U.S. General Services Administration - Central Office
18th & F Sts., NW, Washington, DC 20405 (202) 566-0512

Firm	Approximate Fine Troy Ounces	Price Per Fine Troy Ounces
J. Aron and Company New York, NY	10,000	$213.31
Leytess Metal and Chemical Corporation New York, NY	800 400 400 400	213.57 213.48 213.32 213.26
Metal Traders, Inc. New York, NY	1,200	213.30
Republic National Bank of New York New York, NY	6,000 10,000	213.80 213.46
Swiss Bank Corporation Zurich, Switzerland	8,800	213.23
Union Bank of Switzerland Zurich, Switzerland	10,000 20,000	213.51 213.26

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FOR IMMEDIATE RELEASE August 16, 1978

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,500 million of 52-week Treasury bills to be dated August 22, 1978, and to mature August 21, 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 $1,105,000)

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	92.103	7.810%	8.42%
Low -	91.965	7.947%	8.58%
Average -	92.037	7.875%	8.50%

Tenders at the low price were allotted 7%.

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

Location	Received	Accepted
Boston	$ 35,685,000	$ 35,685,000
New York	3,850,210,000	2,923,010,000
Philadelphia	6,080,000	6,055,000
Cleveland	53,850,000	53,850,000
Richmond	4,415,000	4,415,000
Atlanta	80,795,000	50,795,000
Chicago	349,775,000	299,775,000
St. Louis	30,470,000	25,470,000
Minneapolis	2,645,000	2,645,000
Kansas City	5,385,000	5,385,000
Dallas	2,500,000	2,500,000
San Francisco	161,365,000	87,065,000
Treasury	3,650,000	3,650,000
TOTAL	$4,586,825,000	$3,500,300,000

The $3,500 million of accepted tenders includes $93 million of noncompetitive tenders from the public and $1,087 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 $39 million of the bills will be issued to Federal Reserve Banks as agents of foreign and international monetary authorities for new cash.

B-1109

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FOR IMMEDIATE RELEASE
August 16, 1978

Contact: Robert E. Nipp
202/566-5328

NATIONAL STEEL CORPORATION WITHDRAWAL
OF ANTIDUMPING PETITIONS

The U.S. Treasury Department today announced that National Steel Corporation has withdrawn its antidumping petitions concerning cold rolled and galvanized carbon steel sheets imported from Belgium, France, the Federal Republic of Germany, Italy, the Netherlands and the United Kingdom.

The petitions were filed on October 25, 1977, and formal antidumping proceedings were initiated by the Treasury Department on December 2, 1977.

Subsequent to the initiation of the investigations, a steel "trigger price mechanism" recommended by an Interagency Task Force chaired by Treasury Under Secretary Anthony Solomon became effective February 21, 1978, to monitor imports of steel products, including those covered by the National Steel Corporation petitions. Under the TPM, the Treasury should be able to identify cases of dumping quickly and to expedite antidumping proceedings.

On August 14, National Steel Corporation addressed a letter to Robert Mundheim, General Counsel of the Treasury, stating in part:

> "We recognize that the effective administration of the TPM will continue to require the allocation of substantial Treasury resources. We also are hopeful that, with the expiration of an initial "grace period," the TPM should start to do the job it was intended to do, and that the results of an effectively administered TPM should be seen shortly (and thereafter on a continuing basis) in steel import figures."

The withdrawal is without prejudice to the reinstitution of antidumping proceedings by National Steel Corporation on these products.

B-1110

In a reply, General Counsel Mundheim acknowledged the basis of National's action and confirmed that if National should refile, "Treasury will expeditiously conclude its disposition of any refiled complaints on these products, utilizing all the relevant information contained in its files, including information obtained in updating and implementing the trigger price mechanism."

General Counsel Mundheim also stated in his letter, ". . .the Treasury Department will continue carefully to monitor cold rolled and galvanized steel sheets under the trigger price mechanism and will take appropriate action to ensure the effective enforcement of the Antidumping Act with respect to that product."

A formal notice terminating the investigations is being published in the Federal Register. Copies of the Federal Register notice and exchange of letters between National Steel Corporation and General Counsel are attached.

* * * *

DEPARTMENT OF THE TREASURY
OFFICE OF THE SECRETARY

COLD ROLLED AND GALVANIZED CARBON STEEL SHEETS FROM BELGIUM, FRANCE, THE FEDERAL REPUBLIC OF GERMANY, ITALY, THE NETHERLANDS, AND THE UNITED KINGDOM

TERMINATIONS OF ANTIDUMPING INVESTIGATIONS

AGENCY: U. S. Treasury Department

ACTION: Terminations of antidumping investigations

SUMMARY:

This notice is to advise the public that the antidumping investigations concerning cold rolled and galvanized carbon steel sheets from Belgium, France, the Federal Republic of Germany, Italy, the Netherlands, and the United Kingdom are being terminated. The terminations are based on the withdrawal of the original antidumping petitions, as detailed in the body of this notice and appendices hereto.

EFFECTIVE DATE: (Date of publication in the FEDERAL REGISTER).

FOR FURTHER INFORMATION CONTACT:

Linda F. Potts, Assistant to the Director, Office of Tariff Affairs, U.S. Treasury Department, 15th and Pennsylvania Avenue, NW, Washington, D.C. 20220, telephone (202/566-2951).

SUPPLEMENTARY INFORMATION:

On October 25, 1977, information was received in proper form pursuant to Sec.153.26 and 153.27, Customs Regulations (19 CFR 153.26, 153.27), from counsel on behalf of National Steel Corp., alleging that cold rolled and galvanized carbon steel sheets from Belgium, France, the Federal Republic of Germany, Italy, the Netherlands, and the United Kingdom is being, or is likely to be sold at less than fair value within the meaning of the Antidumping Act, 1921, as amended (19 U.S.C. 160 et seq.).

This information was the subject of "antidumping proceeding notices" which were published in the FEDERAL REGISTER of December 2, 1977 (42 FR 61348-54.) A notice extending the anti-dumping investigatory period for the six investigations was published in the FEDERAL REGISTER on June 8, 1978 (43 FR 24933).

National Steel submitted a letter dated August 14, 1978, indicating a willingness to withdraw its petition if the Treasury agreed with certain understandings concerning National Steel's right to refile its petition. On August 15, 1978, the Treasury Department confirmed these understandings in a letter and on that date, National Steel submitted a letter formally withdrawing its petition. These letters are reproduced as appendices to this notice.

Treasury has been monitoring and will continue carefully to monitor entries of cold rolled and galvanized carbon steel sheets under the trigger price mechanism and to take appropriate action to ensure the effective enforcement of the Antidumping Act with respect to that product. In this connection, it should be noted, as indicated in the notice of proposed rulemaking regarding the special summary steel invoice (42 FR 65214), that Treasury views its authority to withhold appraisement retroactively in appropriate cases as an important tool for providing effective enforcement of the Antidumping Act.

Accordingly, I hereby conclude that based upon the withdrawal of the antidumping petition and in view of the fact that cold rolled and galvanized carbon steel sheets are subject to the "trigger price mechanism" administered by this Department, it is appropriate to terminate these investigations. These terminations are without prejudice to the filing of one or more subsequent antidumping petitions concerning the same products.

(signed) Robert H. Mundheim

Robert Mundheim
General Counsel of
the Treasury

AUG 15 1978

National Steel Corporation

F. E. TUCKER
Vice President - Public Affairs

August 14, 1978

Robert H. Mundheim, Esquire
General Counsel
Department of the Treasury
Washington, D.C. 20220

Re: <u>National Steel Corporation Antidumping Case</u>

Dear Mr. Mundheim:

On October 20, 1977, National Steel Corporation ("National") filed an Antidumping Petition at the U. S. Customs Service. The Petition covered cold rolled and galvanized steel sheets from Belgium, France, Germany, Italy, Netherlands and the United Kingdom. The Petition alleged that these steel products were being sold in the United States at less than fair value under the usual pricing test and under the cost of production/constructed value test.

On December 2, 1977, separate Antidumping Proceeding Notices were published for each of the six European countries involved in this case (42 F.R. 61348-61354).

On December 6, 1977, the Solomon Task Force Report recommended a Trigger Price Mechanism ("TPM") to facilitate administration of the Antidumping Act for certain steel mill products including cold rolled and galvanized sheets. The TPM subsequently was (and is continuing to be) implemented by the Treasury Department.

On May 31, 1978, in recognition of Treasury's need to devote substantial resources to the TPM, National withdrew the cost of production (but not the pricing) allegations in its Antidumping Petition.

On June 2, 1978, Treasury announced a three-month extension of the investigatory period (43 F.R. 42933, June 8, 1978).

We recognize that the effective administration of the TPM will continue to require the allocation of substantial Treasury resources. We also are hopeful that, with the expiration of an initial "grace period", the TPM should start to do the job which it was intended to do, and that the results of an effectively administered TPM should be seen shortly (and thereafter on a continuing basis) in steel import figures.

Therefore, National will withdraw the remaining pricing allegations in its Antidumping Petition (and thus its entire Petition) if Treasury accepts and expressly acknowledges the following:

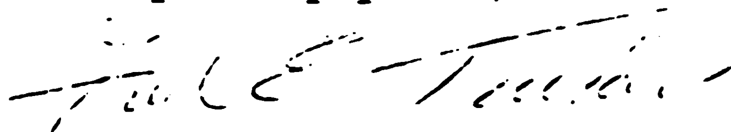
(1) The withdrawal is without prejudice;

(2) The Treasury files pertaining to the National Antidumping Petition will be retained for at least five years from the date on which the Petition is withdrawn; and

(3) Any subsequent filing with respect to the withdrawn Petition will be processed expeditiously using, among other things, the relevant information in these retained files and the accumulated expertise attained in the development of that information.

Upon receipt of your acceptance and acknowledgement of the above three points, National promptly will provide you with a letter confirming the withdrawal of its Petition.

Very truly yours,



Fred E. Tucker

cc: G. A. Stinson
R. M. Golden

AUG 15 1978

Dear Mr. Tucker:

Thank you for your letter of August 14, 1978, in which you indicate that based on certain understandings, National Steel Corporation would withdraw its antidumping petitions relating to cold rolled and galvanized steel sheets from Belgium, France, Germany, Italy, the Netherlands and the United Kingdom.

I want to confirm to you that National Steel Corporations' withdrawal of its petition will be without prejudice to its right to refile antidumping petitions against Belgian, French, German, Italian, Netherlands' and United Kingdom cold rolled and galvanized steel sheets at any time in the future. Moreover, I want to confirm that if National Steel Corporation should refile an antidumping petition against such cold rolled and galvanized steel sheets, relevant evidence submitted or developed in connection with National Steel's previous complaints will be used. As you may know, Treasury normally maintains its files for more than 5 years and would make no exception to that practice in this case. Finally, Treasury will expeditiously conclude its disposition of any refiled complaints on these products, utilizing all the relevant information contained in its files, including information obtained in updating and implementing the trigger price mechanism.

Please be assured that the Treasury Department will continue carefully to monitor cold rolled and galvanized steel sheets under the trigger price mechanism and will take appropriate action to ensure the effective enforcement of the Antidumping Act with respect to that product.

We will act on your withdrawal as soon as you give me formal notification that National Steel Corporation is with-

drawing its antidumping petitions on cold rolled and galvanized steel sheets from Belgium, France, Germany, Italy, the Netherlands and the United Kingdom.

Sincerely yours,

(signed) Robert H. Mundheim

Robert H. Mundheim

Mr. Fred E. Tucker
Vice President - Public Affairs
National Steel Corporation
1050 17th Street, N.W.
Washington, D.C. 20036

National Steel Corporation

F. E. TUCKER
Vice President - Public Affairs

August 15, 1978

Robert H. Mundheim, Esquire
General Counsel
Department of the Treasury
Room 3000
15th & Pennsylvania Avenues, N.W.
Washington, D.C. 20220

Re: National Steel Corporation Antidumping Case

Dear Mr. Mundheim:

Thank you for your letter of August 15, 1978, in which you confirm the understandings set forth in our letter of August 14, 1978.

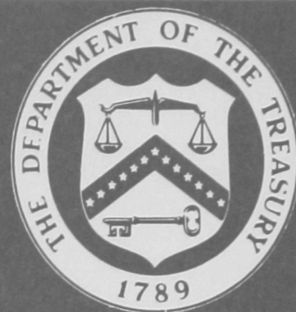
This constitutes formal notification by National Steel Corporation that it is withdrawing its Antidumping Petition on cold rolled and galzanized steel sheets from Belgium, France, Germany, Italy, Netherlands and the United Kingdom.

Very truly yours,

Fred E. Tucker

cc: Counsel of Record
G. A. Stinson
R. M. Golden

partment of the TREASURY NEWS
INGTON, D.C. 20220 TELEPHONE 566-2041



FOR IMMEDIATE RELEASE
August 16, 1978

Contact: Robert E. Nipp
(202) 566-5328

TREASURY ANNOUNCES START OF ANTIDUMPING INVESTIGATION OF SUGAR FROM BELGIUM, THE FEDERAL REPUBLIC OF GERMANY AND FRANCE

The Treasury Department today announced it has initiated an antidumping investigation of imports of sugar from Belgium, the Federal Republic of Germany and France.

Treasury's announcement followed a summary investigation conducted by the U.S. Customs Service after receipt of a petition filed by the Florida Sugar Marketing and Terminal Association, Inc. alleging that growers/processors in these three countries are dumping sugar in the United States. The petitioner claims that sugar from these three countries is sold in this country at lower prices than in the respective home markets.

Although the petitioner also claimed injury from these imports, the Treasury has expressed "substantial doubt" of the injury and has referred the case to the U.S. International Trade Commission for a determination within 30 days of whether there is any reasonable indication of injury from these imports. If the Commission determines there is no reasonable indication of injury, the antidumping investigation will be terminated immediately; otherwise, the investigation will continue.

If, after a full investigation, the Treasury finds sales at "less than fair value," the U.S. International Trade Commission will again consider the question of injury in a full 90-day investigation of that issue. Both sales at "less than fair value" and "injury" must be determined before a dumping finding is reached.

The Treasury Department has recently imposed a 10.8 cents/pound countervailing duty on sugar exported to the United States from these three countries as members of the European

B-1111

Community. This action was taken in a Notice published in the Federal Register of July 31, 1978 after the Treasury found that subsidies are paid on European Community exports of sugar to the United States.

Notice of the start of the investigation will appear in the Federal Register of August 18, 1978.

Imports of sugar from these three countries during calendar year 1977 was valued at approximately $10.4 million as follows: Federal Republic of Germany - $5.3 million, France - $4.8 million, Belgium - $0.3 million.

***

August 17, 1978

Statement by W. Michael Blumenthal
Secretary of the Treasury Regarding the Dollar

The President has asked me to announce that under his instructions, Chairman Miller and I are giving urgent attention to proposals in a number of areas and we would expect a series of continuing actions to be announced as decisions are reached over the next few weeks.

partment of the TREASURY NEWS
HINGTON, D.C. 20220 TELEPHONE 566-2041

FOR IMMEDIATE RELEASE
EXPECTED AT 10:00 A.M.
THURSDAY, AUGUST 17, 1978

STATEMENT BY HELEN B. JUNZ
DEPUTY ASSISTANT SECRETARY FOR
COMMODITIES AND NATURAL RESOURCES
BEFORE THE
SUBCOMMITTEE ON OCEANOGRAPHY OF THE
HOUSE COMMITTEE ON MERCHANT MARINE AND FISHERIES

Mr. Chairman and Members of this Committee:

I am pleased to testify before this Committee in order to clarify the relationship between U.S. international economic policy and the seabed negotiations at the U.N. Law of the Sea Conference. While consistency with the international economic policies of the United States, especially in the areas of commodity policy and technology transfer is important, it clearly cannot be the only criterion for assessing the seabed text. A comprehensive LOS treaty, in the overall national interest, needs to balance a broad spectrum of policy objectives and interests, of which commodity and investment policies are an integral but not an overriding part.

I would like to summarize U.S. policies in these latter areas as they might apply to seabed mining considerations.

The Administration's Commodity Policy

The Carter Administration has sought to integrate domestic and international policy concerns in the commodity area into a single, coherent approach. Central to this approach is our willingness to negotiate international agreements for individual commodities (ICAs) designed to reduce excessive price volatility. Such agreements form a basic part of our efforts to assure a stable domestic and international production, investment, and trading climate for raw materials. In addition, we have agreed to find ways and means to asssist in the financing of buffer stocks as part of individual commodity agreements, and to use existing financial institutions, both national and international, to expand production and processing of raw materials.

Both producing and consuming countries currently face important problems in the commodity area. Excessive short-term price fluctuations can ratchet up inflation in importing countries, and destabilize economic development in exporting countries. Inadequate investment in the production of raw materials creates supply shortages, which in turn result in longer run inflationary pressures world-wide.

International Commodity Agreements

In devising economically rational ICAs, we believe that certain principles are essential to serve the multi-faceted interests of the United States as a major importer/consumer

or exporter/producer of virtually every primary commodity:

-- they must be designed to reduce short-term price fluctuations around underlying market trends, and <u>not</u> to raise prices in the longer-term;

-- they must balance the interests of producers and consumers, in terms of responsibilities and benefits;

-- they must provide wide latitude for the operation of market forces; and

-- decision making within ICAs should be weighted to reflect the relative economic interests of each producer or consumer.

The United States opposes production controls in ICAs. By artificially cutting back on supplies, production controls in ICAs tend to distort markets, raise prices above market trends and provide short-term gains for producers to the detriment of consumers. Such production controls also create inefficient production patterns by forcing both low and high cost producers to cut back output thereby raising the average cost of production.

Because they are usually based upon some average of historical market shares, production controls tend to freeze production and marketing patterns and restrain the entry of newer, possibly more efficient producers. The implementation of supply controls is difficult, with leakages frequent, and errors not easily corrected in the short run. Supply control

mechanisms usually are based on previous years' data and sometimes involve precarious forecasts of future output. Finally, they require long lead times before significant impact on the supply and demand situation becomes apparent. For these reasons, in negotiating ICAs, the Administration prefers buffer stock arrangements.

Commodity Investment Policy:

The United States seeks to facilitate investment in mining and processing in order to:

- -- avoid misallocation of important economic resources and the inflation such misallocations cause;
- -- diversify supply and contribute to a reduction in U.S. vulnerability to collusive price arrangements and disruptions of supply; and
- -- help developing countries expand their economies.

There is evidence of global misallocation of resources which, if continued, could significantly increase the cost of raw materials over the long run. A recent World Bank survey found that 80 percent of all exploration expenditures in 1970-73 were being made in the industrialized countries-- the United States, Canada, Australia, and South Africa. Private firms are reluctant to invest in developing countries, primarily because of political risks. U.S. firms, for example, prefer to develop a copper deposit with less than one-half percent richness in the United States than deposits

which are more than twice as rich in an LDC. Yet the rate of return on minerals projects in developing countries can be higher than in industrial countries. Indeed, for some Fourth World countries, minerals projects may be the only good projects that external private investment could develop.

To avoid this misallocation of resources, the Administration has encouraged the international financial institutions, such as the World Bank, to take measures which will stimulate investment in developing country mining and processing projects. The United States has also expanded the mandate of the Overseas Private Investment Corporation (OPIC) so that it can offer investment insurance for U. S. investors in overseas raw materials projects.

Production Controls in LOS Treaty

In the Law of the Sea Conference land-based producers of nickel are seeking to protect and preserve their future investments from competition from seabed mining. They fear that seabed mining will be subsidized in one way or another, and accordingly, be able to compete with unfair advantage over land-based mining. Canada, as the leader of this group, has stressed the nickel production potential of tropical developing countries in order to gain additional allies. Many might have deposits of nickel bearing laterite ores. The G-77, as a whole, have adopted the position that a production control mechanism is necessary

in order to protect nickel producers in developing countries, even though the number is small.

The United States has agreed to negotiate production control mechanisms that should interfere as little as possible with the currently anticipated production from seabed mining. To this end, we have been prepared to agree to a control formula that would allow ocean miners to supply 100 percent of the projected growth of the nickel market. Offering to agree to such a formula represented a significant effort to reach a compromise as well as a departure from the pure principle of efficient resource allocation by market forces.

At the last session, on an ad referendum basis, the U.S. Delegation negotiated a formula with the Canadians that would be limited to the first 20 years of seabed mining and in which seabed mining would be restricted, under standard assumptions, to a range of 60-70 percent of the projected growth in the world nickel market.

Admittedly, there may be economic costs associated with any production control formula. A restrictive production control formula may misallocate resources and distort efficient market patterns if it attempts to assure any group of producers a fixed share of the projected growth of the market regardless of the relative costs and efficiency of various modes of production.

The interests the U.S. has in a Law of the Sea treaty and in a seabed mining regime clearly are much broader than those that govern our general policy vis-a-vis commodity agreements on specific commodities. Moreover, the entire regime being considered for deep seabed mining raises a unique set of circumstances in which to assess the costs and benefits of any of the elements of that system, including production controls. Thus, a production limitation that would be unacceptable for example in a commodity price stabilization agreement, might be found acceptable to U.S. economic and other interests in a Law of the Sea treaty. Any production limitation would, of course, have to be examined in light of all relevant provisions of the text and relevant economic factors to determine to what extent, if any, it in fact would limit expected seabed mining. The Administration still is weighing the costs and benefits of the various navigational, environmental, scientific and economic considerations that attach to the treaty as a whole.

The Administration's Policy on Technology Transfer

With regard to privately-owned technologies, the Administration favors a generally open, market-oriented international system. In keeping with our foreign investment posture, we do not actively promote or

discourage proprietary transfers through special measures although the activities of our Overseas Private Investment Corporation and EXIM Bank indirectly affect such flows. We support efforts that facilitate an environment conducive to flows of capital and technology. In particular, we support the efforts of LDCs to generate a scientific and technological infrastructure to support economic growth. We believe, however, that a system of appropriate rewards and incentives, including protection of industrial property rights, is essential to induce and sustain high levels of innovation. Such a system should not, however, lend itself to collusion among technology suppliers.

The main forum for the North-South dialogue on the transfer of technology is the UN Conference on Trade and Development (UNCTAD), where negotiations on an international code of conduct for technology transfer have been on-going since 1975. The United States and other industrial countries support the adoption of voluntary guidelines for technology transfer, perhaps similar to the OECD guidelines for multinational enterprises adopted in June 1976. This might involve a code setting out balanced guidelines for government action in respect to technology transactions and conduct by enterprises.

The developing countries, however, are looking for a legally binding convention based on the principle that all countries should have the right of access to technology in order to improve the living standards of their peoples. Thus, the G-77 seek to extend the concept of the universal heritage of mankind to the field of technology. The developing countries seek to revise and limit the protection accorded industrial property rights and to institute rules at the national and international level which limit the negotiating flexibility of enterprises.

The United States believes that erosion of the traditional rights associated with proprietary technology would constitute a significant disincentive to the generation and dissemination of technology.

Many developing countries have national laws and policies affecting the transfer of technology which the United States could not accept as part of an international agreement on technology transfer. For example, some developing countries have laws which tend to reduce patent protection for certain types of technology, require patent rights to lapse if not worked in a short period of time, or tax royalties as if they were profits.

The G-77 often have used restrictive policies regarding technological transfers adopted at a national level as a basis for their positions in multilateral negotiations.

The negotiations on technology transfer conducted at the Law of the Sea Conference are unique in the sense that they aim at assuring that the Enterprise will in fact be able to operate its sites productively. Thus they back up the basic principle of the parallel system. While the Enterprise will need to have access to requisite technology, such tranfer clearly also must occur under fair and commercial terms. The negotiations on technology transfer in the Law of the Sea Conference will be pursued further at future sessions. The Administration will weigh provisions regarding the transfer of technology in an LOS treaty seriously, given the far-reachinng implications they could have for the future of ocean mining.

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HINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m., E.D.T.

STATEMENT OF
HARRY L. GUTMAN
OFFICE OF TAX LEGISLATIVE COUNSEL
OFFICE OF TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES
OF THE HOUSE WAYS AND MEANS COMMITTEE
AUGUST 17, 1978

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on H.R. 12686 and H.R. 10239.

H.R. 12686

H.R. 12686 would amend Code Section 48(a)(1) to make eligible for the investment credit greenhouse structures which are used for the commercial production of plants. The bill is similar to H.R. 12846, which would render structures used to house poultry facilities eligible for the investment credit.

B- 1113

Under current law, buildings and their structural components are generally not eligible for the investment credit. Certain special purpose structures are eligible for the credit but only if (1) the structure houses property used as an integral part of a productive activity and the structure is so closely related to the use of such property that it is clearly expected to be replaced at the same time as the property that it houses is replaced, or (2) the structure essentially constitutes an item of machinery. Thus, H.R. 12686 would render greenhouses eligible for the investment credit even though under current law they are generally ineligible.

As we noted in connection with H.R. 12846, the President has proposed expanding the investment credit to all industrial structures. Under this proposal, greenhouses would be eligible for the credit. We do not support H.R. 12686 because we believe that extension of the credit to industrial structures should be given effect on a general, rather than piecemeal, basis.

H.R. 10239

Code Section 103(b)(4)(G) provides that tax-exempt bonds may be issued to provide "facilities for the furnishing of water, if available on reasonable demand to members of the

general public." H.R. 10239 would eliminate the "general public" requirement and permit tax-exempt bonds to be issued simply for "facilities for the furnishing of water (including water used for the furnishing of electric energy)."

We are opposed to H.R. 10239. We oppose the expansion of the use of tax-exempt industrial development bonds. Such bonds tend to increase the financing cost of traditional governmental functions. Financing for activities, such as schools, is forced to compete with industrial development bonds, which may provide greater security and a higher premium to investors. This competition is particularly unfair because private corporations, unlike state and local governments, have access to other sources of capital. The result is that local taxpayers pay higher taxes to finance their traditional governmental services so that private concerns can pay a lower interest rate to finance their expansion.

Also, the bill would eliminate the "public use" test for water facilities. Thus, under the bill tax-exempt financing would be allowed for any water project, even if only one or two private corporations would benefit from the project. This constitutes a substantial enlargement of the "water facilities" exemption.

Further, the bill would expand present law by permitting tax-exempt bond treatment for water facilities used to provide cooling water for any electrical generating facility. Where the water will be used in conjunction with production of electrical energy, the Internal Revenue Service has taken the position that the bonds will be tax exempt only if they meet the electrical energy exemption requirements; that is, the facility must produce energy that will be used locally. H.R. 10239 would appear to allow the use of cooling water for electric energy even where the electrical power is not "local" within the meaning of the Code and regulations.

Thus, the bill provides a substantial expansion of the industrial development bond exceptions. Water would no longer have to be available on reasonable demand for use by the general public. In addition, the water could be used for cooling purposes in conjunction with the generation of electric energy even where the facility is not local.

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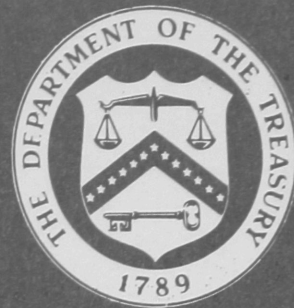

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.

STATEMENT OF
H. DAVID ROSENBLOOM, INTERNATIONAL TAX COUNSEL
OFFICE OF TAX POLICY, DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES
OF THE COMMITTEE ON WAYS AND MEANS
August 17, 1978

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear before you today to discuss H.R. 13336 and H.R. 13758.

H.R. 13336

The proposed bill would amend section 1441(c) of the Code to provide that commissions paid by a ship supplier to a nonresident alien individual will not be subject to withholding if the individual is in the employ of a foreign person in the operation of a ship documented under the laws of a foreign country and the commissions relate to the sale of supplies to be used in the operation of such ship.

The proposed amendment to the Code would apply retroactively to all open years, but refunds of taxes actually withheld are not authorized except as to commissions paid on or after July 1, 1978.

Background

It is Treasury's understanding that the bill has been proposed in reaction to a technical advice issued by the Internal Revenue Service in 1975. The technical advice provided that, under the facts in that particular case, kickbacks or commissions paid by a ship supplier to ship captains were for the performance of services in the U.S. by the ship captain as an independent contractor. The services in question were the purchasing of the ship supplier's wares. As a result, the kickback was subject to withholding and the ship supplier was the responsible withholding agent.

This position conforms to the general rule that payments by a U.S. person to a nonresident alien independent contractor for the performance of services within the United States are subject to withholding at the rate of 30 percent of gross income. Rev. Rul. 58-479, 1958-2 C.B. 60, specifically states that kickbacks from ship suppliers to nonresident alien ship captains are subject to withholding under section 1441.

There is an argument, however, that a ship supplier merely remits wages on behalf of the ship owner to the latter's employee, the ship captain. This argument takes into account that ship suppliers increase their billings to the foreign ship owner by the amount of the kickback and that many foreign ship owners are aware of this practice and take kickbacks into account in setting the captain's salary. In effect the argument is that the ship supplier is not obligated to withhold under section 1441 for wages he remits as agent of the ship owner.

Analysis

The bill proposes to relieve U.S. ship suppliers from the obligation to withhold U.S. tax on kickbacks or commissions they pay to nonresident alien ship captains. There are two reasons why this proposal is justifiable. First, it may be difficult to determine whether the relationship between a ship owner, ship captain, and ship supplier is such that the ship supplier is remitting wages on behalf of the ship owner or making a payment to the ship captain on his own behalf. Various factors, such as the state of the ship owner's knowledge of the kickback practice and whether the ship owner bears the cost of the kickback through inflated prices for goods purchased, appear to be relevant.

Second, in many cases there is little need to withhold U.S. tax. The nonresident alien ship capitan is subject to tax in the United States only with respect to his U.S. source income. The services of a captain or crewmember are viewed as U.S. source only to the extent that the ship is in U.S. territorial waters. In computing the captain's final tax liability a personal exemption is allowed. Thus, adjusted gross income must exceed $750 before U.S. tax liability attaches. Because of the Code source rules and because a ship captain may visit the U.S. only infrequently and for short periods of time, it appears that many nonresident alien ship captains may have little or no final U.S. tax liability and that withholding of tax may frequently serve no purpose. By filing a tax return the captain can in many cases obtain a refund of the taxes that have been withheld.

Treasury Position

The Treasury does not object to section (a) of the bill. However, the Treasury objects to section (b) of the bill, which contains the effective date. The Treasury would not object to section (b) if it were modified so that the proposed changes to section 1441 would apply only to commissions paid on or after the date of enactment of the bill.

As drafted, section (b) would absolve from withholding liability all U.S. ship suppliers who in the past decided not to withhold. Section (b) would, however, prevent refunds of any amounts that had been deducted or withheld under section 1441 prior to July 1, 1978. Presumably, the intention is to preclude the proposed amendment to section 1441(c) from authorizing a refund that would not otherwise have been allowed. The bill is ambiguous on this point, however, and could be read to disallow refunds of withholding tax to which a ship captain would otherwise be entitled when he files his return.

Even if the bill were modified to clarify this point, however, the effective date would have the objectionable effect of retroactively eliminating a withholding tax liability that should have been observed. In this sense it rewards those who were negligent and undermines the general purpose of the Code's withholding provisions.

We understand there has been considerable competitive pressure on ship suppliers not to withhold tax because ship captains would have been more likely to give their business to a ship supplier who did not withhold. Nevertheless, there has been a published IRS position since 1958 stating that kickbacks from ship suppliers to ship captains are subject to withholding under section 1441 and there appears to be no justification for retroactively rewarding those who decided to take their chances by not following the Service's published position.

H.R. 13758

Section 1 of the bill amends section 861(a)(1)(F) of the Code so that it applies to interest on amounts described in a new provision, section 861(c)(2). Section 2 of the bill amends section 861(c) by adding the new section 861(c)(2). This section states that for the purposes of section 861(a)(1)(F) the amounts covered are (1) deposits with persons carrying on the banking business and (2) certain deposits or withdrawable accounts with, in broad terms, chartered savings

and loan associations. Section 3 of the bill provides that the amendments made by sections 1 and 2 shall apply to taxable years beginning after the date of enactment.

Analysis

Code section 861 provides, in relevant part, that interest income paid by a United States person is considered to be sourced within the United States. There are three relevant exceptions to this general rule. First, interest on amounts described in section 861(c) (deposits with persons carrying on the banking business and with chartered savings and loan associations, and certain amounts held by insurance companies) which is received by a nonresident alien or foreign corporation is considered to be foreign source if the interest is not effectively connected with the conduct of a trade or business within the United States. Second, interest paid by a domestic corporation is considered to be foreign source when less than 20 percent of the gross income from all sources of such corporation is from within the U.S. Third, interest on deposits with a foreign branch of a domestic corporation or domestic partnership is considered to be foreign source if such branch is engaged in the commercial banking business. This third exception does not apply to savings and loan associations. Thus, interest paid by a foreign branch of a domestic savings and loan association to a U.S. person or a resident alien is from U.S. sources unless less than 20 percent of the savings and loan association's income is from U.S. sources.

There is a class of U.S. taxpayers that must determine for tax purposes whether interest received is sourced within Puerto Rico -- corporations that desire to qualify for the tax credit extended by section 936 and individuals that seek exemption from U.S. tax provided by section 933. To determine whether interest paid by a savings and loan operating in a foreign country or possession is sourced in that foreign country or possession reliance must be placed on the source rules provided by Code sections 863 and 861(a)(1)(D). In essence, these sections provide that when a U.S. person or resident alien receives interest income from a United States corporation that is a savings and loan association with less than 20 percent U.S. source income, that interest is sourced within a country or possession if and to the extent that the gross income of the savings and loan is from within that country or possession; for this rule to apply, however, at least 50 percent of the savings and loan's income must be from within that country or possession. The percentage of

the interest that is treated as being from, for example, Puerto Rico depends upon the percentage of the savings and loan's gross income that is from Puerto Rico.

In contrast to the section 861(a)(1)(D) pro rata apportionment of the source of the interest paid by the savings and loan is section 861(a)(1)(F). That section provides in conjunction with section 863 that all of the interest paid by a foreign branch of a U.S. corporation engaged in the commercial banking business is sourced in the country or possession in which the branch is located (see regulation section 1.861-2(b)(5)).

Treasury Position

H.R. 13758 has been proposed in order to provide equality of treatment for savings and loan associations and those engaged in the commercial banking business. The current Code provision that sources all bank interest in a particular country or in a particular possession, without regard to the general "pro rata" rule, applies only to those engaged in the commercial banking business. A savings and loan association must source its interest payments based on the proportion of its income that is derived from the particular country or possession, and none of its interest is sourced in the country or possession if it has 20 percent or more U.S. source income.

This statutory inequality has significance in the case of depositors that desire the benefits of sections 936 and 933 of the Code. The Treasury expects that regulations to be proposed under section 936 will cure the problem for section 936 corporations. The problem will remain, however, for individuals resident in Puerto Rico. Those individuals might find it preferable to deposit funds with Puerto Rican branches of commercial banks rather than savings and loans because in the former situation the interest is, in all cases, entirely from within Puerto Rico.

Thus, the Treasury supports the objective sought by H.R. 13758. The language of H.R. 13758 raises, however, a side issue which should be resolved. Section 2 of the bill amends Code section 861(a)(1)(F) so that it would also apply to banks other than commercial banks and savings and loan associations. I refer you to proposed section 861(c)(2)(A) as compared with current section 861(a)(1)(F). This proposed statutory change does not relate to the problem facing the savings and loan associations and we are not aware of the

need for, or the practical consequences of, the change. We recommend, absent a satisfactory explantion, that H.R. 13758 use the relevant language of current section 861(a)(1)(F) referring to "the commercial banking business" (emphasis added). Subject to our reservation on this portion of H.R. 13758, the Treasury supports the bill's enactment.

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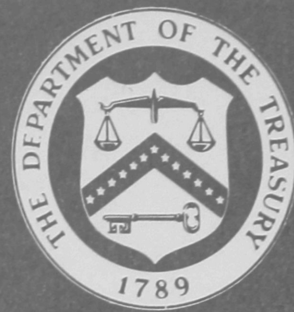

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TREASURY DEPARTMENT

FOR RELEASE UPON DELIVERY
Expected At 10:00 a.m.
August 17, 1978

STATEMENT OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
ON
THE REVENUE ACT OF 1978 (H.R. 13511)
BEFORE THE COMMITTEE ON FINANCE
WASHINGTON, D.C.

Mr. Chairman and members of this distinguished Committee:

The Committee begins consideration today of H.R. 13511, the Revenue Act of 1978. This bill, recently adopted by the House of Representatives, would reduce tax liabilities by $16.3 billion in calendar year 1979. Of this amount, $10.4 billion is attributable to personal tax relief, $4.0 billion to business tax reductions, and $1.9 billion to a cut in capital gains taxes.*

My testimony will assess the House-passed bill in light of the objectives outlined in the President's tax message last January. One goal emphasized by the President is to provide substantial tax relief for individuals, especially those persons in the low and middle-income categories. Another objective is to furnish efficient investment incentives that encourage businesses to modernize productive facilities and to create permanent, meaningful jobs. We also believe that the income tax structure should be improved through reforms that make the system more equitable and simpler for average taxpayers.

H.R. 13511 takes some steps toward these goals, but there is substantial room for improvement. The size of the net tax reduction -- about $16 billion -- is within a reasonable range of tax cuts that will maintain growth without increasing inflationary pressures. Moreover, the bill's

* These revenue figures do not include "feedback" revenues that might be generated through economic stimulus. The Appendix describes the role of "feedback" effects in Treasury revenue estimating procedures.

B-1115

split between personal and business relief is acceptable. But we do not like the distribution of the cuts among taxpayers. In my statement, I will describe ways in which we believe the relief can be distributed more equitably.

I will also suggest additional structural tax changes for the Committee's consideration. We are pleased that the House adopted some of the tax reform proposals recommended by the President. The bill includes new tax shelter restrictions, simplification of the itemized deduction schedule, elimination of the tax exclusion for unemployment benefits at high-income levels, and repeal of the special alternative tax ceiling on the capital gains of persons in the top rate brackets. We urge the Committee to build upon these reforms now contained in H.R. 13511.

In this regard, the results of a recent Roper survey are illuminating. The survey, released last month, indicates that the American public considers tax reform the third most pressing national problem, ranking behind only controlling inflation and lowering the crime rate; and significantly, "tax reform" to the Roper respondents is equated much more frequently with tax fairness than with tax reduction. This timely expression of public sentiment should provide a useful guide for your deliberations.

THE ECONOMIC NEED FOR A PRUDENT TAX REDUCTION

Before turning to specific proposals in the House bill, let me discuss the size of tax reductions needed in 1979 -- an evaluation that must be made in the light of recent economic developments. In many ways, our economy has performed remarkably well over the past year and a half. The unemployment rate at the end of 1976 was 7.8 percent; that rate has now dropped to 6.2 percent in July. Almost 6 million more people are employed now than were employed at the beginning of this Administration, and a larger percentage of the working age population now holds jobs than ever before. In the fourth year of our recovery from recession, we are still experiencing a real growth rate of about 4 percent.

To maintain this recovery, tax policy must take account of several factors. 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. Other tax increases will result as a higher cost of living pushes individuals into higher rate brackets without increasing real incomes.

An income tax cut in 1979 will help to compensate for these factors and thereby to maintain adequate purchasing power to continue our economic growth.

Perhaps the most significant risk in the economic outlook is inflation. Over the first half of 1978, the consumer price index has risen at an annual rate exceeding 10.4 percent. We believe that the inflation rate for the second half of this year will be substantially lower, by perhaps one-third, and that the annual rate will be more moderate in 1979 than in 1978. Nevertheless, inflation will continue to be a troublesome problem.

In recognition of the need to restrain accelerating inflationary pressures, the Administration has called for a reduction in the size of the 1979 tax cut, from the $25 billion figure recommended in January to $20 billion. Moreover, we have urged Congress to trim an additional $5 billion from Federal budget outlays for fiscal year 1979 in order to reduce the deficit for that year to $43.5 billion. Budgetary restraint is essential.

Tax and budget policy must address another threat to continued economic recovery: sluggish business investment. Investment in new plant and equipment now accounts for only one-tenth of our Nation's real gross national product, a much smaller share than is needed to provide the tools of production for a full-employment economy in the 1980's. Manufacturing capacity has increased at an average annual rate of only 3 percent over the past 4 years, as compared to a 4-1/2 percent capacity growth rate during the post-war period through 1973. Incentives, in the form of business tax cuts, are needed to improve this disappointing record of business fixed investment and to avoid inflationary capacity bottlenecks in the years ahead.

We believe that the tax reduction contained in the House bill for 1979 represents generally an appropriate fiscal response to these economic concerns. The magnitude of the cut in H.R. 13511 is about $1.2 billion less than that recommended by the Administration.* Tax relief of this size would help maintain the economic recovery, without bloating the deficit and exacerbating inflation. We recommend that the Finance Committee adopt a tax cut of approximately the same magnitude.

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* Using the same estimating assumptions, the tax cut in H.R. 13511 is $18.8 billion, compared to the Administration's $20 billion recommendation. The Administration did not count the expiration of the $2.5 billion general jobs credit in its tax program as a revenue-raising provision. It was, however, accounted for elsewhere in the budget.

A tax cut substantially larger than that in the House bill would create serious risks to our economic recovery, in particular the creation of inflationary pressures. Whatever temporary benefits might be obtained through lower tax burdens would be quickly negated by the resulting rise in prices and interest rates; increased after-tax incomes for individuals would be illusory, and the tax incentives for business investment and job creation would be undermined. These economic risks should not be taken. We ask this Committee not to adopt a significant increase in the tax reduction now contained in H.R. 13511.

PERSONAL TAX CHANGES

Tax Relief for Individuals

In fashioning the portion of the tax cut relating to individuals, the Committee is urged to bear in mind a fundamental principle of tax equity: taxes should be imposed in accordance with ability to pay. The tax program recommended by the President reflects that principle. We are convinced that tax reduction should be focused on individuals in middle and low-income brackets; these are the persons most in need of relief from tax burdens. The tax bill adopted by the House does not adequately respond to this critical principle of tax equity.

H.R. 13511 would effect the tax cut through several changes. Individual rate brackets would be expanded by about 6 percent. The zero bracket amount ("standard deduction") would be increased from $3,200 to $3,400 for joint returns and from $2,200 to $2,300 for single returns. The personal exemption would be raised from $750 to $1,000, with the general tax credit being eliminated. Rates would be cut in certain brackets.

In the abstract, these changes may appear to have merit. Yet, when one examines the impact of H.R. 13511 on specific taxpayers, the inequities become apparent. As H.R. 13511 was adopted by the House, a typical four-person family with wage income of $10,000 would receive an income tax reduction of only $62 -- a cut one-fifteenth the size of the reduction provided to a family with salary ten times as large. Relief for the typical four-person family at the $20,000 income level would be less than one-sixth of the tax cut enjoyed by a $100,000 income family.

An examination of combined income and social security tax changes reveals the same disturbing pattern. For a family of four at the $15,000 wage level, combined income and social security taxes would be reduced $35 in 1979 in comparison to 1977 levels. The net income and social security tax reduction at the $100,000 level would be $485 -- a cut 14 times as large even though income is only 7 times as large.

Moreover, it is important to recognize that these figures, relating to personal income tax relief, do not present the bill in its full perspective. The comparisons I have just discussed do not include the impact of capital gains relief in H.R. 13511. The proposed capital gains tax changes for 1979 and the subsequent inflation adjustment for capital assets would provide capital gains relief amounting to nearly $7 billion annually by 1983. Like any cut in capital gains taxes, this $7 billion would be enjoyed primarily by persons in higher income brackets. As a result, the inclusion of capital gains cuts in the bill makes it especially important that the personal cuts be focused on middle and low-income groups.

The Administration recommends that the distribution of tax relief be altered to provide greater tax reductions than the House bill for all income classes through $50,000. We would reduce some of the bill's bountiful tax cuts for persons in income classes above $50,000 and increase cuts for taxpayers with incomes under $20,000. The share of the total individual tax cut going to persons below $20,000 should be increased from 25 percent to about 40 percent while the share for those above $50,000 should be reduced from 24 percent to about 10 or 15 percent. This distribution of relief reflects much more accurately the tax principle of ability to pay.

As you know, the distribution of personal tax relief in the bill depends upon two factors: rate changes and the size of the exemption or credit for dependents. Neither of these factors can be viewed in isolation. Changes in tax rates can be combined with an exemption or credit to produce virtually any degree of progressivity the Committee desires.

We suggest that a $240 credit for each dependent be combined with generous rate cuts in the middle-income brackets to achieve the recommended tax cut distribution -- increased tax savings in the bill for all income categories through a

level of about $50,000. The new credit would replace the current $750 exemption for each dependent and the general tax credit, which is equal to the greater of $35 per dependent or 2 percent of the first $9,000 of taxable income. By eliminating this complicated scheme of exemptions and alternative forms of credits, the $240 personal credit would achieve the same simplification as the $1,000 exemption in the House bill.

The $240 credit would provide a more equitable tax differential for various family sizes than would the $1,000 exemption in H.R. 13511. The members of this Committee are well aware of the advantages of providing tax savings through a credit. Since the personal credit would be subtracted directly from tax liability, each additional dependent would furnish $240 in tax savings to a taxpayer regardless of his income level. By contrast, a $1,000 exemption would result in a $700 tax benefit for each dependent in a top-bracket family and a $140 benefit for each dependent in the lowest-bracket family.

In addition to equalizing the tax savings for dependents, the $240 credit would raise the level of earnings at which an income tax begins to be imposed. For example, the tax-free level of income for a family of four would rise from $7,200 under present law to $9,200. This figure compares with a tax-free level of $7,400 under the House-passed bill.

This Committee now has the opportunity to review the tax rate schedules, the exemptions and credits that are proposed for 1979. I urge you to reject the House bill in these areas and to substitute a $240 personal credit and a new rate schedule that direct greater relief to middle and low-income families. A sense of fairness demands these changes to benefit the vast majority of American taxpayers.

Changes in Itemized Deductions

The House responded favorably to a number of personal tax changes recommended by the President. Among these proposals are changes in itemized deductions. I ask that you accept these provisions in order to continue the tax simplification effort that began last year.

In the Tax Reduction and Simplification Act of 1977, Congress worked with the Administration to enact changes that incorporate the standard deduction in the tax tables,

lessen the number of computations made by taxpayers, and simplify the total reporting and recordkeeping burden. As a result of these changes, approximately 40 percent of all individual taxpayers were able to file a short Form 1040A for tax year 1977, and the number of lines on that form was reduced from 25 to 15. The error rate of taxpayers was decreased dramatically, from 9.1 percent to 6.5 percent for the long Form 1040 and from 12 percent to 5.1 percent for Form 1040A.

We hope to sustain this encouraging progress. Itemized deduction changes in the House bill would accomplish further tax simplification without creating significant controversy. The bill would simplify or eliminate a number of deductions that add complexity to the tax system and that do not advance any major objective of public policy.

1. State and Local Taxes. H.R. 13511 would eliminate the deduction for State and local gasoline taxes. We urge the Committee to adopt this provision of the House bill.

The administrative problems associated with the gasoline deduction are large relative to the tax savings involved. Taxpayers using the standard deduction receive no tax benefit. The tax savings of a typical itemizer are calculated arbitrarily and amount to only about $25. Most taxpayers use gasoline tax tables prescribed by the Internal Revenue Service and guess at the number of miles driven in a given year -- a fact which must be known for proper utilization of the tables. Therefore, calculation of the gasoline tax paid is seldom accurate, and the Internal Revenue Service has no adequate way to check the mileage claimed by taxpayers.

In addition to creating these administrative problems, the deductibility of gasoline taxes represents bad substantive policy. Current law lowers the net price of gasoline by the value of the deduction, thereby encouraging the purchase of gasoline relative to other goods. Eliminating the deduction would advance the governmental policy of discouraging the consumption of energy.

We recommend that the Committee also eliminate the special deduction for general sales taxes, personal property taxes and miscellaneous taxes while retaining deductions for State and local income and real property taxes. State sales taxes, like gasoline taxes, are usually determined arbitrarily with reference to published tables that provide nearly

uniform deductions and result in a relatively small tax benefit. Since the tax benefit for itemizers is generally modest and since there is no benefit at all for the 69 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. By extending H.R. 13511 to remove deductions for these other forms of State and local taxes, the Committee could achieve further tax simplification; and tax increases could be avoided by using the revenue raised from these changes to provide larger rate reductions.

2. Political Contributions. The House adopted the Administration's proposal to simplify the confusing scheme of deductions and credits for political contributions. Under current law, a taxpayer can elect to claim itemized deductions 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. The House bill would repeal the political contribution deduction while retaining the credit. As a result, the incentive of the tax subsidy for political contributions would be available equally to itemizers and non-itemizers and would not rise with the income level of the taxpayer.

3. Medical and Casualty Expenses. The current provision for medical deductions is unnecessarily complicated. Twelve lines on schedule A for Form 1040 are devoted to computation of the deduction for dental and medical expenses. 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 including medicines and drugs in excess of 1 percent of adjusted gross income.

The House has accepted the President's proposal to treat medical insurance premiums, drugs and medicines in the same manner. All of these expenditures would be subject to the same floor -- in the House bill, 3 percent of adjusted gross income. This change would greatly simplify return preparation. However, for those who now itemize their medicines and drugs, the House bill would have the effect of reducing the overall floor from 4 to 3 percent. This change by itself would increase the number of itemizers.

The Committee may wish to consider additional simplification measures in this area. Since normal medical expenditures average about 8 percent of income, the floor for medical deductions could be raised -- perhaps to 5 percent of adjusted gross income. This would accord with allowing deductions for hardship cases, but leaving the normal amount of expenses as an element of the standard deduction. On the same theory, casualty losses, now deductible for amounts in excess of $100, could be subjected to an additional floor of 5 percent of adjusted gross income. There is no reason the government should in effect insure property damage losses at a lower threshold than personal injuries or sickness. By substituting rate cuts for the lost deductions, over one million taxpayers would be able to switch to the standard deduction.

Unemployment Compensation

The House also adopted the Administration's recommendation that the current tax exclusion for unemployment compensation benefits be phased out as an individual's income rises above $20,000 for a single person or $25,000 for a married couple. Under the bill, 50 cents of unemployment compensation would be taxed for every dollar of taxable income (including unemployment compensation) received in excess of these income ceilings.

Dollars received from unemployment benefits are just as valuable as dollars received in any other form. Therefore, a continued exclusion at high and middle-income levels violates the principle that a person should be taxed in accordance with ability to pay. In the 1976 Act, Congress repealed the sick pay exclusion for workers at high-income levels on the grounds that sick pay is a substitution 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 example, some individuals receive a substantial income every year through investment income and a salary from a 9-month job; they 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.

Earned Income Credit

The House bill would extend and simplify the earned income credit -- an important provision developed by the Chairman of this Committee to assist workers at lower-income levels. Under H.R. 13511, the earned income credit would be made permanent rather than allowed to expire after 1978. In addition, there would be changes in the calculation and determination of eligibility for the credit. These changes would make the credit easier to compute and would enable the IRS to determine more readily those eligible individuals who fail to claim the credit.

Currently, taxpayer mistakes are caused by difficult computations and by eligibility criteria that differ from the criteria for determining filing status and claiming exemptions. The House bill would achieve substantial simplification through the elimination of calculations and the substitution of published tables for hand computations. In addition, the bill would make it possible to determine eligibility for the earned income credit from the information supplied in claiming dependent exemptions or head of household status. The Administration has strongly supported these efforts, and we believe that enactment of the House bill would result in simplification for both the taxpayer and the Internal Revenue Service.

Deferred Compensation Arrangements

In order to provide similar tax treatment for persons in the same economic circumstances, the tax law generally requires income to be reported by employees regardless of the form in which compensation is received. It is thought that a person who receives cash wages and uses those wages to save for retirement, to purchase insurance, or to make other investments should not be taxed more heavily than the person who receives those benefits through arrangements with his employer.

As exceptions to this general rule, preferential tax treatment is now provided for various employee benefits, including certain pension plans, group life insurance plans, and medical insurance plans. The Administration believes that a tax preference for employee benefits can be justified only as a means of ensuring that a wide range of employees is protected against such contingencies as sickness, disability, retirement, or death. Accordingly, the President's tax

program recommended that tax-favored status be withheld from certain kinds of employee benefit plans that discriminate against rank-and-file employees.

Included in the President's recommendations was a non-discrimination requirement for "cafeteria plans." A cafeteria plan is an arrangement under which a participating employee elects the type of fringe benefits to which employer contributions will be applied on his or her behalf. H.R. 13511 contains a provision which is substantially similar to the President's proposal, and we urge that this Committee retain that provision.

Other sections of the House bill would enable employees to defer taxation under certain plans that permit an employee to elect whether or not to receive a current cash payment. One type of plan covered by the House bill is an unfunded "salary reduction plan"; another type is a "cash or deferred profit sharing plan." We believe that preferred tax treatment for these plans should also be based on a requirement of non-discriminatory coverage. The Treasury Department is working on a detailed proposal in this area, and we will be happy to consult with the Committee members in designing a fair and reasonable provision.

Tax Shelters

Tax shelters are devices used by taxpayers to generate artificial paper losses to offset income from other sources. There are at least two undesirable by-products of tax shelter activity. First, such tax avoidance by high-income persons is demoralizing to average taxpayers bearing a substantial tax burden on all their income. Second, many shelter activities drain investment funds from productive enterprises into schemes designed primarily to generate tax losses.

In 1976, this Committee received extensive evidence regarding tax shelter abuses. You responded with several tax changes. Tax shelter restrictions are among the most significant reforms contained in the Tax Reform Act of 1976.

Unfortunately, shelter gimmicks have now assumed forms intended by promoters to avoid the restrictions in the 1976 Act. Tax shelter activity may have actually increased during 1977. The National Association of Securities Dealers reports that over $1.8 billion of shelters were publicly offered by its members during 1977 -- a 50 percent increase over offerings in 1976. And there is some evidence that private shelter deals may have increased even more dramatically.

In an effort to combat the new shelter devices, the House adopted an extension of the current "at risk" rules recommended by the President. The "at risk" limitation denies deductibility for certain paper losses that exceed an individual's cash investment and indebtedness for which he has personal liability. The 1976 Act extended coverage only to partnerships and to a few specified activities of individuals. Under the House bill, the "at risk" rule would be broadened to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons. This important provision in H.R. 13511 should be retained.

The President has also recommended that the Internal Revenue Service be authorized to implement tax audits of partnerships and to resolve tax issues at the partnership level rather than being forced to proceed against each partner individually. H.R. 13511 now contains only minor portions of the President's proposal: a civil penalty for late filing of partnership returns, and a very narrow version of a proposal to extend a partner's statute of limitations with respect to partnership items. We would like to work with you to adopt additional portions of the Administration's partnership audit proposals.

Entertainment Expenditures

Perhaps no proposal in the Administration's tax program has received as much public attention as the recommended limitation on deductions for entertainment expenditures. This attention is not surprising. For many average taxpayers, the unfairness of current tax law is brought home most vividly by the fact that a few taxpayers are able to spend before-tax dollars to purchase some of the items most taxpayers must buy with income that has already been taxed.

Allowing entertainment expenses to be deducted, without taxing the related personal benefits to the recipient, offends fundamental principles of tax policy because it seriously distorts income measurement. The effect is to provide these benefits partially at public expense. The Federal Treasury loses about $2 billion each year on account of entertainment deductions -- a revenue loss that must be recovered from other taxpayers.

The public resents this form of subsidization of personal luxuries through the tax system. The July Roper poll indicates that 69 percent of Americans believe that there should be no deduction for the "cost of membership in [a] club if [the] job requires entertaining customers and prospects". Seventy-five percent thought there should be no deduction for the cost of theatre and sporting tickets purchased to entertain business customers, and 76 percent of respondents would not allow a full deduction for business lunches.

H.R. 13511 now contains none of the restrictions on deductibility of entertainment expenditures reommended in the President's program. We continue to believe that these proposals are in accord with sound principles of tax policy and, more importantly, address the overwhelming sentiment of the American public for reforms in this area. We urge that the Finance Committee take account of this attitude of average taxpayers and, at least, deny a deduction for the expenses of maintaining facilities such as yachts, hunting lodges and swimming pools and for fees paid to social, athletic or sporting clubs.

BUSINESS TAX CHANGES

Corporate Rate Reductions

Present law taxes the first $25,000 of corporate income at a 20 percent rate and the second $25,000 at 22 percent; income over $50,000 is taxed at a 48 percent rate (a normal tax of 22 percent plus a surtax of 26 percent). The House bill provides for a corporate rate schedule that is much more steeply graduated than the current rate structure. Under H.R. 13511, the corporate rate would be 17 percent on the first $25,000 of corporate income, 20 percent on the second $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,000, and 46 percent on corporate income exceeding $100,000.

The corporate rate reductions in the House bill differ from the cuts proposed by the President. In the President's tax program, he recommended a reduction from 20 to 18 percent on the first $25,000 of corporate income, a reduction from 22 percent to 20 percent on income between $25,000 and $50,000, and a reduction from 48 percent to 44 percent on income exceeding $50,000. The Administration believes that this proposal provides the best means of reducing corporate rates. In our view, the top marginal rate should continue

to apply to corporate income in excess of $50,000 -- the amount of the current "surtax exemption." Certainly, the level of graduation should not be raised above that in the House bill.

A graduated corporate rate structure raises troubling questions of tax equity. It should be borne in mind that individuals are the ultimate taxpayers; therefore, the tax policy goal of progressivity has meaning only as it relates to the impact of the system on individuals. Viewed in this light, a steeply graduated corporate rate schedule is actually regressive.

The principal beneficiaries of the House provision are individual owners of closely-held corporations -- persons who are generally in higher income brackets than the owners of publicly-held companies. Corporations whose shareholders are in lower personal income tax brackets tend to elect subchapter S. In a group of tax returns studied by the Treasury Department, the average income of shareholders in closely-held corporations exceeded $50,000. By contrast, the average income of all individual shareholders receiving corporate dividends was about $25,000.

Moreover, most of the corporate relief would be provided in corporate income brackets from $50,000 to $100,000, the brackets affected by increasing the surtax exemption above the current $50,000 level. The proposed increase in the surtax exemption would provide no relief for small corporations with no taxable income or with taxable income of less than $50,000. Only 10 percent of all corporations would receive any tax reduction from the increase in the surtax exemption. These corporations represent less than 1.5 percent of all business entities.

We fear that an unintended result of the House changes would be the aggravation of tax-shelter abuses by many high-income individuals. To many owners of closely-held corporations, the corporate income tax -- far from being an additional burden -- is actually a relief from taxes which they would otherwise pay if all the income of their corporation were attributed directly to them. The sheltering of income at the corporate level would be made still more attractive if substantial capital gains tax cuts, such as those in H.R. 13511, were adopted; capital gains tax reductions would increase the tax advantage of avoiding the receipt of annual

dividends and postponing a shareholder's realization of corporate profits until he sells his stock. In short, potential for tax abuse might be increased significantly by the use of the close corporation -- a device already advertised widely as the "ultimate tax shelter."

Investment Tax Credit

As part of his program to encourage business investment, the President recommended that the 10 percent investment tax credit be made permanent and be extended to a wider range of taxpayers and a broader scope of investments. Most of these recommendations were adopted by the House.

1. Permanent investment credit. The present 10 percent credit is now scheduled to revert to a 7 percent level after 1980. The House accepted the President's recommendation that the credit be made permanent 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. We hope the Finance Committee will follow this course.

2. Increase in tax liability ceiling. Under current law, 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 three-year carryback and a seven-year carryforward). The Administration proposed that the tax liability ceiling be raised to 90 percent of tax liability in excess of $25,000. We also recommended that a taxpayer be entitled to offset no more than 90 percent of the first $25,000 of tax liability.

The House bill would phase in an increase in the tax liability ceiling, with a 90 percent ceiling to be applicable after 1981 for tax liability exceeding $25,000. We support this provision in H.R. 13511 as a constructive step to make the investment credit more fully available to businesses with high investment needs and low profitability. However, to ensure that no firm will be able to use investment credits to eliminate its entire tax liability, we continue to recommend that the 90 percent ceiling also be applicable to the first $25,000 of tax liability -- a limitation not included in H.R. 13511.

3. Eligibility for the rehabilitation of structures. The House bill would allow the investment credit for investments made to rehabilitate existing structures such as industrial buildings, commercial buildings and retail establishments. Present law generally limits the credit to expenditures made to purchase machinery and equipment. In our view, the extension of the investment credit to the rehabiitation of structures would encourage the renovation of buildings and would thereby assist in the redevelopment of decaying urban areas. For this reason, the Administration generally supports this provision. However, there may be serious problems in defining those structures eligible for the credit and the type of investment that qualifies as a "rehabilitation" expenditure; we would like to consult with this Committee in developing provisions that mitigate these definitional problems.

4. Distressed area credit. In the President's urban program, he recommended that an additional 5 percent credit be available for investments, certified by the Commerce Department, in economically distressed areas. Adoption of this proposal would furnish additional incentives for urban investment.

5. Pollution control facilities. Certain pollution control facilities can now qualify for special tax treatment under two separate Code provisions. These facilities can generally be financed through the issuance of tax-exempt industrial development bonds. In addition, pollution control equipment installed in pre-1976 plants is eligible for special five-year amortization. However, if rapid amortization is elected, only one-half of the full investment credit can be claimed.

H.R. 13511 would generally permit pollution control equipment to qualify for the full 10 percent credit even if rapid amortization is claimed under the provisions of existing law. There would be an exception to this rule. To the extent pollution facilities were financed with tax-exempt industrial development bonds, a taxpayer could not combine a full investment credit with rapid amortization.

The Administration originally proposed the extension of the full investment tax credit to pollution control facilities, but this recommendation was accompanied by a proposal (discussed below) to repeal the tax-exempt status of pollution control bonds. By coupling these two proposals, our intention is to

provide tax relief that is more efficient and does not disrupt the market for state and local government bond issues. We will support the extension of the full investment tax credit to facilities being rapidly amortized only if tax-exempt financing for investments in pollution control facilities is repealed.

Industrial Development Bonds

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.

The President's tax program recommends the termination of tax-exempt status for certain industrial development bonds. Our proposals would provide substantial assistance to State and local government financing efforts and would also improve the equity of the tax system. These important provisions are not included in H.R. 13511 -- an omission we consider to be a serious defect in the bill.

1. Termination of Exemption for Pollution Control Bonds, Bonds for the Development of Industrial Parks, and Private Hospital Bonds. The Administration recommends that there no longer be an exemption for interest on industrial development bonds for pollution control or for the development of industrial parks. We believe the exemption should 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 market place. In 1977, there was nearly $3 billion of tax-exempt borrowing for pollution control, accounting for 6.6 percent of all tax-exempt financing and 86.2 percent of all industrial development bonds. Substituting a liberalized investment tax credit in place of tax-exempt financing for pollution control facilities would provide Federal assistance in bringing existing plants into compliance with environmental standards without undermining the ability of State and local governments to borrow funds.

2. Small Issue Exemption for Economically Distressed Areas. Under the House bill, the small issue industrial development bond limit would be increased from $5 million to $10 million. We oppose this change. By increasing the exemption limit generally, this proposal would not improve the competitive position of depressed localities in seeking funds; it would serve only to increase the supply of tax-exempt bonds and to impair borrowing capacity for governmental purposes.

The Administration recommends that the financial assistance be targeted. The existing "small issue" exemption should be retained only for economically distressed areas; and, with respect to those areas, we recommend that the $5 million exemption be raised to $20 million.

Targeted Jobs Credit

In April, 1978, the President announced his urban program to encourage employment of those individuals who have been experiencing the most difficulty in finding jobs. A targeted employment tax credit was proposed to replace the general jobs tax credit that will expire at the end of 1978. Under the Administration's program, employers would earn a tax credit for employing disadvantaged youth and handicapped individuals.

As modified by the House, the targeted jobs tax credit would provide a maximum credit per employee of $3,000 for the first year of employment and $1,000 for the second year of employment. Eligible employees would include WIN registrants, vocational rehabilitation referrals, youths and Viet Nam veterans eligible for food stamps, SSI recipients, general assistance recipients, and cooperative education students. Like the Administration's proposal, the House bill would

avoid discrimination by company size, industry and region; it places no absolute limitation on the amount of credit claimed by an employer and does not restrict the availability of the credit to companies that have employment growth.

The Administration generally supports the targeted jobs credit contained in H.R. 13511. This proposal is very similar to the recommendation made by the President. The targeted jobs credit is urgently needed to provide job opportunities for economically disadvantaged young people and for others who have not been reached by more general programs to encourage business expansion and to increase employment.

We believe it is especially important that these young people be aided in their efforts to find private employment before they are drawn into the welfare system. For other eligible groups, the incentives offered by the tax credit should be fully coordinated with Federal job placement programs to provide necessary assistance and information and to assure uniform eligibility standards. The Administration would like to assist the Committee in developing technical provisions to reflect these objectives more fully.

Small Business Proposals

We urge the Committee to retain in H.R. 13511 two provisions recommended by the President to provide specific relief to small corporations. First, the Subchapter S rules that treat certain small corporations as partnerships would be simplified and liberalized. Second, risk-taking would be encouraged by doubling (from $500,000 to $1 million) the amount of a small corporation's stock that can qualify for special ordinary loss treatment, by doubling (from $25,000 to $50,000) the amount of losses that can be claimed by any taxpayer with respect to such stock, and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

We do not support a provision in the House bill that increases the first-year depreciation allowances for certain businesses. Under the House bill, the maximum amount of first-year "bonus" depreciation that could be taken would be increased from $2,000 to $5,000, and this special provision would be limited, for the first time, to taxpayers with less than $1 million of depreciable property.

This new "bonus" depreciation provision would add further complications to a system that is already confusing for many small businesses. Far more valuable assistance can be provided to small businesses by simplifying the depreciation calculations that must now be made. We repeat here our recommendation, outlined in H.R. 12078, for a new, simple table for equipment depreciation tantamount to a streamlined ADR system for small business.

Farm Accounting

The Tax Reform Act of 1976 generally requires farming corporations to use the accrual method of accounting in order to match properly farming expenses with farming income. That Act contains exceptions from the accrual accounting requirement for certain corporations. One of the exceptions is for corporate farms with annual gross receipts of $1 million or less; another exception is for farms controlled by one family, without regard to size or the extent of public ownership.

The Administration has recommended the repeal of the one-family corporation exception, so that large corporate farms would be subject to accrual accounting requirements regardless of whether they are family owned. We have also recommended an extension of the accrual accounting requirement to farm syndicates. There is no reason to permit multi-million dollar corporations and tax shelter syndicates to utilize a cash accounting privilege designed for unsophisticated taxpayers.

In lieu of the Administration's proposal, the House adopted an additional exception to the accrual accounting rules for certain farm corporations owned by two or three families. The stated purpose of the House provision is to avoid competitive advantages for one-family corporations now permitted to use cash accounting. We feel that the President's proposals provide the appropriate means of eliminating the competitive imbalances caused by the accrual accounting exceptions. However, if this Committee decides not to adopt the President's recommendations in this area, we will not object to the additional exceptions in the House bill.

H.R. 13511 would also revoke an IRS ruling which requires farmers, nurserymen, and florists who use the accrual accounting method to inventory growing crops. On July 28, 1978, the IRS issued Revenue Procedure 78-22, which allows any farmer,

nurseryman, or florist who is on the accrual method of accounting to change to the cash method. This revenue procedure should eliminate any undue hardship that may have been caused by the previous ruling. The House provision is not needed to provide relief, and we oppose its adoption.

Domestic International Sales Corporation (DISC)

In its tax program, the Administration recommended that the large cuts in corporate tax rates be combined with the elimination of two costly tax preferences for firms conducting international business operations. One proposal would have phased out the foreign tax deferral provision, which permits domestic corporations to avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. Another proposal would have phased out the DISC tax preference. Neither of these proposals is contained in H.R. 13511.

I would like to discuss the DISC provision in some detail. The President's program would eliminate, over a 3-year period, the special tax benefits granted for exports channeled through a company's specially created subsidiary -- a paper entity 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 "incremental" DISC income is deferred as long as these profits are invested in export-related assets.

There are numerous problems with the DISC program. It is incredibly complicated; over 50 pages of fine print in the Internal Revenue Code and Treasury Regulations are devoted to describing this special tax program. DISC is inequitable; special tax benefits apply only to exporters who establish these paper subsidiaries, and well over one-half of DISC benefits is realized by only 2 percent of the DISCs. DISC is expensive; it costs U.S. taxpayers over $1 billion per year in lost Treasury revenues. And there is little evidence that this enormous cost has resulted in a significant increase in exports.

We need to stimulate exports, but the current DISC provision is the wrong approach. If a DISC program is to be maintained, we would like to work with you to focus it more effectively. Many DISC benefits now go to exporters with large profit margins -- companies that would obviously be

exporting in the absence of any special tax incentive. The Committee may wish to consider the elimination of the "50-50" rule that permits one-half of those large profits to be allocated to the DISC. Another possible restriction would place a dollar limitation on DISC benefits in order to target the relief to small companies that may experience difficulties entering the export market. These modifications would result in an export incentive that is much more cost effective and equitable.

CAPITAL GAINS

H.R. 13511 contains significant changes in the tax treatment of capital gains. Following a recommendation of the President, the House bill would repeal the special 25 percent alternative tax that now applies to the first $50,000 of capital gains of high-income individuals. A one-time exclusion would be permitted for up to $100,000 of gain on the sale of a principal residence. The bill would also eliminate capital gains as an item of tax preference for purposes of the individual and corporate minimum tax and as a preference offset to the amount of personal service income eligible for the 50 percent maximum tax ceiling. Capital gains in excess of $20,000 would be subject to a new alternative minimum tax of 5 percent if that tax exceeded regular tax liability. Finally, in determining capital gains or losses, an inflation adjustment would be provided after 1979 for common stock, real estate and tangible personal property. Taken together, these changes would reduce capital gains tax liabilities by $1.9 billion in 1979, with that figure expanding to nearly $7 billion annually by 1983.

If capital gains relief is provided, we recommend consideration of several modifications in the House-passed version of H.R. 13511:

° First, to limit tax avoidance by wealthy individuals, a reasonable alternative minimum tax on large capital gains should be adopted in place of the token "micro-mini" tax in the House bill.

° Second, the existing minimum tax on the capital gains of corporations should be retained.

- Third, the exclusion for residences might be altered to reduce the revenue loss.
- Fourth, the special inflation adjustment for certain capital assets should be eliminated.

I will discuss each of these modifications in some detail.

Adoption of a True Alternative Tax on Capital Gains

In attempting to provide relief for persons with significant capital gains tax liabilities, the House created an undesirable by-product: H.R. 13511 would exacerbate the problem of tax avoidance by wealthy individuals making extensive use of tax shelters. Eliminating the current minimum tax provision would reduce the top rate on capital gains to 35 percent; that result appears to be the objective sought by the House. But the replacement of the current minimum tax with the new "micro-mini" tax also has the effect of reducing from 7-1/2 percent to 5 percent the maximum capital gains rate paid by individuals who have completely sheltered millions of dollars of capital gains from regular tax liability. A present minimum tax with a modest impact on sheltered capital gains would be diluted.

An example derived from actual tax files may help to illustrate the increased sheltering opportunities that would be available under the House bill. An individual with $2,184,982 of capital gains uses $1,095,057 of shelter losses to eliminate all regular tax liability; the regular tax that would normally be paid on one-half of capital gains ($1,092,491) is offset completely by tax losses. Under current law, he would pay a minimum tax of $160,984 -- an effective tax rate on capital gains of 7.4 percent. If the "micro-mini" tax in the House bill were adopted in place of the current minimum tax, this person's minimum tax liability would fall to $108,249 -- a tax rate of less than 5 percent on capital gains exceeding $2 million.

Viewed in the context of the other capital gains changes in H.R. 13511, there is no justification for an alternative minimum tax that is so insignificant. The current minimum tax rate was kept low because it affects unsheltered taxpayers; it can add several percentage points to an effective tax rate that is already substantial. If the current "add-on"

minimum tax on capital gains is eliminated in favor of an alternative tax approach, a graduated alternative minimum tax can be adopted so that persons with very large capital gains would have to pay more than a token 5 or 7-1/2 percent tax.

Such a graduated "true alternative tax" is reflected in the amendment we supported on the House floor -- an approach we commend to this Committee. This amendment would affect only persons with ordinary losses exceeding ordinary income. For those individuals, the true alternative tax would simply require that ordinary losses be offset against capital gains before the special capital gains deduction (equal to one-half of total gains) is applied. This new limitation would never reduce the amount of the special capital gains deduction below $5,000, nor would it apply in a manner to reduce the benefits of charitable deductions.

The "true alternative tax" approach would provide a much more reasonable minimum tax liability for the individual, described earlier, who has sheltered over $2 million of capital gains from all regular tax liability. He would be required to pay tax on about one-fourth of his total capital gains. Rather than paying a "micro-mini" tax of only $108,249 imposed under the House bill, this taxpayer's liability would be $345,628 under the "true alternative tax." The effective tax rate on $2 million of capital gains would rise from 5 percent in the House bill to nearly 16 percent under the amendment.

Mr. Chairman, you and other members of this Committee have played an instrumental role in developing a minimum tax concept -- an effort to minimize the extent to which high-income taxpayers can use various preferences to eliminate all or most tax liability. The Treasury Department will release today its High Income Report for tax year 1976. This report will show that provisions in the Tax Reform Act of 1976 have succeeded in reducing dramatically the number of high-income, nontaxable returns; in 1976, the number of nontaxable returns for individuals with expanded incomes over $200,000 fell by 75 percent, from 210 in 1975 to 53 in 1976. The number of nontaxable individuals with adjusted gross incomes over $200,000 fell from 260 to 22, a decrease of over 90 percent.

The results of this report should not lead to complacency. There are still nontaxable returns with high economic incomes that, for various reasons, do not fit into the categories of "expanded income" or "adjusted gross income." Moreover, for every nontaxable high-income return, there are still ten or more "nearly nontaxable" returns where income has been reduced by more than 80 percent by use of preferences, deductions, and tax credits.

We believe that the true alternative tax on capital gains represents a significant effort to continue the important work already performed by this Committee in reducing large-scale tax avoidance. It begins to focus on the problem of the "nearly nontaxable" return. You may wish to expand the alternative tax concept to include preferences other than capital gains. Whatever course of action is selected, we believe it is critical to amend H.R. 13511 to avoid a serious setback to important minimum tax reform efforts.

Retention of Minimum Tax on Capital Gains of Corporations

A corporation can now elect to have its capital gains taxed at a 30 percent alternative rate, as opposed to the top rate of 48 percent under the regular corporate schedule. The corporate alternative tax on capital gains is considered a preference item for minimum tax purposes. But unlike the individual minimum tax, the corporate minimum tax adds a very insignificant amount to the effective capital gains rate -- a maximum increase of only 1.125 percentage points even if all a corporation's income is eligible for the capital gains preference.

Other provisions in the House bill would cause a corporate minimum tax on capital gains to be even less burdensome than it is now. If the corporate rate schedule in H.R. 13511 is enacted, the impact of a corporate minimum tax would be reduced still further to a maximum 0.717 percentage point addition to the capital gains rate. Moreover, by providing a 30 percent corporate rate on ordinary income between $50,000 and $75,000, the House bill would reduce the number of corporations that would elect the alternative capital gains tax and subject themselves to an additional minimum tax liability.

We see no reason for eliminating the corporate minimum tax on capital gains, as proposed in H.R. 13511. Even with the individual capital gains relief in the House bill, the

maximum corporate rate on capital gains would still be more than 4 percentage points below the maximum individual rate. In our view, the elimination of the corporate minimum tax can be justified only if the alternative capital gains rate for corporations is raised to the maximum individual level -- 35 percent.

Reduction in Revenue Cost of Exclusion for Residences

The Administration believes that capital gains relief should be provided for homeowners. In the Administration's tax program, we recommended that the gain on sales of residences be excluded as a tax preference item for purposes of both the minimum tax and the maximum tax.

Additional homeowner relief may be appropriate. However, the $100,000 exclusion in H.R. 13511 is extremely costly. It would result in an annual revenue loss of approximately $700 million.

To provide significant capital gains tax cuts to homeowners at a reduced revenue cost, the Committee may wish to consider excluding from taxation the gain attributable to the first $50,000 of sales price on residences for persons age 55 or older. This would represent an expansion of the exclusion in current law for gain attributable to the first $35,000 of sales price for persons age 65 and over. Under this approach, the revenue cost of homeowner relief would be reduced to approximately $300 million.

Deletion of Inflation Adjustment

We believe that the Archer amendment, which would provide inflation adjustments for certain capital assets, reflects a serious mistake in the House. This provision is unfair, complicating and very costly. It should be eliminated from H.R. 13511.

The Archer amendment is inequitable because it selects for inflation adjustments only one aspect of the tax law -- the income of persons who already enjoy the benefits of the capital gains preference. It is difficult to justify an inflation adjustment for owners of capital assets while ignoring the effect of inflation on the savings account depositor. Nor is it fair to permit the holder of debt-financed property to adjust the asset's basis for inflation while making no allowance for the fact that the debt is being repaid with cheaper dollars.

These inequities are illustrated graphically by considering three hypothetical taxpayers:

- Taxpayer A has a $100,000 certificate of deposit, which bears interest at the rate of 5 percent.

- Taxpayer B purchases a capital asset for $100,000; he sells it for $105,000 after it appreciates 5 percent in one year.

- Taxpayer C purchases a capital asset for $200,000, financing the purchase with $100,000 of debt bearing 5 percent interest; this asset is sold for $210,000 after it also appreciates 5 percent in one year.

At the end of one year, each of these taxpayers has an additional $5,000 in cash and is in the same economic position before taxes; however, the Archer amendment would result in disparate tax treatment. Assume an inflation rate of 5 percent. Taxpayer A has an additional $5,000 of taxable income and receives no relief under Archer. Taxpayer B has no additional taxable income because the inflation adjustment equals his appreciation. Taxpayer C is in a better position than either A or B; although he has $5,000 more cash upon the sale of his capital asset ($210,000 less the $100,000 initial cash investment and less repayment of $105,000 principal and interest), he will show a loss for tax purposes equal to the $5,000 of interest paid. Such disparities make no tax sense and will distort investment and borrowing decisions.

The economic distortions and tax shelter possibilities of the Archer amendment are only beginning to be analyzed by tax specialists. For example, the special inflation adjustment granted to owners of corporate stock would undoubtedly lead to the subterfuge of incorporating assets not eligible for the adjustment. Indexing the basis of depreciable assets only for purposes of measuring gain would encourage businesses to engage in unproductive asset exchanges, using an inflation adjustment to avoid reporting gain on the exchange while taking a stepped-up basis to increase depreciation allowances for the newly acquired equipment.

The amendment would introduce staggering new complexities into the tax law. Taxpayers and the Internal Revenue Service would have to make determinations such as: (i) whether a particular asset qualifies for indexation, either in whole or in part; (ii) if an asset qualifies only in part, the portion of the asset's basis that is "adjustable"; (iii)

whether a particular transaction is one in which indexation is allowed; and (iv) the holding period for measuring adjustments where, for example, the basis of an asset is the sum of the cost of numerous property improvements made through the years. The answer to each of these questions might differ from that applied for other tax purposes. Recordkeeping and return preparation burdens for taxpayers would be increased substantially, and disputes with the IRS would arise more frequently.

The revenue cost of the Archer amendment would exceed $4 billion annually by 1983. This cut is twice as large as all the other forms of capital gains reductions in the bill. In combination with the other capital gains changes and tax reductions on business and investment income, this amendment would result in a tax bill that provides 71 percent of the total relief to the owners of capital. As H.R. 13511 now stands with the Archer amendment, it is a bill tilted far too heavily away from American wage earners.

In addition to this proposal's inequity, complexity and excessive cost, there is a problem with Archer that is even more fundamental. Indexation is a response to high inflation rates, but the proliferation of indexation schemes tends to make those rates an accepted fact of economic life. The economic defect becomes institutionalized. Rather than accommodating to inflation, we should bend all efforts to control it.

CONCLUSION

As I conclude my remarks, it is appropriate to acknowledge the time constraints under which you are working. The Committee is considering this bill late in the legislative session. For this reason, we are not proposing that you consider far-reaching structural changes in H.R. 13511 that would consume an inordinate amount of time. In fact, we are recommending that the Committee delete from the bill proposals, such as the Archer amendment, that can be considered properly only after extensive testimony and debate.

The recommendations I have outlined today are designed to bring the House bill closer to the tax policy objectives outlined by the President. We urge that greater tax relief be provided to middle and low-income families. We believe the investment incentives in H.R. 13511 should be modified in order to increase their efficiency and fairness. And we are suggesting a reasonable extension of the tax reforms in the House bill so that the system can be made more equitable and simpler. The Administration is anxious to work with this Committee to accomplish these objectives.

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Appendix: Feedback Effects and Revenue Estimation

The term "revenue feedback effect" refers to the fact that the actual change in revenues resulting from a tax revision will depend upon economic responses to that revision. There is general agreement that such feedback effects can be important. To understand more clearly the implications of feedback effects for revenue and receipts estimation, it is useful to separate economic responses into three types.

First, there are short-run responses to changes in spendable income that result from tax increases or reductions. A tax cut, for example, will raise the amounts of after-tax income available to households and to business firms. If there is sufficient additional capacity, higher after-tax incomes will lead to increased consumption and investment which in turn will generate higher incomes and higher revenues. A number of standard macro-economic forecasting models are usually employed to estimate the magnitude of these short-run income effects.

A second type of feedback effect deals with long-run factor-supply responses to tax changes. Taxes alter the after-tax returns for work effort and for saving and thus will influence the supply of labor and capital offered to the market. The size of the capital stock and labor force will in the long run determine economic capacity and, therefore, the income base potentially available for future revenues.

The third type of feedback effect is the behavioral response to price increases or decreases brought about by tax changes. As tax changes alter relative prices, households and business firms tend to shift patterns of consumption and investment away from those activities that have increases in price or cost toward those that have decreases. That is, taxpayers will move into activities which have been granted a tax benefit and away from activities which have lost such a benefit. The result influences the allocation or composition of economic activity and also the volume of Federal revenues.

Therefore, to estimate all potential revenue feedbacks requires determination of (1) the increase or reduction in spending due to changes in income, (2) the changes in economic capacity due to changes in the supply of labor and capital, and (3) the substitution of lower cost for higher cost activities. In general, estimating procedures currently used by the Treasury do incorporate such feedback effects. Budget receipts for each fiscal year include the impact of

tax changes on aggregate demand. Longer-run receipt projections allow for the likelihood of tax-induced changes in the capacity of the economy. Furthermore, whenever it is reasonable to do so, the allocation effects of price changes resulting from tax revisions are incorporated into revenue estimates. Each of the three types of feedbacks is discussed in more detail below.

Macro-economic Responses

According to the macro-economic models, tax law changes which reduce government revenues will, over time, increase demand, resulting in higher GNP, personal incomes and corporate profits and higher tax receipts. Consequently, estimates which do not take into account these short-run multiplier effects tend to overstate revenue losses resulting from proposals which reduce tax rates or narrow the tax base and overstate revenue increases resulting from proposals to raise taxes. Treasury estimates are alleged to suffer from this defect.

However, this criticism is based on a misunderstanding of the longstanding Treasury practice to provide two types of revenue estimates for proposed changes in tax law. The first type of estimate is made for the complete program of tax changes in the President's budget. Feedback effects on incomes and tax receipts resulting from short-run multiplier effects are always incorporated in these figures to show the actual impact of the President's program on the economy.

For example, Treasury estimates of total tax receipts during the 1963-1968 period incorporated such feedback effects. The stimulative effects of the Kennedy tax cut along with anticipated growth in the population, the labor force, prices and productivity were more than enough to fully offset the reduced revenues resulting directly from lower income tax rates. While total receipts were projected to rise over this period, it is generally agreed that the 1964 tax cut by itself, could not have induced an economic response sufficient to restore the initial revenue loss. The figures in Table 1 demonstrate that Treasury anticipated the feedback revenues. The estimating errors taken from the annual budget documents for that period ran about 4 1/2 percent, far too close to the mark for estimates which did not accurately include short-run feedback effects.

In the context of the current tax debate, Table 2 illustrates the impact on receipts of short-run multiplier effects resulting from the President's proposed $20 billion tax reduction program. The Midsession Review of the 1979 Budget shows estimated unified budget receipts of $448.2 billion in 1979 and $507.3 billion in 1980. These figures include proposed tax reductions of $14.1 billion and $21.8 billion, respectively. However, in the absence of these

proposed tax reductions, revenues are estimated to be $459.3 billion in 1979 and $521.1 billion in 1980. Thus, the net cost to the Treasury of the President's proposed program is $11.1 billion in 1979 and $13.8 billion in 1980. These net tax program figures include $3 billion and $8 billion of offsetting revenues attributed to short-run multiplier effects. These feedback revenues are included in the receipt totals but are not separately identified in the published Midsession Budget Review.

The estimation of multiplier effects requires making a number of critical assumptions, including actions the Federal Reserve may take to adjust the money supply and interest rates. These assumptions can influence the multiplier effects on the economy and the resulting revenue feedback. However, there are no plausible assumptions under which induced feedback effects from tax cuts will lead to an increase in tax receipts over what they otherwise would have been. In fact, none of the macro-economic models of the United States economy predict revenue feedback sufficient to offset the initial revenue loss.

The second kind of estimate made by Treasury involves the revenue change from specific proposals without feedback effects (except to the extent Treasury is able to estimate price effects as described below). This kind of estimate is also appropriate for the kind of policy questions which may arise. For example, great attention is focused on the distribution of tax changes among taxpayers at different income levels. For distributional analysis policymakers should look at the direct impact on taxpayers engaged in a particular activity, such as paying private school tuition, or on those receiving a a particular source of income, such as capital gains.

In contrast to the tax side of the Budget, there is general agreement that feedback effects are not appropriate for the expenditure side of the budget. Congressional decisions concerning the expenditure side of the budget are also properly made on the basis of gross expenditures. We should not estimate, for example, that a dam, highway, harbor, or even aircraft carrier costs only 60 percent of its initial outlay on the argument that the Federal government recoups the rest in the form of higher revenues. A dollar of outlay costs a dollar in resources used up and a dollar of tax reduction releases a dollar for use in the private sector. The macro-economic feedback effects of both of these changes are important, but it is also important to evaluate the initial impacts correctly.

Treasury policy to include multiplier effects when overall positions of fiscal policy are being established, as described earlier, is consistent with excluding multiplier effects when alternative programs are being considered that

do not markedly alter the desired fiscal posture. The assumption is made that each separate tax proposal being considered is designed to be incorporated into a comprehensive package of proposals, with net tax reductions consistent with the overall fiscal policy. In this framework, it is clearly incorrect to include offsetting multiplier effects in revenue estimates for individual tax proposals. This is because the budget receipt estimates already include the feedback effect of the aggregate change in taxes. To again include feedback effects, as each component of an overall tax package is being considered, would be to double count induced revenue changes and misguide policymakers as to the size of the budget deficit or surplus.

Capacity Responses

Much attention has recently been focused on the potential for increasing economic capacity by reducing rates of tax. Since income taxes necessarily reduce the reward from additional work effort or from adding to savings or investment, reductions in rates of income taxes--especially reductions of the highest marginal rates--would increase significantly the aggregate amount of work effort and capital supplied in the economy. This increased work effort and larger capital stock would provide increased capacity to produce income that is subject to tax, offsetting at least some of the initial revenue lost by tax reduction.

The fundamental logic of this argument is sound, but there are a number of practical considerations that recommend against regularly reporting separate estimates of these aggregate capacity, or "supply side", effects of tax changes. There are presently no economic models that fully incorporate supply effects and that have also developed a track record over a period of years. In fact neither the magnitude nor the timing of such effects is well known and there is consequently wide professional disagreement about their importance. For example, some advocates of the Roth-Kemp tax reductions claim that induced supply responses would be so large that general rate reductions would bring about higher revenues than would occur without them. Some of these advocates argue that the responses would be so rapid that revenue increases from induced supply would occur in the first year. Other analysts, including those who have developed the well-known econometric forecasting models, predict that in the first few years following a tax change, there will be no significant increases in economic capacity resulting from higher wages or increased returns to saving.

In the case of induced labor supply even the direction of change is at issue. Historically, there has been a tendency, as incomes have increased, for the average worker to work shorter hours and to retire at an earlier age. When taxes on labor income are reduced, the positive response to

higher after-tax earnings will be offset, perhaps completely, by this tendency to take some of the increased potential earnings in the form of increased leisure.

The greatest weight of professional opinion is that increased capacity in response to reduced tax rates will take effect much more slowly than the demand effects induced by higher incomes. Any tendency for labor supply to respond to increases in after-tax wages will be translated into increased economic capacity only over a period of years. In part, this is because it takes time for households to adjust--to seek out a second job, to arrange for child care, to take more schooling, and the like. More important, however, is that it takes time for businesses to make the additional investment necessary to accommodate the increased labor supply.

Nevertheless, these long-run supply effects are very important since they will help to determine the underlying growth and composition of employment and output in the future. Significant supply side factors are not ignored in deriving the long range receipts projections that are included in the budget. These projections show the path of Federal receipts through time that are consistent with attainable increases in capacity and aggregate demand.

The Treasury has been devoting substantial resources to understanding and estimating supply effects. We also closely monitor new research in this area. Analysis of the longer-run implications of tax policy will build upon new research findings as they become available.

Price Effects

Tax policy changes have consequences for economic behavior other than their aggregate demand effects and supply side responses. A further important effect of tax policy changes is that they alter the relative prices or costs of particular types of consumption and investment goods. As a consequence, households and firms respond by changing their consumption and investment patterns. Not all tax changes have significant price effects. Changes in exemptions, the standard deduction, and even across-the-board cuts in tax rates do not bring about significant changes in relative prices. However, when such relative price effects do occur and when there is broad agreement as to both the magnitude and the direction of these impacts, revenue estimates incorporate the behavioral responses to the relative price changes. There are numerous examples of such behavioral responses. They include:

-- The taxable bond option, where it is assumed that some fraction of municipal debt will be issued on a taxable basis as a result of the lower interest costs of issuing

Table 1

Comparison of Estimated and Actual Unified Budget Receipts

Fiscal Years 1963-1968

($ billions)

	Fiscal Years					
	1963	1964	1965	1966	1967	1968
963 budget (January 1962)	113.5					
964 budget (January 1963)	105.4	109.3				
965 budget (January 1964)	106.6*	111.3	115.9			
966 budget (January 1965)		112.7*	114.6	119.8		
967 budget (January 1966)			116.8*	124.7	141.4	
968 budget (January 1967)				130.9*	150.3	158.6
ctual receipts	106.6	112.7	116.8	130.9	149.6	153.7
stimating errors:						
Estimate made 18 months prior to year end minus actual receipts	+7.0	-3.4	-0.9	-11.0	-8.1	+4.9
Error as percent of actual receipts	+6.5%	-3.0%	-0.8%	-8.4%	-5.4%	+3.2%

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July 14, 1978

Denotes actual level of unified budget receipts.

ote: Details may not add to totals due to rounding.

Table 2

Proposed Tax Reductions Included in the
Administration's Midsession Budget Review

($ billions)

	Fiscal Years	
	1979	1980
Unified budget receipts published in the Midsession Review	448.2	507.3
Receipt effects of the President's tax reduction and reform proposals:		
Gross change in receipts	-14.1	-21.8
Offsetting induced receipts	3.0	8.0
Net change in receipts	-11.1	-13.8
Unified budget receipts in absence of the President's tax reduction and reform proposals	459.3	521.1

Office of the Secretary of the Treasury
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subsidized taxable debt compared to the prevailing rate on tax-exempts.

-- The automobile efficiency tax, where consumers are assumed to modify their pattern of automobile purchases in response to the increased prices of gas-inefficient vehicles.

-- Residential and business thermal efficiency and solar tax credits, where the reduction in prices of the subsidized activities are assumed to induce households and firms to install more insulation and to use lower cost sources of energy;

-- Any new program such as subsidies for exports (DISC) or for new retirement programs (IRA), where the revenue estimates depend upon the extent to which the new provision will be used;

-- Integration of corporate and personal taxes, where an increase in corporate dividends would be expected to accompany the reduction in the combined level of personal and corporate taxes on these dividends.

In all of these cases, there may be disagreement over the magnitude of the behavioral responses. Nevertheless, a good faith effort is made to incorporate behavioral responses into the revenue estimates where the behavioral responses will obviously occur and they are believed to be substantial. But we do not try to estimate feedback effects where the predominant responses are unpredictable or where there is no objective basis for making a judgment.

Two specific cases of tax induced price changes are currently of particular interest. They are the cuts of capital gains taxes and the reduction of top marginal tax rates. It has been alleged in both cases that the price effects of the tax change will induce a flood of new revenues to the Treasury, outweighing the initial revenue loss. In the case of capital gains cuts, the claim is made that the increased realizations will be so large as to yield an increase in tax receipts on capital gains. In the case of a reduction in the top marginal tax rates, the switch of investment from sheltered to unsheltered activities along with a vast increase in work effort are the alleged sources of the higher tax receipts.

Claims have been made that solid empirical analysis underlies both behavioral responses. But these claims are greatly overstated. The empirical work to date concerning the response of gains realizations to changes in capital gains tax rates has not distinguished between short-run transitional effects and long-run effects. Further, if the results are interpreted as estimates of permanent long-run effects, they imply such enormous reductions in the average

holding periods of assets as to be totally at variance with the observed historical stability of these holding periods. Also, the estimates assume that every investor has an unlimited amount of unrealized accrued gains just waiting to be realized at lower tax rates, an assumption surely contrary to the facts. Moreover, it may be very difficult to separate statistically the effect of the marginal tax rates from the effect of high itemized deductions for medical expenses or casualty losses. Higher realizations of capital gains may be due to high itemized deductions rather than to low marginal rates themselves.

Attempts to adduce the likely responses of high income taxpayers to reductions in their marginal tax rates by examining historical data for the years before and after the 1964 tax cut also are seriously deficient. While it may be true that at substant ally lower marginal tax rates individuals would find tax shelters of much diminished economic advantage and would therefore tend to invest more in fully taxed assets, the likelihood and magnitude of such a response cannot be determined by merely looking at the income taxes paid by those in the upper income classes before and after the tax cuts of 1964. The upper income group did, in fact, pay more in taxes after their marginal rates were cut, but all income classes experienced tax cuts and all realized significant increases in incomes along with the general expansion of the economy in 1964-66. The share of before-tax income reported by the highest income classes was remarkably stable over the entire period from 1952 through 1972. In addition, it should be pointed out that most of the increased taxable income in these income groups was from higher realized capital gains. But the 1964 Revenue Act did not change the 25 percent alternative tax on capital gains. Thus while it may be desirable to reduce marginal tax rates to provide additional incentives to work and to save, there is little evidence for claiming large revenue gains to the Federal Treasury as a result of tax-induced price effects.

Conclusion

First, estimates of aggregate budget receipts do include the additional receipts resulting from the impact of tax changes on aggregate demand. However, estimates for particular tax changes, just like estimates for particular expenditure changes, do not include feedback effects. To do so when they are already in the aggregate estimates would be double counting.

Second, projections of long-run budgetary figures also accommodate the impacts of tax changes on economic capacity. As research sheds more light on the nature of these effects, it may be possible to incorporate them more formally into longer-run projections.

Third, Treasury does incorporate estimates of changes in specific types of investment or consumption induced by relative price changes whenever it appears the effects are important and it is possible to make reasonable estimates.

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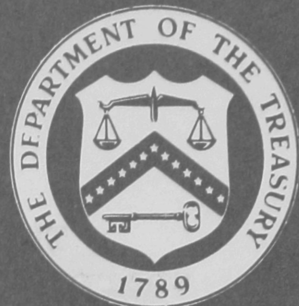

FOR IMMEDIATE RELEASE
August 17, 1978

Contact: George G. Ross
202/566-2356

TREASURY PUBLISHES 2ND ANNUAL REPORT
ON HIGH INCOME TAX RETURNS

The Treasury Department today made available the second annual report on high income taxpayers. The report, "High Income Tax Returns - 1975 and 1976," was prepared as required by Section 2123 of the Tax Reform Act of 1976.

The report contains the first data reflecting the changes made by the Tax Reform Act of 1976. For high income individuals, a major change was the strengthening of the minimum tax including an increase in the rate from 10 to 15 percent and the provision of new tax preference items for intangible drilling expenses and for itemized deductions (other than casualty losses and medical expenses) exceeding 60 percent of adjusted gross income (AGI).

The report highlights the fact that the Tax Reform Act of 1976 was "extraordinarily successful" in reducing the number of high-income nontaxable income tax returns. The number of nontaxable high-AGI returns fell from 260 in 1975 to 22 in 1976, a decline of 92 percent. In proportion, the nontaxables fell from 1 out of 130 high-income returns in 1975 to about 1 out of every 2,000 returns in 1976.

As measured by the more comprehensive expanded income, the decrease was similar although less dramatic. The number of nontaxable high expanded income returns fell by 75 percent, from 215 in 1975 to 53 in 1976. By either measure, there were far fewer high income nontaxable returns than in any year since data first became available in 1966.

In testimony today before the Senate Finance Committee, Secretary of the Treasury W. Michael Blumenthal urged passage of tax legislation that would "avoid a serious setback to important minimum tax reform efforts." He asked adoption of a "true alternative tax" approach that would provide a "much more reasonable minimum tax liability" for individuals with tax sheltered capital gains.

B-1116

The report also highlights the fact that despite the sharp decline in the number of high income nontaxable returns there is still a significant number of high income taxpayers who, while paying some tax, fail to pay a fair share of the tax burden. For every nontaxable high-income return, there are about 10 or more nearly nontaxable returns where income has been reduced by more than 80 percent by use of preferences, deductions, and tax credits. The nontaxables, and these so-called nearly nontaxables, whose effective tax rates are lower than those of a typical middle or lower-middle income family, totaled nearly 500 in 1976. This is about twice the number of high-income nontaxables there were in the late 1960's, whose existence prompted the Treasury Department to focus on this problem and the Congress to enact the minimum tax.

The report finds that while the Tax Reform Act of 1976 reduced the number of nontaxables and nearly nontaxables and raised the average effective tax rate modestly for the remaining nearly non-taxables, it did not significantly change the average effective tax rate for other individuals with incomes of $200,000 or more. In fact, the tax rate on all high expanded income returns other than nontaxables and nearly nontaxables actually declined from 36 percent in 1975 to 35 percent in 1976.

Even the expanded income measure, which is broader than AGI, does not include income from some sources which are very valuable to high-income taxpayers. Thus, expanded income understates economic income because taxpayers are allowed deductions for real estate and agriculture expenses in excess of economic costs and because income such as interest on tax-exempt state and local bonds is omitted. This understatement of economic income results in some high-income individuals being omitted from the report. The actual number of individuals omitted, however, is not known. In addition, the understatement of income makes the effective tax rate for all high income returns appear higher than it actually is.

Presented in the report are data for all individuals with AGI of $200,000 or more, as well as similar data based on three other income measures specified in the 1976 Act. These include the broader-based "expanded income" (AGI plus preferences less investment interest), "AGI plus preferences," and "AGI less investment interest." In 1976, there were 53,587 high income taxpayers, as measured by expanded income. They paid an average tax of $144,942 or 35.0 percent of expanded income. Similarly, the 41,761 returns with AGI of $200,000 or more had an average tax of $167,656, or 44.5 percent of AGI.

The 122 page report includes 57 statistical tables and 2 charts, which contain virtually all of the basic data about high income returns currently available for 1975 and 1976 tax returns.

Copies of the report are available from the Office of Tax Analysis, U. S. Department of the Treasury, Washington, D. C. 20020. Copies also are available from the Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402.

# # #

ederal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-566-2615

FOR IMMEDIATE RELEASE

FEDERAL FINANCING BANK ACTIVITY

July 1-July 31, 1978

Roland H. Cook, Secretary, Federal Financing Bank, announced the following FFB activity for July, 1978.

New Loan to The Milwaukee Road

On July 31, the FFB and the U.S. Department of Transportation (DOT) signed an agreement in which FFB agreed to lend up to $21,419,377 to the Trustee of the Chicago, Milwaukee, St. Paul and Pacific Railroad. This loan, which is guaranteed by DOT under §511 of the Railroad Revitalization and Regulatory Reform Act of 1976, will be used to repair freight cars and locomotives and construct pollution control facilities. The loan is repayable in eleven annual installments beginning in 1981. The first drawdown is expected in early August.

This is the FFB's second loan to The Milwaukee Road, currently in a Chapter 77 reorganization. On April 20, 1978, FFB agreed to lend up to $5.1 million to The Milwaukee Road Trustee for operating expenses. This loan is guaranteed by DOT under §3 of the Emergency Rail Services Act of 1970. To date, no funds have been requested under this loan.

Other DOT-Guaranteed Lending

FFB continued to advance funds to borrowers under other DOT-guaranteed programs.

Borrower	Date	Amount	Maturity	Interest Rate
Amtrak (#15)	7/13	$10,000,000	10/1/78	7.505%
	7/17	6,000,000	10/1/78	7.439%
	7/20	7,000,000	10/1/78	7.329%
	7/24	5,000,000	10/1/78	7.314%
	7/31	6,000,000	10/1/78	7.023%

Other DOT-Guaranteed Lending (continued)

Borrower	Date	Amount	Maturity	Interest Rate
U.S. Railway Assn. (#13)	7/3	$500,000	12/26/90	8.125%
U.S. Railway Assn. (#8)	7/25	144,500	4/30/79	8.352%
Chicago & North Western	7/3	577,531	3/1/89	8.927% annually
Missouri-Kansas-Texas	7/6	674,937	11/15/97	8.735% quarterly
Chicago, Rock Island & Pacific	7/12	89,195	6/21/91	8.875%

The advance to the Trustee of the Rock Island completed a $17.5 million loan entered into in 1976. This loan matures on June 21, 1991 and is also guaranteed under the Emergency Rail Services Act.

Agency Issuers

The Farmers Home Administration continued to be FFB's largest borrower by issuing a $670 million Certificate of Beneficial Ownership to FFB on July 5. The CBO will mature on July 5, 1983, and provides for annual interest payments at an interest rate of 8.84%.

The Tennessee Valley Authority sold two notes to the FFB with a November 31, 1978 maturity: a $70 million note on July 17 with a 7.724% interest rate; and a $270,000,000 note on July 31 with an interest rate of 7.159%.

In its weekly short-term FFB borrowings, the Student Loan Marketing Association, a Federally-chartered private corporation which borrows with a Department of Health, Education and Welfare guaranty, raised $15 million in new cash and refunded $165 million in maturing securities. FFB holdings of SLMA notes now total $705 million.

Guaranteed Loan Programs

FFB advanced a total of $81,572,168.80 to 19 rural telephone and electric cooperatives under notes guaranteed by the Rural Electrification Administration.

On July 19, the FFB purchased $3.695 million in debentures issued by nine small business investment companies. These debentures, which are guaranteed by the Small Business Administration, will mature in 3, 5 and 10 years and carry interest rates of 8.715%, 8.725%, 8.825% respectively. The issuers and the amounts issued were:

3 year:	Southwest Capital Investment, Inc.	$500,000
5 year:	BBS Equities Ltd.	$500,000
	Winfield Capital Corp.	300,000
10 year:	Brittany Capital Corp.	$200,000
	Capital Marketing Corp.	430,000
	Equi-Tronics Capital Corp.	540,000
	Lake Success Capital Corp.	275,000
	Tidewater SBI Corp.	500,000
	TSM Corp.	450,000

The FFB purchased the following General Services Administration Purchase Contract Participation Certificates:

	Date	Amount	Maturity	Interest Rate
Series M-035	7/5	$6,376,550.03	7/31/03	8.841%
Series L-044	7/18	1,670,903.53	11/15/04	8.879%
Series K-010	7/31	1,530,570.17	7/15/04	8.791%

FFB provided Western Union Space Communications with $11.2 million on July 20 and $5.6 million on July 28 at interest rates of 8.937% and 8.904% (annual basis) respectively. These advances are part of the FFB's $687 million financing of a satellite tracking system to be constructed by Western Union and leased to the National Aeronautics and Space Administration.

Under the Department of Defense-guaranteed foreign military sales loan program, the FFB made 25 separate advances to 14 foreign governments totalling $74,263,338.45.

FFB Holdings

As of July 31, 1978, FFB holdings total $45.5 billion. Detailed FFB Activity and Holdings Tables are available on request.

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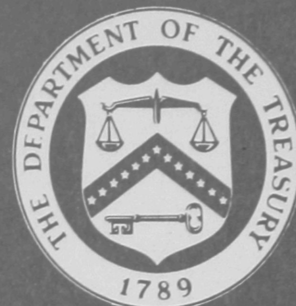

FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
August 18, 1978

STATEMENT OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY FOR DOMESTIC FINANCE
BEFORE THE HUD - INDEPENDENT AGENCIES SUBCOMMITTEE
OF THE SENATE APPROPRIATIONS COMMITTEE

Mr. Chairman and Members of the Committee:

My testimony covers two major points. First, I will discuss the Administration's request for a full appropriation to enable the Secretary of the Treasury to guarantee payments of principal and interest on loans pursuant to the New York City Loan Guarantee Act of 1978, which was signed by the President on August 8, 1978. The second part of my testimony will cover the status of the City's $4.5 billion four-year long-term financing plan and its seasonal financing plans.

Request For Appropriation

First, Mr. Chairman, the Administration requests authority for the Secretary of the Treasury to issue guarantees of the principal and interest on $1.65 billion principal amount of City and MAC bonds and appropriation of such sums as are necessary to make payments of principal and interest on guaranteed bonds if there is a default. The appropriated sums should remain available until September 30, 1998. No guaranteed bonds can be issued after June 30, 1982 and the maximum length of any guarantee is 15 years; therefore the last date on which a guaranteed payment might be due is June 30, 1997. The extra time will allow for resolution of any dispute or litigation over a payment due in 1997. The House Appropriations Committee has already acted favorably and reported out an appropriation bill for the full amount of the authorized guarantees to the full House.

Mr. Chairman, we request a full appropriation because it is needed to raise the $4.5 billion in long-term capital which New York City requires over the 1979-1982 period. In particular, it is needed to obtain commitments to loan on an unguaranteed basis $1.8 billion over the next four years from private lenders.

The financial institutions have specifically stated in their term sheet that they will lend only on the condition that there has been prior enactment of legislation appropriating the full amount of Federal guarantees on a one-time basis. The pension funds' representatives have advised us that in their capacities as trustees they also expect to make such appropriation a condition of their lending on an unguaranteed basis to the City or MAC. They both make the point that they cannot be expected to commit to loan for the next four years if the Federal commitment -- on which they count as the ultimate backstop -- is subject to periodic review and unrestricted withdrawal. While I cannot state that this financing will fail if this condition is not met, I must say that their position is not unreasonable. I should further point out that without a four-year commitment, that is a real commitment, from these lenders, we could have a very difficult time making the necessary findings under Section 103(4) of the Loan Guarantee Act necessary to issue any guarantees.

<u>Status of the City's Long-Term and Short-Term Financing Plans</u>

Mr. Chairman, let me now review the status of New York's financing plans. I'll begin with the more important of the two plans -- long-term financing. The four-year plan, in the process of being developed jointly by City officials and the Municipal Assistance Corporation, is summarized in the table below. Treasury has tentatively concluded that the plan is generally sound. As you can see, the City and MAC intend to raise $4.5 billion in long-term capital over the next four years. Of this total, approximately $2.3 billion relates to true capital spending, $.5 billion is for purposes of bonding the State advance, $.9 billion for financing the remaining operating expenses in the City's capital budget, $.5 billion for refinancing certain MAC debt and $.3 billion for funding the necessary increase in MAC's capital reserve.

New York City

Long-Term Financing Plan FY 1979-1982
($in millions)

Source of Funds	1979	1980	1981	1982	Total
Private Placement of MAC Bonds	$ 401	$ 537	$ 537	$ 325	$1,800
Public Offerings					
MAC Bonds	500	500			1,000
City Bonds	0	0	300 1/	650 1/	950
Federal Guarantees City Bonds	500	250	0	0	750
Total	$1,401	$1,287	$ 837	$ 975	$4,500

1/ Backed up by stand-by guarantee authority up to $900 million.

The plan calls for approximately 82 percent of the four-year total to be raised on an unguaranteed basis. Specifically, $1.8 billion of MAC bonds will be sold privately to financial institutions and City pension funds and $1.95 billion in MAC and City bonds is expected to be sold to the public.

The Treasury has tentatively concluded that $500 million of City bonds will probably have to be guaranteed during the City's current fiscal year. We will make no final decision to issue a guarantee, of course, until all of the conditions listed in Section 103 of the Act are fulfilled. In addition, concerning guarantees in subsequent years, we can only make the necessary findings at the time that such guarantees are requested by the City. While the City's plan for FY 1980 reflects the expectation of a Federal guarantee, let me repeat that the Secretary will issue no guarantees until all of the conditions under Section 103 have been met.

At the moment, Mr. Chairman, intensive negotiations are continuing on (a) the terms and conditions of the $1.8 billion MAC

private placement, (b) the terms and conditions which will be contained in the guarantee agreement between Treasury, the City, MAC and the EFCB, and (c) the terms and conditions of the new City bonds which we will guarantee.

These negotiations are complex and time consuming, but they are proceeding in a satisfactory way. The present target is to execute the long-term financing and guarantee agreements in the first week of September with credit to be extended under the agreements in the latter half of September.

Let me turn now to the City's seasonal financing needs over the 1979-1982 period. The most significant point is that the City's seasonal needs in FY 1979 are expected to be only $800 million, a full one billion dollars lower than the amount borrowed last year. This reduction reflects several expectations, including the partial bonding-out of the State advance, the timely receipt of capital funds, more sophisticated internal financial controls and better utilization of cash management. In general, this reduction is an important accomplishment and one which we think will help speed the City's return to the credit markets.

Negotiations also are underway on lines of credit to supply this seasonal financing for the City. These negotiations have not progressed as far as those on long-term financing, simply because all parties have been concentrating primarily on the latter. We do not expect the City to have difficulty in finalizing the needed seasonal commitments for fiscal 1979, however, or for subsequent years, from local sources. Assuming Congressional passage of an extension of P.L. 94-236, enabling the City pension funds to make further loans to the City (including seasonal loans) without jeopardizing their tax exempt status, the City has informed us that it is not planning to request Federal guarantees of any of its seasonal borrowings in fiscal 1979.

I would be pleased to answer any questions.

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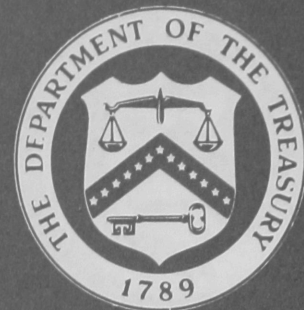

FOR RELEASE AT 4:45 P.M. August 17, 1978

TREASURY TO AUCTION $3,000 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $3,000 million of 2-year notes to refund $2,749 million of notes maturing August 31, 1978, and to raise $251 million new cash. The $2,749 million of maturing notes are those held by the public, including $775 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $200 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders. Additional amounts of the new securities may also be issued at the average price, for new cash only, to Federal Reserve Banks as agents for foreign and international monetary authorities.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-1119

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED AUGUST 31, 1978

August 17, 1978

Amount Offered:	
To the public	$3,000 million
Description of Security:	
Term and type of security	2-year notes
Series and CUSIP designation	Series S-1980 (CUSIP No. 912827 HZ 8)
Maturity date	August 31, 1980
Call date	No provision
Interest coupon rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	February 28 and August 31, 1979; and February 29 and August 31, 1980
Minimum denomination available	$5,000
Terms of Sale:	
Method of sale	Yield auction
Accrued interest payable by investor	None
Preferred allotment	Noncompetitive bid for $1,000,000 or less
Deposit requirement	5% of face amount
Deposit guarantee by designated institutions	Acceptable
Key Dates:	
Deadline for receipt of tenders	Wednesday, August 23, 1978, by 1:30 p.m., EDST
Settlement date (final payment due)	
a) cash or Federal funds	Thursday, August 31, 1978
b) check drawn on bank within FRB district where submitted	Tuesday, August 29, 1978
c) check drawn on bank outside FRB district where submitted	Monday, August 28, 1978
Delivery date for coupon securities	Friday, September 1, 1978

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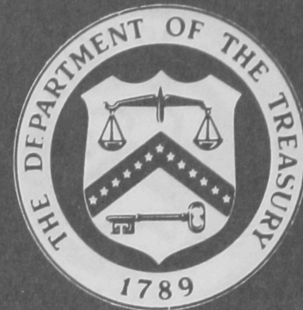

FOR IMMEDIATE RELEASE
August 17, 1978

Contact: Robert E. Nipp
202/566-5328

TREASURY ANNOUNCES COUNTERVAILING DUTY INVESTIGATION ON IMPORTS OF TEXTILE MILL PRODUCTS AND MEN'S AND BOY'S APPAREL

The Treasury Department has started an investigation into whether textile mill products and men's and boy's apparel imports from Malaysia, Mexico, Pakistan, Singapore and Thailand are being subsidized.

This action, under the Countervailing Duty Law, is being taken pursuant to petitions alleging tnat the textile and apparel industries in these countries receive benefits under several government programs that subsidize the manufacture and/or 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 merchandise exported to the United States.

A preliminary determination in this case must be made on or before January 5, 1979, and a final determination no later than July 5, 1979.

Notice of this investigation will be published in the Federal Register of August 23, 1978.

Import figures of textile mill products and men's and boy's apparel by value are not prepared. The 1977 imports in square yards from the five countries totalled 358 million square yards. This included Malaysia, 21 million; Mexico, 162 million; Pakistan, 63 million; Singapore, 65 million, and Thailand, 47 million.

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FOR IMMEDIATE RELEASE
August 18, 1978

Contact: Robert E. Nipp
(202) 566-5328

TREASURY ANNOUNCES FINAL DETERMINATION IN COUNTERVAILING DUTY INVESTIGATION OF CHAIN FROM JAPAN

The Treasury Department today announced a final affirmative determination under the Countervailing Duty Law that imported chain of iron or steel and parts thereof from Japan are being subsidized.

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) which has been paid on merchandise exported to the United States.

As a result of its investigation, Treasury found that Japanese manufacturers of this merchandise received benefits which are considered bounties or grants. Treasury's decision was made in the absence of the information necessary to properly quantify these benefits.

Notice of this action will appear in the Federal Register of August 23, 1978.

Imports of the subject merchandise from Japan during 1977 were valued at $3.2 million.

* * *

B-1121

DATE: August 21, 1978

	13-WEEK	26-WEEK
TODAY:	7.267%	7.471%
LAST WEEK:	6.887%	7.259%
HIGHEST SINCE:		
12/2/74	7.524%	
7/17/78		7.497%
LOWEST SINCE:		

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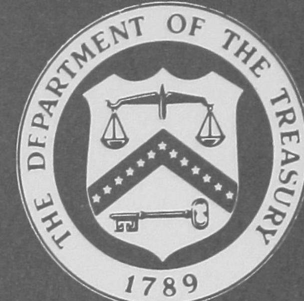

FOR IMMEDIATE RELEASE August 21, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 2,300 million of 13-week Treasury bills and for $3,401 million of 26-week Treasury bills, both series to be issued on August 24, 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 November 24, 1978			26-week bills maturing February 22, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.151a/	7.235%	7.47%	96.234b/	7.449%	7.85%
Low	98.138	7.286%	7.53%	96.218	7.481%	7.88%
Average	98.143	7.267%	7.51%	96.223	7.471%	7.87%

a/ Excepting 1 tender of $1,000,000
b/ Excepting 1 tender of $250,000

Tenders at the low price for the 13-week bills were allotted 61%.
Tenders at the low price for the 26-week bills were allotted 46%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 34,160,000	$ 34,160,000	$ 36,000,000	$ 11,000,000
New York	3,331,415,000	1,951,565,000	5,316,120,000	3,155,320,000
Philadelphia	19,430,000	19,430,000	8,260,000	8,260,000
Cleveland	30,540,000	28,590,000	27,640,000	12,640,000
Richmond	24,525,000	24,135,000	22,955,000	20,955,000
Atlanta	24,700,000	24,700,000	16,150,000	14,150,000
Chicago	233,585,000	78,585,000	224,970,000	34,470,000
St. Louis	41,225,000	31,225,000	29,440,000	11,440,000
Minneapolis	19,425,000	19,425,000	17,635,000	13,635,000
Kansas City	22,715,000	22,715,000	16,230,000	16,230,000
Dallas	11,610,000	11,610,000	10,185,000	10,185,000
San Francisco	167,755,000	47,755,000	209,480,000	84,480,000
Treasury	6,545,000	6,545,000	7,995,000	7,995,000
TOTALS	$3,967,630,000	$2,300,440,000c/	$5,943,060,000	$3,400,760,000d/

c/Includes $ 331,945,000 noncompetitive tenders from the public.
d/Includes $ 186,575,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-1122

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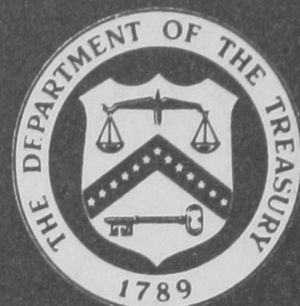

RELEASE UPON DELIVERY
Expected at 2 PM E.D.T.
August 20, 1978

REMARKS BY THE HONORABLE
W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
AT THE
UNIVERSITY OF MICHIGAN COMMENCEMENT
ANN ARBOR, MICHIGAN
AUGUST 20, 1978

President Fleming, . . . , ladies and gentlemen, first let me convey -- to the extent that spoken words can do so -- my sense of gratitude for this act of recognition. I am deeply touched. In one of his cheekier moments, H. L. Mencken wrote that honorary degrees were appropriate tokens for bankers, company directors, college professors, Presidents of the United States and "other such riffraff." Thank you for including me among the riffraff!

- I -

The other day, I asked a thoughtful graduate student what I could usefully say to an audience of his peers. He replied: "Offer them jobs."

That's fair enough. At this stage in your lives, after years of rigorous preparation, you are entitled to have jobs on your minds. Yet it was just a few years ago that college graduates were marching to the tune of an entirely different drummer, one beckoning them to drop out and tune in to some cosmic rather than worldly order.

It is, I understand, no longer in fashion to use pharmaceutical wonders for creating private experience and avoiding the challenge of public experience. I regard that as good news. Good news for me, for it provides me less opportunity to feel old fashioned. But also good news for the country, because your generation has the pragmatic determination that the times so obviously require. The United States faces down-to-earth problems of enormous complexity. It is now your turn to help solve them.

- II -

The effects on this nation of slowing economic growth and, more recently, of unprecedented inflation, have created wholly new patterns of inefficiency and discrimination. There has rarely been a time when the art of governance was more demanding. And equally certain, there has never been a time when those that govern have found it so hard to deliver . . .

Our national security is being threatened by gluttonous energy consumption and an excessive dependence on imported oil. Yet we creep at a snail's pace toward a national energy program.

Our welfare system is wasteful and inefficient. Yet we are unable to enact a program of reform.

Our economy is stifled by government interference, putting in question our ability to compete in international markets. Yet we find it nearly impossible to provide urgently needed relief.

Government bureaucrats enjoy a system of job security that would turn even the most fervent defender of academic tenure pale with envy. Yet it is like moving mountains to enact civil service reform.

We seem wedded to a haphazard system of social services. A welfare widow with children must check with 11 different Federal agencies to obtain help. Yet even to mention improving the efficiency of these systems raises an ideological furor. For some, efficiency is seen as an assault on free enterprise; for others, an assault on the New Deal. The result is stalemate -- which is a continuing assault on common sense.

A final example: We labor under a patchwork of government regulations that too often impose excessive costs, stifle competition, or simply drive us to distraction with their irrelevance. Estimates of the cost to our economy of Federal regulations range from $60 billion a year to well over $100 billion. Just filling out Federal reports costs businesses $25 to $32 billion a year. Yet we do very little to budget these enormous costs or to measure them against the benefits they yield.

Small wonder that some are fast losing faith in our economy and that many are uncertain about the future and about our ability to cope.

What has gone wrong? Why can't we make simple, logical and basic reforms whose necessity is obvious to any well-informed person?

The problem is not with our aspirations and intentions. But it is simply not enough that our intentions are good. In fact, American government today suffers from a surfeit of good intentions -- a great confusion of benevolent impulses, all running up against each other.

What is missing, in practically every area of policy, is the institutional discipline to sort out the conflicts and move in a single direction.

- III -

This is in part because government is too big. But only in part. The matter is more complex and dynamic. Government is not only enlarging itself but growing ever more skillful at tying itself in knots.

In a perceptive lecture entitled "An Imperial Presidency leads to An Imperial Congress leads to An Imperial Judiciary," Senator Moynihan sets out what he terms "The Iron Law of Emulation:"

> When any branch of government acquires a new technique which enhances its power in relation to other branches, that technique will soon be adopted by those other branches as well.

The Executive Branch was the original sinner here. The new alphabet agencies of the 20th Century learned how to promulgate laws and try cases through the regulatory process, becoming three branches in one.

But the imperial impulse has now spread to the other branches. The managerial role of the Congress in almost all aspects of policy making (and unmaking) has become more nearly equal to that of the Executive.

The Congress, for example, creates a Congressional Budget Office to rival the Executive's OMB.

The Congress acquires an Office of Technology Assessment to parallel the President's Office of Science and Technology Policy.

In the office of every Congressional member and committee, there has been an explosion of advisors and experts, to match the specialists in every Executive agency.

The list of analogous functions is very long.

The result is Congressional bureaucracy, which our forefathers would have thought a contradiction in terms. A recent report stated that The Senate budget for FY 1978 will be greater than the budgets of 74 countries. As for the House, $282

million will be spent this year merely to manage the affairs of its 435 members: about $650 thousand per member. In the Senate alone, the number of committees and subcommittees has increased by 50 percent in the last 15 years.

All this added help has failed to make life easier for the Congress. Quite the reverse. In the first session of the 85th Congress -- 20 years ago -- there were 107 votes in the Senate and 100 in the House. In the first session of the current 95th Congress there were 636 in the Senate and 706 in the House. A Congressional study committee in 1977 found that for one-third of their day, Members of the House were supposed to be in at least two places at the same time. This is a good way to keep one's waistline down, but it is otherwise an exhausting regime and hardly a good way to ensure sound decisions.

Government by frenzy is not a problem for Congress alone. It is now expected that a Cabinet member be equally ubiquitous. In the 20 months that I have been Secretary of the Treasury, I have made 56 formal appearances before Congressional committees. Earlier this year, I was scheduled to testify eight times in eight consecutive working days, sometimes before more than one committee on the same day. In addition, my staff spends much of its time preparing for Congressional testimony by top Treasury officials.

The impulse to grow and aggrandize has also been noted in the judiciary. This is largely alien ground for me. So I leave you with just one small poem crafted by my friend George Ball. This might best be entitled "Lament for the Tennessee Valley Authority" or "Ode to the Snail Darter":

Wee, cowering snail darter
You need not be martyr
To the woes of Jimmy Carter
For the Court with all its power
Will protect each fish and flower
From the Ultimate damnation
Caused by power dam escalation
As our shrinking oil ration
Terrifies the whole darn nation!

Within the Executive Branch itself, every interest group and idea has acquired its own department, agency, or office. As a result, no single official can do anything, even the smallest thing, without an exhaustive round of consultations and inter-agency meetings. In this regard, the Executive has evolved into a mini-legislature. Decisions are of necessity made -- or not made -- through a process of endless talk and compromise and consensus.

A system of checks and balances? Yes. But the kind of check that comes to mind is that used in ice hockey. With elaborate, conflicting bureaucracies in place and growing in each

branch of government, the result is often an abrupt cutting off of forward progress. A systemic stalemate is imposed on government policy making.

On top of this, the very notion of governmental authority has been eroded: Vietnam and Watergate, Elizabeth Ray and Fanny Foxe, Koreagate and Tongsun Park. We in Washington are hamstrung by institutionalized skepticism -- some of it good, some overdone. And the loss of confidence is measurable. The idea of government is doing badly in the polls.

-- At the end of the 1950's three quarters of the American people thought that their government was "run primarily for the benefit of all the people." By 1976, only 24 percent thought so.

-- According to the Lou Harris Poll, the proportion of the population having a "great deal of confidence" in the leaders of major governmental institutions was cut in half between 1966 and 1977.

-- A separate Lou Harris survey reveals that, in 1966, 37 percent of the people believed that what they thought "doesn't count much anymore." By 1977 the figure had grown to 61 percent.

Our view of politics has taken on a cynical edge. A New York Times reporter recently asked a Texas farmer if it didn't bother him that his state legislature met for only 140 days every 2 years. The farmer replied: "Shoot, I wish it 'war 2 days every 140 years."

- IV -

I am trying to make two points:

The first point is, I suppose, a defensive one. The Carter Administration is being blamed for a Washington malaise that is largely institutional and goes well beyond the personalities and power of a single Administration.

The Administration is on the cutting edge of a new system of checks and balances with the other branches of government.

The President has been fighting for programs that, in my judgment, make obvious sense: cutting our dependence on imported energy, rationalization of the civil service, tax reform, welfare reform, containment of hospital costs, deregulation of airline fares, wage and price moderation, fiscal restraint and a balanced budget. We have of course made our share of mistakes. But these initiatives have faced heavy weather not because they are flawed,

but because each of them challenges the status quo, runs against the grain of entrenched interests, and requires the system to take decisive action. Over the past decade, we have allowed the system to complicate itself to such an extent that decisive action, of any kind, is nearly impossible in the absence of a dire emergency.

The governing principle today is inertia, and no leader will fare easily who violates that principle.

My second point is observational. "Progress," observed C. K. Chesterton, "is the maker of problems." Our government -- your government -- has sought over time to improve the quality of life for all Americans, to eliminate discrimination and assure that everyone has a chance to develop his or her talent to its full potential. We have made great progress towards these fundamental goals. But a severe problem of management has accumulated in the process. During the forty years since Franklin Roosevelt gave tangible meaning to the Federal government's responsibility for the general welfare, Presidents and Congresses have evolved program upon program to address one aspect after another of the complex problems of poverty and discrimination. Yet, because of the circuitous and controversy-laden way these programs have evolved, many are overlapping, contradictory and self-defeating. Some favor only narrow groups, which now have the political muscle to deny resources to others who need them equally as much or more. Many of these programs need drastic revision. Some must be reshaped to meet radically changed conditions. Others are ripe to be abandoned.

In short, the United States Government is in clear need of consolidation and rationalization. The Carter Administration knows it and is striving to get it done. The American people not only know it, but have begun demanding it. And, our foreign allies are watching us with interest -- and with a high degree of anxiety.

I want to emphasize that putting our house in order, regaining our traditional efficiency, is a responsibility we owe to others, as well as to ourselves. The political destinies of the Western nations are inextricably linked. So, too, are our economic destinies. The role of the United States is unique and unprecedented. We are the defenders of the free world. We are its largest economy and provider of money. We are still its standard of democracy. To the extent we falter, we cripple the hopes of millions beyond our shores.

We would do well to remember that last line of Shakespeare's 94th Sonnet: "Lilies that fester smell worse than weeds." Precisely because of its enormous success in the past, America's responsibility to the future is awesome. We cannot afford to fail. The world cannot afford a paralysis of the American political process.

- V -

My young graduate student friend asked me to offer you jobs. You have a job: to make this country work better.

Jack Kennedy, at a similar occasion at Vanderbilt University, said: "the educated citizen has an obligation to serve the public" and "be a participant not a spectator."

The counsel offered by Pericles is even more pointed: "he who holds himself aloof from public life is not quiet, but useless."

The opportunities for useful involvement in government are great. We need bright, energetic policy makers to make the consolidation and rationalization process work, people who are not bogged down by the intellectual baggage of the New Deal, of Keynsianism or Monetarism, of the Vietnam War, of Watergate.

We need political scientists to study bureaucracy and teach us how to make it work.

We need scientists and business men and women to help us discover new sources of economic growth.

We need economists and mathematicians to help us encourage that growth and channel it to productive uses.

We need social workers eager to lift the weak, the poor, and the old beyond welfare to greater self-sufficiency.

Each and everyone of you will have an opportunity to serve in government at some time in your career -- be it in the Executive, the Legislative or the Judiciary. Do it. Don't succumb to the temptation to let others do it for you. Don't succumb to the temptation to run away, to say "to hell with it, a plague on your houses."

America has always been a "can-do" nation. You are the trustees of America's future. The burden is on you to make our government and our nation work.

- VI -

So much for the good advice of a man deeply touched by the honor you have bestowed upon him. I understand now why the commencement speakers who spoke at me never seemed to quite overcome the temptation to speak forever. But I shall heed the advice given me by my staff as I left Washington to come here. They handed me a note which read as follows: "Socrates was a very wise man. He went around giving people good advice. They poisoned him." End of speech.

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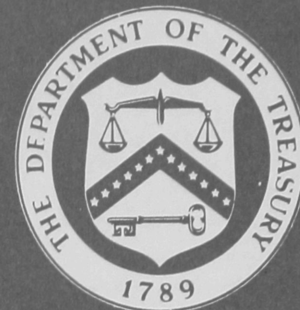

FOR RELEASE AT 4:00 P.M. August 22, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,700 million, to be issued August 31, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,714 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 June 1, 1978, and to mature November 30, 1978 (CUSIP No. 912793 U6 1), originally issued in the amount of $3,406 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,400 million to be dated August 31, 1978, and to mature March 1, 1979 (CUSIP No. 912793 X2 7).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing August 31, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,281 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 Daylight Saving time, Monday, August 28, 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-1124

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 August 31, 1978, in cash or other immediately available funds or in Treasury bills maturing August 31, 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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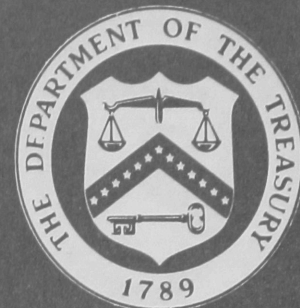

FOR RELEASE AT 4:00 P.M. August 22, 1978

TREASURY TO AUCTION $2,250 MILLION OF 4-YEAR 1-MONTH NOTES

The Department of the Treasury will auction $2,250 million of 4-year 1-month notes to raise new cash. Additional amounts of the notes may be issued to Federal Reserve Banks as agents of foreign and international monetary authorities at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-1125 (over)

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 4-YEAR 1-MONTH NOTES TO BE ISSUED SEPTEMBER 6, 1978

August 22, 1978

Amount Offered:	
To the public..........................	$2,250 million
Description of Security:	
Term and type of security...........	4-year 1-month notes
Series and CUSIP designation........	Series J-1982 (CUSIP No. 912827 JA 1)
Maturity date.........................	September 30, 1982
Call date.............................	No provision
Interest coupon rate.................	To be determined based on the average of accepted bids
Investment yield.....................	To be determined at auction
Premium or discount..................	To be determined after auction
Interest payment dates...............	March 31 and September 30 (first payment on March 31, 1979)
Minimum denomination available......	$1,000
Terms of Sale:	
Method of sale.......................	Yield auction
Accrued interest payable by investor.............................	None
Preferred allotment..................	Noncompetitive bid for $1,000,000 or less
Deposit requirement..................	5% of face amount
Deposit guarantee by designated institutions........................	Acceptable
Key Dates:	
Deadline for receipt of tenders.....	Tuesday, August 29, 1978, by 1:30 p.m., EDST
Settlement date (final payment due)	
a) cash or Federal funds.......	Wednesday, September 6, 1978
b) check drawn on bank within FRB district where submitted...................	Friday, September 1, 1978
c) check drawn on bank outside FRB district where submitted...................	Thursday, August 31, 1978
Delivery date for coupon securities.	Tuesday, September 12, 1978

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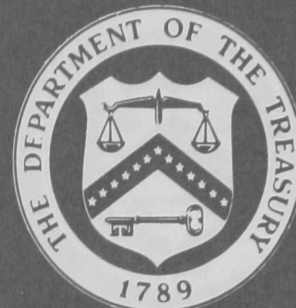

For Release at 6:00 p.m. EST
August 22, 1978

CONTACT:
Robert Nipp
202-566-5328

Increase in the Amount of Gold Sales by the U.S. Treasury

The Treasury announced today that it will increase the amount of gold offered at its monthly auctions to 750,000 ounces, beginning with the scheduled November 1978 auction. Currently 300,000 ounces are sold at each auction.

At the new level of 750,000 ounces per month, Treasury gold sales will be roughly equivalent to the 1977 rate of net gold imports. The sales will thus make an important contribution toward reducing the U.S. balance of payments deficit on current account. At the current price the balance of payments benefit would be more than $1.8 billion at an annual rate. The continuing sales will also represent further progress toward elimination of the international monetary role of gold.

When the present gold auction program was announced last April, the Treasury indicated that the auction level of 300,000 ounces per month would be maintained for six auctions and that the amounts to be offered at subsequent auctions would be determined in the light of the initial experience. Four of these auctions have now been completed. Results have been quite satisfactory. The receipts, which have totaled $230 million in the four auctions held to date, can be said to have reduced the U.S. trade and current account deficits by that amount. Since those deficits remain at an excessive level, however, and net gold imports in the period preceding the initiation of the auctions were running at an annual rate of about 9.5 million ounces, the Treasury has concluded that a substantial increase in the rate of sale would be desirable.

The 750,000 ounce level of sales will be continued for a period of four months. The amounts of sales at subsequent auctions will be reviewed well in advance of the final auction of this four-month series.

For the present no changes are planned in the manner in which the auctions are conducted or in the bid procedures. It is expected that invitations to bid will continue to specify payment in U.S. dollars and provide for delivery at the U.S. Assay Office in New York or at other U.S. gold depositories. Auctions will be conducted at 11:00 AM on the

third Tuesday of each month in the General Services Administration Office at 7th and D Street, S.W., Washington, D.C. The minimum bid accepted will be for 400 ounces. A bid deposit of $10 an ounce will be required.

The gold will be made available in bars, each containing approximately 400 ounces. Sales will be by competitive bids, with all successful bidders paying the price bid for each ounce of gold. The Treasury reserves the right to reject any or all bids. Bids by or on behalf of foreign governments or central banks will not knowingly be accepted.

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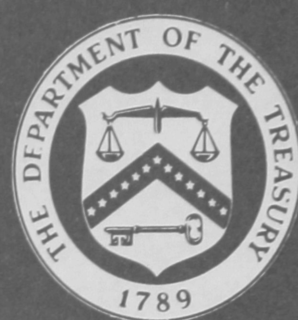


FOR IMMEDIATE RELEASE
August 23, 1978

Press Contact: Robert E. Nipp
202/566-5328
Non-Press Contact: 202/566-8235
566-5286

TREASURY ANNOUNCES NEW COLD FINISHED BAR EFFECTIVE DATE

The Treasury Department announced today a change in the effective date of the revised trigger prices on cold finished bars that were announced on July 20.

The Third Quarter trigger prices in effect prior to the July 20 revisions will continue to apply to cold finished bars exported through September 30, 1978. The base trigger prices as revised for the Fourth Quarter will apply to cold finished bars exported on or after October 1, 1978.

In this way, cold finished bars are treated like other products whose base prices were revised by the Task Force.

All other effective dates remain as previously announced.

* * * * *

B-1127

DEPARTMENT OF THE TREASURY

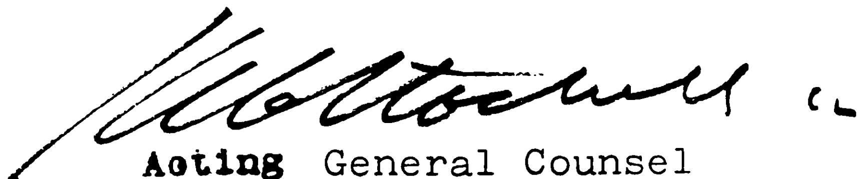
OFFICE OF THE SECRETARY

NOTICE

Trigger Price Mechanism
Cold Finished Bars Revision
New Effective Date

I am hereby announcing a change in the effective date for the revised cold finished bar trigger price announced in the Treasury Department Release of July 20, 1978 (43 F.R. 33993, August 2, 1978). The base trigger prices as shown in footnote 1/ below (i.e., the Third Quarter trigger price for this product prior to the July 20 revisions) will continue to apply to cold finished bars exported through September 30, 1978. The announced Fourth Quarter revised base trigger prices will apply to carbon cold finished bars shipped on or after October 1.

The new effective date is being established since the revised cold finished bar trigger price represents a change in a previously announced trigger price and many parties have acted in reliance on the previously published trigger price. The Department has concluded that substantial unfairness would result if the revised price were to take effect before October 1. Thus, the revised cold finished bar prices are effective on or after October 1 consistent with the previously announced prices of galvanized sheets, tin plate, double reduced plate, and others noted on page 12 of Treasury's July 20 press release, 43 F.R. 33993.



Acting General Counsel

Dated: AUG 22 1978

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TPM page	Grade	Applicable 3rd Quarter Base Price (per M/T)	4th Quarter Base Price Applicable to Shipments Exported on or after 10/1/78
12-1	Cold Finished Round Bar AISI 1008 to 1029	381	460
12-2	Cold Finished Sulphur Free Cutting Round Bar AISI 1212 to 1215	430	521
12-3	Cold Finished Free Cutting Lead Round Bar 12L14 & 12L15	452	544

8-3/8% TREASURY NOTES OF SERIES S-1980

DATE: August 23, 1978

HIGHEST SINCE:

LAST ISSUE: 8-1/2% (R-1980) July

LOWEST SINCE: 8-1/4% (Q-1980) June, 78

TODAY:

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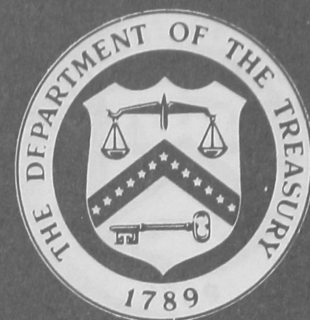

FOR IMMEDIATE RELEASE August 23, 1978

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $3,002 million of $6,129 million of tenders received from the public for the 2-year notes, Series S-1980, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	8.37% 1/
Highest yield	8.39%
Average yield	8.38%

The interest rate on the notes will be 8-3/8%. At the 8-3/8% rate, the above yields result in the following prices:

Low-yield price	100.009
High-yield price	99.973
Average-yield price	99.991

The $3,002 million of accepted tenders includes $ 600 million of noncompetitive tenders and $2,032 million of competitive tenders from private investors, including 89% of the amount of notes bid for at the high yield. It also includes $370 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 to the $3,002 million of tenders accepted in the auction process, $ 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 August 31, 1978, and $289 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash.

1/ Excepting 2 tenders totaling $55,000

B-1128

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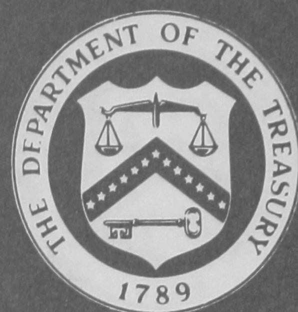

FOR IMMEDIATE RELEASE
August 23, 1978

Contact: George G. Ross
202/566-2356

USA/NIGERIA INCOME TAX TREATY TO BE TERMINATED

The Treasury Department today announced that the Government of Nigeria has officially informed the United States Government of Nigeria's intention to terminate the income tax treaty now in force between the two countries. The notice of termination was delivered under the terms of Article XXIV of the treaty.

The present tax treaty is the United States/United Kingdom income tax convention of 1945 which was extended to Nigeria, as a U. K. overseas territory, in 1959 and continued in force after Nigerian independence in 1960.

Under Article XXIV, termination will be effective for Nigerian income tax purposes for years of assessment beginning on or after January 1, 1979.

Upon termination of the tax treaty, statutory rules in both countries will apply in place of the former treaty rules. Thus, for example, statutory tax withholding rates on dividends and royalties will apply in place of the exemptions or reduced rates of tax withholding provided in the treaty. Similarly, there will no longer be a reciprocal exemption for the income of shipping and aircraft companies.

It is anticipated that negotiations will begin between the United States and Nigeria on a tax treaty to replace the one which will terminate.

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B-1129

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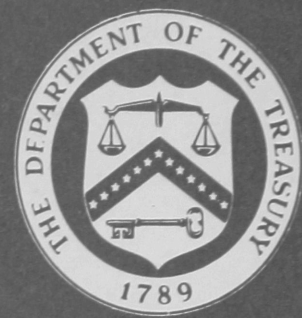

FOR IMMEDIATE RELEASE
August 23, 1978

Contact: Robert E. Nipp
(202) 566-5328

TREASURY DEPARTMENT FINDS STEEL WIRE STRAND FROM JAPAN SOLD HERE AT LESS THAN FAIR VALUE

The Treasury Department announced today that it has determined that Japanese steel wire strand for prestressed concrete is being sold in the United States at "less than fair value" within the meaning of the Antidumping Act.

The affirmative determination affects all Japanese manufacturers of this merchandise except Kawatetsu Wire Products Co. The investigation with respect to Kawatetsu is being discontinued on the basis of minimal margins and formal prices assurances. The bulk of all other imports from Japan are produced by Shinko Wire Co., Sumitomo Electric Industries, Suzuki Metal Industry Co., and Tokyo Rope Manufacturing Co., whose weighted-average margins of sales below fair value (in percent) were, respectively, 13.3, 15.8, 6.9 and 4.5.

The case is being referred to the U.S. International Trade Commission, which must decide, within 90 days, whether a U.S. industry is being, or is likely to be, injured by these sales. If the Commission's decision is affirmative, dumping duties will be collected on those sales found to be at "less than fair value." Sales at less than fair value generally occur when the prices of the merchandise sold for export to the United States are less than the prices of the same merchandise sold in the home market.

Interested persons were offered the opportunity to present oral and written views prior to this determination.

Notice of this action will appear in the Federal Register of August 28, 1978.

Imports of steel wire strand for prestressed concrete from Japan were valued at $19.6 million during the period investigated, June-November 1977.

B-1130

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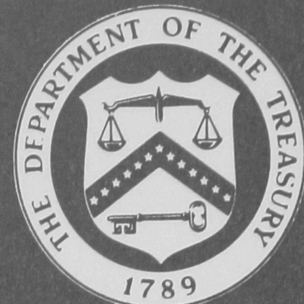

For Release Upon Delivery
Expected at 2:00 p.m.

STATEMENT OF DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)
BEFORE THE
SENATE FINANCE COMMITTEE
AUGUST 24, 1978

Mr. Chairman and Members of the Committee:

We welcome the opportunity to present the Treasury Department's views on S. 3370. In broad terms, this bill would roll back the Treasury's recent regulations concerning arbitrage, sinking funds, and advance refundings. It would also put a freeze on further regulations for approximately a year and a half.

We are strongly opposed to S. 3370. The bill would result in substantial federal revenue losses and would seriously and adversely affect the market for tax-exempt securities.

Arbitrage

Generally, an "arbitrage bond" is a municipal bond that is used to make an investment profit. The yield on a tax-exempt municipal bond is ordinarily lower than the yield on Treasury notes, certificates of deposit, and other high-grade taxable investments. Thus, for example, a substantial profit can be made by selling municipal bonds at six percent and investing the proceeds in Treasury notes at 8-1/2 percent. Bonds used to secure this profit are called "arbitrage bonds."

B-1131

A State or local government can earn a substantial profit from arbitrage. However, arbitrage has two drawbacks that more than offset this profit. First, the cost to the Treasury is considerably more than the profit earned by the State or local government. Thus, arbitrage results in a net loss to the taxpayers of the country as a whole. Second, arbitrage damages the market for municipal bonds. Arbitrage bonds tend to crowd out bonds that are sold to finance roads, schools, and other traditional projects. Thus, in the long run, arbitrage tends to drive up the cost of municipal borrowing, and therefore is self-defeating and contrary to the interests of State and local governments. For these reasons, in 1969, Congress delegated broad authority to the Treasury to keep arbitrage bonds off the market. To that end, the Treasury has written extensive regulations. However, these regulations have not been completely successful. A series of devices has been invented to circumvent the arbitrage regulations, the most recent being the invested sinking fund (sometimes called the "Bullet" or the "Nashville Goose").

Invested sinking funds

Typically, municipal bonds have serial maturities. For example, if a city sells $10 million of 20-year school bonds, the city may use property taxes to pay a portion of the principal off each year. Thus, for the protection of the bondholders, the bonds will be paid off gradually over 20 years, and the $10 million principal amount will not come due all at once. However, if the city employs an invested sinking fund, it will not pay any principal off until the bonds come due in 20 years. Instead, the city will periodically pay property taxes into a sinking fund. Amounts held in the sinking fund will be invested in Treasury notes or high-grade taxable investments, enabling the city to make a substantial investment profit.

The invested sinking fund was devised as a way around Treasury's arbitrage regulations. In the short run, certain State and local governments were able to gain a financial advantage from invested sinking funds. However, in the long run, invested sinking funds (like other forms of arbitrage) are a burden on taxpayers and a threat to the market for municipal bonds. In particular, invested sinking funds damaged the tax-exempt market in two ways. First, bonds that used this device were left outstanding longer because they were not retired serially. Second, many refunding issues were motivated chiefly by the profit that could be earned from an invested sinking fund; these issues would not have been sold if that profit had not been available. The

invested sinking fund -- if unchecked -- could have resulted in nearly a 50-percent income in the amount of tax-exempt bonds outstanding. The estimated annual loss in Federal revenue could ultimately have reached $3 to 3.5 billion at 1979 levels. It is also important to note that the elimination of the invested sinking fund was regarded favorably by a substantial segment of the concerned financial community.

Advance refundings

The remainder of the regulations apply primarily to advance refunding. An advance refunding is an unusual type of financial transaction, almost unique to municipal finance. It is also a highly sophisticated type of transaction, and generally cannot be done without the aid of computers.

An ordinary refunding is a relatively simple transaction. It enables an issuer to substitute new bonds for outstanding bonds. Generally, the substitution is made because the outstanding bonds were sold on unfavorable terms. For example, the interest rate on the old bonds may be too high, or the indenture for the old bonds may contain unduly restrictive covenants. In an ordinary refunding, a state or local government simply sells new bonds, and uses the proceeds to call in its outstanding bonds.

By contrast, in an advance refunding, both sets of bonds remain outstanding. For example, assume that a sanitation district has $10 million of bonds outstanding. In an advance refunding, the district will typically sell an additional $11 or $12 million of refunding bonds. However, it will not call its outstanding bonds immediately. These bonds will remain outstanding for perhaps 5, 10, or even 20 years. Until the sanitation district calls in its old bonds, the proceeds of the new bonds will be kept in an escrow fund. The escrow fund will be invested in United States Treasury obligations. These obligations will be selected with the aid of computer so that the cash flow earned by the escrow fund is just sufficient to pay debt service on the old bonds.

Advance refundings raise serious questions of tax policy. First, they double the amount of tax exempt bonds outstanding for any project. As a result, they tend to increase borrowing costs for state and local governments. According to rough estimates, this increase in borrowing costs may amount to 20 or 30 basis points in the long run. An increase of this magnitude could substantially impair the ability of hard-pressed state and local governments to provide essential services.

Second, the holders of the old bonds get a double benefit. In addition to being tax-exempt, these bonds are effectively guaranteed by the United States. Thus, the old bonds are superior both to obligations of the United States Treasury and to conventional municipal obligations. Recently, the Congress rejected this double benefit -- both a tax exemption and a federal guarantee -- in the case of the New York City Financial Assistance Act. The Congress determined that it was inappropriate to provide New York City with this double benefit, even in connection with a program necessary to assure the City's financial survival. In the case of a typical advance refunding, where much less than financial survival is at stake, this double benefit is still less appropriate.

And third, advance refundings have been the principal cause of the difficulties that we have had with the arbitrage regulations. As stated earlier, a continuing series of devices has been invented to circumvent the arbitrage regulations. For a variety of reasons, these devices have been used almost exclusively in connection with advance refundings. Thus, advance refundings have been the principal cause of frequent changes in the arbitrage regulations. These frequent changes have tended to disrupt the tax exempt market. They have been bad for the Treasury, bad for state and local governments, and generally bad for all concerned.

IDB's

Advance refundings of industrial development bonds (or IDB's) are particularly questionable. Generally, IDB's are governmental in form, but are issued to raise capital for private business enterprise. Most frequently, the proceeds of an issue of IDB's are used to build a facility which is "leased" for its useful life to an industrial user at a rental exactly sufficient to pay debt service on the bonds; generally the government unit is not liable on the bonds and the holders must look solely to the credit of the industrial user. The use of the tax-exempt market for such essentially private purposes places a burden on that market and drives up the cost of municipal borrowings for conventional governmental purposes. Therefore, on November 4, 1977, the Treasury announced regulations that generally prevent advance refundings of industrial development bonds.

However, the Treasury recognized that these regulations might, in certain cases, cause hardship to state and local governments. As a result, the Treasury announced that it would support legislation to alleviate these hardships. In

the past nine months, the Treasury has worked closely with affected governmental officials to develop appropriate legislation. Our work on this legislation is now substantially complete, and we expect that it will be made public shortly.

Administrative costs

In the case of any advance refunding, the existing regulations permit an issuer to earn enough arbitrage to cover most or all of the administrative costs. We believe that this is bad policy. While some advance refundings may have a legitimate financial purpose, we believe that they should pay their own way.

The ability to earn back administrative costs has led many issuers to pay inflated and excessive fees to lawyers, accountants, underwriters, and others. This inflation of administrative costs has had a corrosive effect on the ethics of the bond community. In addition, it has brought into being a class of talented financial advisors who make their living by finding ways around the arbitrage regulations.

However, this history of abuse is not the only reason for requiring issuers to pay the administrative costs of advance refundings. The ability of issuers to recover administrative costs has led to many refundings that are economically unsound. For example, assume that the administrative costs of an advance refunding are $3 million, and the gross debt service savings are $2 million. Economically, the transaction does not make sense. There is no good reason to spend $3 million in order to save $2 million. However, under the existing regulations, this transaction would probably be done. The issuer would save nearly $2 million, and underwriters, lawyers, and financial advisors would earn $3 million at the expense of the Federal Treasury. The public cannot benefit from a transaction in which $3 million is spent to save $2 million. Only the recipients of the $3 million -- the underwriters, the lawyers, and the financial advisors -- can benefit.

Further, the treatment of expenses in the case of advance refundings discriminates against new money issues in two ways. First, issuers generally cannot recover their administrative costs in the case of new money issues. Recovery of such costs is generally possible only in connection with advance refundings. And second, advance refundings occupy a considerable share of the market, crowding out new money issues needed for schools, roads, water systems, and other essential projects.

Certification

The last aspect of the new regulations we would like to address is certification. Under existing regulations, issuers are able to "certify" their bonds conclusively. As a result, they are able to act as the sole judge of whether their bonds comply with Internal Revenue laws. This ability has been a major cause of the continuing series of devices that have been invented to circumvent the arbitrage regulations. It permits bond lawyers to interpret the regulations in a highly aggressive manner and has severely handicapped the IRS in its efforts to protect the tax-exempt market.

Therefore, the certification is revised under the new regulations. These revisions are designed to make bond lawyers stand behind the opinions they give. After September 1, bond lawyers will no longer be able to give irresponsible opinions and hide behind a conclusive certification. This will enable the IRS to enforce the regulations effectively, and at the same time to protect issuers acting in good faith.

Customary financial practices

We wish to emphasize particularly that the new amendments are not intended to interfere with customary financial practices. They are aimed only at sophisticated transactions -- the computerized sinking funds and advance refundings. Some state and local governments have expressed the concern that the regulations will disrupt customary financial practices. These concerns are absolutely genuine. To a large extent, however, they are unjustified. They reflect advice given by certain bond counsel who insist -- for reasons of their own -- on reading the regulations is a way that was never intended. In order to allay these concerns, the Treasury issued a press release yesterday that contained two revenue rulings to clarify the regulations.

There may be ambiguities and technical defects in the proposed regulations. Municipal finance is a complicated area, and our regulations are not always perfect. However, we believe that any problems can be solved by appropriate amendments to the regulations. Further, we believe that S. 3370 is a drastic over-reaction to these problems.

In May of this year, before the sinking fund rules became effective, the volume of sinking fund bonds was large and growing rapidly. If the sinking fund rules are repealed,

we would anticipate an enormous volume of sinking fund bonds. The total amount of municipal bonds now outstanding is approximately $250 billion. From a short-run perspective, it would be highly advantageous, at least initially, to refund the great majority of these bonds. If only 20 percent are refunded, this would amount to a volume of $50 billion. Fifty billion dollars is more than the total volume for the entire year of 1977. If anything approaching $100 billion of sinking fund bonds were sold, the effect on the market could be catastrophic. Borrowing costs, and hence local taxes, would go up. Communities that have financial problems -- and these are the communities that need access to the market most -- might be unable to sell their bonds. Thousands of innocent people who have put their savings into tax exempt municipal bonds could suffer substantial losses. The strain on the market would be very considerable indeed.

In conclusion, the new regulations are aimed at sophisticated arbitrage devices put together by resourceful and ingenious financial advisors and computer experts. They are not aimed at customary financial practices. To the extent that they are problems with the regulations, we are absolutely willing to work out whatever changes are necessary. In this connection, we have been consulting frequently with representatives of state and local governments, and will continue to do so.

On the other hand, S. 3370 would be the worst possible way to atttack these problems. It would turn the municipal market into a playground for bond lawyers and computer experts, to the vast detriment of state and local governments, thousands of innocent bondholders, and taxpayers throughout our country.

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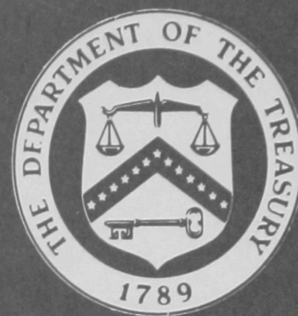

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TREASURY DEPARTMENT

REMARKS BY THE HONORABLE DANIEL H. BRILL
ASSISTNT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY
AT THE
1978 SESSION OF THE GRADUATE SCHOOL OF BANKING
UNIVERSITY OF WISCONSIN
MADISON, WISCONSIN
AUGUST 23, 1978

Thank you for inviting me to participate in your program. An invitation to return to school has a special attraction these days for anyone from Washington working in the field of economic policy.

I can think of no better time -- or perhaps no worse time -- to be speaking on the subject of economic policy-making. Even in normal times, the process is exciting, frustrating, demanding, risky, and -- all too infrequently -- rewarding. But these are not normal times, so the process is more agonizing than usual.

Before plunging into the substance of today's menu of policy issues, I would like to sketch for you some of the ground rules that underlie the policy-making process. Otherwise, it would be impossible to understand the wide range of considerations that must -- and do -- get involved in every policy decision. Some of these observations may seem trite, but they are often overlooked in the very popular game of "second-guessing Washington."

First, we must always keep in mind that we live in a pluralistic society with multiple objectives. By pluaralistic I mean that in our body politic, the majority on any issue does not ride roughshod over the interests and aspirations of the minority. The considerations in forming policy, and in enacting legislation to implement policy, must accomodate a wide range of needs and interests: regional, sectoral, social. That is why Washington is sometimes called the "City of the Second Best." What appears to experts to be the most direct and efficient solution to an economic or social problem must be tempered to insure that no one sector of our society is too severely disadvantaged by that solution. The result is often a compromise, scorned by many but, I submit, a testimonial to the strength and virtues of our democratic institutions.

Concomitantly, we are committed to achieving not just one economic goal, but to several simultaneously. Thus, we are dedicated to achieving higher employment _and_ reasonable price stability, to using less oil and gas and _more_ coal at the same time as we try to improve the environment, to promote worldwide economic growth and development while we moderate the pace at which our less-competitive industries adjust to foreign competition.

This need to serve several objectives, which often appear to be in conflict, is where newspaper columnists and financial newsletter writers have a great advantage over policy makers. They can -- and often do -- focus on only one policy objective, and insist that all actions serve that goal, and that goal only, whatever the cost to our other objectives. An example is the advice so freely bestowed on us to engineer a recession, tolerate high unemployment for several years, in order to lick inflation. Even if any of these simple solutions would work -- and I doubt it -- a cost-benefit analysis would quickly indicate that they yield a poor payoff in terms of the balance among the several objectives we must achieve. Only those not burdened with the responsibility of administering public policy can afford the luxury or arrogance of determining what single objective must override all others.

A final point to make about the ground rules for policy making is that we have to recognize that policies are formulated in an environment of less than perfect knowledge. Policy makers are neither omniscient nor abysmally ignorant. It amused me, when I was out of government service and a participant in the private financial community, to hear some of my business colleagues bitterly inveigh against the regulations and legislation coming out of Washington. "Those stupid s.o.b.'s know better than that; they are just being malicious." In almost the same breath, the same commentator would add: "What can you expect from those pinhead briefcase carriers; they don't know any better."

The fact is that in formulating and recommending economic policy, we know less than we want to know, less than we need to know, but more than we are given credit for. It is not only the facts which are often missing. Of equal gravity is the fact that the analytical frameworks have not kept pace with the changing economic environment, particularly in light of the rapid social and structural changes that have occurred during recent years.

It is certainly a fact that some of our generally accepted propositions in economics have recently been placed on the injured reserve list, whether permanently or temporarily remains to be seen. This is not making the economic policy task any easier. It is difficult enough to chart a policy course without finding that some of the road signs are pointing in unexpected directions.

One basic relationshiip that we came to depend upon connects the rate of unemployment to the economy's rate of real growth. I am sure that my good friend, Art Okun, must be tired of hearing that Okun's Law has been repealed. As you know, Okun determined that it required economic growth at a rate of some 3 percent above the economy's long-run potential growth rate to achieve a 1 percent reduction in the unemployment rate. And indeed, in the early years of the current expansion, the reduction of the rate of unemployment tracked closely with the behavior of real growth. But over the past year or so, this relationship has gone awry. The economy has grown only a shade faster than its trend potential, yet the unemployment rate has fallen sharply. The fall in the unemployment rate was good news; the accompanying fall in productivity was not.

Or take the so-called Phillips curve, which was once held to relate the rate of unemployment to the rate of inflation. For a while, economists were referring vaguely to the possibility that the curve was shifting to the right. I think that by now it must have shifted right out of view. On the few recent occasions when I have inquired as to its whereabouts, the answer ran in such esoteric terms that I regretted having asked the question.

Monetary matters are another example where we know a good deal less than we once thought we did. There was an age of innocence during which high hopes were held for a purely monetary approach to many of our problems. But that was before there had been much practical experience with attempting to control the growth of the monetary aggregates. Now sadder but wiser, with monetary velocity frequently living a life of its own, we have found that these matters are not nearly as simple as some once thought.

The crumbling away of some of these older propositions leaves econonic policy better off in some respects and worse off in others. On the one hand, we no longer can place as much faith in econometric projections, since they depend heavily upon past relationships, some of which are at least temporarily out of action. That may be a step forward, but, on the other hand, we do not always have much that is both new and reliable to put in place of the older relationships. This is not simply a matter of how to forecast, or what theories to espouse, but a practical question of trying, through a simulation process, to forecast what policies will yeild what results. The basis for such forecasting is a lot shakier now than it was when I first began to participate in the policy making process.

The seeming breakdown of some of the older theoretical approaches reflects in large measure, I believe, the persistence of inflation and the effects that it has been having on personal and business behavior. My own conclusion is that after such a sustained period of inflation, and after a basic and enduring change in the cost of energy, the path back to a more stable economic and financial environment will inevitably be a fairly

long one even if optimal policies are followed. It will involve a change in public perceptions and economic and social values. These do not come quickly or cheaply. As far as policy making goes in this sort of environment, there are no easy solutions and no shortcuts.

Let me cite two examples of shortcuts that we should not follow, because they don't lead where we want to go. First, some would direct us down a trail of very slow growth for a very long period of time. Fiscal and monetary restraint throughout this period would be severe and unremitting.

There are convincing economic objections to following such a policy course, even if it were feasible politically. From an analytical point of view, it is a policy to reduce excess demand, but when demand is not excessive. From a more practical point of view, the economic cost of following such a policy would be exorbitant. Econometric evidence suggests that an extra percentage point of unemployment lowers the rate of inflation by only a few tenths of a percent, even if maintained for three years. And in the process it would cost over a million jobs and some $60 billion of real production in each of those three years. In view of my earlier sideswipes at Okun's Law and the Phillips curve, these estimates should not be taken as the last word on the matter. However, they do suggest that the policy of deliberately contriving very slow growth is really not a promising alternative.

Moreover, one must possess insights denied to the rest of the economics profession, or an arrogance bordering on pathological insanity, to be confident that we can deliberately run the economy close to its stalling point for a protracted period without actually stalling, and then be able to rev it back up to desired speed whenever it suited our purpose. It seems appropriate to me, in the context of current demand and inflationary pressures, to accept a short-term growth rate close to our long-run potential, estimated to be in the 3-1/4 to 3-1/2 percent per annum range. But to assume we can force growth well below that, perhaps even into the negative range, and then snap back as soon as inflation abated goes beyond what I regard as the bounds of reason. This is a risk that no responsible official could or should undertake.

A second shortcut would, in my opinion, carry us even farther from where we should be headed. That is the old snake oil of wage and price controls. In the public mind, controls have the advantage of simplicity and direct action. But experience in many countries at many different times demonstrates the futility of this approach. Prices and costs may be held down temporarily, but only at the cost of serious economic distoritons and inefficiencies. When the controls are removed, as they must be eventually in a market economy, prices rise even more rapidly as the pent-up pressures are released. Price controls do no lasting good and inflict a great deal of incidental damage. The Administration has repeatedly disavowed any intention of moving to wage-price controls and for very good reason.

If these shortcuts are ruled out, what is the appropriate road to travel? I am sure it will come as no surprise to you that the recommended course is the one that we are actually trying to follow. However, I am not here to try to sell the program, but to explore its logic with you.

The cornerstone of the program is a measured amount of fiscal and monetary restraint. Too much abrupt restraint would cause a sharp rise in the unemployment rate, without much benefit to the price situation, and could bring on a recession. Too little restraint would lead to even sharper rises in inflation than we have been experiencing and would sooner or later surely bring on recession, perhaps a very serious one.

Moreover, I do not feel that we are in a razor's edge situation between too much and too little restraint. The U.S. economy and its financial markets are strong and resilient. They can adjust to a fairly wide range of fiscal-monetary outcomes. At the present time, there is a case for tilting on the side of restraint. At the beginning of the year, fiscal dials were set to offset the drag on the flow of income from large state and local surpluses and a big foreign deficit. Forces now appear to be in motion which are reducing both of these drags, thereby reducing the need for such a large Federal fiscal offset. In addition, the inflationary situation is much worse now than it was expected to be when the earlier fiscal plans were made. While we do not diagnose the current inflation as the simple excess demand variety, it is clear that reduced demand does have some dampening effect on costs and prices.

Furthermore, in terms of policy mix, there may be a case for pressing farther with fiscal restraint than with monetary tightening under present circumstances. It is apparent that it takes a much higher level of nominal interest rates now to achieve a reduction in credit availability, for a variety of reasons including the fact of inflation and widespread institutional adaptation to that fact. What is not so apparent is just where and how hard monetary tightening might eventually bite under these altered circumstances. On the other hand, reduction of the growth rate of Federal expenditures can have a more predictable and equitable effect in the present setting.

Tangible progress is being made in the area of fiscal restraint. In January of this year, the 1979 fiscal Federal budget deficit was estimated at $60.5 billion. In July, the Mid-Session Review of the 1979 budget lowered the deficit estimate to $48.5 billion -- $12 billion below the initial estimate. More recently the Office of Management and Budget has recommended a further $5 billion reduction in fiscal 1979 outlays to the Congress. Behind the scenes, planning is going forward on the fiscal year 1980 budget. There are groans and cries of distress from executives with programs to administer for the momentum of Federal spending is strong. But the President has established counter-momentum

for spending restraint, and he "ain't foolin." I am a member of a task force created to find ways of improving efficiencies in government and reducing the budget, and we are invested with full support from the White House.

Treasury has a special interest in this process of Federal restraint. First, we are responsible for the financing of the budget deficits that actually result and are fully aware of the financial dislocations that excessively large deficits can cause. Thus far in the current expansion, debt management objectives have been met without constricting the availabiliy of credit for private borrowers. Restraint over growth in Federal spending and close control of the expansion of Federal credit programs can help insure the continuation of that good financial record.

Second, we at Treasury are responsible for the continued efficiency of the tax system. Revenue losses arise from the use of the so-called tax expenditures which allow special tax breaks to individuals or corporations. It is pleasant to use euphemisms such as "tax credits" for the less palatable term "subsidy." But that's what tax credits are. And we must apply as rigorous standards in restricting subsidies resulting from tax breaks as we are in disciplining ourselves with respect to direct handouts. It makes little sense to hold down budget outlays but to use tax expenditures indiscriminately.

If fiscal restraint is the order of the day, one might question why the Administration is supporting a tax cut in the $15 to $20 billion range. We do not rest our case on the debatable supply side effect which the Kepm-Roth adherents claim to have discovered. They seem to think there is a free lunch. We know there is not. But the modest tax cut that we are advocating would only partially offset the drag otherwise imposed by higher social security taxes and the effects of inflation pushing taxpayers into higher brackets. In short, there would be little net fiscal stimulus but a gradual move toward restraint.

The other major element in the fight against inflation is the deceleration strategy. Wages and prices are caught up in a self-reinforcing spiral which benefits no major segment of the public. Over the past decade, real wages have been virtully flat despite large increases in monetry compensation. Also, after adjustment for inflation and cyclical swings, the return to capital has actually drifted down slightly. Neither labor nor capital has benefited from the inflationary spiral. And, in the process, heavy losses have been inflicted on other segments of the population. Public attitudes have, therefore, shifted strongly against an indefinite continuation of inflation at current rates. This provides a potential base of support for any sensible measures to reduce inflationary pressures.

The problem is how to insure that inflation can be unnwound without asking for an unrealistic sacrifice from either labor or business. It is not clear that the final solution has been

found. We are in the process of reviewing ways in which the current deceleration strategy might be strengthened and made more effective. It is no secret that the so-called TIP plans are under intensive reexamination to determine whether or not they are a practical step to recommend. And other avenues of relief from inflationary pressure are being explored.

Indeed, our reexamination is covering every alternative except controls. For the umpteenth time, let me stress our rejection of the controls approach. As Santayana said, "he who refuses to read history is condemned to repeat it." We have read the history of the late 60's and early 70's. We remember that a process of trying to reduce inflation by protracted deflation of the economy was unsuccessful and was abandoned for controls. And we remember that controls were unsuccessful and counterproductive and were abandoned just before the price explosion in 1973. We're determined to find a better way of coping.

I have emphasized the need -- for both domestic and international reasons -- of making progress on the inflation front. At the same time, the Administration is vigorously pursuing an energy policy which places great emphasis on using the market price mechanism to achieve the necessary conservation in energy consumption. Contradictory? Perhaps! But illustrative of the policy-making problem I discussed early on, namely, that we often have to optimize two or more objectives rather than maximize only one. To continue subsidizing oil imports, to the detriment of our international trade account and to the detriment of the objective of energy conservation, would serve this nation poorly over the intermediate-term and long run, whatever short-term price benefits might appear to accrue. We can, and will, bring the cost of energy up to its true replacement cost. And we will do this in a way that is equitable and economically efficient.

Many of us working on the energy problem have gotten impatient for more decisive action on the legislative front. I think I understand some of the more mundane political considerations that have contributed to the protracted debate, but that is not my province of expertise. What is more impressive to me is that the slow, very deliberate pace of Congressional consideration must reflect an inarticulated perception that what is involved is the most dramatic change likely to occur in our social and economic structure in this quarter of the century.

Our postwar economic structure and its social values have been built very much on the basis of cheap, readily accessible energy. It is cheap energy that has permitted the realization of the middle-class idyll of a home in the suburbs with all the electrical gadgets one can imagine, the delights of shopping malls, the willingness and ability to commute long distances for work or play.

We now have to come into the era of expensive energy. It will be expensive because we will be at the mercy of a foreign cartel, or expensive because there will be major capital costs in developing adequate domestic alternatives. I think you must share with ~~me~~ respect for a President who is willing to force us

to face these unpleasant facts now, before they become unpleasant realities. And who has designed a program for conserving use and promoting supply, without allowing the economic rent to be siphoned off? And who has had the persistence to keep up the pressure on the Congress to act?

In my cataloguing of the economic policy issues of greatest moment this day, there is one on which I haven't touched, and deliberately so. This may appear strange in light of the media emphasis on the "dollar crisis." I have avoided specific discussion for several reasons. First, it is my observation that whenever a Treasury official speaks directly about exchange markets, the dollar drops -- whatever he might say. Second, I am not the right Treasury official to speak directly on the subject -- our Secretary and our Under Secretary for Monetary Affairs are the appropriate spokesmen on this issue. But finally, I think I have addressed the issue. As we are perceived to be making progress on our major domestic economic problems -- inflation and energy -- the fundamental strength of our economy will be more apparent to all investors, domestic and foreign.

Let me make one point in closing. Whenever a discussion focuses on policy issues of the day, the impression necessarily is created that we have only problems. To be sure, we have many and grave ones. But we do have some successes, and our legitimate concerns should not blind us to the areas where significant economic progress has been made.

The current expansion is now moving into its fourth year, a very long-lived recovery indeed. The list of accomplishments in this period is impressive:

-- Real GNP has risen on average at roughly a 5 percent annual rate from the recession trough, and now stands 11 percent above its previous peak.

-- Income per person -- after taxes and after correction for inflation -- has risen 13 percent since early 1975.

-- The rate of unemployment has been reduced from 9 percent to about 6 percent, and the ratio of employment to overall population has recently been at record highs.

-- Real business fixed investment, so essential to our long-run economic performance, has rebounded after lagging early in the recovery. Growth in real capital investment in the past year and one-half has proceeded at a vigorous 9 percent annual rate; in the second quarter of this year, real investment finally rose above its previous peak of early 1974.

We must be doing some things right in the economic policy area. Now we have to extend our winning streak to the as yet unconquered areas of inflation and energy. That's where the policy action is at.

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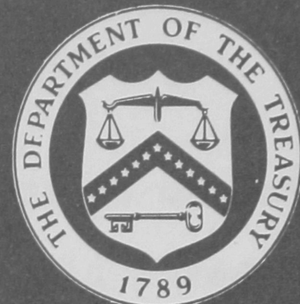

FOR IMMEDIATE RELEASE
EXPECTED AT 10:00 A.M. EDT
FRIDAY, AUGUST 25, 1978

STATEMENT BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

It is my privilege, on behalf of Secretary Blumenthal, to respond to your invitation to testify before the Committee on the question of Treasury gold sales and on S.2843, a bill to provide for the issuance of gold medallions by the Treasury. You have asked us to address a number of specific questions, Mr. Chairman, and I will do my best to respond.

The Monetary Role of Gold

The monetary role of gold, both domestically and internationally, has been declining progressively over a period of many years due to the general recognition that neither gold nor any other commodity provides a suitable base for monetary arrangements -- a view that is strongly shared by the Administration.

New gold production is strictly limited. Industrial demand is growing as GNP expands. Hence the residual supplies available for monetary use are both inadequate for, and unrelated to, the liquidity needs of an expanding national or world economy.

B-1133

Furthermore, the extreme volatility in the market price of gold makes it a high risk asset. For example, the price of gold moved from a peak of $195 per ounce at the end of 1974 to a trough of $104 in mid-1976, and back to a new high of $215 on August 16. As of August 24 the price was about $203 per ounce.

To our knowledge, there is no major nation in the world today in which official gold holdings act as an effective limit on the domestic money supply. The United States abandoned the domestic gold standard by a series of laws enacted in 1933-34 which effectively removed the domestic monetary system's direct link with gold. Moreover, the provision in the Federal Reserve Act for a gold certificate reserve against bank required reserves was eliminated in 1968. In August 1971, the U.S. also ended the convertibility into gold of United States dollars held by foreign monetary authorities.

Since August 1971, transactions in gold between central banks have been very rare and limited primarily to a few instances in which gold has been used as collateral for official loans; there have also been a few instances in which gold has been sold in the private market to acquire foreign currencies to finance balance of payments deficits. Basically, there is now a general reluctance among central banks to acquire gold, given the fact that there is no fixed official price and no commitment by any central bank to buy or sell, and in view of the volatile private price. I have attached at Table 1 a listing of the gold holdings of IMF members which shows the slow but steady decline in world gold reserves since 1972.

The amended IMF Articles of Agreement, which entered into force in April of this year, formally removed gold from its previous role in the international monetary system. The amendments contain three major changes with respect to gold. First, the official price of gold is abolished and gold loses its formal position as a common denominator for the IMF (and thus the international monetary system). Second, gold is eliminated as an important instrument in IMF transactions, and the IMF is prohibited from accepting gold unless specifically provided for by a decision requiring an 85 percent majority vote. Finally, the IMF is empowered to dispose of its remaining gold holdings in a variety of ways. These actions constitute important progress in phasing out the monetary role of gold.

In 1976, the IMF initiated a four year program to dispose of one-third of its gold holdings, with 25 million ounces being sold at public auction for the benefit of developing countries and a further 25 million ounces sold to members in proportion to their quotas at the official price of SDR 35 per ounce. Thus far, the IMF has held 24 public auctions at which about 15 million ounces of gold were sold, at a profit of nearly $1.7 billion. About 12.3 million ounces have been distributed to members under the second program, of which the United States has received about 2.8 million ounces. (See Table 2)

The United States has strongly supported these changes. This Administration, like its predecessors, considers gold to be an unsuitable basis for a stable monetary system. This view has been endorsed by the Congress, which authorized the actions removing gold from the U.S. domestic monetary system

and approved the recent amendments to the IMF Articles by a wide margin. In its 1973 report on the amendment of the Par Value Modification Act, the Senate Banking Committee stated that "it is important that a reformed international monetary system calls for a diminished role for gold and eventual removal of gold from the center of the system. In that connection the Committee believes that sales of gold in the private market from official monetary stocks could make an important contribution to this goal and to more orderly conditions in international currency markets."

Consistent with the general move toward elimination of a monetary role for gold, and toward its treatment internationally and domestically like any other commodity, the United States repealed the prohibition on the holding of gold by private U.S. citizens effective December 31, 1974.

At that time, U.S. gold stocks totaled 276 million ounces, a sum roughly equivalent to nine times the world's annual production of new gold. Given the reduction in gold's utility as a monetary reserve, and the fact that strategic requirements are less than the volume of annual domestic production, gradual disposal of these stocks has been appropriate and has contributed to two important U.S. objectives -- continued demonetization of gold and a reduction of our trade and current account deficits. (Since the United States acquired 2.8 million ounces from the IMF in 1977 and 1978 under the restitution program, the total U.S. stock despite the sales program has risen to 277 million ounces as of end June.)

At the same time, the market for gold can be affected importantly by the rate at which the United States and others dispose of gold, and we have faced the task of determining under what circumstances and at what rate we should sell.

Two auctions were held in 1975, at which a total of 1.3 million ounces of gold were sold. Shortly after the Carter Administration took office, Chairman Reuss of the House Banking Committee wrote to Treasury Under Secretary Solomon urging the resumption of U.S. gold sales. In response, Mr. Solomon stated that U.S. policy remained to sell gold from time to time to help meet U.S. demand for imported gold and in support of our objective of reducing the monetary role of gold. He indicated that the timing of such sales would depend *inter alia* on U.S. demand for gold imports, the IMF gold sales program, the needs of other countries to sell gold for balance of payments purposes, and progress towards eliminating gold's monetary role.

The Treasury Gold Sales Program

On April 19, 1978 Treasury announced the initiation of a series of monthly gold auctions, indicating that auctions of 300,000 ounces each would be held for six months and that the amounts to be offered in subsequent auctions would be determined in the light of the initial experience. Four auctions have now been completed, and Treasury earlier this week announced monthly sales of 750,000 ounces beginning with the November auction. The new auction level will be maintained for four months, with amounts to be offered at

subsequent auctions to be determined well before the end of the four-month series.

This latest action is being taken on the basis of two main considerations. First, the sales program has operated smoothly and the results to date (summarized in Table 3) have been quite satisfactory, with receipts of $230 million having reduced the U.S. trade and current account deficits by a roughly equivalent amount. Our judgment is that the market should be able to absorb substantially larger U.S. sales without serious difficulty.

Second, the United States must take all appropriate actions to improve its trade and current account positions. A variety of measures is needed -- most importantly to reduce our energy imports, to combat inflation, to promote exports, and to encourage satisfactory growth abroad.

Sales of gold can also make a significant and quite tangible contribution to this effort. At the new level of 750,000 ounces per month, such sales will be at an annual rate nearly equal to the 9-1/2 million ounces of net U.S. gold imports in 1977. At current prices, this would represent an improvement in the trade position of about $1.8 billion annually. The sales will also represent continued progress toward elimination of gold's monetary role.

The United States has been a major importer of gold. Net imports (on a balance of payments basis) last year totalled 9.5 million ounces, including 1.6 million ounces of gold imported in the form of coins. In the first half of 1978, net imports amounted

to 4.8 million ounces, of which 1.5 million ounces were coins. In 1977, net U.S. gold imports were equivalent to roughly 18 percent of supplies coming onto the world market, including new gold production and sales from stocks. Sources of gold moving into world markets and their estimated uses are shown in Table 4. These are rough estimates, but they help to provide a composite picture of the world gold situation.

Table 5 offers a similar estimate of sources and uses of gold for the United States alone. You will note that the domestic demand for gold, including demand for inventories and trading purposes, has been running about five times domestic production, leaving us primarily dependent on imports in the absence of sales from the Treasury stock.

The figures on gold transactions reported in the U.S. balance of payments statistics need a bit of explanation. The relevant data assessing the balance of payments impact of the gold sales program are those presented on a balance of payments basis. They differ substantially from the data series on U.S. gold trade compiled by the Census Bureau, which records the actual physical movement of gold into and out of the United States (Table 6). The Census data show large net exports of bullion in 1977 (rather than net imports), and also very small net exports during the first six months of this year.

In measuring the balance of payments impact The Census data must be adjusted to reflect the fact that, in addition to actual physical shipments of bullion into and out of

the country, there are very large amounts of foreign-owned gold -- especially those stocks held at the New York Federal Reserve Bank for the IMF and foreign central banks -- already physically located in the United States. Sales from these stocks -- for example, when the IMF holds one of its periodic auctions -- into the private New York market are included in U.S. import statistics on a balance of payments basis, but not on the Census basis. Transactions between central banks are excluded entirely from the U.S. statistics on either basis. With the exception of transactions between central banks, all physical shipments of gold abroad show up in the Census export statistics. Since much of this gold originated in central bank or IMF stocks already in the United States, the Census data do not record the offsetting import and thus give the impression that the United States is a net exporter of gold when in fact we are a net importer, as the data on a balance of payments basis show.

The principal purchasers of gold at the U.S. auctions have been seventeen firms and banks which specialize in gold trading. The largest purchasers of the 1.2 million ounces sold through August have been the Dresdner Bank (641,600 ounces), the Swiss Bank Corporation (145,200 ounces), the Union Bank of Switzerland (128,000 ounces) and the Bank of Oman (100,000 ounces). These firms normally purchase for the account of their customers; the ultimate buyer and his purpose cannot be identified.

The fact that large purchases have been made by firms owned by residents of the United Kingdom, Switzerland, and Germany does not necessarily mean that the purchases are for the account of foreign customers. These firms have branches in the United States and are active suppliers and dealers of gold in the United States. Furthermore, U.S. trade figures show that very little of the Treasury gold has actually been exported. This suggests that it is effectively being sold to U.S. customers, particularly since the Treasury gold is industrial grade needed by U.S. fabricators.

You have asked about the factors which determine the market price of gold, and about the impact of the Treasury sales on that price. There are no definitive answers to either question. There are two widely divergent types of demand for gold, and they react to changing conditions in very different ways. Industrial and commercial demand appears to follow a pattern quite similar to that of demand for other metals. When the economy is growing rapidly, industrial and commercial demand for gold will grow. When the price rises rapidly, particularly in relation to the prices of other metals which can be used as substitutes, the industrial and commercial demand slackens.

The hoarding demand for gold, however, rises when the fear of inflation grows and falls when there is a prospect of growing price stability. In some periods, the prospect for price stability has been such that hoarding demand has disappeared and there have been efforts to dispose of such holdings.

It is not possible to say what effect the Treasury gold sales have had on the gold price. As a significant addition to supply, one would expect some price effect. However, the impact has not been such as to disrupt the market or to be inequitable to American producers and firms holding gold inventories.

All sales at the Treasury auctions have called for payment in U.S. dollars. In announcing the sales program last April, Treasury stated that it planned to study technical aspects of selling gold against payment in West German Deutschemarks, with a view to determining whether sales of gold would provide a technically feasible and advisable means of acquiring Deutschemarks for use in countering disorderly conditions in foreign exchange markets.

The major gold markets, both here and abroad, operate in U.S. dollars. Prices are normally quoted in U.S. dollars and payment is normally made in U.S. dollars. Typically, non-residents of the United States who buy gold in these markets either use existing dollar balances or enter the foreign exchange markets to buy dollars with which to purchase the gold.

If Treasury were to call for payment in Deutschemarks at its auctions, it is likely that many buyers, whether American or foreign, would sell dollars on the foreign exchange market to obtain the Deutschemarks to make the payment. Holders of Deutschemarks might simply forego purchases of

dollars which they would have had to make to finance a gold purchase payable in dollars. In such cases, the initial impact on the dollar's position on the foreign exchange markets would be negative, and the subsequent sale of Deutschemarks by the Treasury would do little more than offset the earlier adverse impact. Nonetheless, the situation is not absolutely clear, and it may be that at some point such sales would appear desirable.

The Manufacture and Sale of Gold Coins and Medallions

American residents presently have ample opportunities to buy gold in small amounts, both in coins and other forms. A number of bullion coins currently being minted are available in the United States, such as the Krugerrand, Mexican peso, Austrian krona, and British sovereign. These coins contain 1/4 ounce to 1 ounce of gold. Small gold bars, produced by Swiss banks, are also available in the 1/2 ounce and 1 ounce sizes.

The markup charged by South Africa on the Krugerrand, 3 percent over the bullion price, is enough to cover only the minting and advertising costs to the South African Chamber of Mines which markets the coin. The dealers, in turn, are free to take what markup they can, but efficient competition has generally limited this markup to an additional 2 to 3 percent above the gold value of the coin.

For this reason, private minters of gold medallions have been unable to compete effectively with the Krugerrand. One United States refiner, Engelhard Industries, did mint

a one ounce medallion called the "American Prospector," which was sold to dealers at the same markup as the Krugerrand. However, only about 20,000 of these medals were sold before the effort was ended because it was felt that the advertising costs necessary to sell large amounts of the medallion would be too high to permit a reasonable profit.

Official production of gold medals and medallions has been very small. Most countries that have produced gold coins in recent years have done so for a combination of revenue and commemorative purposes. The markup on such issues has usually run from 50 percent to 100 percent over the market value of the gold in the coin, and the issues have usually been limited in order to enhance their numismatic value. For example, of the forty-nine countries that minted gold coins in 1977, forty-two limited the issues to less than 15,000 ounces each. The total official gold coinage by all countries other than South Africa in 1977 contained only 1.5 million ounces of gold. South Africa and the USSR were the only countries producing coins as a technique for marketing gold production, rather than for coinage profit or a commemorative purpose. The minting of Krugerrands amounted to 2.9 million ounces in 1977 and 2.7 million in the first half of 1978.

The American Bicentennial Administration produced three Bicentennial gold medals in 1976, as part of a program of selling bronze, silver, and gold medals. The Treasury sold gold to

the Bicentennial Administration at the current market price and the Administration contracted with the Mint to produce the medals. Sales of the medals involved about 36,000 ounces of gold and yielded profits of about $2.7 million which were used to finance Bicentennial activities. This also was a limited issue sold as a collectors item.

Proposed Gold Medallion Act

Let me turn now to the bill on which you have asked us to comment. S.2843 would provide that, upon determination by the Secretary of the Treasury to sell gold, all or part of the sales would be in the form of one ounce and one-half ounce gold medallions. The first 1.5 million ounces to be sold in the first fiscal year after the passage of the Act would be required to be sold in this form, while any remaining gold to be sold could be in a manner as the Secretary deems appropriate. In following years, the Secretary of the Treasury would have the discretion to determine the number of medallions to be produced and sold in light of anticipated import demand.

The medallions, although not legal tender, would have the style of coins, with the Great Seal of the United States on one side. The bill specifies that they would be sold at market-related prices and in a manner to encourage broad public participation. The purposes of producing the medallions would be to reduce sales to the American public of South African Krugerrands and other similar gold coins, and to provide U.S. citizens the opportunity to buy a United States-issued source of gold.

The Administration believes that issuance of gold medallions as called for by this bill would be unwise and inappropriate for several reasons.

On the one hand, there would be little, if any, additional balance of payments or budgetary receipts from the sale of gold medallions rather than gold bullion. In order to compete against the one ounce Krugerrand, any U.S. gold medallion would have to be priced close to the market value of the gold bullion content, as is the case of the Krugerrand.

In addition, there would be direct budgetary costs arising from the manufacturing and distribution of the medallion. The U.S. Mint estimates that the cost of minting a U.S. medallion would be about $2 per medallion. While the General Services Administration is unable to make an accurate estimate of distribution costs, the medallion would be expensive to distribute to the public on a wide basis. It should be borne in mind that the Krugerrand has been in production for some time and the distribution system is well developed and efficient. Furthermore, that coin is deliberately designed to develop a market for South African gold production, rather than to generate revenue.

While being of little or no budgetary or balance of payments benefit to the United States, the proposal in S.2843 would have several negative effects. It would: (1) raise questions about the Government's determination to fight inflation, (2) offer official encouragement to U.S. citizens to invest in a highly speculative commodity,

and (3) call into question the sincerity and credibility of the policy of eliminating the monetary role of gold, contrary to long-standing and widely supported U.S. policy. Accordingly, the Administration opposes the passage of S.2843.

First, the issuance of these medallions would tend to create the erroneous impression that the U.S. Government needs to supply the public with an officially issued gold piece as a hedge against inflation. This implication would be particularly apparent in the case of a medallion deliberately patterned after the Krugerrand, because the latter is actively promoted as a hedge against inflation.

There may have been one or two instances where the intent of governments in issuing gold pieces was to absorb domestic liquidity as a means of fighting inflation. For the United States, however, such a policy would be totally impractical. No amount of gold sales which could realistically be absorbed by the market would have any appreciable effect on liquidity in the United States, nor would such sales meet any needs that cannot be met by use of existing monetary policy instruments.

It is thus clear that gold medallion sales could make no positive contribution to the effort to combat inflation. They are much more likely to be harmful to that effort.

Second, the production and sale of an American medallion, as specified in S.2843, could be interpreted as a U.S.

Government effort to encourage investment in gold. The fact that the medallions were minted by the U.S. Government and bore the Great Seal of the United States would suggest to potential investors that the U.S. Government was favorably disposed toward such investment.

As I have pointed out, gold is a highly speculative commodity subject to volatile swings in price. The investor in such a Government-sponsored medallion at the end of 1974 would have seen the value of his investment drop by 47 percent by mid-1976. We should thus avoid any implication that the U.S. Government is promoting such investment.

U.S. citizens who want to buy gold for investment or speculative purposes can, of course, do so in the private markets now. There is no need for U.S. Government involvement to enable U.S. investors, large or small, to buy gold coins or medallions.

Third, there are certain aspects of S.2843 which would be inconsistent with the U.S. policy of continuing progress toward demonetizing gold. In introducing the bill last April Senator Helms suggested that a U.S. gold medallion would meet a commercial need in connection with payment of gold clause contracts. But such a use of these medallions would give them a clear monetary character.

In addition, the very existence of the U.S. Seal on the gold medallion would be an invitation to those who favor the remonetization of gold to press for designation of the

medallions as legal tender -- if not now, then at some subsequent date. Foreign governments might well question whether passage of this legislation meant that the U.S. Government was reconsidering its policy with respect to gold.

Conclusion

The trend toward demonetization of gold has evolved gradually but with steady progress over many years. This trend has reflected the inherent inadequacies of basing either a national or an international monetary system on a commodity. The United States and other nations have removed gold from their domestic monetary systems. Quite recently, the international community has followed this path formally through amendment of the Articles of Agreement of the IMF.

With the reduced monetary role for gold, continued large U.S. gold imports and trade deficits, and the existence of large U.S. gold stocks, it has seemed desirable to engage in a program of gold sales by the Treasury. The sales have been successful, and it is desirable to maintain flexibility to adapt the program to changing circumstances.

The proposed gold medallion legislation would add nothing toward achieving any of the objectives which are already being met by the bullion sales program. To the contrary, it would raise some important problems and questions concerning U.S. domestic and internationl economic policy. For these reasons we urge the Committee not to approve this proposal.

oOo

Table 1

GOLD RESERVES

End of Period; Millions of Ounces

	1972	1973	1974	1975	1976	1977	1978 (May)	Change a/ 1972 - 1977	Change a/ 1978 to date
World	1,177.6	1,176.4	1,175.3	1,174.1	1,164.0	1,154.7	1,152.1	-22.9	-2.6
IMF	153.4	153.4	153.4	153.4	149.5	131.6	128.6	-21.9	-3.0
IMF Members									
All Countries	1,017.3	1,017.4	1,015.9	1,014.8	1,009.9	1,011.7	1,013.4	- 5.6	+1.7
Industrial Countries	850.1	850.7	850.7	849.4	849.3	857.0	859.1	+ 6.3	+2.1 b/
Other Europe	51.9	52.0	52.4	52.3	52.3	49.2	48.0	- 2.7	-1.2
Australia, N.Z., S. Africa	25.4	26.4	25.7	25.1	20.1	17.4	17.6	- 7.9	+0.1
Oil Exporting Countries	33.3	33.7	34.3	34.9	37.0	34.4	34.6	+ 1.0	+0.2
Other Less Developed Countries	56.0	54.7	52.9	53.1	51.3	53.7	54.1	- 2.3	+0.4

a/ As part of the 1975 IMF gold agreement, the IMF has initiated a program to dispose of one-third of its gold holdings by selling 25 million ounces at public auction for the benefit of developing countries and restituting a further 25 million ounces to members by sales at the official price. The change in IMF gold holdings in 1976 and subsequent periods reflect these transactions. Information on these IMF gold transactions are listed below and are based on data contained in the IFS.

IMF Gold Transactions: In Period
(million ounces)

	1976	1977	1978 (to May)
Restitution	--	11.9	0.3
Sales	3.9	6.0	2.6
TOTAL	3.9	17.9	2.9

b/ Reflects change in Japanese gold reserves due to transfer of gold between government accounts.

Source: International Financial Statistics, August 1978

OASIA/OFEO:JNisenson
August 24, 1978

Table 2

IMF Gold Auctions: Summary Statistics

Date (1)	Pricing method (2)	Place of delivery (3)	Ounces bid (thousands) (4)	Subscription ratio 1/ (5)	Number of bidders: Total (6)	Number of bidders: Successful (7)	Number of bids: Total (8)	Number of bids: Successful (9)	Cut-off price (10)	Average award price (11)	Average market price 2/ (12)	Differential (11)-(12) (13)
June 2, 1976	Common	New York	2,320.0	2.97	30	20	220	59	126.00	126.00	126.78	-0.78
July 14, 1976	Common	New York	2,114.0	2.71	23	17	196	56	122.05	122.05	122.23	-0.18
Sept. 15, 1976	Bid	New York	3,662.4	4.70	23	14	380	41	108.76	109.40	110.38	-0.98
Oct. 27, 1976	Bid	New York	4,214.4	5.40	24	16	383	37	116.80	117.71	117.75	-0.04
Dec. 8, 1976	Common	London	4,307.2	5.52	25	13	265	33	137.00	137.00	135.15	1.85
Jan. 26, 1977	Common	New York	2,003.2	2.57	21	15	192	49	133.26	133.26	132.55	0.71
Mar. 2, 1977	Bid	New York	1,632.8	3.11	21	7	187	14	145.55	146.51	144.98	1.53
Apr. 6, 1977	Bid	New York	1,278.0	2.43	18	11	136	22	148.55	149.18	147.90	1.28
May 4, 1977	Bid	New York	1,316.4	2.51	17	14	107	38	147.33	148.02	147.85	0.17
June 1, 1977	Common	New York	1,014.0	1.93	14	13	75	35	143.32	143.32	143.80	-0.48
July 6, 1977	Common	Paris	1,358.4	2.59	15	15	83	35	140.26	140.26	140.80	-0.54
Aug. 3, 1977	Common	London	1,439.2	2.74	18	16	136	44	146.26	146.26	145.93	0.33
Sept. 7, 1977	Bid	New York	1,084.4	2.07	15	11	115	21	147.61	147.78	147.25	0.53
Oct. 5, 1977	Bid	New York	971.2	1.85	17	12	103	32	154.99	155.14	155.13	0.01
Nov. 2, 1977	Bid	London	1,356.4	2.58	18	7	90	21	161.76	161.86	161.63	0.23
Dec. 7, 1977	Common	New York	1,133.6	2.16	19	19	108	58	160.03	160.03	160.45	-0.42
June 4, 1978	Common	New York	984.8	1.88	19	19	103	64	171.26	171.26	172.18	-0.92
Feb. 1, 1978	Common	Paris	598.4	1.14	17	17	76	62	175.00	175.00	176.50	-1.50
March 1, 1978	Bid	New York	1,418.0	2.70	19	16	127	76	181.13	181.95	183.15	-1.20
April 5, 1978	Bid	New York	1,367.0	2.60	21	15	122	30	177.61	177.92	178.53	-0.61
May 3, 1978	Bid	London	3,104.0	5.91	24	17	192	36	170.11	170.40	170.38	+0.02
June 7, 1978	Bid	New York	1,072.4	2.28	21	15	137	28	182.86	183.09	182.95	+0.14
July 5, 1978	Bid	New York	797.2	1.69	22	19	101	44	183.97	184.14	184.20	-0.06
August 2, 1978	Bid	New York	1,467.6	3.12	21	20	117	42	203.03	203.28	203.25	+0.03

1/ The ratio of total bids to the amount on auction, i.e., 780,000 ounces in the auctions from June 2, 1976 through January 26, 1977; 525 000 ounces in auctions from March 2, 1977 through May 3, 1978; and 470,000 ounces in subsequent auctions.

2/ Average of London fixing prices on auction day.

8/21/78

U.S. Treasury Gold Sales
1978

	May 23	June 20	July 18	August 15
Number of Bidders	44	31	27	17
Quantity bid (troy ounces)	1,364,000	1,036,000	1,385,600	564,400
Number of successful bidders	12	21	9	12
Quantity sold (troy ounces)	300,000	300,000	300,000	300,000
Price range of awards	$180.01-$182.35 per oz.	$186.52-$190.29 per oz.	$185.05-$189.00 per oz.	$213.23-$216.17 per oz.
Average Price	$180.38 per oz.	$186.91 per oz.	$185.16 per oz.	$213.53 per oz.
London Second Fixing	($179.75)	($186.50)	($184.85)	($213.20)
Proceeds (millions of dollars)	$54.1	$56.1	$55.5	$ 64.1
Retirement of gold certificates	$12.7	$12.7	$12.7	12.7
Miscellaneous receipts of the Treasury	$41.4	$43.4	$42.8	51.4

August 21, 1978

Table 3

TABLE 4

World
Supply and Demand for Gold
(millions of ounces)

Production	1975	1976	1977
South Africa	22.9	22.9	22.5
Canada	1.7	1.7	1.8
United States	1.0	1.0	1.0
Other	5.2	6.5	5.8
Total	30.8	31.2	31.1
Net Communist Sales	4.8	13.3	12.9
IMF Sales		3.9	6.0
U.S. Sales	1.3		
Other Official (net)	- 1.8	- 1.6	1.8
Total Other	5.3	15.5	20.7
Total Supply	36.0	46.7	51.7
Fabrication Demand			
Jewelry	16.6	30.0	31.5
Other Industrial Fabrication	5.8	6.7	7.2
Official coins	7.8	5.9	4.4
Fake coins, medals	0.7	1.5	1.6
Bars for Hoarding	0.2	5.7	2.2
Residual 1)	5.0	-3.0	4.9
Total	36.0	46.7	51.7

Source: Gold 1978,
Consolidated Gold Fields Ltd.

1) Believed to be bars for investment, includes errors in estimating supply and demand.

August 21, 1978

Supply and Distribution of Gold in the United States
(millions of ounces)

	1975	1976	1977	Jan.-June 1978
Source				
Domestic Production [2/]	2.2	2.0	2.1	1.3
Treasury Sales	1.3			0.3
Net Imports of Bullion	0.6	4.8	7.9	3.3
Gold Coin Imports	1.7	1.3	1.6	1.5
Total	5.8	8.1	11.6	6.4
Uses				
Industrial & Commercial Fabrication	3.7	4.7	4.9	2.3
Commodity Exchange Stocks 1/	0.5	- 0.2	1.5	1.2
Industry Stocks	0.1	-	1.0	- 0.9
Coin Purchases	1.7	1.3	1.6	1.5
Unexplained	- 0.2	2.3	2.6	2.3

1/ Includes gold held by dealers to back up trading on commodity futures exchanges.

2/ Refinery Production which includes gold from U.S. mining output and old scrap. These were 1.0 million ounces, and 1.1 million ounces respectively in 1977.

August 22, 1978

Table 5

Table 6

United States Foreign Trade in Gold by Month - 1977/78
(Thousands of Ounces)

	Gold Bullion									
	Imports				Exports					
1977	Census (1)	IMF Account (2)	Foreign Accounts (2)	Total	Census (1)	Foreign Accounts (2)	Total	Net Imps. & Exps. (1)	Gold Coin Imports	Total Net Imps. & Exps. (1)
Jan.	227	-	959	1,186	1,103	-	1,103	83	160	243
Feb.	175	780	167	1,122	481	-	481	641	112	753
Mar.	183	514	236	933	42	-	42	891	122	1,013
Apr.	161	32	259	452	13	-	13	439	111	550
May	194	1,025	937	2,156	671	-	671	1,485	137	1,622
June	615	529	165	1,309	197	32	229	1,080	92	1,172
July	182	-	188	370	1,642(3)	64	1,706	-1,336	39	-1,297
Aug.	190	-	965	1,155	664	18	682	473	124	597
Sept.	601	525	560	1,686	50	41	91	1,595	94	1,689
Oct.	287	525	803	1,615	1,612	-	1,612	3	121	124
Nov.	1,072	-	1,120	2,192	259	-	259	1,933	157	2,090
Dec.	372	525	214	1,111	510	11	521	590	345	935
	4,259	4,455	6,573	15,287	7,244	166	7,410	7,877	1,614	9,491
1978										
Jan.	443	525	672	1,640	1,061	164	1,225	415	227	642
Feb.	191	-	43	234	146	-	146	88	231	319
Mar.	773	525	55	1,353	207	31	238	1,115	365	1,480
Apr.	523	525	32	1,080	1,028	32	1,060	20	158	178
May	289	-	129	418	188	14	202	216	321	537
June	434	463	638	1,535	126	-	126	1,409	187	1,596
	2,653	2,038	1,569	6,260	2,756	241	2,997	3,263	1,489	4,752

(1) Includes small amounts of ores, scrap, and base bullion.
(2) Gold delivered to and from foreign official accounts at the Federal Reserve Bank of New York.
(3) Exports for the month of July 1977 include 1,602 million ounces which were actually exported in prior months.

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

FOR RELEASE AT 4:00 P.M. August 25, 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 $5,600 million, to be issued September 7, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,606 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $2,200 million, representing an additional amount of bills dated June 8, 1978, and to mature December 7, 1978 (CUSIP No. 912793 U7 9), originally issued in the amount of $3,403 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,400 million to be dated September 7, 1978, and to mature March 8, 1979 (CUSIP No. 912793 X3 5).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing September 7, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $ 3,445 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 Daylight Saving time, Friday, September 1, 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-1134

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 September 7, 1978, in cash or other immediately available funds or in Treasury bills maturing September 7, 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.

partment of the TREASURY NEWS
HINGTON, D.C. 20220 TELEPHONE 566-2041

FOR IMMEDIATE RELEASE
August 24, 1978

Contact: George G. Ross
202/566-2356

UNITED STATES AND HUNGARY REACH TECHNICAL AGREEMENT ON PROPOSED INCOME TAX TREATY

The Treasury Department today announced that representatives of the United States and Hungary have reached agreement at the technical level on a proposed income tax treaty between the two countries. The two delegations will submit the proposed text to their governments for the necessary review prior to signature.

The proposed treaty will be the first such treaty concluded between the United States and Hungary. It is intended to facilitate economic and cultural relations between the two countries by removing income tax obstacles to such relations. The proposed treaty will clarify the rules governing income tax jurisdiction, and will provide for administrative cooperation between the tax authorities of the two countries to avoid double taxation of income.

The proposed treaty between the United States and Hungary is similar to agreements concluded by the United States with Poland and Romania, and to the model draft treaty published by the Organization for Economic Cooperation and Development (OECD) in January 1977. Thus, it provides rules for the taxation at source of business, investment and employment income, specifies the method to be used by the residence country to avoid double taxation, guarantees nondiscriminatory treatment and provides for mutual consultations to resolve any problems which might arise in implementing the treaty and avoiding double taxation.

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B-1135

partment of the TREASURY NEWS
INGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE UPON DELIVERY
Expected at 9:30 a.m.

TESTIMONY OF
DANIEL I. HALPERIN
ACTING DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION)
OFFICE OF TAX POLICY, DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE
August 28, 1978

Mr. Chairman and Members of this Subcommittee:

I am pleased to have this opportunity to appear before you this morning to present the views of the Department of the Treasury on the nine bills on the Subcommittee's agenda. These bills range from items that the Treasury regards as relatively noncontroversial to those that raise what we view as very serious policy problems meriting considered review by this Subcommittee. With respect to the less controversial or more narrow items -- H.R. 810, H.R. 4030, S. 2771, H.R. 5099 and S. 3345 -- I will outline briefly the Treasury's position, elaborating in appropriate instances in the appendix to my testimony.

The bulk of my testimony will be devoted to S. 1611 and S. 3049, both of which deal with product liability; S. 3176, dealing with contributions in aid of construction to the capital of certain public utilities; and S. 3341, the "Independent Local Newspaper Act of 1978".

H.R. 810, H.R. 4030, S. 2771,
H.R. 5099, S. 3345

H.R. 810 we regard as relatively noncontroversial. The Tax Reform Act of 1969 added a provision to the Code (section 4941) which in general prohibits certain transactions between private foundations and certain "disqualified persons," by imposing a graduated series of excise taxes on the disqualified person (and in certain circumstances on the foundation manager). Government officials are "disqualified persons" for this purpose except for certain specifically set forth transactions including the payment of expenses of domestic

travel. The bill would provide an additional exception for payment or reimbursement of foreign travel expenses of a government official by certain foundations within specified limits.

The Treasury Department recommends that H.R. 810 be amended to limit the permitted amount of reimbursable transportation expenses to the cost of the lowest coach or economy air fare charged by a commercial airline.

The recommended change would make the reimbursable amounts under the bill consistent with the limitation on deductions for attending foreign conventions under the Administration's 1978 tax program. Treasury would not oppose H.R. 810 if this change were made.

H.R. 4030, in contrast, would amend the provisions governing the activities of private foundations in a manner the Treasury does not support. It would create an *ad hoc* exception to the tax on excess business holdings of a private foundation (section 4943) in cases where the foundation owns over 50 percent of the voting stock of a public utility which had taxable income of less than $1 million during its first taxable year ending after May 26, 1969 if certain other conditions are met. While there were a variety of considerations underlying the provisions of the Tax Reform Act of 1969 that were designed to eliminate the use of private foundations to preserve control of business enterprises, one principal consideration was that the presence of control on the part of the foundation would tend to direct the foundation's efforts toward operating the business and to divert its attention from its legitimately charitable purposes. The Treasury Department opposes H.R. 4030 not only because it creates a special *ad hoc* exception to section 4943, but also because, by preserving the opportunity for private foundations to control certain kinds of taxable businesses, it would tend to undermine one of the policies of section 4943. Our views on H.R. 4030 are set forth in greater detail in the appendix.

S. 2771 would exempt from the unrelated trade or business income tax generally applicable to exempt organizations, income from the conduct of bingo and similar games of chance. Eligible games are defined as those in which wagers are placed, winners determined, and prizes distributed in the presence of participant. The bill also would require that such games not be "ordinarily carried on on a commercial basis" and that their conduct not be in violation of applicable local law. One of the underlying policies of the unrelated business income tax is to prevent unfair competition by tax exempt organizations with commercial enterprises. Because in many states bingo may be regularly carried on only by

exempt organizations, it is arguably consistent with this underlying policy not to tax the income from such games. Consequently, Treasury would not oppose this legislation provided that it was limited to the conduct of bingo and did not confer tax exemption on income from other, essentially casino activities; and, that it was limited to the conduct of bingo in jurisdictions where, under applicable law, bingo may lawfully be carried on only by exempt organizations. We also regard it as essential to clarify S. 2771 to provide that exempting the income from bingo does not foreclose the possibility, which exists under current law, that where bingo has become an overly substantial part of the organization's activities the organization may forfeit its tax exemption. Modified in this fashion, the Treasury would not oppose this legislation. We do not endorse the effective date, which is retroactive to 1969.

The Treasury is also unable to support H.R. 5099, which would provide relief for two individuals who were unable to sell their old principal residence within 18 months after purchasing a new principal residence and thus did not qualify for the rollover of section 1034. It adversely affects the equity of our tax system to create special exceptions for particular taxpayers to general limitations with which the rest of us must comply. This bill would provide just such special relief. It has been suggested in support of this legislation that these individuals could have qualified for an extension of the rollover period available under section 1033 if their propoerty had been involuntarily converted. We have concluded, for the reasons set forth in greater detail in the appendix, that this premise is incorrect. The Treasury opposes H.R. 5099.

Finally, the Treasury supports S. 3345, which would make available to certain regulated investment companies--those that constitute Small Business Investment Companies (SBICs)--a deficiency dividend procedure similar to that now available for personal holding companies and real estate investment trusts. The Treasury sees no reason, indeed, why a deficiency dividend procedure should not be made available to all regulated investment companies, provided that the procedure were made identical with that accorded real estate investment trusts by the Tax Reform Act of 1976. (*See* §§1601(b)-(f) of P.L. 94-455.)

Product Liability (S. 1611, S. 3049)

Mr. Chairman, I would now like to turn to S. 1611 and S. 3049, both of which are measures designed to facilitate

self-insurance of product liability risks. With the Chair's consent, I would also like to consider with the Subcommittee an Administration-sponsored alternative to the approach taken by S. 1611 and S. 3049, both of which the Administration opposes.

Both S. 3049 and S. 1611 would amend Section 165 of the Code to provide current deductions for contributions to product liability self-insurance accounts. In both instances, annual contributions would be limited to a percentage of gross revenues subject to a dollar maximum, and the aggregate funding of the trust would similarly be subject to both percentage and dollar limitations. S. 3049, which constitutes the more comprehensive treatment, provides separate limitations for taxpayers in general and for those having a "severe product liability problem." Contributions are required to be made to an independently trusteed, segregated account, the assets of which may be invested only in Federal, State or local debt securities or instruments of deposit in a financial institution, and which may not be used for any purpose other than satisfying product liability losses. To the extent a product liability loss is paid out of the proceeds of the account, no further deduction under Section 165 is allowed, and penalty taxes are imposed to insure that proceeds of the account are not used for an inappropriate purpose. Special rules are provided for groups of affiliated companies and for contributions to a wholly-owned (or "captive") insurance company.

The tax treatment of product liability self-insurance is a subject that not only has been the source of lively public and Congressional debate, but has received a most thoroughgoing review by the Administration. My testimony on this subject will constitute an effort to share with this Subcommittee the reasons that have led the Administration to oppose S. 1611 and S. 3049 and to endorse an alternative proposal that would extend to ten years the carryback period for net operating losses attributable to product liability.

The nature and degree of the product liability problem has been thoroughly studied by an Interagency Task Force headed by the Department of Commerce. In its Final Report, the Task Force outlined a number of steps, including a variety of tort law revisions and changes to casualty insurance ratemaking practices, that ought to be seriously studied and possibly implemented to deal with the root causes of the product liability problem. At the same time, the Task Force Report suggested that _interim_ relief _might_ be

provided through the tax system. The relief considered in the report would have been to permit deductions within certain limits for contributions to self-insurance trusts. This proposal was recognized by the Task Force as being of an admittedly short-term nature, and to constitute no substitute for longer term revisions to local tort law and insurance ratemaking practices needed to deal with the root causes of the product liability problem. Moreover, the short-term tax recommendation was based principally on the perception that by permitting deductions for casualty insurance premiums but not for contributions to self-insurance funds, the tax law discriminated against self-insurance. The Task Force Report cautioned, however, that any such proposal should not be advanced without a more thorough study of its merits.

That follow-up study now has been completed. The Administration's conclusions and proposal were announced by Commerce Secretary Kreps on July 20, 1978. The reasons that led the Administration not to endorse a deduction for contributions to product liability self-insurance reserves are essentially three. First, the superficially appealing notion that the tax law discriminates in favor of commercial insurance and against self-insurance is in fact based on a misapprehension. Second, the existing proposals for current deductibility of contributions to self-insurance trusts provide an opportunity for deferral of taxes and thereby would operate to subsidize self-insurance. Because self-insurance is inherently inefficient by contrast with commercial insurance, and because of technical difficulties stemming from the inability to estimate future product liability losses, we concluded that extending such a subsidy would not be appropriate. Finally, we concluded that existing law, with some modification, would provide virtually the same tax benefits, other than deferral, as proposals providing current deductibility for contributions to a self-insurance trust, and with far less administrative complexity. The necessary modification, as I have already noted, would be to amend current law to provide a special 10-year net operating loss carryback, in contrast to the three-year net operating loss carryback generally available under current law, for losses attributable to product liability. Let me now explore each of these reasons in somewhat greater detail.

It is a misconception to believe that, because commercial insurance premiums paid in the ordinary course of a trade or business are deductible and contributions to a self-insurance trust are not, the tax law discriminates

against self-insurance. Product liability losses incurred in a trade or business are, of course, deductible when incurred under section 165 of the Code. The belief that the tax treatment of insurance premiums is more favorable must be based on the assumption that a deduction is allowed at an earlier point even if the insurance company is building up a reserve.* The deduction under 165 is disallowed, however, for any loss to the extent such loss is "compensated for by insurance or otherwise." Thus, the enterprise paying premiums for commercial product liability insurance may only deduct those premiums when paid or incurred. To the extent the loss is reimbursed by the insurer, however, no further deduction is permitted even though because of earnings on the reserve the total amount of losses might well exceed the premiums paid. If this were the case the total deduction to the self-insurer is greater and offsets the benefit obtained from the earlier deduction by those who use commercial insurance. Consequently, the tax treatment of self-insured and commercially insured losses is essentially symmetrical. There is no discrimination to be cured.

In view of the fact that the tax law does not discriminate against self-insurance, some other rationale for permitting current deductions to self-insurance trusts must be found. And, in considering the possibilities, one must recognize that conferring current deductions for contributions to self-insurance trusts, where such trusts are tax exempt, invariably gives rise to tax deferral.** That deferral constitutes a subsidy to self-insurance. Consequently, the pivotal question is whether any subsidy, and if so whether a subsidy in the form of deferral, is warranted.

Taking the second question first, the Administration concluded that if a subsidy for product liability self-insurance was appropriate, deferral was not the appropriate mechanism by which to deliver it. The benefits of deferral vary with the marginal rate of the taxpayer and with the period of time for which taxes are deferred. Thus, while a good many corporate taxpayers are in the top 48 percent bracket, those in lower brackets would benefit less. Similarly, the greatest benefits would accrue to those whose

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* To the extent commercial insurers do not build up a reserve, self-insurance obviously increases the total amount deducted.

** The earnings of the trust are in effect taxed at the time of the loss since no further deduction is allowed even though the loss exceeds the original contribution.

funds remained on deposit the longest, who well might be those with less in the way of product liability losses. Finally, because a subsidy in the form of deferral is off-budget, it is subject to less rigorous scrutiny than a subsidy required to be appropriated.

The Administration also concluded that the case for subsidizing self-insurance of product liability losses generally was not strong. The principal basis for this conclusion was that self-insurance very well may be the least efficient form of insurance. By "least efficient", I mean simply that, to self-insure, the insured party is required to put up $1 of capital for every dollar of risk insured. Because, in contrast, commercial insurance involves the pooling of covered risks, the amount of capital required per dollar of coverage is significantly smaller. Consider, for example, the case of four business enterprises each of which is reasonably certain that it will incur a $100 loss at some time during the next four years. None is certain when its loss will occur but probability tells us that if each of the participants has a one-in-four chance of incurring a loss during each of the next four years, it is likely that one of the four will incur a loss each year. For each firm to self-insure would require each to place roughly $100 in a self-insurance trust. If the four were, instead, to engage in a pooling arrangement similar to mutual insurance, each would have to tie up only roughly $25 each year. The $100 ($25 from each participant) would be pooled in the participants' mutual insurance company and would be used to pay the likely claim of the one participant who incurred a loss each year. By sharing their risks, each participant would thus be able to spread its contribution to the shared risks over a four-year period, rather than having to self-insure for nearly the full $100 for the entire period. Because of such economies in a risk-sharing arrangement, commercial insurance is inherently more efficient than self-insurance.

The problems with self-insurance are compounded where, as in the case of product liability, it is next to impossible to predict the magnitude of future risks. This difficulty is reflected by the fact that both S. 1611 and S. 3049 provide for deductions limited, not by a taxpayer's anticipated experience, but by a percentage of sales subject to ceilings on annual contributions and maximum funding of the product liability loss reserve account. Because such contributions are not limited, and indeed in practice could not be limited,

to amounts that bear some relationship to a taxpayer's actual experience, the contributions to such accounts well might be excessive for some taxpayers, wholly inadequate for others, and in only random instances would bear any relationship to the need of particular taxpayers. Because of this randomness, the amount of subsidy afforded by these proposals would also be random.*

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* Indeed, the amounts for which S. 3049 and S. 1611 would permit tax deductibility would not be properly accruable for financial accounting purposes. A reserve for self-insurance of possible future losses is in the nature of a general contingency reserve, the contingency in the case of S. 3049 and S. 1611 being possible future product liability loss. Statement number 5 of the Financial Accounting Standards Board ("FASB") provides that, before liability for a loss contingency may be recognized, (1) information available must indicate that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statement, and (2) the amount of the loss must be reasonably estimated. Under these provisions, contingency reserves constitute liabilities for which no accrual is permitted and FASB Statement number 5 specifically so provides. A potential liability of this type need not be disclosed in supplemental information unless there is a reasonable possibility that a loss has been incurred. This treatment is required by generally accepted accounting principles even though the reserve is funded through a segregated trust or through the use of a captive insurer.

It is also worth noting that amounts for which a deduction would be permitted by S. 3049 or S. 1611 would not have been deductible under the general rules, once promulgated by Congress, that would have conformed tax accounting to general accepted accounting principles. As originally enacted, the Internal Revenue Code of 1954 contained two sections--Sections 452 and 462--which would have allowed for the deferral of prepaid income and deductibility of additions to reserves for estimated expenses. These provisions were repealed retroactively in 1954. It is noteworthy that the regulations promulgated under Section 462 provided that allowable reserves for estimated expenses did not include reserves for general, undetermined contingencies for indefinite possible future losses. <u>See</u> Regulations Section 1.462-5(b)(4), T.D. 6134. Thus, even under the liberal standards of former Section 462, no deduction would have been allowed for additions to reserves for product liability losses.

Finally, the existence of exempt, self-insurance trusts would require complex administrative controls. For one thing, the Internal Revenue Service would be required to insure that such trusts were not overfunded and that their investments were limited in the manner required by, for example, S. 3049. Moreover, extremely complex accounting would be required to define the appropriate tax treatment to be applied on nonqualifying distributions from, or liquidations of, such product liability loss reserve accounts. Presumably, the sponsors of such provisions would wish to provide that, if an enterprise established a product liability loss reserve account and, after a number of years, decided that it no longer needed the account, the taxpayer should reap no benefits by virtue of having established and maintained the account. In order to give effect to this result, extremely complex accounting provisions would be required to bring the taxpayer back to square one. It would, I should note, not be sufficient simply to provide that all amounts distributed from the account be subjected to tax.

For all these reasons -- the fact that self-insurance is inherently inefficient, the fact that contributions to such accounts would bear no relationship to a taxpayer's actual experience, and the administrative complexity that these proposals would entail -- we do not think the Congress should endorse a provision that would subsidize such self-insurance through the tax system.

Having concluded that the Administration should not endorse proposals to subsidize through the tax system self-insurance of product liability risks, did not stop there. Apart from its deferral aspect, a proposal to allow a current deduction for contributions to a self-insurance trust can be regarded as a method of averaging product liability losses over a period of several years. For example, a taxpayer who put a thousand dollars in a product liability loss reserve account for each of 10 years, and who at the end of that 10 years incurred a $10,000 product liability loss, would effectively have spread the burden of that loss over a 10-year period. Thus, we asked whether there were any revisions to current law that might accomplish this result but that would not entail deferral. Under current law, the method by which taxpayers are permitted to average losses over a longer period than the year in which the loss is incurred is in the net operating loss carryover provisions of Section 172 of the Code. In general, a net operating loss may be carried back and applied against taxable income earned during the three years perceding, and carried forward

and applied against income in the seven years following, the year in which the loss was incurred. Where a net operating loss is carried back to a prior taxable year, it is applied against income earned during that year and gives rise to an immediate claim for refund of taxes paid on that income. In view of the fact that product liability may give rise to sporadic but extraordinary losses, we were prompted to inquire whether the three year carryback period of current law was adequate. In this connection, we noted that in some instances, for example financial institutions, the Congress had already concluded that a net operating loss carryback period of longer than three years would be appropriate, and we asked whether a similar proposal might not be adopted for net operating losses attributable to product liability. We have concluded, Mr. Chairman, that it would. Consequently, as you know, on August 1, 1978, the Administration forwarded to Chairman Long, Chairman Ullman and other interested members of the Congress a proposal to modify Section 172 to provide a ten-year net operating loss carryback for losses attributable to product liability.

Mr. Chairman, we believe that this net operating loss carryback proposal constitutes an appropriate tax response to the product liability problem and should be endorsed by this Subcommittee in lieu of proposals such as S. 3049 and S. 1611. As modified by this proposal, we believe that current law will provide nearly all the benefits to taxpayers--other than deferral of taxes--that they would obtain from being permitted to deduct contributions to a product liability self-insurance trust. In this connection, I would like to consider two arguments that have been raised in support of the contention that allowing a deduction for product liability set-asides would be preferable to current law, even as modified by the ten-year net operating loss carryback that the Administration has proposed.

First, it is said that by encouraging businesses to establish self-insurance reserves for product liability, measures such as S. 3049 would facilitate retention of product liability risks and put pressure on the insurance industry to reduce rates for commercial product liability coverage. The answer, we believe, is that nothing in current law precludes a firm from self-insuring by setting aside some reserves--in tax paid rather than pre-tax dollars--to provide for product liability risks. Indeed, a firm that desired to obtain under current law the equivalent in self-insurance through contributions to a self-insurance trust would be required to put up roughly half the amount in tax

paid dollars as would be required for a reserve funded with pre-tax dollars. This difference arises because, when a reserve is funded with after-tax dollars, the loss against which the reserve is maintained remains fully deductible and the deduction gives rise to a corresponding decrease in Federal income tax liability. Businesses will, therefore, remain free to self-insure a portion of their risk with after-tax dollars, knowing that, through their ability to deduct the loss, they are essentially "insured with the government" for the amount of the tax benefit of the deduction. Moreover, if the ten-year net operating loss carryback proposal is adopted, as we believe it should be, such businesses will have the assurance that the government will defray a portion of their loss even if they have no taxable income in the year the loss is incurred.

Second, it has been suggested that when a firm establishes a self-insurance reserve, the knowledge that its own money is "at stake" should a product liability loss be incurred will encourage it to show greater concern for the safety of its products. We believe that, under current law, and as modified by the Administration proposal, the incentive to make safe products will be every bit as great. The firm that self-insures without providing segregated self-insurance reserves--the firm that "goes bare"--has perhaps the greatest incentive to make safe products since, absent commercial coverage or a reserve, the equity in its business is at stake. This incentive would not be reduced by extending the net operating loss carryback for product liability losses. While the availability of that carryback would tend to insure that each taxpayer will realize immediately the tax benefits of being able to deduct the loss, even for a taxpayer in the 48 percent tax bracket, the government only pays 48 cents on each dollar of loss. To the extent of the other 52 percent, the taxpayer's reserve (if it has one), or its equity in its business (if it does not), remains at risk for the loss. Consequently, we do not think current law as modified by the ten-year net operating loss carryback, will diminish at all the incentives that exist to produce safe products.

In sum, Mr. Chairman, we believe that current law, as modified by a ten-year net operating loss carryback, provides an appropriate response to those who desire to encourage self-insurance of product liability risks. We think it would be far more equitable than either S. 3049 or S. 1611, since it would not involve tax deferral. We think it is far more efficient, since it neither requires nor forecloses

businesses from setting up self-insurance reserves--with tax- paid dollars--at the level they consider to be appropriate. And we think it would be far more simple to administer, since the loss carryback would come into play only to the extent it was necessary, and would not require cumbersome administrative machinery to police the use of self-insurance trusts. For these reasons, the Administration urges the Subcommittee to give favorable consideration to the ten-year net operating loss carryback proposal. It would oppose adoption of either S. 3049 or S. 1611.

Contributions in Aid of Construction to the Capital of Public Utilities (S. 3176)

S. 3176 would make contributions in aid of construction to regulated electric energy or gas public utilities eligible for treatment as nontaxable contributions to capital under section 118(b). This bill, which is framed as an extension of the treatment currently accorded water or sewerage disposal facilities by section 118(b) of the Code, invites this Subcommittee to reexamine the rationale for current law.

Section 118(b), added by the Tax Reform Act of 1976, provides that amounts received after January 31, 1976, as contributions in aid of construction by a water or sewerage disposal utility which are used for qualified expenditures and which are not included in the utility rate base for ratemaking purposes are treated as nontaxable contributions to capital of the utility.

An amendment to extend section 118(b) treatment to electric and gas utilities was offered on the Senate floor and defeated. The relief was limited to water and sewerage utilities because it was felt that they were more significantly affected than were other utilities. Moreover, the revenue loss, measured from a base which treated contributions as taxable income, was manageable if confined to water and sewerage facilities but could be as high as $200 million if gas and electric utilities were included.

The issue posed by S. 3176 is the appropriate tax treatment of contributions in aid of construction in general. The further question of what taxpayers other than water and sewerage disposal utilities should receive section 118(b) treatment must be dealt with as a separate issue only if it is decided that section 118(b) is correct as a general matter.

This is an extremely difficult and complex issue which is currently under study by the Treasury Department. Put simply, Treasury believes that section 118(b) is incorrect and can permit substantial amounts of income to be received tax free.* However, we would also agree that in some circumstances full current taxation of so-called "contributions to capital" would overstate actual economic income. Thus, in the absence of section 118(b) utilities would have to seek other forms of financing.

The issue posed is whether it would create significant difficulties for utilities and their customers, beyond a loss of tax exemption for real income, if they had to use the other means of financing. If this can be shown then we must either decide to provide a tax benefit or seek a third solution (which will not be easy) which will correctly measure income. In any event, we believe the matter requires substantial study and we continue to welcome input from all interested parties.

The "Independent Local Newspaper Act of 1978" (S. 3341)

S. 3341, the "Independent Local Newspaper Act of 1978," is designed to provide tax relief to those who own independent "local" newspapers. The Treasury Department opposes this bill, which in reality constitutes special relief legislation.

The bill is divided into two principal parts. The first permits the establishment of a trust by an independent "local" newspaper for the purpose of paying the estate tax attributable to any owner's interest in the business. The trust must have an independent trustee and its corpus may be invested only in United States obligations. The value of the trust cannot exceed 70 percent of the value of the owner's interest in the business. The income earned on the trusteed assets will be exempt from tax. The transfer of assets to the trust is deductible by the newspaper business, but is also excluded from the taxable income of the owner. The corpus of the trust is excluded from the owner's gross

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* Contributions in aid of construction represent a present payment for future services. As such they constitute gross income to the recipient. If we were to stretch the facts and assume that the contributor has made a loan to the utility to be repaid through reduced charges for services, it would seem that "interest" on this hypothetical loan should be taxed.

estate and the estate does not realize income when its estate tax liability is discharged by the trust.

The newspaper must have all its publishing offices located in a single state, and if it is a partnership or corporation, it cannot be traded on an established securities market. Deductions for transfers from the business to the trust are limited to 50 percent of the business profits.

The second part of the bill provides for an elective deferral of the estate tax attributable to the newspaper interest not otherwise paid from the assets of the estate tax payment trust essentially on the same terms as Code section 6166, with the same preferential 4 percent interest rate but without regard to the size of the interest in relation to the owner's estate.

I would like to take a few moments to examine the major aspects of the bill. First, the bill permits a deduction for earnings diverted to the estate tax payment trust. Although the bill provides that such a deduction is allowable under section 162, the payment in no way can be said to meet the "ordinary and necessary" business expense criteria of that section. Nor, is there in the tax law any other provision similarly allowing a deduction for amounts to be used to pay death taxes.

Second, the bill provides that the funds transferred to the estate tax payment trust will not be included in taxable income by the owner. To the extent that the newspaper business is held in corporate form, this payment would in all other cases be treated as a taxable dividend.

Third, the exemption of trust earnings is contrary to existing law which would normally, in this case, treat the beneficiary as the owner of the trust and taxable on its income.

Fourth, exclusion of the corpus of the trust from the owner's gross estate violates existing principles which would include in a decedent's estate any asset in which the decedent or his estate had an interest.

Finally, if it was appropriate to exclude the funding and earnings of the trust from the decedent's income, then the exclusion from estate income of the amount paid by the trust to relieve the estate of its estate tax liability

contravenes the basic income tax rule that discharge of an obligation of another results in income to the party whose obligation has been discharged.

The proponents of this bill may argue that many of its provisions are analogous to provisions of existing law. For instance, there are provisions in the deferred compensation area dealing with business deductions, exclusions from income, tax-exempt trusts, and estate tax exclusions. But this is a poor analogy. First, in the employee plan area the law does not discriminate between industries or businesses. Second, although deductions are allowed at the business level, these deductions are allowed only insofar as they meet the "ordinary and necessary" standards of section 162 or 212. Third, although the employee participating in a retirement plan is not taxed currently as contributions are set aside for him by his employer, those amounts and their accumulated earnings are taxed to the employee, or his heirs, when received. Finally, the estate tax exclusion for certain employee benefits is limited to benefits payable as annuities and does not extend to lump-sum payments. Furthermore, this exclusion is specifically not applicable to the extent the payment is made to or for the benefit of the decedent's estate.

It has been suggested that special estate tax relief was granted in 1976 to family farmers and that this bill merely extends comparable benefits. This is not so. The special estate tax valuation provisions of Section 2032A relating to farm property contain substantial restrictions regarding the pre- and post-death family ownership and operation of the farm business, which are totally absent from this bill. Furthermore, the benefits of that section are limited to cases in which the farm interest is a major part of the estate.

Apart from its significant departure from accepted tax principles the bill has other deficiencies. The benefits are available to any shareholder of an independent "local" newspaper, no matter how many shares are owned and without regard to whether such ownership creates an estate tax liquidity problem. Moreover, there is no provision for the recapture of benefits if the family of the owner does not continue operating the local newspaper.

While we are sympathetic to the plight of some owners of small businesses in planning the payment of estate taxes while retaining control of their business in the heirs, we

oppose this special relief for one group of "small business-men." We well understand that these problems have in some cases increased following the enactment of the Tax Reform Act of 1976. In particular, there is now a greater likelihood of a significant income tax liability in the event that a business interest is sold to provide funds for the payment of estate taxes.

It must be noted, however, that present law already provides relief for small business owners and their heirs. Section 303 provides that in certain cases the redemption of stock by a corporation to pay estate taxes will be treated as a redemption and thus subject to capital gains tax rather than as a dividend subject to ordinary income tax. Also, if a portion of the business must be sold to generate funds to pay estate taxes, the gain realized will generally be taxed at the capital gains rate. Further, the transaction can often be structured as an installment sale, in which case the payment of the income tax is deferred over the installment payment period.

In computing the estate tax, there are special relief provisions. In the 1976 Act, the amount of property which may be passed without being subject to the estate tax was increased from $60,000 to $175,000. Also, the marital deduction for transfers to surviving spouses, which before the 1976 Act was limited to one-half the estate, was changed to a limit of the greater of 50 percent of the value of the gross estate or $250,000.

Finally, the payment of the estate tax may be deferred where a business interest constitutes a major part of the estate. Under section 6161(a) the time for payment of the estate tax may be extended for up to 10 years upon a showing of reasonable cause. Reasonable cause exists when an estate consists largely of a closely-held business and does not have sufficient funds to pay the tax on time, or must sell assets to pay the tax at a sacrifice price. In section 6166 a five-year deferral and 10-year installment payment is allowed if the value of an interest in a closely-held business exceeds 65 percent of the adjusted gross estate. Finally, section 6166A is applicable to a broader number of situations, those in which the value of the closely-held business interest is either 35 percent of the gross estate or 50 percent of the taxable estate. Under that section the estate tax attributable to the closely-held business interest may be paid in up to 10 annual installments.

As valuable as a free and vigorous press is to this nation, we do not believe that an ownership interest in such business should be entirely free from tax. If the independent local newspaper industry has particular problems arising from its economic circumstances, the tax expenditure method may be one of the least controllable methods of dealing with them. Consideration should be given to other means of relieving the burdens of payment outside the framework of the tax laws. For instance, special loan programs might be considered. To the extent the value of these businesses is being artificially escalated by takeover bids from larger newspapers, the possible application or modification of the anti-trust laws should be considered.

The adoption of this bill would provide a wedge to be used again and again by other segments of society, each arguing its own importance. We do not believe in this piecemeal approach to legislation. There are existing provisions intended to minimize the problems inherent in the payment of taxes. If they are inadequate they should be reviewed in a comprehensive and not an *ad hoc* manner.

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SUMMARY OF TREASURY POSITIONS

H.R. 810 -- Reimbursement by certain private foundations of foreign travel expenses of government officials: Would not oppose if modified.

H.R. 4030 -- Exception to tax on excess business holdings for holdings in certain public utilities: Opposed.

S. 2771 -- Tax treatment of bingo income of exempt organizations: Would not oppose if modified.

H.R. 5099 -- Relief under section 1034 for Mr. and Mrs. Hall: Opposed.

S. 3345 -- Deficiency dividend procedure for Small Business Investment Companies: Not opposed. Would not oppose extending the deficiency dividend procedure accorded real estate investment trusts by the Tax Reform Act of 1976 to all regulated investment companies.

S. 1611 &
S. 3049 -- Product liability self-insurance trusts: Opposed. The Administration recommends adopting a 10-year carryback for net operating losses attributable to product liability.

S. 3176 -- Contributions in aid of construction to capital of electrical energy and gas utilities: Opposed.

S. 3341 -- "The Independent Local Newspaper Act of 1978": Opposed.

APPENDIX

1. H.R. 4030

H.R. 4030 would create an exception to the tax on the excess business holdings of a private foundation in cases in which a private foundation owned over 40 percent of the voting stock of a public utility which had taxable income of less than $1,000,000 during its first taxable year ending after May 26, 1969, and which meets certain other conditions. One of the basic goals of the 1969 Act was to eliminate the use of private foundations to maintain control of business enterprises. Foundation control of business interests had produced a number of undesirable results: competing businesses owned and operated by taxable entities were placed at a competitive disadvantage; benefits to charity were deferred through the accumulation of funds in controlled businesses; and foundation managers became primarily concerned with business affairs rather than with the charitable objectives of their foundations. A provision (section 4943) was added to the Code by Congress in 1969 to limit the involvement of private foundations in business enterprises by imposing a tax of up to 200 percent on the business holdings of private foundations in excess of certain prescribed percentages. The adoption of special exceptions to the excess business holding provisions would undermine one of the basic goals of the 1969 Act. While we recognize that an exception to the tax on excess business holdings for holdings by a private foundation in a public utility would not run counter to all of the arguments advanced for the adoption of the tax on excess business holdings (*e.g.*, a public utility operates as a regulated monopoly in a certain area and, therefore, does not "compete" with other business) we are, nevertheless, opposed to creating exceptions on an *ad hoc* basis to the limitations imposed by Section 4943. Regardless of the nature of the business controlled by the foundation and its donor or donors, the mere existence of foundation control inevitably tends to direct the foundation's efforts to operating the business and thus to divert attention from the charitable purposes of the foundation.

2. H.R. 5099 -- A Bill for the Relief of Brian and Vera W. Hall

Section 1034 of the Code provides for the nonrecognition of gain from the sale of a taxpayer's principal residence if the taxpayer purchases a new principal residence within a

period beginning 18 months before the date of such sale and ending 18 months after such date.

H.R. 5099 would treat the sale of the Halls' former personal residence as if it had occurred within 18 months after they purchased their new residence for purposes of Section 1034 even though the sale of the former residence occurred almost 20 months after the purchase. The enactment of H.R. 5099 would thereby allow the Halls to avoid recognition of gain realized on the sale of the former residence, even though they did not comply with the requirements of Section 1034. It is contended that the Halls encountered difficulty in selling the former residence because of the construction of and controversy surrounding a highway project in the area which was opposed by local groups and after 18 years is not yet completed.

The statutory period aggregating 36 months provided for in Section 1034 is a reasonable time for a taxpayer to purchase a rew residence. To override this statutory limitation for the benefit of two individuals would open the door to similar requests by other taxpayers. On the other hand, to waive the 36-month requirement only for these individuals would discriminate unfairly against similarly situated taxpayers who, because of failure to meet the requirement, paid tax on the gain realized on the sale of their residences.

It has also been suggested that because an extension of the reinvestment period under Section 1033 (involving involuntary conversions) is available, Section 1034 should also contain such an extension. However, in contrast with Section 1034, Section 1033 provides relief for those subjected to involuntary conversion of property rather than for individuals who voluntarily dispose of a residence. Persons selling residences can be expected to have more time for advance planning than those who are victims of involuntary conversion.

Moreover, even under the standards of Section 1033, it is unlikely that the Halls could have secured an extension. Revenue Ruling 76-488, 1976-2 C.B. 244 and Revenue Ruling 76-540, 1976-2 C.B. 245, hold that when reinvestment is delayed because of a sewer moratorium in the area of indefinite duration, "reasonable cause" does not exist for failure to reinvest the proceeds in a timely fashion under Section 1033. However, when a taxpayer can demonstrate that a moratorium of limited and specific duration has delayed reinvestment, an extension may be granted.

The project that delayed the sale of the Halls' former residence was of indefinite duration. It had been the subject of some controversy for 18 years, and there is no indication that it is expected to be completed in the near future. This is not a circumstance which arose unexpectedly to thwart the Halls' sale of their residence. They had full and adequate notice regarding this controversial project.

Because of the inequities involved in granting the relief requested by the Halls, because of the differences between Section 1033 and Section 1034, and because the Halls may well have not qualified under the Section 1033 time extension standard in any event, the Treasury opposes H.R. 5099.

artment of the TREASURY NEWS
INGTON, D.C. 20220 TELEPHONE 566-2041

FOR IMMEDIATE RELEASE August 28, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,301 million of 13-week Treasury bills and for $3,401 million of 26-week Treasury bills, both series to be issued on August 31, 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 November 30, 1978			26-week bills maturing March 1, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.157	7.291%	7.53%	96.195	7.526%	7.93%
Low	98.143	7.346%	7.59%	96.175	7.566%	7.98%
Average	98.149	7.323%	7.56%	96.183	7.550%	7.96%

Tenders at the low price for the 13-week bills were allotted 39%.
Tenders at the low price for the 26-week bills were allotted 32%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 117,890,000	$ 92,890,000	$ 107,935,000	$ 82,935,000
New York	3,175,675,000	1,933,575,000	4,935,190,000	3,094,590,000
Philadelphia	18,555,000	18,555,000	22,065,000	22,065,000
Cleveland	46,160,000	43,110,000	50,590,000	10,590,000
Richmond	36,245,000	33,245,000	23,820,000	18,820,000
Atlanta	27,030,000	26,830,000	16,320,000	14,320,000
Chicago	187,365,000	46,365,000	192,290,000	46,790,000
St. Louis	34,015,000	18,575,000	36,050,000	11,050,000
Minneapolis	11,840,000	11,840,000	13,940,000	13,940,000
Kansas City	21,475,000	16,565,000	14,495,000	11,470,000
Dallas	10,920,000	10,920,000	9,840,000	9,840,000
San Francisco	198,610,000	42,510,000	208,815,000	53,815,000
Treasury	6,040,000	6,040,000	10,325,000	10,325,000
TOTALS	$3,891,820,000	$2,301,020,000a/	$5,641,675,000	$3,400,550,000b/

a/Includes $301,700,000 noncompetitive tenders from the public.
b/Includes $174,025,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

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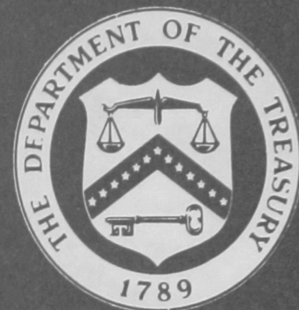

Contact: Carolyn Johnston
(202) 634-5377

FOR IMMEDIATE RELEASE AUGUST 29, 1978

TREASURY SECRETARY BLUMENTHAL NAMES HAROLD W. POPE SAVINGS BONDS CHAIRMAN FOR NEW HAMPSHIRE

Harold W. Pope, Chairman and Chief Executive Officer, Sanders Associates, Inc., Nashua, has been appointed Volunteer State Chairman for the Savings Bonds Program by Secretary of the Treasury W. Michael Blumenthal, effective immediately.

Mr. Pope will head a committee of business, financial, labor, media, and governmental leaders, who -- in co-operation with the Savings Bonds Division -- assist in promoting the sale of Savings Bonds.

Mr. Pope joined Sanders Associates in 1953 as Vice President of Operations. In 1960 he was appointed Corporate Vice President; in 1968 he was elected Executive Vice President, and in February 1975 he became President. He assumed his present position September 8, 1976.

Prior to joining Sanders Associates, Mr. Pope was Chief Engineer, Guided Missile Division of General Dynamics, Pomona, California. Previously, he had been Chief of Dynamics in the San Diego Division of CONVAIR, and Project Engineer on a number of early missile programs for the U.S. Navy, including LARK, TERRIER, and TALOS.

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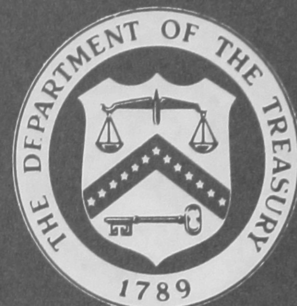

FOR IMMEDIATE RELEASE
August 28, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES PRELIMINARY COUNTERVAILING DUTY ACTION ON PAPERMAKING MACHINERY AND PARTS FROM FINLAND

The Treasury today announced its preliminary determination that Finland is not subsidizing exports of papermaking machinery and parts thereof.

The action is being taken pursuant to a petition filed in February 1978 by the Pulp and Paper Machinery Manufacturers Association. Under the law, Treasury must make a final decision no later than February 9, 1979.

The preliminary determination was based upon a review of all information currently available regarding the alleged subsidies. This review revealed that three of the arrangements investigated did not constitute "bounties or grants" (subsidies) within the meaning of the Countervailing Duty Law and that all remaining programs were either not utilized by, or not available to, Finnish papermaking machine manufacturers.

Under the Countervailing Duty Law, the Treasury is required to assess an additional Customs duty that equals the amount of a bounty or grant paid on imported merchandise.

Imports of papermaking machines and parts thereof from Finland were valued at approximately $21 million in 1977.

Notice of this action will be published in the Federal Register of August 29, 1978.

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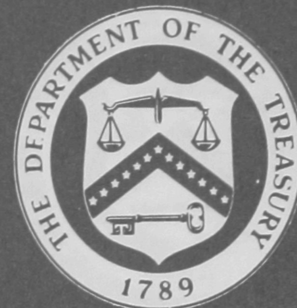

FOR IMMEDIATE RELEASE
August 28, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT WITHHOLDS APPRAISEMENT
ON SILICON METAL FROM CANADA

The Treasury Department today said that it has tentatively determined that silicon metal from Canada has been sold at less than fair value and that it is, accordingly, withholding appraisement on imports of the product from that country.

If the Secretary makes a Final Determination that sales at less than fair value are occurring, the U. S. International Trade Commission must subsequently decide whether they cause or threaten injury to an American industry. Both sales at less than fair value and injury must be found to exist before a dumping finding is reached and antidumping duties are assessed.

The Treasury's Final Determination is due by November 29, 1978, and, if affirmative, the Commission will have three months from the publication of that determination to consider the injury issue.

Under the Antidumping Act, the Secretary of the Treasury is required to withhold appraisement whenever he has reason to believe or suspect that imports of the product are being sold at less than fair value. Sales at less than fair value generally occur when imported merchandise is sold in the United States for less than in the home market or to third countries. The withholding of appraisement will not exceed six months.

When appraisement is withheld, the Customs Service defers valuation of goods imported after the date of publication of the notice, thus allowing any dumping duties ultimately imposed to be levied on all imports entered after that date.

Notice of this action will appear in the Federal Register of August 29, 1978.

Imports of silicon metal from Canada during the period January 1 through October 31, 1977, were valued at $7 million.

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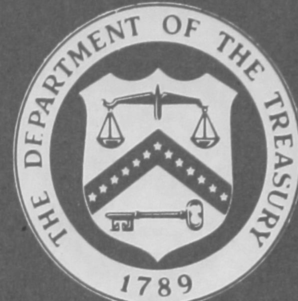

FOR IMMEDIATE RELEASE August 29, 1978

RESULTS OF AUCTION OF 4-YEAR 1-MONTH TREASURY NOTES

The Department of the Treasury has accepted $2,254 million of $3,880 million of tenders received from the public for the 4-year 1-month notes, Series J-1982, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	8.38% 1/
Highest yield	8.42%
Average yield	8.41%

The interest rate on the notes will be 8-3/8%. At the 8-3/8% rate, the above yields result in the following prices:

Low-yield price	99.961
High-yield price	99.826
Average-yield price	99.859

The $2,254 million of accepted tenders includes $ 350 million of noncompetitive tenders and $1,904 million of competitive tenders from private investors, including 96% of the amount of notes bid for at the high yield.

In addition to the $2,254 million of tenders accepted in the auction process, $ 325 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities for new cash.

1/ Excepting 6 tenders totaling $39,000

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FOR IMMEDIATE RELEASE August 30, 1978

AMENDED RESULTS OF TREASURY'S 4-YEAR 1-MONTH NOTE AUCTION

During the recording of competitive bids at a Federal Reserve Bank for the 4-year 1-month Treasury notes, Series J-1982, a competitive bid was overstated by $100 million. As a result of correcting this overstatement, the amount accepted is changed from $2,254 million to $2,154 million. This adjustment does not affect the average yield and the range of accepted competitive bids remains as announced on August 29.

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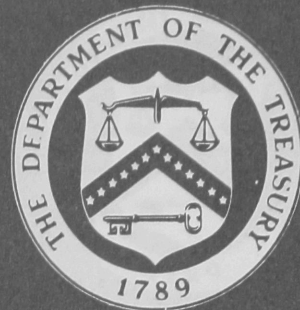

August 31, 1978

BIOGRAPHICAL NOTES

Bette B. Anderson
Under Secretary of the Treasury

Bette B. Anderson of Savannah, Georgia, the first woman to be named Under Secretary of the Treasury, was nominated by President Jimmy Carter on March 3, 1977, and she was confirmed by the United States Senate on March 30, 1977. As Under Secretary, Ms. Anderson is responsible for Treasury's Office of Administration and the Office of Enforcement and Operations; the Secret Service; the Bureau of Alcohol, Tobacco, and Firearms; the Bureau of Customs; the Bureau of the Mint; the Bureau of Engraving and Printing; and the Office of the Treasurer of the United States. In her capacity as the Under Secretary she serves as the Treasury Representative to the Interagency Council on Minority Business Enterprise and the Settlement Policy Committee on Conrail Valuation Litigation.

Before becoming the Under Secretary, Ms. Anderson was affiliated for twenty-seven years with The Citizens and Southern National Bank of Savannah. She had served most recently as Vice President, after having moved up through the ranks from teller-trainee, Assistant Cashier, Assistant Trust Officer, and Assistant Vice President. She worked closely with and helped develop the bank's affirmative action and equal employment programs for women.

Ms. Anderson's professional banking affiliations include the National Association of Bank Women, of which she was President until she resigned to take the Treasury post. She helped to develop the Association's education programs for women in middle and upper level management. Ms. Anderson has also been affiliated with the American Bankers Association and the Banking Marketing Association.

Ms. Anderson attended Georgia Southern and Armstrong State College and earned certification in 1975 from the Stonier Graduate School of Banking at Rutgers University.

Ms. Anderson is married to George H. Anderson of Grumman Aviation of Savannah. They have one daughter, Sue, who is the wife of Charles Strickland of Savannah.

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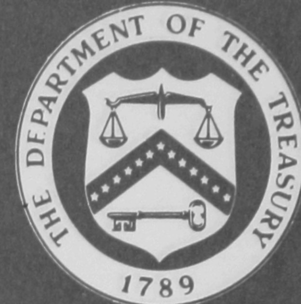

FOR IMMEDIATE RELEASE
August 31, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT ANNOUNCES TENTATIVE DETERMINATIONS REGARDING CUMENE IMPORTS FROM ITALY AND THE NETHERLANDS

The Treasury Department has tentatively discontinued its antidumping investigations of cumene from Italy but has made a preliminary determination that imports of that product from the Netherlands have been sold here at less than fair value.

Cumene is an intermediate chemical used to make acetone and phenol and, ultimately, plastics and solvents. Imports of cumene from Italy during the period September 1, 1977, to February 28, 1978, were valued at $10 million; imports from the Netherlands, $16.7 million.

Under the Antidumping Act of 1921, a discontinuance of an investigation can occur if the Treasury is satisfied that margins of dumping involved are minimal in relation to the volume of exports in question, price revisions have been made that eliminate any likelihood of present sales at less than fair value, and assurances have been received that eliminate any likelihood of sales at less than fair value in the future. The Secretary will determine within three months whether final discontinuance of this case is warranted.

The Act requires the Treasury to withhold appraisement whenever it has reason to believe or suspect that sales at less than fair value are taking place. (Sales at less than fair value generally occur when imported merchandise is sold in the United States for less than in the home market or to third countries.) The withholding of appraisement will not exceed six months.

If Treasury finds that sales at less than fair value are occurring, the U. S. International Trade Commission must subsequently decide whether they cause or threaten injury to an American industry. Both sales at less than fair value and injury must be found to exist before a dumping finding is reached and antidumping duties are assessed.

(MORE)

The Treasury's final decision is due by December 1, 1978, and, if affirmative, the Commission will have three months from the publication of that determination to consider the injury issue.

When appraisement is withheld, the Customs Service defers valuation of the goods imported after the date of publication of the Notice, thus allowing any dumping duties ultimately imposed to be levied on all imports entered after that date.

Notices of these actions will appear in the Federal Register of September 1, 1978.

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INGTON, D.C. 20220 TELEPHONE 566-2041

FOR IMMEDIATE RELEASE
September 1, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY PROPOSES AMENDMENTS
TO ARBITRAGE BOND REGULATIONS

The Treasury Department today announced that it has proposed additional amendments to the arbitrage bond regulations. The amendments will be published in the Federal Register on September 7. The text of the amendments is attached.

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B-1145

[4830-01]

INTERNAL REVENUE SERVICE

[26 CFR Part 1]

[LR-1671]

ARBITRAGE BONDS

NOTICE OF PROPOSED RULEMAKING

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the arbitrage bond regulations. The amendments are designed to clarify and correct the regulations. They affect purchasers and governmental issuers of tax-exempt bonds.

DATES: Written comments must be delivered or mailed by

. The proposed amendments are effective as specified in the text of the regulations. Where no effective

date is specified, the changes apply retroactively because they merely correct technical errors or interpret the statute or pre-existing regulations.

ADDRESS: Send comments to: Commissioner of Internal Revenue, Attention: CC:LR:T, Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT: Leonard T. Marcinko of the Legislation and Regulation Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3459, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 103(c) of the Internal Revenue Code of 1954. These amendments are to be issued under the authority contained in sections 103(c)(6) and 7805 of the Internal Revenue Code of 1954 (83 Stat. 656 and 68A Stat. 917; 26 U.S.C. 103, 7805).

Previous Notices of Proposed Rulemaking

On May 3, 1973, the FEDERAL REGISTER published proposed Income Tax Regulations (26 CFR Part 1) under section 103(c) of the Internal Revenue Code of 1954 (38 FR 10944). The proposed regulations were revised by notices of proposed rulemaking published in the FEDERAL REGISTER for December 3, 1975 (40 FR 56488), October 9, 1976 (41 FR 47679), May 31, 1977 (42 FR 27610), June 9, 1977 (42 FR 29517), and May 8, 1978 (43 FR 19675) and corrected by notices published in the FEDERAL REGISTER for May 11, 1973 (38 FR 12405), December 18, 1975 (40 FR 58656), November 24, 1976 (41 FR 51840), and June 21, 1977 (42 FR 31462). This notice of proposed rulemaking further revises the proposed regulations.

General Statement of Policy

Arbitrage

Generally, an "arbitrage bond" is a municipal bond that is used to make an investment profit. The yield on a tax-exempt municipal bond is ordinarily lower than the yield on Treasury notes, certificates of deposit, and other high-grade taxable investments. For example, a substantial profit can be made by selling municipal bonds at six percent and

investing the proceeds in Treasury notes at 8-1/2 percent. Bonds used to secure this profit are called "arbitrage bonds."

Arbitrage has serious drawbacks. In particular, arbitrage damages the market for municipal bonds. Arbitrage bonds tend to crowd out bonds that are sold to finance roads, schools, and other traditional projects. As a result, arbitrage tends to drive up the cost of municipal borrowing, and therefore is self-defeating and contrary to the interests of State and local governments. For these reasons, in 1969, Congress delegated broad authority to the Treasury to keep arbitrage bonds off the market. To that end, the Treasury has written extensive regulations. However, these regulations have not been completely successful. A series of devices has been invented to circumvent the arbitrage regulations, the most recent being the invested sinking fund.

Invested sinking funds

Typically, municipal bonds have serial maturities. For example, if a city sells $10 million of 20-year school bonds, the city may use property taxes to pay a portion of the principal each year. Thus, for the protection of the bondholders, the bonds will be paid off gradually over 20 years,

and the $10 million principal amount will not come due all at once. However, if the city employs an invested sinking fund, it will not pay any principal until the bonds come due in 20 years. Instead, the city will periodically pay property taxes into a sinking fund. Amounts held in the sinking fund will be invested in high-yield Treasury notes or other high-grade investments, enabling the city to make a substantial investment profit.

The invested sinking fund was devised as a way around Treasury's arbitrage regulations. Certain State and local governments were able to gain a financial advantage from invested sinking funds. However, invested sinking funds (like other forms of arbitrage) have the long-term effect of being a burden on taxpayers and a threat to the market for municipal bonds. In particular, invested sinking funds damaged the tax-exempt market in two ways. First, bonds that used this device were left outstanding longer because they were not retired serially. Second, many refunding issues were motivated chiefly by the profit that could be earned from an invested sinking fund; these issues would not have been sold if that profit had not been available. The invested sinking fund device could have resulted in nearly a 50-percent increase in the amount of tax-exempt bonds outstanding without taking account of advance refundings.

Advance refundings

An ordinary refunding is a relatively simple transaction. It enables an issuer to substitute new bonds for outstanding bonds. Generally, the substitution is made because the outstanding bonds were sold on unfavorable terms. For example, the interest rate on the old bonds may be too high, or the indenture for the old bonds may contain unduly restrictive covenants. In an ordinary refunding, a state or local government simply sells new bonds, and uses the proceeds to call in its outstanding bonds.

By contrast, an advance refunding is a highly sophisticated financial transaction, almost unique to municipal finance. In an advance refunding, both sets of bonds remain outstanding. For example, assume that a sanitation district has $10 million of bonds outstanding. In an advance refunding, the district will typically sell an additional $11 or $12 million of refunding bonds. However, it will not call its outstanding bonds immediately. These bonds will remain outstanding for perhaps 5, 10, or even 20 years. Until the sanitation district calls in its old bonds, the proceeds of the new bonds will be kept in an escrow fund. The escrow fund will be invested in United States Treasury obligations.

The serious questions of tax policy raised by arbitrage bonds are compounded in the context of advance refundings. First, they double the amount of tax exempt bonds outstanding for any project. As a result, they tend to increase borrowing costs and impair the ability of hard-pressed state and local governments to provide essential services.

Second, the holders of the old bonds get a double benefit. In addition to being tax-exempt, these bonds are secured by what amounts to a guarantee of the United States (i.e., they are secured by Treasury obligations held in escrow). Thus, the old bonds are superior both to obligations of the United States Treasury and to conventional municipal obligations. Recently, the Congress rejected this double benefit in the case of the New York City Financial Assistance Act. The Congress determined that it was inappropriate to provide New York City with this double benefit, even in connection with a program necessary to assure the City's financial survival. In the case of a typical advance refunding, where much less than financial survival is at stake, this double benefit is still less appropriate.

And third, advance refundings have been the principal cause of difficulties with the arbitrage regulations. As stated above, a continuing series of devices has been employed to circumvent the arbitrage regulations. For a variety of reasons, these devices have been used almost exclusively in connection with advance refundings. Advance refundings have been the principal cause of frequent changes in the arbitrage regulations. These frequent changes have tended to disrupt the tax exempt market. The amendments that go into effect on September 1, 1978 are designed to eliminate the need for continual changes in the regulations.

<u>Administrative costs</u>

In the case of any advance refunding, the regulations in effect until September 1, 1978 permitted an issuer to earn enough arbitrage to cover most or all of the administrative costs. On re-examination, this has proved to be a bad policy.

The ability to earn back administrative costs has contributed to payment of inflated and excessive fees to lawyers, accountants, underwriters, and others. In addition, the ability of issuers to recover administrative costs has led to many refundings that are economically

unsound. For example, assume that the administrative costs of an advance refunding are $3 million, and the gross debt service savings are $2 million. There is no good reason to spend $3 million in order to save $2 million. However, under the old regulations, this transaction would be advantageous to those involved. The issuer would save nearly $2 million, and underwriters, lawyers, and financial advisors would earn $3 million, which could be recovered largely at the expense of the Federal Treasury. The public cannot benefit from a transaction in which $3 million is spent to save $2 million. Only the recipients of the $3 million -- the underwriters, the lawyers, and the financial advisors -- can benefit.

Further, the treatment of expenses in the case of advance refundings discriminates against new money issues in two ways. First, issuers generally cannot recover their administrative costs in the case of new money issues. Recovery of such costs is generally possible only in connection with advance refundings. And second, advance refundings occupy a considerable share of the market, crowding out new money issues needed for schools, roads, water systems, and other essential projects.

Certification

Under the regulations in effect until September 1, 1978, issuers were able to "certify" their bonds conclusively. As a result, they were arguably able to act as the sole judge of whether their bonds complied with Internal Revenue laws. This ability has been a major cause of the continuing series of devices that have been invented to circumvent the arbitrage regulations. It permitted certain bond lawyers to interpret the regulations in a highly aggressive manner and severely handicapped the IRS in its efforts to protect the tax-exempt market.

Therefore, the certification procedure is revised under the new regulations. After September 1, bond lawyers will no longer be able to give questionable opinions and be protected by a conclusive certification. The revised certification will enable the IRS to enforce the regulations effectively, and at the same time protect issuers acting in good faith.

Customary financial practices

The amendments published on May 8, 1978 were not intended to interfere with customary financial practices.

They were aimed at sophisticated devices to circumvent the arbitrage regulations. Some state and local governments have expressed the concern that the regulations will disrupt customary financial practices. These amendments are designed primarily to respond to that concern.

Explanation of Provisions

This notice of proposed rulemaking makes certain technical and clarifying changes to the certification provisions contained in paragraph (a)(2) of section 1.103-13. First, the old certifiction procedure, which is set out in paragraph (a)(2)(ii), will apply to reasonable expectations of an issuer as to events occuring after September 1, 1978, if the bonds were issued on or before that date. Second, paragraph (a)(2)(iii) is amended to indicate that the regulations do not dictate the contents of the issuer's certification, but rather limit the certification's conclusive effect. Third, the notice makes it clear that facts and estimates on which the issuer's expectations are based may be set forth in brief and summary terms in the certification. No independent investigation of the facts by bond counsel is required under the proposed regulations. Fourth, a number of examples are added to paragraph (a)(2)(v) that illustrate various certifications that could be made in

connection with an issue of govermental obligations. Finally, the notice adds new paragraph (a)(4) which provides that bonds are not arbitrage bonds merely because the issuer makes an inadvertent, insubstantial error.

A substantive change is made by the notice of proposed rulemaking through the addition of new paragraph (a)(2)(iv) to section 1.103-13. This provision applies in the case of an issue of governmental obligations with a face amount of $2,500,000 or less issued after September 1, 1978. Generally, if counsel gives a reasonable, unqualified opinion that the obligations in question are not arbitrage bonds, the opinion can be conclusively relied upon by the holders of the obligations. This exemption for small issues applies only to the first $2,500,000 of obligations issued for the same project in any twelve-month period.

The proposed amendments make a clarifying change to paragraph (c)(5) of section 1.103-13 regarding the treatment of acquired purpose obligations allocable to governmental obligations issued after September 1, 1978. This provision states that administrative costs paid by the obligor are disregarded in calculating yield on acquired purpose obligations. These administrative costs include the cost of issuing, carrying, or repaying the issue, the underwriter's

spread, and the cost of purchasing, carrying, selling, or redeeming the acquired purpose obligations.

The notice of proposed rulemaking adds a new paragraph (j) to section 1.103-13 of the proposed regulations. It provides that if an artifice or device is employed in connection with the issuance of a governmental obligation, such obligation will be considered an arbitrage bond. An "artifice or device" is defined as a transaction or series of transactions that attempts to circumvent the provisions of section 103(c) or the regulations thereunder, enabling the issuer to exploit the difference between tax-exempt and taxable interest rates and increasing the burden on the market for tax-exempt obligations. However, it is not considered an artifice or device to invest bond proceeds at a materially higher yield if specifically provided for in section 103(c)(4). The proposed amendments provide examples of the application of the artifice or device rule in various situations.

The proposed amendments delete paragraph (b)(2)(iii) of proposed section 1.103-13 relating to indirect proceeds. Most situations to which the indirect proceeds rules would have applied either will be covered by the sinking fund rules or will be considered an artifice or device within the meaning of section 1.103-13(j).

The notice of proposed rulemaking adds a new paragraph (h) to section 1.103-13, which sets forth the rules relating to acquired program obligations that were contained in section 13.4 of the temporary regulations under section 103(c). Although a few clerical changes were made to these rules, their inclusion in the proposed regulations is not intended to have any substantive effect. The rules in the proposed regulations relating to acquired program obligations will supersede those contained in the temporary regulations.

Section 1.103-13(g) of the proposed regulations, which was added by a notice of proposed rulemaking published in the Federal Register for May 8, 1978 (43 FR 19675), contains rules relating to invested sinking funds. In response to the comments received with respect to these rules, this current notice of proposed rulemaking makes a number of changes to the proposed regulations in order to lessen the impact of the sinking fund rules on customary financial practices and to correct certain technical problems.

Paragraph (g)(2) of proposed section 1.103-13 is amended to make it clear that receipts from the investment of a sinking fund, as well as amounts originally held in the sinking fund, are treated as proceeds of the issue. New

paragraph (g)(7) provides that a sinking fund for two or more issues must be allocated among the issues in proportion to their original face amounts, or according to the debt service on the issues that will actually be paid from the sinking fund. In addition, new paragraph (g)(8) contains two examples illustrating the application of the sinking fund rules.

Section 1.103-14 of the proposed regulations provides for the temporary investment of bond proceeds at a materially higher yield. The notice of proposed rulemaking revises the 13-month temporary period for amounts contributed to a bona fide debt service fund. Paragraph (b)(10) of section 1.103-14 provides that if a portion of a fund satisfies the requirements of a bona fide debt service fund, then that portion is allowed a 13-month temporary period under this provision. A definition of bona fide debt service fund is added to the proposed regulations in section 1.103-13(b)(12).

The proposed regulations also contain rules (section 1.103-14(b)(11) and (b)(14)) for situations where a debt service fund is combined with another fund (e.g., a reserve fund or an operating fund). These rules are designed to put the issuer in the same position that it would have been in if it had established two separate funds. The rules elaborate

on the position taken in Rev. Rul. 78-349, announced by the Internal Revenue Service on August 22, 1978.

A relief provision is added in paragraph (b)(11) of section 1.103-14 for a revolving fund. A revolving fund is one that consists of receipts from the sale of property acquired with bond proceeds or payments of principal and interest on acquired program obligations, and that will generally be used for the acquisition of additional property or acquired program obligations. The temporary period for such a revolving fund is three years.

Paragraph (b)(12) of proposed section 1.103-14 adds a new temporary period for sinking funds for certain new money issues. This temporary period begins on the date of issue and ends on the first call date (but not more than 10 years after the date of issue). The new temporary period does not apply to a refunding issue unless the prior issue had a term of less than three years and was issued in anticipation of permanent financing. If this provision does apply to a refunding issue, then the 10-year limitation is reduced by the term of the prior issue. In addition, this temporary period does not apply to an issue unless the issuer makes a reasonable effort to schedule payment of as much debt service as is practicable in each year before the first call date.

The notice of proposed rulemaking makes several amendments to the provisions in the regulations relating to reasonably required reserve or replacement funds. Paragraph (d)(2) of section 1.103-14 is amended so that if an issuer requests a ruling that a reserve or replacement fund in excess of the amount provided in section 1.103-14(d) of the regulations is reasonably required, it need not wait for such a ruling before issuing the obligations. A similar change is made to paragraph (e)(5)(iv) of section 1.103-14 with respect to reasonably required reserve funds for refunding issues. Where an issuer applies for a ruling under one of these provisions, new paragraph (b)(13) of section 1.103-14 provides a temporary period for the amount of the reserve fund in excess of the amount specified in section 1.103-14(d). This temporary period continues from the date of issue until 30 days after final disposition of the ruling request.

Section 1.103-14(e)(5)(ii)(B) of the proposed regulations states that the proceeds of a refunding issue may not be invested at a materially higher yield as a reasonably required reserve or replacement fund before the adjusted maturity date of the prior issue. The notice of proposed rulemaking creates an exception to this rule with respect to

amounts deposited in reasonably required reserve or replacement funds for a refunding issue sold after the effective date of the sinking fund rules. New paragraph (e)(7) of section 1.103-14 provides that paragraph (e)(5)(ii)(B) does not apply to these amounts, if they were held in a reasonably required reserve or replacement fund for the prior issue or would (but for the refunding) have been deposited in such a fund for the prior issue. Two examples are included within this new subparagraph that also illustrate the operation of the replacement theory under section 103(c)(2)(B). This replacement theory was recently applied in Revenue Ruling 78-348, announced by the Internal Revenue Service on August 22, 1978.

Comments

Before adopting these proposed amendments, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying.

Drafting Information

The principal author of these proposed regulations was Leonard T. Marcinko of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated

in developing the regulations, both on matters of substance and style.

PROPOSED AMENDMENTS TO THE REGULATIONS

The proposed amendments to 26 CFR Part 1 are as follows:

Paragraph 1. Section 1.103-13 is amended as follows:

1. Paragraph (a)(2) is amended by revising subdivision (i) and (iii), by redesignating subdivisions (iv) and (v) as subdivisions (v) and (vi), by adding a new subdivision (iv), and by revising subdivision (vi) as redesignated.

2. Paragraph (a) is amended by redesignating subparagraph (4) as subparagraph (5) and by adding a new subparagraph (4).

3. Paragraph (b)(1)(ii) is amended by inserting "paragraphs (c) and (d)" in lieu of "paragraph (c)" and by inserting "paragraphs (h) and (e)" in the sixth sentence in lieu of "paragraphs (d) and (e)" in the seventh sentence thereof.

4. Paragraph (b)(2) is amended by redesignating subdivision (ii) as subdivision (ii)(A), by adding a new subdivision (ii)(B), and by deleting subdivision (iii).

5. Paragraph (b)(4)(iv) is amended by inserting "section 103(b)(6)" in lieu of "section 103(c)(6)" in the third sentence thereof.

6. Paragraph (b)(5) is amended by inserting "or (iii)" immediately after "paragraph (a)(2)(ii)" in the third sentence of subdivision (i)by adding a new sentence at the end of subdivision (iv), by revising subdivisions (v) and (vi), and by adding new subdivisions (viii) and (ix).

7. Paragraph (b) is amended by revising subparagraph (11) and adding a new subparagraph (12).

8. Paragraph (c) is amended by inserting "1978" in lieu of "1980" in example (1) of subparagraph (3)(i), by revising subparagraph (5), and by adding a new subparagraph (6), (7), and (8).

9. The last sentence in paragraph (f)(2) is deleted.

10. Paragraph (g) is amended by revising subparagraphs (1), (2), (3), and (5), and by adding new subparagraphs (6), (7), and (8).

11. New paragraphs (h) and (j) are added.

Section 1.103-13 Arbitrage bonds.

* * * * *

(a) Scope.***

(2) Reasonable expectations. (i) Under section 103(c)(2), the determination whether an obligation is an arbitrage bond depends on the issuer's reasonable expectations, as of the date of issue, regarding the amount and use of the proceeds of the issue. Thus, an obligation is not an arbitrage bond, if, based on the issuer's reasonable expectations on the date of issue, the proceeds will not be used in a manner that would cause the obligation to be an arbitrage bond under section 103(c)(2), this section, section 1.103-14, and section 1.103-15. Reasonable expectations regarding the amount and use of the proceeds of a governmental obligation issued on or before September 1, 1978 may be established by the certification described in subdivision (ii) of this subparagraph. Reasonable expectations as to future events regarding governmental obligations issued after September 1, 1978 may be established to the extent permitted by the certification described in subdivision (iii) of this subparagraph. For the treatment of

certain issues with a face amount of $2,500,000 or less, see subdivision (iv) of this subparagraph.

* * * * *

(iii)(A) A state or local governmental unit may certify, in the bond indenture or a related document, reasonable expectations of the issuer on the date of the issue as to future events.

(B) Certification by a State or local governmental unit will not tend to establish conclusions of law (including legal characterizations of future events).

(C) An officer responsible for issuing the bonds must certify for the issuer.

(D) In addition to the matters certified, the certification must set forth (in brief and summary terms) the facts and estimates on which the issuer's expectations are based and state that, to the best of the knowledge and belief of the certifying officer, the issuer's expectations are reasonable.

(E)(1) If the temporary period for a construction issue is more than 3 years but not more than 5 years, the issuer must commission an independent architect or engineer to prepare a study of the planned construction. An architect or engineer will be considered independent if he is not employed by the issuer on a permanent basis.

(2) The study prepared by the architect or engineer must accompany the certification and must include an estimated completion date for each stage of the construction.

(F) Subsequent events do not affect a certification made in accordance with this subdivision.

(iv) In the case of an issue with a face amount of $2,500,000 or less issued after September 1, 1978, an unqualified opinion of counsel that such obligations are not arbitrage bonds can be conclusively relied upon by the holders of the obligations; provided that the opinion is reasonable and is not given in bad faith. This subdivision (iv) shall apply only to the first $2,500,000 of governmental obligations issued by (or on behalf of) a State or local governmental unit for the same project in any twelve-month period. Thus, for example, if a town issues $2,500,000 of bonds for a school building on July 1, 1980, this subdivision

does not apply to additional bonds issued for the same school building before July 1, 1981.

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(vi) ***

Example (3). (i) On July 5, 1980, city A issues $3,000,000 of municipal bonds to finance the construction of a water treatment facility. The city includes in the bond indenture a certification which contains a statement that 95 percent of the receipts from the sale of the bonds will be used for construction costs by July 5, 1983.

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Example (4). On January 1, 1980, city A sells $5 million of 6 percent refunding bonds. City A certifies the bonds in the manner described in subparagraph (iii) of this subparagraph. In addition, attorney X gives an opinion that the bonds are not arbitrage bonds. In connection with the refunding issue, city A makes use of an artifice or device as described in paragraph (j) of this section. As a result, the legal conclusion reached by attorney X is erroneous and the refunding bonds are arbitrage bonds despite the certification.

Example (5). (i) The Chairman of the County Commission of County X made the following certification with respect to an issue of governmental obligations.

(1) The County is issuing and delivering, simultaneously with the delivery of this certificate, $2,500,000 principal amount of its General Obligation Library Bonds dated December 1, 1978 (herein called "the Bonds"). The Bonds are being issued for the purpose of providing for payment of a portion of the costs of constructing and equipping a new public library in and for the County.

(2) The estimated total costs of constructing and equipping said library (which is herein called "the Library") will be not less than $3,235,000. The said total costs are

expected to be financed with (i) $2,500,000 of proceeds from the sale of the Bonds, (ii) a Federal grant in the amount of not more than $560,000, and (iii) approximately $151,000 in building funds made available to the County by the County X Library Board. The County has not yet determined how it will finance the deficiency ($24,000).

(3) The County has heretofore entered into a contract for the construction of the Library, which contract obligates the payment by the County of not less than $100,000. The actual work of constructing the Library began during the month of September, 1978. It is contemplated that such work will proceed with due diligence to completion, expected on or about October 1, 1979.

(4) The County has heretofore expended, for payment of costs incurred in constructing and equipping the Library, approximately $758,000, derived from (a) portions of the aforesaid Federal grant, (b) short-term borrowings made in anticipation of the issuance and sale of the Bonds and which will be fully repaid within five (5) days following the issuance of the Bonds, and (c) building funds made available to the County by the County X Library Board.

(5) The principal proceeds to be derived by the County from the sale of the Bonds [excluding the "premium" anticipated to be received by the County from such sale, which premium will, as required by law, be applied to payment of interest maturing with respect to the Bonds on June 1, 1979] are expected to be used, needed and fully expended for payment of costs of constructing and equipping the Library [including the repayment of the short-term borrowings referred to in the preceding Paragraph (4)] by no later than May 1, 1980.

(6) Except for the Debt Service Fund established under Section XII of the Bond Resolution, the County has not created or established, and does not expect to create or establish, any sinking fund or other similar fund.

(7) To the best of my knowledge, information and belief, the above expectations are reasonable.

(8) The County has not been notified of any listing of it by the Internal Revenue Service as an issuer that may not certify its bonds.

(9) This certificate is being executed and delivered pursuant to sections 1.103-13, 1.103-14, and 1.103-15 of the

Income Tax Regulations under the Internal Revenue Code of 1954, as amended, and the undersigned Chairman of the County Commission is one of the officers of the County charged (by resolution and order of the said County Commission) with the responsibility of issuing the Bonds.

(ii) This certification by County X meets the requirements of subdivision (iii) of this subparagraph and conclusively establishes the County's reasonable expectations on the date of issue as to the future events described in the certification. However, nothing contained in this certification tends to establish any conclusions of law.

Example (6). (i) The Chairman of the Board of Directors and the Secretary-Treasurer of The Industrial Development Board of City A, a public corporation organized under the laws of State B (herein called "the Industrial Board"), made the following certification:

(1) The Industrial Board is issuing and delivering simultaneously with the delivery of this certificate, its Environmental Improvement Revenue Bonds, 1978 Series A dated November 1, 1978, in the principal amount of $6,000,000 (herein called "the Bonds"). The Bonds are being issued for the purpose of providing funds for the permanent financing of costs of acquiring, constructing, installing and equipping, on certain real property located in J County, the air pollution control facilities described on Exhibit A attached hereto and made a part hereto (the said facilities being herein together called "the Project Facilities"). Those of the Project Facilities described in Paragraph (1) of said Exhibit A are herein called "the Quench Car Facilities"; those described in Paragraph (2) of said Exhibit A, "the Sinter Line Facilities"; and those described in Paragraph (3) of said Exhibit A, "the Mixer Fume Control Facilities."

(2) The Project Facilities and certain real property (and interests therein) appurtenant thereto are, upon the completion of the acquisition, construction, installation and equipment of the Project Facilities, to be sold by the Industrial Board, on an installment basis, to Corporation C, a Delaware corporation (herein called "the Corporation"), under and pursuant to an Agreement of Sale dated as of November 1, 1978 (herein called "the Agreement"), between the Industrial Board (as seller) and the Corporation (as buyer).

(3) The actual work of acquiring, constructing, installing and equipping the Quench Car Facilities has, pursuant to the provisions of a Letter Agreement between the

Corporation and the Industrial Board (which Letter Agreement was executed on behalf of the Industrial Board on May 10, 1978 and the Corporation on May 11, 1978), heretofore begun, and binding contracts or commitments obligating the expenditure, for the work of acquiring, constructing, installing and equipping the Quench Car Facilities, of not less than $100,000 have heretofore been entered into or made. It is anticipated that the total financeable costs of such acquisition, construction, installation and equipment [excluding a pro rata portion of (a) interest during construction, and (b) the expenses anticipated to be incurred in connection with the issuance of the Bonds] will be approximately $1,231,370. It is expected that the work of acquiring, constructing, installing and equipping the Quench Car Facilities will proceed with due diligence to full completion, presently anticipated on or about October 1, 1979.

(4) The actual work of acquiring, constructing, installing and equipping the Sinter Line Facilities has, pursuant to the provisions of a Letter Agreement between the Corporation and the Industrial Board (which Letter Agreement was executed on behalf of the Industrial Board on May 10, 1978, and on behalf of the Corporation on May 11, 1978), heretofore begun, and binding contracts or commitments obligating the expenditure, for the work of acquiring, constructing, installing and equipping the Sinter Line Facilities, of not less than $100,000 have heretofore been entered into or made. It is anticipated that the total financeable costs of such acquisition, construction, installation and equipment [excluding a pro rata portion of (a) interest during construction, and (b) the expenses anticipated to be incurred in connection with the issuance of the Bonds] will be approximately $1,780,000. It is expected that the work of acquiring, constructing, installing and equipping the Sinter Line Facilities will proceed with due diligence to full completion, presently anticipated on or about January 1, 1980.

(5) While the actual work of acquiring, constructing, installing and equipping the Mixer Fume Control has not yet begun, binding contracts or commitments obligating the expenditure, for the work of acquiring, constructing, installing and equipping the Mixer Fume Control Facilities, of not less than $100,000 have heretofore been entered into or made, and such actual work is expected to begin on or about June 30, 1979. Further, all such work is anticipated to proceed with due diligence thereafter to completion, presently expected on or about September 1, 1980. The total

financeable costs of acquiring, constructing, installing and equipping the Mixer Fume Control Facilities [excluding a pro rata portion of (a) interest during construction, and (b) the expenses anticipated to be incurred in connection with the issuance of the Bonds] are expected to be approximately $2,680,000.

(6) The total proceeds to be received by the Industrial Board on the sale of the Bonds, i.e., the gross sum of $5,998,633.33, does not exceed the total of--

(i) the estimated total financeable costs of acquiring, constructing, installing and equipping the Project Facilities [excluding (a) interest during construction, and (b) the expenses anticipated to be incurred in connection with the issuance of the Bonds] (viz., the gross sum of $5,691,370), plus

(ii) interest on the Bonds during construction of the Project Facilities and the expenses anticipated to be incurred in connection with the issuance of the Bonds (viz., the gross sum of $263,630), plus

(iii) the amount required to be set aside out of the proceeds to be derived by the Industrial Board from the sale of the Bonds, for payment of a portion of the interest maturing thereon on May 1, 1979 (viz., the sum of $43,633.33).

(7) The proceeds to be derived by the Board from the sale of the Bonds (viz., the gross sum of $5,998,633.33) are expected to be needed and fully expended as follows:

(a) $43,633.33 of said proceeds will be set aside and paid into the "Bond Fund" (as said term is used and defined in the Trust Indenture dated as of November 1, 1978 between the Industrial Board and The First National Bank of A, under which the Bonds are being issued) simultaneously with the issuance and delivery of the Bonds and used and applied for payment of a portion of the interest maturing thereon on May 1, 1979;

(b) $263,630 of said proceeds will be expended, for payment of (i) interest on the Bonds during construction of the Project Facilities, and (ii) the expenses anticipated to be incurred in connection with the issuance of the Bonds; and

(c) the remaining $5,691,370 of said proceeds will be expended for payment of the costs of acquiring, constructing,

equipping and installing the Project Facilities [excluding (i) interest on the Bonds during construction of the Project Facilities, and (ii) the expenses anticipated to be incurred in connection with the issuance of the Bonds], substantially in accordance with the following schedules:

Quarter during which Expected to be Expended	Amount Expected to be Expended			
	Sinter Line	Quench Car	Mixer Fume Control	Total
1978, Fourth	$ 280,000	$ ---	$ ---	$ 280,000
1979, First	250,000	---	50,000	300,000
1979, Second	430,000	720,250	350,000	1,500,250
1979, Third	550,000	511,120	800,000	1,861,120
1979, Fourth	270,000	---	1,150,000	1,420,000
1980, First	---	---	300,000	300,000
1980, Second	---	---	30,000	30,000
TOTALS	$1,780,000	$1,231,370	$2,680,000	$5,691,370

(8) The facts and estimates in Paragraphs (2) through (7) are based on representations made by Corporation C. The Board is not aware of any facts or circumstances that would cause it to question the accuracy of the representations made by Corporation C.

(9) Money deposited in the Debt Service Fund established by Article X of the indenture for the Bonds will be used to pay principal of and interest on the Bonds and the Board reasonably expects that there will be no other funds that will be so used.

(10) Any money deposited in the Debt Service Fund will be spent within a thirteen-month period beginning on the date of deposit, and any amount received from investment of money held in the Debt Service Fund will be spent within a one-year period beginning on the date of receipt.

(11) To the best of our knowledge, information and belief, the above expectations are reasonable.

(12) The Industrial Board has not been notified of any listing of it by the Internal Revenue Service as an issuer that may not certify its bonds.

(13) The undersigned are those officers of the Industrial Board charged, by resolution of the Board of Directors of the Industrial Board, with the responsibility of actually issuing and delivering the Bonds.

(ii) This certification by the Industrial Board of City A meets the requirements of subdivision (iii) of this subparagraph and conclusively establishes the Board's reasonable expectations on the date of issue as to the future events described in the certification. However, nothing contained in this certification tends to establish any conclusions of law.

(iii) It has been assumed that the Letter Agreements described in this example constitute "some other similar official action" within the meaning of section 1.103-8(a)(5).

Example (7). City D issues $10 million of 7-percent revenue bonds for the purpose of constructing a water treatment facility. Certain proceeds of the revenue bonds will be deposited with a trustee. In part, the trust agreement provides as follows: "In the event City D is of the opinion that it is necessary to restrict or limit the yield on the investment of any moneys paid to or held by the Trustee hereunder in order to avoid the Bonds, or any series thereof, being considered "arbitrage bonds" within the meaning of the Internal Revenue Code of 1954, as amended, the Board or the Medical Center may issue to the Trustee a written certificate to such effect (along with appropriate written instructions), in which event the Trustee will take such action as is necessary so to restrict or limit the yield on such investment in accordance with such certificate and instructions, irrespective of whether the Trustee shares such opinion." If city D uses reasonable care in the selection of the trustee, it can reasonably expect the trustee to invest the funds in accordance with the trust agreement. This reasonable expectation will be conclusive without regard to the subsequent actions of the trustee.

Example (8). County Y, in connection with an issue of revenue bonds, covenants in the bond indenture that it will proceed with due diligence to spend the bond proceeds for the construction of a library. This covenant is included in the indenture as a bona fide safeguard for the protection of the bondholders. County Y can reasonably expect to comply with this covenant and, therefore, to satisfy the due diligence test of section 1.103-14(b)(4). The result is the same whether or not the bond proceeds are actually spent with due diligence.

*   *   *   *   *

(4) Innocent mistake. Bonds are not arbitrage bonds merely because of an inadvertent, insubstantial error (e.g., in arithmetic).

*   *   *   *   *

(b) Definitions.***

(2) Proceeds.***

(ii) ***

(B) Despite section 1.103-13(b)(2)(ii)(A), "investment proceeds" do not include receipts from investment of amounts treated as proceeds under section 1.103-13(g) (relating to invested sinking funds).

*   *   *   *   *

(5) Materially higher.***

(iv) *** Nothing in this subdivision implies that the deliberate overissuance of less than 5 percent will not be treated as an artifice or device (see section 1.103-13(j)).

(v) The following examples illustrate the application of paragraph (b)(5)(iv) of this section:

Example (1). On July 1, 1977, city A sells $10 million of 7-percent Series A revenue bonds and $5 million of 4-percent Series B special obligation bonds at par in the full cash defeasance of a prior issue. Assuming that under State law and the bond indenture the amount necessary to achieve the purpose of the refunding is only $10 million, paragraph (b)(5)(iv) of this section applies to both the Series A and the Series B issues. Thus, for example, if transferred proceeds of the Series A issue are invested at more than 7 percent, the Series A bonds are arbitrage bonds.

Example (2). On July 1, 1978, city B sells $10 million of 7-percent revenue bonds at par. One and a half million dollars of the bond proceeds will be placed in a debt service reserve fund and invested for 25 years in Treasury bonds at a yield of 8-1/2 percent. Assume that a reserve fund of no more than $800,000 is reasonably required for the revenue bonds. Based on these facts, paragraph (b)(5)(iv) of this section applies to the revenue bonds. Therefore, the revenue bonds are arbitrage bonds.

Example (3). On July 1, 1979, City C has outstanding $20 million of revenue bonds. In addition, City C has accumulated $15 million in a sinking fund for the revenue bonds. Assume that City C sells approximately $23 million of refunding bonds at par, defeasing the prior issue and freeing the sinking fund from any lien. The $15 million held in the sinking fund will continue to be invested in long-term Treasury bonds. Of the proceeds of the refunding issue, $20 million will be used to call the revenue bonds at par and $3 million will be used to establish a reserve of $3 million. Based on these facts, paragraph (b)(5)(iv) of this section applies to the refunding issue. The amount necessary to call the outstanding revenue bonds is only $5 million (i.e., $20 million less the $15 million held in the sinking fund). Thus, at least $15 million of the proceeds of the refunding issue will not be needed for any governmental purpose.

* * * * *

(vi) Except as provided in subdivision (viii) of this subparagraph (and despite anything in section 1.103-13(b) or

(e) to the contrary), section 1.103-13(b)(5)(vii) applies to any acquired obligation that is allocated to amounts treated as proceeds under section 1.103-13(g) (relating to invested sinking funds).

* * * * *

(viii) The yield on an acquired program obligation is materially higher than the yield on an issue if the yield on the acquired program obligation exceeds--

(A) The yield on the issue, plus

(B) One and a half percentage points.

(ix) In lieu of the amount described in section 1.103-13(b)(5)(viii)(B), the issuer may substitute such larger amount as is necessary to pay expenses (including losses resulting from bad debts) reasonably expected to be incurred as a direct result of administering the program, to the extent that such amounts are not payable with funds appropriated from other sources.

(11) Discharged. An issue is "discharged" when cash is available on the date due (whether at maturity or upon prior

call for redemption) at the place of payment, and interest ceases to accrue on the issue.

(12) Bona fide debt service fund. (i) A bona fide debt service fund is a fund that is used primarily to achieve a proper matching of revenues and debt service within each bond year.

(ii) A bona fide debt service fund for a single issue must be depleted at least once a year except for a reasonable carryover amount (not to exceed the greater of (A) one year's earnings on the fund, or (B) 1/12 of annual debt service).

(iii) A bona fide debt service fund may be established for two or more issues; provided that the total amount in the fund at no time exceeds the total of the amounts that could be held in bona fide debt service funds established separately for each of the issues.

(c) Computation of yield.***

(5) Certain administrative costs. If acquired purpose obligations are allocable (under section 1.103-13(f)) to an issue issued after September 1, 1978, then the following rules apply:

(i) In determining the yield on the acquired purpose obligations, administrative costs paid by the obligor shall not be taken into account.

(ii) Subdivision (i) of this subparagraph applies whether or not the obligor's payments are made from bond proceeds, and whether or not such payments merely reimburse the issuer. For this purpose, any payments made by the obligor may be treated as reimbursements of administrative costs; provided that the present value of such payments does not exceed the present value of administrative costs paid by the issuer.

(iii) In determining the present value of any payments or costs, the yield on the issue (as determined under section 1.103-13(c) and (d)) shall be used as the discount rate.

(iv) For purposes of this subparagraph, the term "administrative costs" means --

(A) The cost of issuing, carrying, or repaying the issue,

(B) The underwriter's spread, and

(C) The cost of purchasing, carrying, and selling or redeeming acquired purpose obligations.

(6) Monthly payments. An issuer may treat regular monthly payments on an acquired purpose obligation as if they were received semiannually.

(7) Examples. The following examples illustrate the application of subparagraphs (5) and (6) of this paragraph:

Example (1). On January 1, 1979, authority A sells $1,050,000 of single-family housing bonds. The yield on the bonds is 7 percent (determined under section 1.103-13(c) and (d) on the basis of semi-annual compounding). Authority A uses the bond proceeds to make 50 identical 25-year mortgage loans of $20,000 each. The mortgage loans are acquired program obligations (within the meaning of section 1.103-13(h)). Authority A uses the remaining $50,000 of proceeds to cover the underwriter's spread and to pay other administrative costs on January 1, 1979. Under the terms of each mortgage loan, authority A will receive level monthly payments of $168.98. Of each payment, $161.87 will be denominated principal and interest, and the remaining $7.11 will be denominated a "finance fee." On January 1, 1979, the present value of all these finance fees (using a discount rate of 7 percent) is $50,000. Therefore, these fees merely reimburse authority A for $50,000 of administrative costs. Accordingly, the finance fees are not taken into account in determining the yield on the mortgage notes. Consequently, the yield on the mortgage notes (computed by treating monthly payments as received semiannually on January 1 and July 1 of each year) is only 8.5 percent. Under section 1.103-13(b)(5)(viii), this yield of 8.5 percent is not materially higher than the yield on the single-family housing bonds.

Example (2). The facts are the same as in example (1), except that the entire monthly payment of $168.98 on each mortgage note will be denominated principal and interest. Although the stated interest rate on the mortgage notes is 9.02 percent, the results are the same as in example (1). There is no requirement that reimbursement for administrative costs must be stated separately as a finance fee; it may be included in interest.

(8) Insurance. (i) Premiums paid to insure a governmental issue are treated as interest paid on the issue; provided that the present value of the premiums is less than the present value of the interest reasonably expected to be saved as a result of the insurance.

(ii) In determining present value for purposes of this subparagraph, the yield on the governmental issue (determined without regard to this subparagraph) shall be used as the discount rate.

(g) Invested sinking fund--(1) Effective date.***

(ii) This paragraph does not apply to bonds sold before May 16, 1978, if--

(A) The sale of the bonds was either authorized or approved for sale before May 3, 1978, by a governing body of the governmental unit issuing the bonds or by the voters of such governmental unit, or by an administrative body or duly constituted authority (including an Oklahoma Trust or similar entity) on behalf of the governmental unit, statutorily empowered to do so,

*   *   *   *   *

(2) In general. Amounts held in a sinking fund for an issue (and receipts from investment of the sinking fund) are treated as proceeds of the issue.

(3) Sinking fund. The term "sinking fund" includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent that the issuer reasonably expects to use the fund to pay principal or interest on the issue.

*   *   *   *   *

(5) Prior issue. Original proceeds, investment proceeds, and transferred proceeds of the prior issue are not treated as proceeds of a refunding issue under this paragraph. See, however, section 1.103-14(e)(2)(ii) for rules relating to transferred proceeds.

(6) Other proceeds. Amounts treated as proceeds of an issue under section 1.103-13(b)(2) (relating to original proceeds and investment proceeds) are not treated as proceeds of the issue under this paragraph.

(7) Allocation. A sinking fund for two or more issues must be allocated between the issues--

(i) In proportion to their original face amounts, or

(ii) According to the debt service on the issues that will actually be paid from the sinking fund.

(8) Illustrations. The following examples illustrate the application of this paragraph:

Example (1). On January 1, 1979, city A sells $8 million of general obligation bonds at par. All the proceeds of the general obligation bonds will be spent before January 1, 1980 to build a new library. Beginning on January 1, 1980, city A will make periodic deposits into a sinking fund for the general obligation bonds. The amount held in the sinking fund will increase until it equals $8 million on January 1, 2008, and then it will be used to retire all of the outstanding general obligation bonds. The first $1.2 million (i.e., .15 x $8 million) accumulated in the sinking fund may be invested at an unrestricted yield pursuant to section 1.103-13(b)(1)(ii) (relating to the major portion test). Except as provided in section 1.103-14(d) (relating to temporary periods), none of the remainder may be invested at a yield that is materially higher (within the meaning of section 1.103-13(b)(5)(vii)) than the yield on the general obligation bonds.

Example (2). The facts are the same as in example (1). In addition, city A establishes a bona fide debt service fund for the general obligation bonds. No amounts are held in the debt service fund longer than 13 months. The result is the same as in example (1).

(h) *Acquired program obligations*--(1) *General rule*. The term "acquired program obligations" means acquired purpose obligations that carry out the purpose of a governmental program described in subparagraph (2) of this paragraph.

(2) *Governmental programs*. A governmental program is described in this subparagraph if--

(i) The program involves the acquisition of acquired purpose obligations.

(ii) At least 90 percent of all such obligations acquired under the program, by amount of cost outstanding, are evidences of loans to a substantial number of persons representing the general public, loans to exempt persons within the meaning of section 501(c)(3), or loans to provide housing and related facilities, or any combination of the foregoing;

(iii) At least 90 percent of all of the amounts received by the governmental unit with respect to obligations acquired under the program shall be used for one or more of the following purposes: to pay the principal or interest or otherwise to service the debt on governmental obligations

relating to the governmental program; to reimburse the governmental unit, or to pay, for administrative costs of issuing such governmental obligations; to reimburse the governmental unit, or to pay, for administrative and other costs and anticipated future losses directly related to the program financed by such governmental obligations; to make additional loans for the same general purposes specified in such program; or to redeem and retire governmental obligations at the next earliest possible date of redemption and

(iv) The program documents require that any person (or any related person, as defined in section 103(b)(6)(C)) from whom the governmental unit may, under the program, acquire obligations shall not, pursuant to an arrangement, formal or informal, purchase the governmental obligations in an amount related to the amount of the obligations to be acquired under the program from such person by the governmental unit.

(3) Examples. The following examples illustrate governmental programs described in subparagraph (2) of this paragraph:

Example (1). State A issues obligations the proceeds of which are to be used to purchase certain home mortgage notes from commercial banks. The purpose of the governmental

program is to encourage the construction of low income residential housing by creating a secondary market for mortgage notes and thereby increasing the availability of mortgage money for low income housing. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) to service the debt on the governmental obligations, (2) to retire such obligations at their earliest possible date of redemption, (3) to purchase additional mortgage notes. The governmental program is one which is described in subparagraph (2) of this paragraph.

Example (2). State B issues obligations the proceeds of which are to be used to make loans directly to students and to purchase from commercial banks promissory notes made by students as the result of loans made to them by such banks. The legislation authorizing the student loan program provides that the purpose of the program is to enable financially disadvantaged students to continue their studies. The legislation also provides that purchases will be made from banks only where such banks agree that an amount at least equal to the purchase price will be devoted to new or additional student loans. The governmental program is one which is described in subparagraph (2) of this paragraph.

Example (3). Authority C issues obligations the proceeds of which are to be used to purchase land to be sold to veterans. The governmental unit will receive purchase-money mortgage notes secured by mortgages on the land from the veterans in return for such land. The purpose of the program is to enable veterans to acquire land at reduced cost. Amounts received as interest and principal payments on the mortgage notes are to be used for one or more of the following purposes: (1) to pay the administrative costs directly related to the program, (2) to service the debt on the governmental obligations, (3) to retire such governmental obligations at their earliest possible call date, and (4) to purchase additional land to be sold to veterans. The governmental program is one which is described in subparagraph (2) of this paragraph.

(i) [reserved]

(j) Artifice or device. If an artifice or device is employed in connection with the issuance of a governmental

obligation, such obligation will be considered an arbitrage bond within the meaning of section 103(c)(2). For purposes of this section, the term "artifice or device" means a transaction or series of transactions that attempts to circumvent the provisions of section 103(c), this section, section 1.103-14, or section 1.103-15,--

(1) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to gain a material financial advantage, and

(2) Increasing the burden on the market for tax-exempt obligations.

Examples of increased burdens on the market for tax-exempt obligations include selling obligations that would not otherwise be sold, selling more obligations than would otherwise be necessary, and issuing obligations sooner or allowing them to remain outstanding longer than would otherwise be necessary. In no case shall it be considered an artifice or device to invest bond proceeds (or amounts treated as bond proceeds) at a materially higher yield if specifically provided for in section 103(c)(4). The provisions of this paragraph may be illustrated by the following examples:

Example (1). Authority E decides to advance refund certain revenue bonds. However, E intentionally delays the issuance of the refunding bonds until 2 years before the call date of the refunded bonds in order to take advantage of the 2-year temporary period provided by section 1.103-14(e)(3)(ii)(B). The ability of authority E to invest proceeds of the refunding issue at a materially higher yield during the temporary period makes this refunding more attractive than would be the case if such investment were not permitted. Authority E's decision to delay the issuance of the refunding bonds to take advantage of this temporary period is not an artifice or device within the meaning of this paragraph, because investment of bond proceeds at a materially higher yield during a temporary period is specifically provided for in section 103(c)(4). In addition, the purpose of the temporary period in section 1.103-14(e)(3)(ii)(B) is to encourage issuers to delay advance refundings until later in the term of the prior issue.

Example (2). On January 1, 1981, authority K sells $1 million of 40-year industrial development bonds at par. The proceeds of the industrial development bonds will be needed to make a $1 million loan to corporation X for 5 years. When the principal of the loan is repaid on January 1, 1986, authority K will invest this sum in Treasury bonds at a yield that is materially higher than the yield on the industrial development bonds. By selling bonds with a term that is 35 years larger than necessary, authority K has attempted to use an artifice or device to defeat the purpose of section 103(c).

Example (3). On January 1, 1981, city L sells $10 million of tax anticipation notes. For purposes of determining the cumulative cash flow deficit on January 1, 1982, city L assumes that the amount of its anticipated expenditures for the month of January, 1982 is reasonably required as a cash balance. See section 1.103-14(c)(2). City L conducts no investigation into its actual cash balance requirements. Therefore, city L is unable to ascertain whether one month's expenditures is, in fact, a reasonable balance. City L has not used an artifice or device in connection with the tax anticipation notes. The purpose of the one-month figure in section 1.103-14(c)(2)(ii) is to eliminate the need for city L to conduct an investigation of its cash balance requirements.

Example (4). On January 1, 1983, city M sells $10 million of 6-percent refunding bonds. The proceeds of the refunding bonds will be held in escrow until they are used to pay principal and interest on a 3-percent prior issue. Although the prior issue is callable at par, it will be left outstanding until maturity. Moreover, amounts held in the escrow will be invested at a yield of 6 percent. Based on these facts, city M has not used an artifice or device. It has allowed the 3-percent prior issue to remain outstanding merely because it would be unwise to buy back the prior issue at par. Further, city M does not stand to make any profit by exploiting the difference between taxable and tax-exempt interest rates.

Paragraph 2. Section 1.103-14 is amended as follows:

1. Paragraph (b) is amended by deleting subparagraphs (7) and (10), by redesignating subparagraphs (8), (9), and (11) as subparagraphs (7), (8), and (9), and by adding new subparagraphs (10), (11), (12), (13), (14), and (15), and by inserting "subparagraph (8)" in lieu of "subparagraph (9)" in subparagraph (9) (as redesignated).

2. Paragraph (d) is amended by inserting "Except as provided in subparagraphs (2) and (4) of this paragraph" in lieu of "As a general rule" in the second sentence of subparagraph (1), by adding a new sentence at the end of subparagraph (1), by revising subparagraph (2) and by adding a new subparagraph (4).

3. Paragraph (e) is amended by deleting the sixth, seventh and eighth sentences in subparagraph (2)(ii), by adding a new subparagraph (2)(iv), by deleting the last sentence in subparagraph (3)(i) and inserting three new sentences in lieu thereof, by revising subparagraph (5)(iv), and by adding a new subparagraph (7).

Section 1.103-14 Temporary investments, reserve fund and refunding issues.

(b) Temporary Period.***

(10) Debt Service Fund. (i) Despite subparagraphs (8) and (9) of this paragraph, 13 months is the temporary period for amounts contributed to a bona fide debt service fund (as defined in section 1.103-13(b)(12)).

(ii) If a portion (but not all) of a fund satisfies the requirements of bona fide debt service fund, then that portion is allowed a 13-month temporary period under this subparagraph. However, the remainder of the fund is not allowed the 13-month temporary period. Thus, for example, assume that a single fund serves both as a bona fide debt service fund and as a reserve fund. The portion of the fund that serves as a bona fide debt service fund is allowed a 13-month temporary period under this subparagraph. However,

the remainder of the fund is not allowed a temporary period of 13 months. If this subdivision applies, then the requirement for annual depletion in section 1.103-13(b)(12) applies only to the portion of the fund that constitutes a bona fide debt service fund

(11) Revolving Fund. (i) The term "revolving fund" means a fund--

(A) That consists of receipts from the sale of property acquired with bond proceeds and payments of principal and interest on acquired program obligations; and

(B)(1) That will be used for the acquisition of additional property or acquired program obligations, or

(2) Whose governing instrument requires the acquisition of additional property or acquired program obligations to the extent that suitable property or obligations are reasonably available.

(ii) For purposes of this subparagraph, the term "property" does not include securities (within the meaning of section 165(g)(2)(A) or (B) or obligations (other than obligations described in section 103(a)(1) or (2)).

(iii) Despite subparagraphs (8) to (10) of this paragraph, the temporary period for amounts deposited in a revolving fund is three years from the date of deposit.

(12) Certain new money issues. (i) In addition to the other temporary periods allowed by this paragraph, a sinking fund for an issue shall have a temporary period that--

(a) Begins on the date of issue, and

(b) Ends on the first call date (but not more than 10 years after the date of issue).

(ii) This subparagraph does not apply to an issue unless the issuer makes a reasonable effort to schedule payment of as much debt service as is practicable in each year before the first call date. Thus, nothing in this subparagraph implies that the use of a sinking fund to postpone the maturity of bonds will not be treated as an artifice or device under section 1.103-13(j). On the other hand, use of the temporary period allowed by this subparagraph is not, in and of itself, an artifice or device.

(iii) This subparagraph does not apply to a refunding issue, unless the prior issue had a term of less than three years and was issued in anticipation of permanent financing.

(iv) Despite subdivision (iii) of this subparagraph, the term of the prior issue may be longer than three years if the issuer demonstrates to the satisfaction of the Commissioner, prior to the issuance of the permanent financing, that a longer period of time was necessary.

(v) If this subparagraph applies to a refunding issue, then the 10-year limit in subdivision (i)(B) shall be reduced by the term of the prior issue.

(vi) The following example illustrates the application of this subparagraph:

Example. On January 1, 1980, housing authority A issues $4 million of bond anticipation notes. The bond anticipation notes have a term of five years. On January 1, 1980, authority A reasonably expects to roll the notes over into permanent financing within three years. However, due to unexpected difficulties, authority A is unable to issue permanent financing until July 1, 1984. Assume that, prior to July 1, 1984, authority A demonstrates to the satisfaction of the Commissioner that a term of 4-1/2 years was necessary for the temporary financing. Unless subdivision (ii) of this subparagraph applies, amounts accumulated in a sinking fund for the permanent financing will be allowed a temporary period beginning on July 1, 1984 and ending on the first call date. However, this temporary period may in no event exceed 5-1/2 years (i.e., ten years minus 4-1/2 years).

(13) Reserve or replacement funds. (i) In addition to the other temporary periods allowed by this paragraph, where an issuer has applied for a ruling that a reserve or replacement fund is necessary under paragraph (d)(2) or (e)(5)(iv) of this section, any amount in excess of the amount provided in paragraph (d)(1) of this section shall have the temporary period allowed under subdivision (ii) of this subparagraph.

(ii) The excess amount described in subdivision (i) shall have a temporary period that--

(A) Begins on the date of issue, and

(B) Ends 30 days after the earlier of (1) the date the ruling is issued (whether favorable or unfavorable), or (2) the date the request for such ruling is withdrawn, or (3) the date such request is administratively closed by the Internal Revenue Service.

(iii) This subparagraph does not apply unless the ruling request is made in good faith and satisfies the procedural requirements of section 601.201.

(14) Methods of accounting. For purposes of this paragraph, the issue may account for a sinking fund in any reasonable manner. Thus, for example, the issuer may use the first-in-first-out method or the last-in-first-out method. Further, if net revenues for any bond year equal or exceed debt service, then the issuer may assume that current debt service is paid entirely from current revenues.

(15) Illustrations. The following examples illustrate the application of this paragraph:

Example (1). (a) On September 1, 1980, city W sells a $2 million 20-year issue of 6-percent special assessment bonds. The original proceeds of the issue amount to $1,950,000. Of this amount, $60,000 will be used to make the first payment of interest, $140,000 will be deposited in a reasonably required reserve fund, and the remainder will be used to pave streets.

(b) Persons who own property in city W will be subject to a special assessment totaling $2 million. Each property owner will be required to pay his share of the special assessment in equal annual installments due on August 1 over the next 20 years. The special assessment may be prepaid at any time. However, if the special assessment is not prepaid, then the outstanding balance of the assessment will bear interest at 6 percent, due on August 1 of each year.

(c) One hundred thousand dollars of the special assessment bonds will mature on September 1 of each year 1981 to 1990. In addition, $1 million of term bonds will mature on September 1, 2000. The term bonds are callable at par beginning on September 1, 1990.

(d) City W will accumulate prepayments of the special assessment in a sinking fund until September 1, 1990. At that time, all amounts in the sinking fund will be used to call term bonds due in the year 2000.

(e) Based on these facts, city W's sinking fund is allowed a ten-year temporary period that ends on September 1, 1990. See subparagraph (12).

(f) After September 1, 1990, the sinking fund will be mandatory in character. All amounts deposited in the sinking fund will be used to call term bonds on September 1 of each year. Therefore, the sinking fund will serve merely as means to match revenues and debt service. Accordingly, amounts deposited in the sinking fund after September 1, 1990 will be allowed a 13-month temporary period under subparagraph (10).

Example (2). On July 1, 1981, Authority X sells a $3 million 20-year issue of 6-percent school bonds. Authority X uses the original proceeds of the issue to build a school building, and leases the building to school district Y. School district Y has general taxing powers. Under the terms of the lease, school district Y is unconditionally obligated to pay $130,000 on January 1 and July 1 of each year 1982 to 2002. These payments will be sufficient to enable authority X to pay level debt services and retire the school bonds over 20 years. Nevertheless, authority X will not pay any principal on the school bonds until July 1, 1991. Instead, authority X will deposit the excess of rents over interest in a sinking fund until July 1, 1991. Based on these facts, authority X will not make a reasonable effort to pay principal on the school bonds before July 1, 1991. Therefore, rents deposited in the sinking fund will be allowed a temporary period of only 30 days.

* * * * *

(d) Reasonably required reserve or replacement fund.

(1) In general. *** A reasonably required reserve or replacement fund may consist of one or more funds, or portions of funds, however labeled, derived from one or more sources.

(2) <u>Exception</u>. If an amount in excess of the amount provided in paragraph (d)(1) of this section is invested in a reserve or replacement fund, such excess will be considered to be invested in a reasonably required reserve or replacement fund if--

(i) At least two weeks prior to the issuance of the governmental obligations, the issuer applies for a ruling that the specified reserve or replacement fund is necessary, and

(ii) A ruling to that effect is subsequently issued to the governmental unit (before or after the date of issuance of the obligations).

The procedure set forth in the preceding sentence does not preclude an issuer from relying on a published ruling in which the Commissioner specifically designates a category of reserve or replacement funds as reasonably required.

* * * * *

(4) <u>Pledge of endowment</u>. Endowment funds of a college, university, or other similar institution (such as a hospital or charity) pledged as collateral for an issue will be considered to be a reasonably required reserve if the pledged funds:

(A) Were derived from gifts or bequests (including the income thereon);

(B) Were not raised for the purpose of carrying out the project financed by the issue;

(C) Are not reasonably expected to be used (directly or indirectly) to pay principal or interest on the issue; and

(D) Are held as part of the institution's permanent capital.

The following example illustrates the application of this subdivision:

Example. The Health and Educational Facilities Authority of State X ("the X Authority") plans to issue long-term bonds to finance a new medical school building for College A. The bonds will be collateralized by a pledge of securities held by College A as quasi-endowment funds (funds functioning as endowment). In the financing agreement, College A represents that the pledged securities are quasi-endowment funds derived from gifts or bequests (or the income therefrom) and that it will expend on the construction of the medical school building an amount equal to or greater than the amount of funds raised for the purpose of such construction (including amounts that it reasonably expects to receive in the future from pledges or otherwise), and no such funds will be pledged as collateral for the issue. Authority X is not aware of any facts or circumstances that would cause

it to question the accuracy of the representations made by College A. In addition, on the basis of facts and estimates including projections indicating that revenues from other sources during the next five years will be more than sufficient to pay debt service on the issue, Authority X does not reasonably expect that the pledged funds or the income therefrom will be required to make payment of principal or interest on the issue. Accordingly, Authority X reasonably expects that the pledged funds satisfy the requirements of this subdivision, and such funds will be considered a reasonably required reserve fund. Authority X does not need a ruling under subparagraph (2) of this paragraph.

(e) Refunding issue.***

(2) Definitions.***

(iv) Despite section 1.103-14(e)(2)(ii), the term "transferred proceeds" does not include amounts treated as proceeds of the prior issue under section 1.103-13(g) (relating to invested sinking funds).

(3) Temporary period. (i) *** Except as provided in the preceding sentence, the issuer shall be allowed the longer of the temporary periods determined under paragraph (e)(3)(ii)(A) or (B), or (at the issuer's option) the temporary period determined under paragraph (e)(3)(ii)(C). This subparagraph (except for subdivision (viii) and (ix)) does not apply to amounts treated as proceeds under section 1.103-13(g) (relating to invested sinking funds). For the temporary period for an invested sinking fund, see section 1.103-14(b)(8) to (12).

* * * * *

(5) <u>Reasonably required reserve or replacement fund</u>.***

(iv) If an amount in excess of the amount allowed under paragraphs (d)(1) and (e)(5) of this section is invested in a reserve or replacement fund for a refunding issue, such excess may be invested at a yield that is materially higher than the yield on the refunding issue only if--

(A) At least two weeks prior to the issuance of the governmental obligations, the issuer applies for a ruling that the specified reserve or replacement fund is necessary, and

(B) A ruling to that effect is subsequently issued to the issuer (before or after the date of issuance of the obligations).

The procedure set forth in the preceding sentence does not preclude an issuer from relying on a published ruling in which the Commissioner specifically designates a category of reserve or replacement funds as reasonably required for refunding issues.

(7) <u>Exception</u>. (i) Section 1.103-14(e)(5)(ii)(B) does not apply to amounts deposited in a reserve or replacement fund for a refunding issue sold after the effective date of section 1.103-13(g) to the extent that such amounts--

(A) Were held in a reasonably required reserve or replacement fund for the prior issue, or

(B) Would (but for the refunding) have been deposited in a reasonably required reserve or replacement fund for the prior issue.

(ii) The following examples illustrate the application of this subparagraph:

<u>Example (1)</u>. On July 1, 1977, city A issues $10 million of revenue bonds. No reserve or replacement fund is created for the revenue bonds. On July 1, 1979, city A issues $11 million of refunding bonds to defease the 1977 issue. City A accumulates a reserve fund of $800,000 for the 1979 issue. This reserve fund is pledged as collateral for the 1979 issue, and city A is unable to make withdrawals from the reserve fund at any time during the term of the 1979 issue (except to pay debt service on the 1979 issue). Assume that the entire 1977 issue will be called on July 1, 1987, and no portion of the 1977 issue will be retired before that date. Based on these facts, the proceeds of the 1979 issue replace amounts held in the reserve fund within the meaning of section 103(c)(2)(B). Therefore, these amounts are subject to the same yield restrictions, and generally have the same status, as proceeds of the 1979 issue. As a result, the revenues deposited in the reserve fund are subject to arbitrage yield restrictions until July 1, 1987 (see section 1.103-14(b)(5)(ii)(B)), unless city A makes the demonstration

required by section 1.103-14(b)(5)(iv). The result is the same whether or not city A reasonably expects to use amounts held in the reserve fund to pay debt service on the 1979 issue.

Example (2). On January 1, 1978, city B issues $10 million of revenue bonds. Under the bond indenture, city B is required to deposit revenues of $200,000 a year for 5 years in a reasonably required reserve fund for the 1978 issue (the "1978 reserve"). On January 1, 1980, city B issues $11 million of refunding bonds to defease the 1978 issue. At that time, city B transfers the $400,000 accumulated in the 1978 reserve to a reasonably required reserve fund for the 1980 issue (the "1980 reserve"). In addition, city B deposits revenues of $200,000 a year in the 1980 reserve for the next three years. Based on these facts, the amounts held in the 1980 reserve may be invested at an unrestricted yield pursuant to section 1.103-14(d).

Paragraph 3. Section 1.103-15 is amended by revising paragraph (k) to read as follows:

Section 1.103-15 Excess proceeds.

* * * * *

(k) Transferred proceeds--(1) Effective date. This paragraph applies to refunding bonds issued after September 1, 1978.

(2) In general. For purposes of this section, all original proceeds, investment proceeds, and transferred proceeds of the prior issue are treated as transferred proceeds of the refunding issue, except for amounts spent before the refunding bonds are issued.

- - - - - - -

Commissioner

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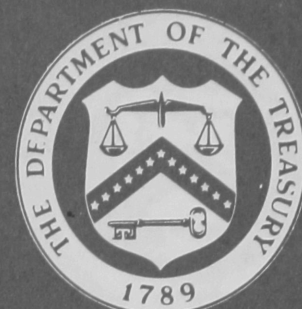

FOR IMMEDIATE RELEASE September 1, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,202 million of 13-week Treasury bills and for $3,404 million of 26-week Treasury bills, both series to be issued on September 7, 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 December 7, 1978			26-week bills maturing March 8, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.067a/	7.647%	7.91%	96.092	7.730%	8.16%
Low	98.061	7.671%	7.93%	96.084	7.746%	8.17%
Average	98.064	7.659%	7.92%	96.086	7.742%	8.17%

a/ Excepting 1 tender of $80,000

Tenders at the low price for the 13-week bills were allotted 2%.
Tenders at the low price for the 26-week bills were allotted 56%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 20,950,000	$ 20,355,000	$ 26,125,000	$ 6,125,000
New York	4,006,920,000	1,899,730,000	5,080,010,000	2,992,640,000
Philadelphia	14,750,000	13,560,000	7,555,000	7,030,000
Cleveland	128,930,000	104,590,000	64,280,000	11,385,000
Richmond	29,310,000	26,310,000	35,060,000	7,060,000
Atlanta	36,790,000	20,675,000	11,720,000	9,620,000
Chicago	173,900,000	27,390,000	259,105,000	22,555,000
St. Louis	42,295,000	12,555,000	24,045,000	5,740,000
Minneapolis	13,480,000	4,480,000	53,695,000	2,695,000
Kansas City	20,610,000	20,290,000	14,175,000	13,110,000
Dallas	23,445,000	8,445,000	5,410,000	5,410,000
San Francisco	238,165,000	35,325,000	536,255,000	311,255,000
Treasury	8,205,000	8,205,000	8,895,000	8,895,000
TOTALS	$4,757,750,000	$2,201,910,000b/	$6,126,330,000	$3,403,520,000c/

b/Includes $ 310,710,000 noncompetitive tenders from the public.
c/Includes $ 154,730,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-1146

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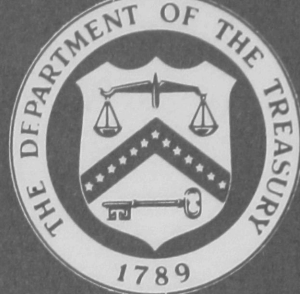

FOR IMMEDIATE RELEASE
September 1, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES PRELIMINARY
COUNTERVAILING DUTY ACTION ON
OLEORESINS FROM SPAIN

The Treasury Department today announced its preliminary determination that exports of oleoresins from Spain are subsidized. Treasury must make a final decision no later than February 17, 1979.

An oleoresin is a thick liquid extract of the flavor of a spice used primarily in the food industry. Imports of oleoresins from Spain were valued at approximately $3.4 million for the period January-November 1977.

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) found to have been paid on the exportation or manufacture of merchandise imported into the United States.

The subsidy under review is received in the form of an over-rebate of the Spanish indirect tax, the "Desgravacion Fiscal."

Notice of this action will be published in the Federal Register of September 5, 1978.

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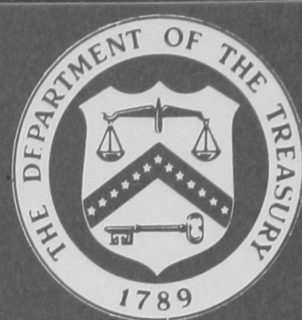

FOR RELEASE AT 4:00 P.M. September 5, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,700 million, to be issued September 14, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,709 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 June 15, 1978, and to mature December 14, 1978 (CUSIP No. 912793 U8 7), originally issued in the amount of $3,410 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,400 million to be dated September 14, 1978, and to mature March 15, 1979 (CUSIP No. 912793 X4 3).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing September 14, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,388 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 Daylight Saving time, Monday, September 11, 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-1148

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 September 14, 1978, in cash or other immediately available funds or in Treasury bills maturing September 14, 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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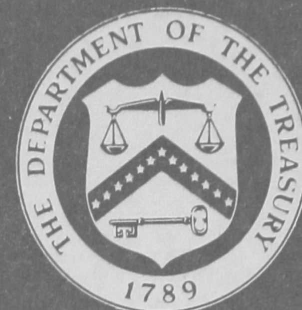

FOR RELEASE UPON DELIVERY
EXPECTED AT: 10:00 A.M. EDT
WEDNESDAY, SEPTEMBER 6, 1978

STATEMENT BY GARY C. HUFBAUER
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR TRADE AND INVESTMENT POLICY
BEFORE THE
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
SCIENTIFIC PLANNING, ANALYSIS, AND COOPERATION
OF THE
COMMITTEE ON SCIENCE AND TECHNOLOGY
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman, thank you for this opportunity to testify on the international transfer of technology. This subject has interested me for some years.

Prior to entering government service, I published a number of articles on the economic aspects of international technology flows. More recently, I testified, in a personal capacity, before a joint session of two Senate subcommittees on changes in U.S. technological leadership and the effects of those changes on our trade performance. While my presentation before those subcommittees was primarily analytical, many of the points I made then are relevant to the policy concerns you have raised today. I would therefore like to submit my earlier statement for the record.

B-1149

Basic Concepts

Beginning with the basics, it is useful to distinguish in broad terms between science and technology. Science explains observable facts in terms of theoretical models. Technology translates scientific relationships and concepts into workable applications. Science advances man's understanding of natural phenomena, while technology leads to cheaper and better goods in the economic marketplace.

These differences have important implications for the choice of appropriate public policies. In the United States and most countries, science is largely the province of academic institutions, supported by government funds. Scientists thrive, in status and in stimulation, from the immediate transmission of their ideas to colleagues all over the world. Secrecy and science do not mix; and scientific ideas, relating, for example, to the laws of nature, are not patentable.

By contrast, industrial technology is primarily the domain of private firms. Firms which finance the improvement of technology must generally look to the marketplace for their reward. This reward can only be obtained by keeping new technology closely held as a trade secret, or by securing the legal

protection of a patent. If new technology were freely and instantly transmitted to all users, the market reward for innovating firms would be much reduced.

Technology has two distinct but related phases: first, generation, and second, diffusion. In the United States, the generation of industrial technology largely results from the research and development efforts of commercial firms. In some countries, such as Japan, France, and Germany, government-sponsored institutions, working closely with private firms, play a larger role in developing new industrial technologies. Whatever the system, it is a fair generalization that the generation of technology by or on behalf of private firms in the industrial OECD nations depends on commercial reward. The system of commercial reward accomplishes two purposes: it discourages the development of technology which has no social use, and it provides both the funds and the incentive for useful discoveries.

The conditions governing diffusion go a long way to determine what proportion of the benefit of a new technology will show up in private returns. If diffusion were to take place freely and instantly, the commercial returns to the inventing company would be small; if diffusion were controlled for decades by the inventing

firm, the private return would approach (and possibly even exceed) the benefits to society. Professor Mansfield's study of a sample of innovations indicates that, on average, private returns have amounted to only 20 to 40 percent of total (private plus social) returns resulting from new technologies. Put another way, society at large benefits more than the innovating firm from the generation of new technology. One reason is that much technology is not patentable; another reason is that the patent system by design grants a monopoly of limited duration, and the scope of that monopoly is circumscribed by our antitrust laws.

The patent system institutionalizes the relationship between technology generation and diffusion. In the United States, a patent monopoly is awarded to the successful inventor for a period of time, 17 years, after the patent is granted. This legal monopoly provides rewards for and public disclosure of inventions; at the same time, the patent system ensures diffusion of the opportunity to utilize useful inventions no later than 17 years after a patent is granted. Attempts at inventing around profitable inventions are certain to occur much sooner, often with some success. Under the patent system, more generation of technology today

necessarily means more diffusion of use 17 years later, if not sooner.

As I mentioned, much technology is never patented. A firm can obtain some legal protection against the disclosure of its unpatented trade secrets by faithless employees, but it has no protection against reverse engineering or independent attempts at imitation. I would guess that very few firms manage to preserve exclusive control of profitable, but unpatented technology for as long as 10 years. Trademark laws do afford a lesser degree of legal protection for the markets for trade secrets which are embodied in branded products. A brand which acquires a reputation for superior performance cannot be instantly displaced by physically identical products.

International transfers of patented and unpatented technology may take place through a variety of different mechanisms:

-- The holder of a patent or trademark may license another party, in return for money payments, cross licensing of other patents, or other compensation;

-- The firm may license its patent and trademark rights and trade secrets to a foreign subsidiary or joint venture in which it has a direct investment;

-- The firm may export goods which incorporate the technology;

-- The firm may construct turn-key plants or other facilities that embody its process technology;

-- The firm may assign personnel with managerial or technical expertise abroad under a management, service, or other type of contract;

-- Foreign competitors may acquire a firm with a desired technology by a takeover bid, or they may simply copy the product or process, and litigate any patent infringement questions that arise.

At the American Economic Association meetings in Chicago a few days ago, Professor Mansfield reported on his findings from a recent survey of U.S.-based multinational firms. Approximately 30 percent of the expected returns from R&D projects now underway by the sampled firms are expected to come from outward sales of technology, principally exports of goods from the United States and licensing of foreign subsidiaries. Further, if all foreign outlets for the exploitation of new technology were foreclosed, the R&D budgets of the sampled firms would be cut by 16 to 26 percent; if only the licensing

of their foreign subsidiaries were foreclosed, their R&D budgets might be cut by 12 to 16 percent.

At the same meeting, Dr. Halder Fisher reported his findings concerning the operations of several European multinational firms with subsidiaries in the United States. The European multinationals were predominately interested in transferring European technology to the American subsidiaries, rather than vice versa. The takeover of American firms as a vehicle for acquiring American technology does happen, but to a greater extent in our ethnocentric thinking than in reality.

I mention these findings because of their implications for the policy concerns which I would now like to discuss.

Policy Issues

Over the years, a number of policy issues have arisen regarding technology transfer. I would like to address four major issues which concern the role of the U.S. Government in the technology transfer process.

(1) What action should be taken on the international level to meet the demands of the developing countries for access to technology on preferential terms?

(2) What data should the U.S. Government be collecting concerning international technology transfer?

(3) What support should the U.S. Government give to research and development activity?

(4) Should we restrain transfers of U.S. technology to foreign countries?

International Negotiations

The primary forum for international discussion on the transfer of technology is the U.N. Conference on Trade and Development (UNCTAD), where negotiations on an international code of conduct for technology transfer have been in progress since 1975. A negotiating conference is scheduled for October 16 - November 10, 1978. The principal topics under consideration there are standards for governments and enterprises, competition policy, dispute settlement procedures, and national regulation.

The United States and other developed countries prefer the adoption of voluntary guidelines for technology transfer. The developing countries, however, have a different objective. They insist that a legally-binding convention be negotiated as the basis for international regulation of technology transfers. This convention would attempt to make proprietary technology available to developing

countries on terms and conditions which could undermine our present system for technology development and transfer.

The United States is seriously concerned that the legal attributes of proprietary technology might be eroded in these negotiations. Any erosion could in turn diminish the level of R&D activity, not only in the advanced industrial countries but ultimately in the developing countries themselves. The erosion of legal protection would also cause firms to be more wary about diffusing technology to developing countries.

These are not idle concerns. The work of Mansfield and others points to a strong link between the expected profitability and the level of R&D activity. Moreover, a major reason why firms today are much slower to license independent foreign firms than their own subsidiaries is that independent licensees can mount legal challenges to the patent itself or to the terms of the license. For the same reason, firms are even more hesitant to convey their process technology, which is often unpatented, to independent foreign firms. Unless the United States and other industrial countries contemplate radically new methods for promoting the generation and diffusion of technology, they would disserve themselves

and the developing world by weakening the existing system of legal protection. In light of Mansfield's estimates that the typical private firm reaps only 20 to 40 percent of the total benefits of its innovation, I question G-77 rhetoric that the existing system gives rise to the wholesale exploitation of developing countries.

A forum for broader discussion of science and technology issues will be the U.N. Conference on Science and Technology for Development (UNCSTD). This conference was spawned by the developing countries' efforts to dramatize the scientific and technological needs of the Third and Fourth Worlds. The conference has been set for late summer 1979.

The United States supports the efforts of UNCSTD to build a scientific and technological infrastructure for economic growth. Governments can contribute to the exchange of scientists and students, and improve the capacity of poor countries to develop and assimilate useful technology. But the United States also believes that decisions on where and how existing commercial technology is transferred should remain the responsibility of private firms.

A third international forum where the developing countries are pressing for change involves the Paris Convention for the Protection of Industrial Property. The Paris Convention, signed by 87 nations, provides, among other things, for national treatment and right of priority for owners of patents and trademarks. Since 1975, the developing countries have made various proposals for revision of the Convention to facilitate their access to patented technology.

They believe that the international industrial property system is skewed in favor of the developed countries with their greater capability to devise and work patents. The developing countries have proposed compulsory exclusive licensing obligations on patent and trademark holders: the exclusive opportunity to use such patents would be transferred to host country parties if the patent was not worked locally within a shorter period of time -- a "use it or lose it" principle.

The U.S. Government opposes this concept. We see no justification for pre-empting the patent rights of companies simply because they have chosen not to exercise those rights in a particular country. It is quite impractical and economically unfeasible to expect companies to

work each of their many hundreds of patents in every country. The adverse effects of a "use it or lose it" principle are obvious. What foreign firm would purchase a license from a U.S. inventor if it feared that a firm in another country might produce the same goods under a compulsory license? What would happen to the financial incentives for carrying out R&D if the U.S. inventor, having lost its patent rights under a "use it or lose it" scheme, had to face competition, both in the United States and abroad, from foreign producers using its technology under a compulsory license?

Thus far, the United States and other market economy countries have opposed, with limited success, moves to adopt the "use it or lose it" principle on an international basis. However, a number of developing countries have adopted aggressive national policies designed to increase the quantity and quality of technology they receive from the industrialized nations at a lower cost. If this trend continues, it is possible that some countries might incorporate offensive principles in their regulatory regimes.

Existing U.S. law provides for certain actions that we might use in the event that our interests were threatened by the overly aggressive policies of other

nations. The Trade Act of 1974, for example, contains two relevant provisions. Under Section 337, the U.S. Government may move, in certain circumstances, to exclude imports of products produced under infringed patents or stolen technology. Section 301 sanctions retaliation in a variety of ways against exports of such products to third country markets. Both of these remedies are available on a case-by-case basis, if private parties find it necessary to initiate complaints.

Data Collection and Analysis

The description of technology transfer that I gave in my opening remarks was rather general. The very concept of technology is itself diffuse and defies the kind of easy quantification applied to financial statistics. Technology is characterized by various features which can take different values for different technologies: for example, the extent to which it is conceived of as a cumulated stock or an annual flow; the extent to which it is a public good or a private good; the extent to which it must be embodied in machinery or can be applied in disembodied form; and the extent to which it is potentially mobile from one location to another.

The existence of these various dimensions considerably complicates our efforts to collect satisfactory

data on the various aspects of technology transfer, such as how much is occurring and what forms it is taking. We have traditionally used balance of payments data on royalties and management fees as a proxy for international transfers, but, for obvious reasons, these financial magnitudes do not adequately portray events.

Under the direction of Dr. Rolf Piekarz, the Division of Policy Research and Analysis of the National Science Foundation has sponsored a number of valuable studies designed to increase our knowledge of international technology flows. Some of their best studies have looked very closely at relatively small samples. Cumulatively, these studies have been much more revealing than large scale, but shallow, data collection efforts.

Nevertheless, we hope to improve our broad data base with a survey now being conducted by the Commerce Department on the foreign investments of U.S. firms. The survey covers calendar year 1976. In this survey, U.S. firms are asked to provide information on such things as whether they have licensing agreements with unaffiliated foreigners, their R&D expenditures in the United States and abroad, and the number of their employees engaged in R&D work, as well as more detailed data on their

receipts from abroad of royalties and fees. They are also being asked to report on a similar list of items with respect to each of their foreign affiliates.

The completed forms have been received from 3,000 U.S. firms with roughly 23,000 foreign affiliates -- representing about 80 percent of the total number of firms expected to report. Once the data have been analyzed we will be better able to decide what additional information could usefully be collected by the Federal Government. Additional information may be collected in small-scale special surveys devoted exclusively to technology transfer.

U.S. Government Support for R&D

Over the past decade, there has been much discussion concerning the relative and even absolute loss in the United States' position as a post-war leader in technology. A closely related question is what effects any changes in our relative standing in the league of technologically sophisticated nations may have had on our exports and imports. These two questions quickly lead to a policy issue: should the U.S. Government increase or alter the form of its support for R&D activity?

I addressed the first two questions in some detail in my statement before the Senate subcommittees last spring.

Since I have given you a copy of that statement, I will only mention a few highlights today.

It is quite true that our technological lead has been cut down or lost in a number of areas, corresponding to the rise of Western Europe and Japan as major industrial powers. This is evidenced in a variety of indicators, ranging from patent statistics (foreign firms are taking an increasing share of U.S. patents) to productivity growth (especially Germany and Japan by comparison with the United States) to common sense observations about the source of a number of new products.

Yet our R&D situation is not as bad as is commonly thought. While total industrial R&D spending in the United States has barely kept up with inflation, private industry spending on R&D -- which dollar-for-dollar possibly makes a more immediate contribution to our economy -- actually increased by an average 3.8 percent in real terms between 1966 and 1976. In 1977 the increase was some 10 percent in real terms. The overall level was highly influenced by Federal spending which, although it increased in current dollars by 50 percent over this period, declined in real terms.

As to U.S. trade in high technology goods, we have enjoyed a surplus of exports over imports in these products for a number of years -- making them a source of strength in our trade balance. Efforts to trace the relationship between R&D and trade performance are inhibited, however, by the problem of isolating the influence of R&D from closely related factors such as skilled labor, industrial concentration, and economies of scale. Moreover, it is difficult, if not impossible, for a country at or near the technological frontier, such as the United States, to pinpoint which processes or products offer the most promising trade benefits from larger R&D spending. In other words, a trade-oriented government R&D strategy would probably not achieve significantly better results than more general R&D support strategies.

I conclude that the strongest case for government R&D support rests not on international trade arguments, but rather on other grounds. As I pointed out earlier, the typical private firm can capture only a portion -- usually less than one-half -- of the total benefits flowing from its inventions. Scientific findings and theories are, of course, not even subject to legal protection, and private financial rewards are not a significant source of support for the basic sciences.

On the basis of these two observations I conclude that the private market, left entirely to its own devices, would badly underfund our scientific and technological efforts.

The present level of public support is not, however, trivial. The great bulk of scientific work in academic institutions is publicly supported (perhaps $6 billion in 1977). Nearly 40 percent of the R&D activity in private industry is financed by Federal funds (some $10 billion in 1977). The Federal Government itself performed about $6 billion of research in 1977.

In addition, Section 174 of the Internal Revenue Code, which permits the immediate expensing of R&D outlays on salaries and expendable supplies (but not capital equipment), entails a modest incentive by comparison with the conceptual alternative of capitalizing and amortizing all R&D outlays. The value of this incentive in 1977 was about $1.4 billion. Section 1235 of the code allows capital gains rather than ordinary income treatment for the sale by a noncorporate holder of patent rights. By court decisions, corporations can usually characterize the sale of proprietary technology as a disposal of a capital asset and thus also obtain capital gains treatment. These provisions provide

incentives for R&D activity on the order of less than a hundred million dollars annually. Finally, the special tax status of losses on the sale of small business stock, the pass-through provisions of Subchapter S, the special treatment of regulated investment companies and small business companies and the general capital gains provisions all provide some indirect support for R&D activity.

In summary, direct and indirect public support financed perhaps $25 billion of the $40 odd billion of the R&D activity (including basic science) performed in the United States in 1977. I would like to see substantially more support for basic science, especially since so many of our young graduate scientists have not been able to find work in their chosen fields. But whether or not a major across-the-board expansion of public support for industrial R&D would be justified is another matter. I am mindful of the views of experienced executives in high technology firms who complain that their main difficulty is not inadequate R&D funding but rather the numerous local, state, and Federal regulations that slow down the implementation of new technologies. Some of these executives say that the implementation time has doubled in the past

decade. If this is generally true, perhaps Federal attention should be directed towards lower barriers to implementation rather than towards higher levels of public R&D spending.

To be sure, a special case can be made for an accelerated research effort in certain sectors, particularly energy and environment. But Federal bureaucrats possess no special gift for sorting the rubies from the rubbish in choosing industrial research projects. I would rather leave these high-risk decisions to individual inventors and R&D executives in the private sector. Moreover, in those cases where publicly-funded research involves the assignment of patent rights and trade secrets to the public domain, a higher level of Federal involvement might weaken the nexus between market rewards and research activity and, as a consequence, could crowd out some private R&D effort. (I should hasten to add that no easy generalizations are possible: we do not know the extent to which Federally-supported research complements or substitutes for private research. I understand, however, that the NSF is beginning research that is intended to shed some light on the subject.) Finally, when the results of publicly-funded research are made available

to foreign firms on nearly the same terms as U.S. firms, there are obvious "free rider" implications.

These particular concerns are less serious if greater public support is channeled through the tax system rather than through direct funding, or if direct funding is conducted in a way that leaves patent rights and trade secrets with the private sector. This is a subject that will be examined closely by the Industrial Innovation Coordinating Committee established last May at the direction of the President.

Restraints on Transfers of U.S. Technology

A position often heard is that the United States should "protect" its lead role in the development of technology by restricting the export of technology. Advocates of this position often share one of the premises I discussed earlier: the existence of a direct and immediate relationship between R&D and exports. From this premise, they reason that the United States is disadvantaged if technology developed here is transported abroad before its potential for contributing to U.S. exports has been fully exploited. The seemingly logical conclusion is that the export of advanced U.S. technologies should be restricted. A subsidiary argument is that foreign

countries are often highly secretive about their own technology -- the finger here is often pointed at Japan -- and we should reciprocate with restrictive policies imposed at the Federal level.

In thinking about these arguments, we should distinguish between proprietary technology, technology that resides in the public domain because it was funded by public money, and technology with national security consequences. I will leave aside the important question of national security limitations in my remarks today.

The U.S. Government's policy on the transfer of proprietary technology is based on our long-standing commitment to an open international economic system. This does not mean that the proprietary technology of U.S. firms is free for the asking. It does mean that U.S. firms should be free to merchant their technology abroad for a suitable reward. As with our general policies concerning flows of goods and investment, we believe that technology will be used most efficiently if its allocation is governed by market forces. Our general policy is neither to encourage nor to discourage technology transfers. If market imperfections exist, we would rather see them corrected directly, rather than

offset with another layer of government intervention. Thus, the burden of persuasion rests with those who advocate either restrictive or promotional measures.

As Mansfield's survey indicates, many firms derive a significant percentage of their returns to R&D activity from the exploitation of technology in foreign markets. Restrictions on technology transfer could render many projects less attractive and cause a decline in our overall R&D efforts. Faced with restrictions on the transfer of proprietary technology, large U.S.-based multinational firms might shift more of their research facilities abroad. In the final analysis, our technological competitiveness could be damaged rather than bolstered by a restrictive approach.

Even if we reversed our present policy and determined as a general principle that restricting outflows of proprietary technology would be advantageous, it is questionable whether restrictions would prove effective. Private firms in search of profit have shown a devilish ingenuity in evading or avoiding government controls on the flow of capital, goods, and other resources in the international marketplace. There is no reason to believe that their talents would fail them if they were faced with controls on technology. In different eras, Flanders, France,

Britain and Germany have all tried to keep vital know-how within their national boundaries. In the end, their barriers proved extremely porous.

An enthusiast for controls should also find reason to pause over the associated bureaucratic costs -- costs that would inevitably take their toll on the profitability and hence the level of R&D activity. A conscientious system of technology control would require scores of personnel to promulgate and enforce a web of complex and often arbitrary regulations. Bureaucrats and lawyers thrive under this kind of regime; technological creativity does not.

Finally, we must take into account possible retaliation by other governments. The character of the international economic system decisively depends on the example set by the United States. Regrettably, our worst policy initiatives are imitated more rapidly than our best. The "trade wars" of the 1930's illustrate what could develop if the United States adopted a restrictive posture. Imported technology is becoming increasingly important to the United States, and retaliation is not a contingency that we can ignore.

Patented and unpatented technology which resides in the public domain because it was funded by public money

presents a more difficult problem. There is no uniform practice across agencies in contracting for research. Some require that patents be assigned to the public domain, others do not. When patents are assigned to the public domain, often the technology will be readily available to foreign firms at little or no cost. The one-sided nature of this access is not particularly troublesome if other industrial countries are equally open with their own publicly-funded technology. But the situation is more troublesome if U.S. firms are denied equivalent access to publicly-funded technology in other industrial countries. This is a complicated topic and I am not prepared to discuss it in detail today. However, the subject deserves the close attention of the Industrial Innovation Coordinating Committee.

Thank you Mr. Chairman. I will be pleased to answer any questions you and the other members of the subcommittee might have.

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

FOR RELEASE UPON DELIVERY
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STATEMENT OF
GARY C. HUFBAUER
DEPUTY ASSISTANT SECRETARY
FOR INTERNATIONAL TRADE AND INVESTMENT
DEPARTMENT OF THE TREASURY
BEFORE
THE SUBCOMMITTEE ON MERCHANT MARINE AND TOURISM
OF THE COMMITTEE ON COMMERCE, SCIENCE AND TECHNOLOGY
UNITED STATES SENATE

Mr. Chairman, I am pleased to discuss with you the Treasury Department's views on S. 2873, a bill to provide for the regulation of rates and charges by certain state-owned carriers in the foreign commerce of the United States.

We share the concern reflected in this bill, that certain carriers may be competing unfairly in our ocean trades by engaging in "predatory" pricing. By persistently selling shipping services below cost over a large number of routes, those carriers may be driving out U.S. vessels and capturing a larger share of the trade. Laws to prevent unfair practices in our foreign merchandise trade are already on the books -- specifically, the Antidumping Act of 1921 (as amended) and Section 301 of the Trade Act of 1974. We should also be able to deal with similar unfair competition in international shipping.

B-1150

Pricing below cost by carriers -- whether or not "controlled" -- may well occur under current market conditions. Overtonnaging is a prominent characteristic of our ocean trades today. Oversupply of any good or service, including ocean shipping, can lead to temporary pricing below cost. Goods or services provided by state-controlled economy countries pose an additional problem since their prices are not necessarily established even in the long run by market considerations.

We wish to avoid prejudging whether controlled carriers are actually engaging in pervasive unfair pricing practices. Such practices may not be as widespread as is frequently asserted. Nevertheless, the United States Government should have the tools available to prevent unfair competition.

The Administration is prepared to support this legislation, but would recommend certain amendments. My colleagues from other Departments have presented these to you in detail. I would like to touch briefly on aspects of particular concern to the Treasury.

First, we fear that the bill's grant of authority to the FMC to determine whether rates are "just and reasonable" is too broad and vague a standard. We also oppose FMC authority to set minimum rates during any period a rate

suspension is in effect, or after the FMC has found that rates are not "just and reasonable". Finally, we believe that controlled carrier rate decreases should become effective on the same conditions as rate decreases by other carriers. Under present law, there is no waiting period for rate decreases by any carrier, but the bill as drafted would impose a 30 day waiting period selectively on controlled carriers.

We think the level of rates subject to FMC suspension should be more carefully delineated. Suspension should take place only when unfair practices are occurring, and not to defeat fair competition. We think the benchmark of rates charged by independent non-controlled carriers, or 85 to 90 percent of the rate charged by the lowest-price conference operating in the same trade, represents a fair standard. Controlled carriers should be allowed to be as competitive as any other carrier in a trade. An 85 or 90 percent test is reasonable because independent carriers generally underprice conference carriers by approximately that amount. Independent carriers have been able to offer shipping services at rates below those charged by conferences and still earn a profit.

We believe that granting rate-setting authority to the FMC is not warranted. If a controlled carrier's rates are suspended or disapproved, the carrier should be able to file and operate under new tariffs as long as these tariffs meet the standard the Administration proposes. Finally, controlled carriers should not be required to file rate decreases 30 days in advance. Currently, all carriers are required to file rate increases 30 days before they may become effective (except carriers employing dual rate contracts, which must give 90 days notice), while rate decreases may take effect immediately upon filing. Controlled carriers should be able to compete on an equal basis. If a waiting period is required for the rate decreases of some carriers, it should be required for the rate decreases of all carriers.

These proposals will assure that U.S. carriers are not being victimized by predatory controlled carrier pricing. At the same time, they will allow controlled carriers to continue in the trade as long as they compete fairly. We believe that competition in shipping should be strengthened. Competition will encourage cost-effective service. This is an important consideration, especially in view of President Carter's emphasis on curbing inflation.

We believe that S. 2873, with the suggested amendments, can effectively prevent predatory pricing by controlled carriers without discouraging desirable competition in shipping.

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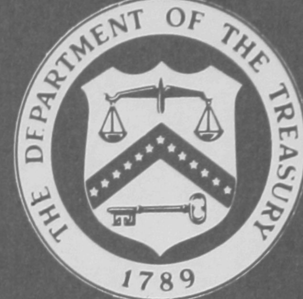

FOR RELEASE ON DELIVERY
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TESTIMONY OF LEWIS W. BOWDEN
DEPUTY FOR SAUDI ARABIAN AFFAIRS, DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL SCIENTIFIC PLANNING,
ANALYSIS, AND COOPERATION
COMMITTEE ON SCIENCE AND TECHNOLOGY
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the subcommittee today to discuss the United States-Saudi Arabian Joint Commission on Economic Cooperation and, in particular, the role the Joint Commission plays in the transfer of technology from the United States to Saudi Arabia. Approaching these subjects in a logical order, I would first like to present a brief overview of the Joint Commission's history, goals, and current activities.

The United States-Saudi Arabian Joint Commission, the first of its kind between the U.S. and a Middle Eastern country, was formally established on June 8, 1974, by a joint communique issued by Secretary of State Kissinger and Prince Fahd, who is now Saudi Arabia's Crown Prince and First Vice President of its Council of Ministers. I would like to submit this communique, the June 8 Joint Statement of Cooperation, for the record. In part, this communique stated the mutual desire of the United States and Saudi Arabia to "promote programs of cooperation between the two countries in the fields of industrialization, trade, manpower training, agriculture, and science and technology." It also stated that the Treasury Department and the Saudi Ministry of Finance would consider general types of cooperation in the area of finance.

With these goals in mind, the Joint Commission was established to provide a formal government-to-government mechanism by which the expertise present in the various parts of the U.S. and Saudi Arabian governments and their respective private sectors could be pooled and brought to bear on the developmental needs of the Saudi economy.

As established in the June 8 communique, the Joint Commission is chaired by U.S. Secretary of the Treasury W. Michael Blumenthal and Saudi Arabian Minister of Finance and National Economy Muhammad Abalkhail. It is coordinated on the U.S. side by Assistant Secretary of the Treasury C. Fred Bergsten and on the Saudi side by Deputy Minister of Finance and National Economy Dr. Mansoor Alturki. I am, in effect, the general manager of the Commission.

In order to support and coordinate U.S. involvement in the Joint Commission, the Department of Treasury established an Office of Saudi Arabian Affairs in Washington and the Office of the U.S. Representation to the Joint Commission in Riyadh. Technical assistance provided by the Joint Commission is carried out on a reimbursable basis in accordance with a Technical Cooperation Agreement signed February 13, 1975, by the U.S. and Saudi Arabian governments, which I will submit for the record. Expenses are defrayed by drawing against a Treasury-held trust fund established by the Saudi Government pursuant to this agreement.

The idea of establishing Joint Commissions with Middle Eastern countries can be traced to a proposal from the American Embassy in Jidda in January 1974, shortly after the October 1973 Middle East conflict and during the Arab oil embargo. These traumatic events had highlighted the interdependence of American welfare and that of the various Middle Eastern countries, and it was thought that joint commissions could broaden the network of contacts and associations between the U.S. and several key countries, thus creating relationships that could better withstand temporary stress. Establishment of the U.S.-Saudi Arabian Joint Commission thus reflected a conscious effort to strengthen relations between the two countries by broadening areas of mutual economic and political interest.

Other joint commissions were established in quick succession. Following the Saudi example in June 1974, commissions were established with Egypt and Jordan; in July one was established with Israel; one with India in October; one with Iran in November; and one with Tunisia the following May. But the Saudi commission quickly moved

ahead of the others in its level of activity due to various political, economic, and even bureaucratic reasons, and over the past four years this pre-eminence has become even more apparent.

The Saudi Government sees the Joint Commission as one aspect of its program of rapid economic and social development. The United States does not have a monopoly on foreign economic activity in Saudi Arabia. Firms and governments from all over the world have mounted aggressive campaigns to penetrate the Saudi market for imported goods and services. Logically enough, this has led to the rapid expansion of non-American foreign economic activity in Saudi Arabia. But Saudi business and government leaders still realize that the United States has resources of great importance to Saudi Arabia's economic development, a view derived from years of satisfactory experience with such U.S. entities as ARAMCO and the Army Corps of Engineers. American technology, American products, and American management are highly respected by Saudi leaders and considered necessary for the successful implementation of the $142 billion five-year development plan. The Joint Economic Commission is recognized as an important mechanism for facilitating the flow to Saudi Arabia of American goods, services, and technology.

During the four years since its establishment, the Joint Commission has acted to achieve the objectives outlined in the 1974 Joint Statement of Cooperation by:

--dispatching U.S. specialists and technical teams to Saudi Arabia to analyze current conditions in specific areas and to make recommendations for actions;

--developing proposals for major technical assistance projects using these recommendations as a base;

--coordinating U.S. Government and U.S. private-sector activity in implementing projects approved by the two governments;

--developing the institutional framework necessary for carrying out government-to-government technical assistance projects; and

--stimulating U.S. private-sector involvement in the overall Saudi development effort.

More than 40 separate groups of U.S. specialists have been sent to Saudi Arabia under Joint Commission auspices in the last four years. These teams have conducted short-term studies in a large number of areas and their recommendations have led to the development of numerous proposals for technical assistance. To date, 16 agreements for major technical cooperation projects have been signed. I would like to note here for the record that copies of all 16 project agreements have been sent via the State Department to the Congress under the provisions of the Case Act.

These 16 project agreements provide for assistance in the following areas:

--statistics and data processing;
--electrical equipment procurement (two agreements);
--national electrification planning;
--formation and operation of a national center for science and technology;
--vocational training and construction;
--desalination research;
--consumer protection services;
--financial information services;
--solar energy research;
--customs services;
--national park planning;
--highway development;
--government procurement; and
--government auditing and accounting.

Detailed descriptions and up-to-date status reports of these projects are submitted separately.

New Joint Commission projects are constantly being suggested, some of which result in _ad hoc_ assistance of a short-term nature while others will ultimately result in formal project agreements. The next agreement that will probably be signed calls for assistance in the development of Saudi Arabia's domestic transportation system, with a focus on bus transport in the Kingdom's five major cities. The total value of Joint Commission projects thus far undertaken, estimated by projecting over the foreseeable life of the projects, is now in excess of $800 million.

I should note that projects are actually undertaken by action agencies such as, for example, the Department of Labor and the Department of Energy. In securing the implementation of projects, the action agency may either call upon its own resources, those of another government department, those of a private-sector firm, or some combination of these, as will be illustrated in the following

exposition. I have submitted separately for the record a list of action agencies and private-sector firms that have been involved in Joint Commission activities. In cases where an agency other than Treasury is given primary action responsibility, Treasury is a co-signatory to the project agreement. This has proved to be an effective way of maintaining a cooperative effort while at the same time providing the framework for Treasury to carry out its coordinating role. In all cases, Treasury carries out the financial arrangements for projects, and also provides logistical support for program implementation in Saudi Arabia.

Specific projects aside, though, there is little doubt that the Joint Commission has served the broader interests of U.S.-Saudi friendship and cooperation, as when Joint Commission meetings have provided an opportunity for high-level discussions between U.S. and Saudi officials. Thus, for example, during Finance Minister Abalkhail's visit to Washington for the third Joint Commission meeting in May 1977, he called on Vice President Mondale, Secretary of State Vance, Office of Management and Budget Director Lance, Assistant to the President Schlesinger, and Federal Reserve Board Chairman Burns.

Having discussed the Joint Commission in general terms, I would now like to address more specifically the question of technology transfer, the actual subject of today's hearings.

It is important to recognize that Joint Commission projects do not generally involve the transfer of what we in the United States have come to think of as highly sophisticated technology. This is not to belittle the technological content of Joint Commission projects or the technical competence of American advisors assisting with these projects; we provide the best expert assistance available, and certainly intend to continue doing so. What I am driving at is that the Saudis are at a stage of economic development demanding the development of basic economic infrastructure, not the ability to produce the latest generation computer chips or send men to the moon. What they are most concerned about are projects involving crucial but relatively mundane activities such as building roads and houses, providing electricity to meet skyrocketing

demand, developing limited manpower and agricultural resources, desalinating water to cope with the country's critical shortage of this essential commodity, and developing a basic industrial capacity, especially in the petro-chemical area. It is true that Saudi Arabia's approach to development is capital intensive, as its resources dictate, but this does not undermine my basic point about the type of technology presently demanded for Saudi development.

It follows logically that the most important Joint Commission projects, using monetary value as a convenient indicator of importance, are those relating to vocational training and electrification. I will summarize briefly what is involved in these two areas in order to illustrate somewhat more specifically the type of work being done under Joint Commission auspices.

In June 1976, a formal project agreement, which I will submit for the record, was signed which calls for the U.S. Department of Labor to provide 20 to 30 manpower development specialists to work with the Saudi Ministry of Labor and Social Affairs in 11 capacities relating to vocational training, make arrangements for architectural and engineering work and follow-on construction related to the establishment of new vocational training facilities and the expansion of existing facilities, and assist the Ministry of Labor and the Saudi Education Mission in Houston in monitoring skill-upgrading programs being held in the U.S. for Saudi vocational training instructors. In February 1977, the Labor Department entered into an inter-agency agreement with the U.S. General Services Administration calling for GSA to oversee design and construction work on the vocational training facilities.

The vocational training project currently has a staff of 31 long-term vocational training advisors and four engineers in Riyadh working with the Ministry of Labor. Two American firms, CRS Design Associates from Houston and Hope VTN JV from San Diego, are handling design and construction planning for the necessary project facilities and actual construction should begin this December of January.

Joint Commission assistance with electrification falls under three separate project agreements, all three of which I will submit for the record.

The first agreement, signed in November 1975, provided for Treasury arranging the purchase of approximately $57.6 million of electrical equipment and related goods and services, including the construction of three warehouses, for the Saudi Ministry of Industry and Electricity. An interagency agreement was signed in December 1975 under which GSA agreed to handle procurement of the equipment. Shipping, warehousing, and technical assistance on specifications were contracted to a private non-profit firm, Overseas Advisory Associates, Inc. of Detroit. In January 1977 the Saudi Government deposited an additional $10.4 million in the Trust Account to cover costs related to installing part of the requested equipment. All the requested electric power equipment, valued at $41 million, is now in Saudi Arabia. The warehouses and generating units at the Nasseriah Royal Power Plant, at the Riyadh Industrial Estates, and in the provincial town of Abha are ready for operation, though work is continuing on certain ancillary facilities at various sites.

The second electrification agreement, signed in February 1976, provided for U.S. assistance to the Saudi Ministry of Industry and Electricity in the development of a comprehensive electrification plan for the Kingdom, the operation of the Department of Electricity on a day-to-day basis, and any other areas of concern to the Ministry. The three aspects of the project have been underway concurrently. A draft 25-year electrification plan was presented to the Ministry in December 1977 by the Charles T. Main Company of Boston, the private firm contracted for this project, and the final version of the plan will be submitted in October or November of this year together with a scale model. Since the future power system in the Kingdom will have many American features, we fully expect that U.S. firms will compete successfully for many of the contracts for providing equipment and services for the new system. In another aspect of this project, work continues in an effort to upgrade the Riyadh Electric Company's capability to cope with the increased demand for electricity in the Saudi capital. Eighteen Charles T. Main personnel are presently working in Saudi Arabia.

The third electrification agreement was signed in March 1977, and provides that Treasury will procure electrical equipment requested by the Saudi Consolidated Electric Company (SCECO), which is managed by ARAMCO. This equipment is being procured through GSA, with technical assistance provided by Overseas Advisory Associates. Shipping is being handled by the ARAMCO Services Company.

All the equipment, valued at approximately $11 million, has been purchased, though deliveries will continue through 1978.

All of these projects entail the transfer of technology in one sense or another, whether this is educational technology relating to vocational training, the technology necessary for constructing vocational training centers or installing electrical equipment, or the planning technology involved in formulating a nation-wide electrification plan. Similarly, there is a transfer of technology involved in other Joint Commission projects such as, for example, the computer technology involved in the statistics and data processing project and the R & D work that will be done in the desalination project. Given our limited time today, I must restrict myself to summarizing this activity since a comprehensive review of 16 major projects is impossible.

I would like, though, to go into somewhat greater detail regarding three projects that may perhaps relate more directly to the interests of the Subcommittee: the establishment and operation of a national center for science and technology; solar energy research; and the establishment of a financial information center in the Ministry of Finance and National Economy.

A project agreement was signed in February 1976 calling for the U.S. National Science Foundation to assist in drawing up an overall three-stage plan for science and technology development. First, specialists are to conduct an inventory and evaluation of existing Saudi S & T resources. Second, the U.S. and Saudi Arabia will undertake a number of discrete cooperative S & T projects. And third, the U.S. will assist in the long-term development of the Saudi Arabian National Center for Science and Technology which, for convenience, we have abbreviated to SANCST.

The overall objectives of SANCST are listed in Appendix A of the project agreement, which I will submit for the record, but U.S. involvement in this project can be pictured as being three-pronged. First, there will be an inventory of existing resources in Saudi Arabia, both human and physical (i.e., lab facilities and equipment, etc.). A 13-person American team will visit Saudi Arabia in October 1978 to conduct this survey, and a final report will be submitted to SANCST in April or May 1979. It is hoped that during the course of this survey a number of Saudis will receive training in inventory techniques and data compilation, but that is not a major objective of the exercise. Second, an S & T information system will be set up for

SANCST which will ultimately include a data line from SANCST to S & T data bases in the U.S. and a national S & T information system. Work relating to this system commenced in May 1978 with the travel of a five-person NSF team to Saudi Arabia to survey information needs of libraries, universities, and other potential users of the system. It is projected that the Joint Commission will be responsible for both installing the hardware for the information system and training an on-line search manager. The third aspect of U.S. involvement in SANCST will be the design of a research plan by NSF. Areas for consideration include solar energy, use of arid lands, environmental studies, transportation planning, and industrial research. However, work towards establishing this research plan has barely begun.

A second project agreement particularly relevant to the subject of technology transfers is the one signed in October 1977 for cooperation in the field of solar energy, which I will also submit for the record. This project, for which the Department of Energy is the U.S. action agency, calls for each country to provide $50 million for a five-year cooperative effort in the development and application of solar energy technology. Preliminary technical and management plans for the project were agreed on by U.S. and Saudi representatives at discussions held in June 1978, and later this month further discussions will be held in Colorado regarding more specific project plans. At the June meetings, it was agreed that the solar research and development should concentrate on five major areas: solar energy availability in Saudi Arabia; thermal processes; storage and fuel production; electrical generation; and other alternative solar-related sources of energy such as wind, geothermal, and ocean-thermal energy. These five areas of research and development will be applied to practical applications in agriculture, industry, and urban use. Both sides agreed that this cooperative solar energy program will emphasize both active and passive solar cooling, solar desalination, solar-generated electricity for remote regions, and thermal processes. Moreover, it was agreed that approximately 30 percent of the total effort will be directed at each of the following three areas: research and development; the testing of prototypes; and application development. It is expected that project work will begin in FY 1979.

The third project which I think is of particular interest to the Subcommittee is that calling for financial information services. In May 1977 the Treasury Department signed an agreement with the Saudi Ministry of Finance and

National Economy, which I will submit for the record, under which Treasury is assisting in the establishment of a major multi-media financial information center in Riyadh which will upgrade the Ministry's ability to gather and analyze worldwide financial data.

Treasury signed a contract in April 1978 with CRS Design Associates of Houston, Texas, for project management services and in February 1978 with Ford, Powell, and Carson of San Antonio, Texas, for architectural and design services relating to the project. Work on the new financial information center is now underway, the anticipated completion date for the $24 million facility being April 1980.

Six Treasury employees (three economists and three information specialists) are currently in Riyadh working on this project, and three additional specialists are expected to arrive in Riyadh before the end of this year. This team is:

- --providing oversight to project constructors as work progresses;
- --working with the Ministry to recruit and train personnel to staff the center;
- --providing the Ministry with up-to-date economic reporting and analyses;
- --assisting in the development of an expanded library collection which will be organized similar to the Library of Congress system;
- --assisting in the specification and provision of related equipment and materials; and
- --establishing computerized ordering, book-inventory, and internal-management systems.

To permit the center to communicate with commercial economic data bases in the U.S., a dedicated phone link using the commercial satellite facilities of Western Union International, a New York-based company, was established between Riyadh and Washington in early 1978. Computer equipment relating to this communications line is currently temporarily housed in the main Ministry of Finance building, but will be moved into the financial information center when it is completed. This system will provide the American economic advisors in Riyadh and their Saudi counterparts with rapid access to economic and financial data. This data is in private-sector, not government, data banks and is publicly available.

The establishment of the financial information center provides for the transfer of several types of technology including the latest information storage and retrieval techniques and the computer technology necessary for upgrading Saudi economic analysis and planning capabilities. This is a good example of technology transfers benefitting both the donor and the recipient since the twin goals of improved Saudi economic and financial planning and improved economic and financial coordination between the two countries are being served.

This theme of mutually beneficial cooperation stands, as I have tried to indicate, at the heart of all of the activities undertaken by the Joint Commission. I feel strongly that recognizing the long-term economic interdependence between the United States and Saudi Arabia is an important step towards ensuring the future well-being of both countries, and furthermore, that our approach towards this relationship should be active, not passive. We, no less than they, have much to gain, both economically and politically, from successfully meeting the challenge presented by Saudi Arabia's giant step forward into the twentieth and twenty-first centuries.

Although I recognize that foreign policy considerations are the province of my State Department colleagues, in concluding, Mr. Chairman, I would like to return once more to the larger question of U.S. policy in the Middle East. The Middle East is a troubled part of the world in which U.S. initiatives have met with mixed success. In this setting the strength and longevity of the U.S.-Saudi relationship stands out as remarkable. The Joint Commission exemplifies both the vitality and the forward-looking nature of this relationship, and demonstrates again that the United States shares many interests with Middle Eastern countries that can be furthered through mutually beneficial cooperation.

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

FOR RELEASE ON DELIVERY
~~EXPECTED AT 10:00 A.M.~~
SEPTEMBER 7, 1978

STATEMENT BY F. LISLE WIDMAN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL MONETARY AFFAIRS
BEFORE THE SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
SCIENTIFIC PLANNING, ANALYSIS AND COOPERATION
OF THE
HOUSE COMMITTEE ON
SCIENCE AND TECHNOLOGY

Mr. Chairman and Members of the Subcommittee:

I welcome the opportunity to appear before the Subcommittee to discuss the size, disposition and significance of the financial surpluses of the oil producing countries which I will also attempt to place against the backdrop of global financial developments.

Since 1973, world payments flows have undergone a profound transformation as a result of massive increases in oil prices, unprecedented and persistent inflation, deep recession and hesitant economic recovery and growth in many countries.

The 13 countries which make up the Organization of Petroleum Exporting Countries (OPEC), after years of of approximate balance on current account, registered cumulative (net) current account surpluses of something

B-1152

like $175 to $180 billion during the four years 1974 through 1977.* During this period of large OPEC surpluses, the industrial countries as a group, which historically had run current surpluses and exported capital to the rest of the world, experienced cumulative current account deficits of unprecedented magnitude -- about $80 billion. Similarly, the non-oil exporting developing countries and the non-market economies of Eastern Europe sustained deficits much larger than they had previously experienced -- about $125 billion for the four-year period.

The sudden and severe increase in the cost of oil left many nations facing the necessity of major structural adjustment in their domestic economies. Many were already struggling with very high rates of inflation and heavy external deficits. In the period immediately after the oil price increase, there was widespread concern that nations would be forced, by the lack of sufficient financing to pay for oil, to curb their imports so sharply as to have a devastating impact on the world economy. The

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*The term "current account" is used here to include official and private grants or unilateral transfers as well as international transactions in goods and services. The cumulative surplus on goods and services is estimated at roughly $185 billion and net official grants at $7 billion. Many OPEC countries do not compile detailed balance of payments data. Thus, the figures used here are U.S. Treasury staff estimates.

international economic and financial organizations--the International Monetary Fund and the Organization for Economic Cooperation and Development--concentrated heavily on measures to ensure that financing would be available to the oil importing countries and on avoidance of uncooperative and ultimately self-defeating actions by financially strapped countries to improve their own positions at the expense of others.

The success of these measures provided a valuable breathing space, enabling the required structural adjustment to be stretched out over a longer period of time and thus to be less disruptive. The inevitable economic slowdown did not begin until late in 1974 although it has been perhaps the deepest and, for much of the world, the longest slowdown since the 1930's. Countries which delayed their adjustment efforts too long and allowed their inflation rates to soar above those of their trading partners were compelled to institute strong stabilization programs. Nevertheless, the basically open trade and payments system which is so crucial to the economic health of all major trading nations has been preserved.

Unfortunately, the task of adjusting the complex world economy to relatively high energy costs is far

from complete even today. Structural changes must yet take place in many economies, often involving significant alteration of traditional attitudes and patterns of production and consumption. Our own need, here in the United States, to reduce our dependence on imported oil is perhaps the most critical of all the structural changes required. These structural changes do not come easily. Yet they must take place if satisfactory levels of growth and employment -- and an open system of trade and payments -- are to be maintained.

The greatly increased global need for balance of payments financing in the last 4-1/2 years has been matched by a general expansion of credit. The OPEC surpluses, as a matter of necessity, have been invested in the oil importing countries. Thus, directly or indirectly the OPEC members provided financing. Of course, the individual OPEC countries placed their funds according to their own investment preferences. Since the geographic placement of OPEC surplus funds has not corresponded to the pattern of current account deficits, financial intermediation on an unparalled scale has been required to redistribute, or recycle, these huge surpluses

to the countries in need. The IMF established a special financing facility and took a number of other steps to enhance the availability of balance of payments financing. Nevertheless, private capital markets and the international banking system have met the bulk of the financial intermediation requirements. They have done so efficiently and successfully.

Given the private market orientation of the world economy, it was natural for the bulk of this financing to be handled by private rather than official channels. The period was one of rapid institutional expansion in the international banking system. Many institutions were competing eagerly for new customers, as they sought to establish themselves in new activities and new geographic areas, and endeavored to broaden their scope of operations so as to spread risks and diversify portfolios at a time when domestic loan demand was less buoyant than in immediately preceding years. Thus, the private institutions were in a position to expand the level of their activity. As a result, a large portion of the huge surpluses by OPEC and other countries was placed with the banks and other financial intermediaries, particularly in 1974 and 1975.

In reaction to the growth of U.S. commercial banks' activities abroad, U.S. regulatory authorities strengthened their bank supervision procedures. They have also implemented new reporting requirements which provide information on the extent of U.S. bank exposure by country of risk covering both home offices and all majority-owned banking affiliates abroad.

The jump in OPEC member revenues was so sudden and so large that these countries were generally not in a position during the early part of the period to place much of their surpluses in long-term investment instruments. Also from the outset, most of the OPEC members expected to be able to spend their new-found surpluses fairly quickly for imports of goods and services to develop their own countries. For these various reasons, most of the surpluses were placed in short-term instruments. The bulk of the funds in these first surplus years went into time deposits with banks or short-term securities issued by governments of major industrialized countries.

Over the four year period, 1974-1977, about $70 billion, or nearly 40% of OPEC's surpluses, were placed in deposits with commercial banks in the industrial countries. About 40% of these deposits -- between

$25 and $30 billion--were placed with U.S. banks, partly with the head offices in the U.S. and partly in branches abroad.

The balance of the OPEC surpluses -- about $115 billion -- was placed outside the banks. About $37 billion was invested in the U.S., consisting of about $14-1/2 billion of Treasury securities, and a little over $10 billion of purchases of other U.S. securities, almost evenly divided between stocks and corporate and government agency bonds, including private placements. The rest has been used to amortize debt, prepay imports, make direct investments, etc. (The amount which has gone into direct investments, including real estate is relatively small. We estimate that the total value of such holdings in the U.S. by OPEC member countries is around $1 billion). The Middle East oil producing countries account for about 90% of all OPEC assets in the U.S.

An equal amount of the cumulative OPEC surplus -- $37 billion -- is believed to have been invested in other industrial countries in non-bank assets. In addition some $10 billion has been placed with international financial institutions such as the IMF and the World Bank. Only about $5 billion was put in the non-market

countries. We estimate that about $25 billion or about 13% of the OPEC surplus was devoted to aid to developing countries, either in the form of loans or as outright grants.

The bulk of OPEC investments--even those outside the United States--has been in dollar-denominated instruments. OPEC member countries have, in other words, loaned dollars to other countries and they expect to be repaid in dollars. The proportion of their new investments placed in dollar assets of course, fluctuates from month to month, but the overall proportion has remained relatively steady, ranging from an estimated 75% to 80% of their total external investments. This high proportion is the result of a number of factors, including the preeminent position of the U.S. capital market, the role of the dollar as the principal transactions currency in the world, and the relative lack of suitable investment opportunities elsewhere. The OPEC pattern is similar to that of other international lenders.

The pattern of OPEC investments has been gradually changing since 1973. The information available to us, even though incomplete, reveals clearly that in 1976 and 1977 the Middle East oil producers placed a much

larger proportion of their investible surplus in longer-term maturities, including deposits with banks and purchases of U.S. Treasury securities. This lengthening of the maturity structure coincided with--and is probably the result of--more sophisticated investment planning and a much better definition of the domestic economic objectives of the major surplus countries. It reflected a better appraisal of the amount of funds which would not be needed in the short-term and thus could be used for longer-term investments yielding higher returns.

At the same time, the size of the OPEC surplus has been diminishing. The decline is primarily the result of a continuing increase in the absorptive capacity of the OPEC countries and the consequent rapid growth in their imports of goods and services. Slower growth among the industrial countries, coupled with conservation efforts by oil importing countries and continuing development of oil production from the North Sea and other non-OPEC sources has also played a role. In 1973 the combined imports of merchandise of the OPEC nations amounted to only $20 billion. This year we estimate OPEC imports will reach $95 billion, which represents a compound growth rate of about 35%

a year since 1973.

Because the surpluses have fallen sharply, the level of new foreign investments by OPEC member countries has been declining sharply. In fact, some OPEC members have apparently found it necessary to liquidate some of their earlier investments in order to meet expenditure commitments. A number of OPEC countries are now running current account deficits and borrowing increasing amounts of funds in the international capital markets to finance their domestic development plans.

Thus, the OPEC surplus has come to be concentrated primarily in a handful of countries in the Arabian Peninsula. Even these surpluses have been falling. The combined OPEC surplus on goods, services and private transfers this year will probably be only about half the $36 billion surplus of 1977 and thus the amount available for either official grants or investments will be sharply reduced. OPEC merchandise imports are projected to grow by perhaps $11 billion. Their oil revenues will probably fall by $5 billion or so, reflecting slackened global demand for OPEC petroleum.

The combined surplus may fall further next year, perhaps to about $10 billion, assuming no further increases in the price of oil. Each percentage point

of increase in the oil price would add roughly $1 billion to the combined surplus. We would expect a further increase of about 10% in merchandise imports by the OPEC group in 1979, and a small increase in oil revenues (assuming no change in price) as non-OPEC oil production continues to increase and growth rates in the oil consuming countries continue at a moderate level. Surpluses are likely to continue beyond 1979, but I would caution that forecasts of trends in OPEC surplus are highly tenuous, especially the further out one looks. Both the global supply and demand for oil and the ability of OPEC countries to continue to absorb goods and services from abroad at a rapid, uninterrupted pace are highly uncertain, as is the oil price.

Before concluding, I would like to make a few observations about both U.S. policies and the policies of the major OPEC surplus countries toward their investments in the United States. Our policies toward OPEC investment should be viewed in the light of our overall position on capital movements.

We are convinced that global resources will best be allocated to their most efficient uses if market forces are the main determinants of international capital movements. Accordingly, we seek, in general,

to avoid the use of either government incentives or disincentives which would artifically distort the direction or the form of international capital movements. We do not discriminate among foreign investors according to their nationality. We have urged other nations to follow the same principles. In fact, we have negotiated a series of Friendship, Commerce and Navigation Treaties with many countries around the world which commit the signatories to these principles.

Two somewhat conflicting concerns about OPEC investments in the U.S. are expressed from time to time. Some people have been concerned that OPEC countries might suddenly withdraw their holdings in the U.S., imperiling U.S. institutions and depriving the economy of important sources of capital. Others have felt that OPEC investment may exert an excessive or even pervasive influence in the U.S. and should be strictly controlled, perhaps even prohibited. I think it would be appropriate to comment briefly on these concerns.

Although the individual OPEC countries pursue independent investment policies based on their own perceptions and needs, virtually without exception their approach to investments in the U.S. has been

conservative and responsible. As I have noted, the bulk of their investments is in financial instruments which are designed to obtain satisfactory yields without sacrificing the security of their assets.

The Saudi Arabian Government has been most explicit in detailing the approach it takes toward investments. The Saudis have stated that they seek to play a constructive role, recognizing the need to act with larger issues in mind than solely profit. In this regard, they have sought to avoid sudden or largescale shifts in assets, speculative transactions, investment in the sensitive area of real estate, and controlling interests in U.S. firms. According to Govenor Quraishi, head of the Saudi Arabian Monetary Agency, their investment managers in this country have been instructed that at no time may Saudi investments reach 5% of the voting stock of any company. He further indicated that their holdings of U.S. Government securities constitute the largest single component of their international reserves.

It is also necessary to put the size of OPEC investment activity in proper perspective. Although the value of the U.S. assets held by the Middle East producers is large in an absolute sense--about $36 billion

at end 1977--their total holdings are very small in comparison with the size of the total U.S. capital market which is estimated to be on the order of $3.3 trillion. The volume of Middle East investment activity is also small in comparison comparison with the total turnover in U.S. investment instruments. Although their investments are concentrated in Treasury securities, Middle East investors account for less than 10% of all foreign holdings of U.S. Treasury securities and less than 3% of total public holdings of U.S. Treasury securities. Both on a stock basis and on an annual purchase basis their investment in corporate bonds and equities represent less than 1% of the total outstanding value and dollar volume of each of these types of U.S. securities. Similarly, their deposits in all U.S. banks here and in their branches abroad account for only about 5% of the total deposits of the large U.S. banks and only about 2-1/2% of the deposits of all U.S. commercial banks.

There are two additional reasons why U.S. banks would not be particularly vulnerable to a sudden withdrawal of Mid-East oil producer deposits. First, nearly all of these deposits are time deposits with varying maturities stretching out over months and years. Second, banks have immediate access to

several alternative sources of funds which have evolved to support an essential function of banking--maturity transformation. These sources (for example, the federal funds market and the international euro-dollar market) would enable affected banks to satisfy their liquidity requirements until funds could be attracted from other depositors.

If funds were suddenly withdrawn from a U.S. bank or banks and placed with foreign banks, the recipient banks would have to find outlets for the additional funds. The normal procedure would be to offer these funds to the interbank market -- where the banks which had initially lost the deposits could borrow them back.

Obviously, if an OPEC investor--or any other foreign holder of dollars--decided to sell dollars or dollar assets to purchase assets in other parts of the world which were to be paid for with another currency, he would have to buy that other currency with dollars. This action would tend to increase the demand for the foreign currency while increasing the supply of dollars on the foreign exchange market. It would, therefore, tend to cause the foreign currency to appreciate against the dollar.

Thus, the primary importance of OPEC investment policy to the U.S. lies in the effect which it has on the exchange rate.

I think it is important to recognize that we live in an interdependent world. We provide a profitable outlet for the surplus funds generated by the Mid-East oil producing countries--through one of the very few capital markets in the world capable of absorbing such large sums. These investments will be a primary source of financing of the future development of their own countries.

The Mid-East countries in turn produce the oil we need and in the cases of several of these countries at a level that exceeds their immediate requirement for capital.

In conclusion, we do not view OPEC investments in the U.S. as a threat to our economic or political independence. To the contrary, they are important to the financing of the U.S. balance of payments deficit and the strength of the dollar. These investments are an element, albeit highly visible, of what I would characterize as a modern, somewhat complex, inter-statal relationship, that fosters a high volume of exchanges of goods, services and capital for

productive use in the economic development of each our countries. The OPEC nations benefit; so do the U.S. and the world at large.

Estimated Disposition of OPEC Investible Surplus *
(Billions of U.S. Dollars)

	1974	1975	1976	1977	1978 QI
United States	12 1/2	9 1/2	12	9 1/4	1 3/4
of which					
Treasury securities					
Bills	(5.3)	(.4)	(-1.0)	(-.9)	(.3)
Bonds and notes	(.2)	(2.0)	(4.2)	(4.3)	(-)
Other marketable U.S. bonds	(.9)	(1.6)	(1.2)	(1.7)	(.2)
U.S. stocks	(.4)	(1.6)	(1.8)	(1.4)	(.3)
Commercial bank liabilities	(4.1)	(.6)	(1.6)	(.4)	(.5)
Subtotal (banking and portfolio placements)	(10.8)	(6.3)	(7.8)	(6.9)	(1.3)
Other (including direct investment, prepayments on U.S. exports, debt amortization, etc.)	(1.7)	(3.2)	(4.2)	(2.3)	(.4)
Euro-banking market	22 1/2	8	11	12	1 3/4
United Kingdom	7 1/2	1/4	-1	3/4	1/4
Other developed countries	6	7 3/4	8	8	1
Less developed countries**	4	6	6	8 1/2	3/4
Non-market countries	1/2	2	1 1/4	1 1/2	1/4
International financial institutions (including IMF oil facility)	3 3/4	4 1/4	1 3/4	1/2	-
TOTAL ALLOCATED	56 3/4	37 3/4	39	40 1/2	5 3/4
Estimated current account surplus	72 1/4	36 1/2	39 3/4	35 1/2	NA
Adjustment for lag in receipt of oil revenues	-11 1/4	+1	-4 1/2	+3	NA
Estimated gross borrowings	1/2	4	8	12	
Cash surplus plus borrowings	61 1/2	41 1/2	43 1/4	50 1/2	NA
Discrepancy in estimates	4 3/4	3 3/4	4 1/4	10	NA

*Receipts from exports of goods and services and gross borrowing abroad less payments for imports of goods and services.
**Includes grants
NA - Not Available

U.S. Treasury Department
Office of International Banking and Portfolio Investment/OASIA
September 7, 1978

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041
THE DEPARTMENT OF THE TREASURY 1789

Embargoed For Release 6:30 P.M.
September 6, 1978

Contact: Robert E. Nipp
566-5328

SECRETARY BLUMENTHAL MEETS WITH JAPAN'S VICE MINISTER OF FINANCE, TAKEHIRO SAGAMI, FOR DISCUSSION OF JAPAN'S ECONOMIC MEASURES

The Vice Minister of Finance for International Affairs for Japan, Takehiro Sagami, met with Treasury Secretary Blumenthal this afternoon. It was Minister Sagami's first visit to the United States since his appointment as Vice Minister in June.

Minister Sagami described for Secretary Blumenthal the comprehensive economic measures including additional public investments of 2.5 trillion yen (approximately $13 billion) which the Government of Japan recently adopted with a view to assuring the achievement of its 7% target for real growth in the current fiscal year (April 1, 1978 to March 31, 1979).

Secretary Blumenthal said he appreciated the opportunity to meet with Vice Minister Sagami and welcomed the measures adopted by the Government of Japan as evidence of Japan's intent to fulfill the pledge made by Prime Minister Fukuda at the Bonn summit.

Secretary Blumenthal reviewed for Minister Sagami the steps being taken in connection with the concern expressed by President Carter over the recent sharp decline in the dollar and disorderly conditions in the foreign exchange markets. Secretary Blumenthal indicated his expectation that the U.S. would be announcing further actions as decisions are reached to deal with this situation.

Secretary Blumenthal and Minister Sagami expressed satisfaction with the recent strengthening of the consultation arrangements between the two countries and indicated an intent to continue to consult closely on both exchange market developments and more fundamental policy measures.

Minister Sagami will be continuing on to Paris to attend the meeting of the Deputies of the Group of Ten on September 8.

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B-1153

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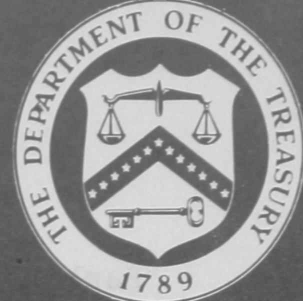

FOR RELEASE AT 4:00 P.M. September 7, 1978

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for $3,036 million, or thereabouts, of 364-day Treasury bills to be dated September 19, 1978, and to mature September 18, 1979 (CUSIP No. 912793 Z6 6). 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 September 19, 1978.

This issue will not provide new money for the Treasury as the maturing issue is outstanding in the amount of $3,036 million, of which $1,731 million is held by the public and $1,305 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 1:30 p.m., Eastern Daylight Saving time, Wednesday, September 13, 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.

(OVER)

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 September 19, 1978, in cash or other immediately available funds or in Treasury bills maturing September 19, 1978. 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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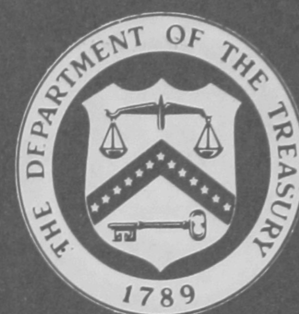
WASHINGTON, D.C. 20220 TELEPHONE 566-2041



FOR IMMEDIATE RELEASE
September 7, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY TENTATIVELY DISCONTINUES ANTIDUMPING INVESTIGATION ON VISCOSE RAYON STAPLE FIBER FROM AUSTRIA

The Treasury Department today announced its tentative decision to discontinue its antidumping investigation of viscose rayon staple fiber from Austria. A final determination is due by December 8, 1978.

This action results from an investigation conducted under the Antidumping Act of 1921. The investigation was started in March 1978 as a reopening of an earlier antidumping investigation that had been discontinued in January 1978. The investigation was reopened to determine whether the product was being sold in the home market by the sole Austrian exporter to the United States, Chemiefaser Lenzing A.G., for less than it cost to make. The investigation uncovered no evidence of below-cost sales and found that Lenzing was adhering to the terms of the prior discontinuance.

Notice of this action will appear in the Federal Register of September 8, 1978.

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B-1155

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

FOR IMMEDIATE RELEASE
September 8, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES COUNTERVAILING
DUTY INVESTIGATION ON IMPORTS OF
AMOXICILLIN TRIHYDRATE FROM SPAIN

The Treasury Department has started an investigation into whether imports of amoxicillin trihydrate, a semi-synthetic penicillin, from Spain are being subsidized.

A preliminary determination in this case must be made on or before January 27, 1979, and a final determination no later than July 27, 1979.

Imports of amoxicillin trihydrate in 1977 are estimated to have been valued at approximately $1.2 million.

This action, under the Countervailing Duty Law, is being taken pursuant to a petition alleging that manufacturers and/or exporters of this merchandise receive benefits from the Government of Spain under its "Desgravacion Fiscal" system. This system of remitting or rebating certain elements of the Spanish turnover tax has been the subject of previous Treasury investigations, and Treasury is currently soliciting public comment on the matter.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional customs duty equal to the size of a "bounty or grant" (subsidy) paid on merchandise exported to the United States.

Notice of this investigation will be published in the Federal Register of September 11, 1978.

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B-1156

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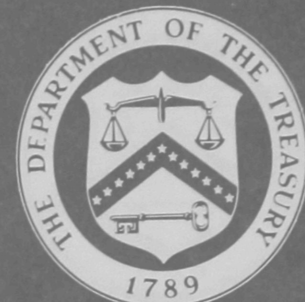


FOR IMMEDIATE RELEASE September 11, 1978

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $2,300 million of 13-week Treasury bills and for $3,401 million of 26-week Treasury bills, both series to be issued on September 14, 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 December 14, 1978			26-week bills maturing March 15, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	98.066	7.651%	7.91%	96.077a/	7.760%	8.19%
Low	98.048	7.722%	7.99%	96.047	7.819%	8.25%
Average	98.055	7.695%	7.96%	96.060	7.793%	8.23%

a/ Excepting 1 tender of $25,000

Tenders at the low price for the 13-week bills were allotted 32%.
Tenders at the low price for the 26-week bills were allotted 53%.

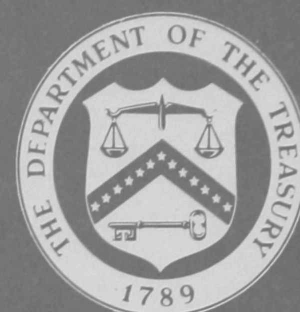
TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS AND TREASURY:

Location	Received	Accepted	Received	Accepted
Boston	$ 20,775,000	$ 20,775,000	$ 37,315,000	$ 32,615,000
New York	3,390,890,000	1,914,090,000	4,501,870,000	2,971,020,000
Philadelphia	16,970,000	16,970,000	7,655,000	7,655,000
Cleveland	45,335,000	45,335,000	71,395,000	71,395,000
Richmond	21,520,000	21,520,000	20,535,000	18,535,000
Atlanta	25,350,000	25,350,000	19,950,000	19,950,000
Chicago	223,920,000	78,920,000	223,345,000	73,345,000
St. Louis	43,255,000	32,255,000	28,220,000	17,220,000
Minneapolis	4,565,000	4,565,000	26,180,000	26,180,000
Kansas City	32,910,000	32,910,000	25,975,000	25,975,000
Dallas	17,510,000	17,510,000	11,885,000	11,885,000
San Francisco	151,380,000	83,380,000	193,705,000	115,705,000
Treasury	6,670,000	6,670,000	9,155,000	9,155,000
TOTALS	$4,001,050,000	$2,300,250,000b/	$5,177,185,000	$3,400,635,000c/

b/Includes $342,085,000 noncompetitive tenders from the public.
c/Includes $199,590,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-1157

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



FOR RELEASE ON DELIVERY
September 14, 1978 -- 10:00 a.m. EDST

STATEMENT OF THE HONORABLE RICHARD J. DAVIS
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to appear before you today on behalf of the Department of the Treasury to discuss the growing problem of arson for profit and the role of the Treasury Department in investigating those incidents. With me is John Krogman, Acting Director of the Bureau of Alcohol, Tobacco and Firearms; and William E. Williams, Deputy Commissioner of the Internal Revenue Service.

There can be no doubt as to the seriousness of the arson for profit problem. It has been characterized as the nation's fastest growing crime; its cost is felt in human suffering as well as in extraordinary economic effects such as the loss of homes, businesses, and jobs; and it is a difficult crime for law enforcement to successfully detect, investigate,and prosecute. The impact of arson has not fallen on any single state or part of our country alone, but has affected all of our major urban areas in various degrees. The National Fire Prevention and Control Administration has informed us that there were approximately 150,000 arsons committed in the United States in 1976, and that the direct losses were estimated at approximately $1 billion. In addition, we believe that there is evidence that in various areas arson serves as a source of income to organized crime.

Currently, the Treasury Department's role in the investigation or apprehension of those engaged in arson for profit lies with the Bureau of Alcohol, Tobacco and Firearms (BATF). The responsibilities of the Bureau is to investigate violations

of the Federal firearms and explosives statutes which prohibit the possession of many of the explosive and incendiary devices which are commonly used by arsonists. Therefore, BATF has statutory jurisdiction to investigate arsonists who employ certain proscribed devices to commit arsons. In addition, the Internal Revenue Service, whose mission is the administration and enforcement of our internal revenue laws, has the authority to investigate individuals or entities who fail to report their profits from arsons. As you can see, the Bureau of Alcohol, Tobacco and Firearms has a direct role to play in dealing with this problem, while, on the other hand, the Internal Revenue Service has a much more indirect responsibility in the arson area.

The Federal statutes which currently direct themselves at arson are the National Firearms Act, 26 U.S.C. 5801 et seq., (Title II of the Gun Control Act of 1968), and Title XI of the Organized Crime Control Act of 1970, 18 U.S.C. 841 et seq. Violations of both of these statutes may be punishable by fines of $10,000 and/or imprisonment for up to 10 years. Justice Department officials will be appearing before this Subcommittee and will be offering their views as to the effectiveness of these statutes as they relate to arson, as well as some other statutes which might be applicable such as those involving Racketeer Influenced and Corrupt Organizations and mail fraud.

Arson, like many other crimes, involves a blending of Federal, State and local jurisdictions and responsibilities. The Treasury Department believes that, at its core, arson is primarily a state and local crime. These entities have the basic responsibility to maintain public safety within their respective boundaries and, obviously, the Treasury Department does not have the resources to actively investigate more than a small percentage of the arsons which are committed each year.

This does not mean, however, that we believe there is no federal role in the arson area. To the contrary, the Treasury Department believes that organized and direct Federal involvement is necessary, and we have acted to provide it. BATF has already provided substantial assistance in attacking this problem and is currently directing its arson investigative activities to those instances where there is organized criminal involvement, white collar crime, and arson for hire rings which cross state lines in carrying out their illegal activities. We have also been committed to providing technical support and assistance to state and local law enforcement authorities.

In the past the Treasury Department has attempted, within its limited resources, to play an active role in combatting arson and arson-related crimes, predicated upon ATF's enforcement of the Federal firearms and explosives laws. As the members of the Subcommittee may know from the GAO Report, the number of ATF arson cases cannot accurately be measured without great difficulty because what is now reported as an arson or arson-related offense until January, 1978, was reported as a violation of the Federal firearms and explosives laws. I am able to report, however, that between January and July 1978, ATF had 163 active arson-for-profit schemes under investigation, nationwide, 75 of which were being conducted by ATF Arson Task Forces.

I am also able to report that in cases where direct ATF investigative involvement at the State and local levels was precluded for jurisdictional reasons, the Bureau always stood ready to furnish technical and investigative assistance. For instance, during 1976 and 1977, ATF's four forensic laboratories provided technical assistance in over 2,000 arson cases, and investigative assistance in 606 cases.

As the problem of arson grew, the Treasury Department in the past year has sought to develop new and more effective strategies within the Department to combat it. We have also recognized the need for a coordinated Federal effort and have initiated programs with other Federal law enforcement agencies.

I would like to share some of these initiatives with the Subcommittee:

In January 1977, an ATF Arson Task Force was established in the Philadelphia, Pennsylvania, area consisting of personnel from BATF, the FBI, the Postal Inspection Service, and Philadelphia police and fire investigators. This task force was created to assist local law enforcement authorities in arson investigations where violations of the Federal firearms and explosives laws were suspected. The task force was very effective and has led to the convictions of three individuals who had employed professional arsonists to burn down commerical structures for the purpose of defrauding insurance companies. The task force has also investigated nine other cases, three of which are now awaiting prosecution, and six others awaiting grand jury action.

In the fall of 1977, my office had discussions with the Justice Department concerning the feasibility of establishing Arson Task Forces in the twenty-three Department of Justice primary and satellite strike force locations. The purpose of these task forces is to develop cases against organized crime and racketeering figures who are believed to be involved in arson schemes; and to assist state and local authorities in the investigation and prosecution of significant arson-for-profit cases.

During this same period of time, ATF investigative personnel met with officials of the Criminal Division's Organized Crime and Racketeering Section to develop specific investigative standards and guidelines to be used in determining when an arson-related organized crime or white-collar crime should be investigated. The purpose of setting these guidelines is to ensure that the limited Justice Department and ATF resources would be utilized in the most effective manner by investigating only those cases where there was a reasonable likelihood of successful prosecution.

On February 1, 1978, the task force concept was approved. Beginning in March, ATF began training special agents in arson investigations and since then has trained 120 special agents. The special agents chosen for these assignments all underwent intensive instruction in the detection and investigation of arson-for-profit schemes at the Federal Law Enforcement Training Center in Glynco, Georgia. Since then, ATF, in cooperation with the Department of Justice,also has held a seminar in arson investigative techniques for Special Agents in Charge.

In January, 1978, we also met with representatives of the Commerce Department's National Fire Prevention and Control Administration to offer our assistance at the National Fire Academy in the training of state and local law enforcement and fire-fighting personnel in the detection and investigation of arson. Previously such training had been provided by ATF on only an ad hoc basis at the district level. Final arrangements for ATF participation have been made, and it is expected that ATF will begin assuming teaching duties at the Academy within the immediate future.

Because we have recognized the obvious interest that insurance companies have in halting the growth of arson and their wide experience in investigating this crime, we recently enlisted their cooperation in combatting arson-for-profit schemes. For instance, in April and June, 1978, ATF met with representatives of the Insurance Crime Prevention Institute and the Property Loss Research Bureau in order to obtain information regarding major arson-for-profit schemes, and to make arrangements for the future exchanges of information regarding detection techniques. Representatives of both

organizations have pledged their full cooperation in support of the ATF Arson Task Force projects. In the case of the Insurance Crime Prevention Institute, there were also arrangements made for ATF to participate on a limited basis in the instruction of new investigators.

Treasury recognizes that further initiatives will be required if the Federal effort against arson-for-profit schemes is to be fully effective and as our experience grows we are prepared, within our resource capability to undertake them. For instance, we know that there must be a better and more efficient procedure for sharing information on suspected arsonists with Federal, State and local authorities. Studies to develop these procedures are now underway.

While we continue to believe that primary responsibility in this area should remain with the State and local authorities, we are committed to continuing our role in this area. However, we caution against heightened expectations that the Federal government alone will be able to provide sufficient resources to attack this problem. It can only be successfully addressed by a coordinated federal/state effort. This is a reflection of the fact that federal resources, law enforcement and others, are not unlimited. This is particularly true of the Bureau of Alcohol, Tobacco and Firearms, whose proposed 1979 budget was severely reduced by the Congress. Nevertheless, we are determined to try to do what we can to try to meet this problem, even though our primary actor -- BATF -- may have less people to meet all its responsibilities.

I will now ask Acting Director Krogman and Deputy Commissioner Williams to present their statements after which we will be glad to answer any questions you may have.

Thank you.

Department of the TREASURY NEWS
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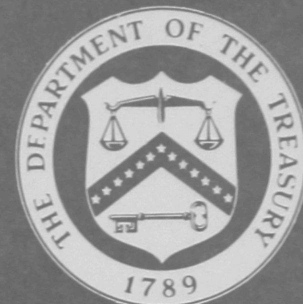

FOR RELEASE AT 4:00 P.M. September 12, 1978

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $5,600 million, to be issued September 21, 1978. This offering will not provide new cash for the Treasury as the maturing bills are outstanding in the amount of $5,605 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $2,200 million, representing an additional amount of bills dated June 22, 1978, and to mature December 21, 1978 (CUSIP No. 912793 U9 5), originally issued in the amount of $3,404 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,400 million to be dated September 21, 1978, and to mature March 22, 1979 (CUSIP No. 912793 X5 0).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing September 21, 1978. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,320 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 Daylight Saving time, Monday, September 18, 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-1159

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 September 21, 1978, in cash or other immediately available funds or in Treasury bills maturing September 21, 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.

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

FOR IMMEDIATE RELEASE
September 12, 1978

Contact: Alvin M. Hattal
202/566-8381

EMERGENCY TRADE EMBARGO
AUTHORITY IS EXTENDED

Treasury today announced that the President has extended for another year the emergency legal authorities under which Treasury administers the trade embargoes against Viet-Nam, North Korea, Cambodia, and Cuba. This action was in compliance with recent Congressional amendments to the Trading With the Enemy Act, requiring an annual determination by the President that these emergency powers are necessary in the furtherance of U. S. foreign policy objectives.

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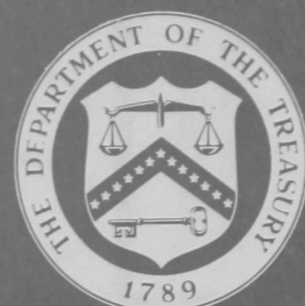
B-1160

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



FOR IMMEDIATE RELEASE
September 13, 1978

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT WITHHOLDS
APPRAISEMENT ON BICYCLE TIRES
AND TUBES FROM KOREA AND TAIWAN

The Treasury Department today said that it has tentatively determined that bicycle tires and tubes from the Republics of Korea and China (Taiwan) have been sold at less than fair value and that it is, accordingly, withholding appraisement on imports of that merchandise from those countries. The withholding action will not exceed six months.

If the Secretary makes a final determination that sales at less than fair value are occurring, the U. S. International Trade Commission must subsequently decide whether they cause or threaten injury to an American industry. Both sales at less than fair value and injury must occur before a dumping finding is reached and antidumping duties can be assessed.

The Treasury's final determinations are due by December 18, 1978. If affirmative, the Commission will have three months from the publication of those determinations to consider the injury issue.

Imports of bicycle tires and tubes from Korea and Taiwan were valued at $14.5 million and $15.3 million, respectively, during calendar year 1977.

The preliminary affirmative determination with respect to Taiwan is based on the sales of only one of the four companies investigated, Cheng Shin Rubber Industrial Co., Ltd. Two of the other three Taiwanese companies investigated, Nan Kang Rubber & Industrial Corp., Ltd., and Hwa Fong Rubber Industrial Co., Ltd., are excluded from the determination on the basis of no margins, in the case of Nan Kang, and *de minimis*, or insignificant margins, in the case of Hwa Fong. The fourth company, Kenda Rubber Tire Corp., is being given a discontinuance based on minimal margins and assurances that all future sales will not be at less than fair value.

B-1161

(MORE)

Under the Antidumping Act, the Secretary of the Treasury is required to withhold appraisement whenever he has reason to believe or suspect that imports of the product are being sold at less than fair value. Sales at less than fair value generally occur when imported merchandise is sold in the United States for less than in the home market or to third countries.

When appraisement is withheld, the Customs Service defers valuation of goods imported after the date of publication of the notice, thus allowing any dumping duties ultimately imposed to be levied on all imports entered after that date.

In a related matter, the Treasury made a preliminary ruling in late July under the Countervailing Duty Law that the Governments of the Republic of Korea and Taiwan were subsidizing in whole or in part exports of these same products to the United States. Final determinations in those cases are due by December 28, 1978.

Notice of the antidumping actions will appear in the Federal Register of September 18, 1978.

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federal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-566-2615

FOR IMMEDIATE RELEASE September 13, 1978

FEDERAL FINANCING BANK ACTIVITY

August 1-August 31, 1978

Roland H. Cook, Secretary, Federal Financing Bank, announced the following activity for August, 1978.

Guaranteed Loan Programs

On August 23, the FFB purchased a total of $10,290,000 in debentures issued by 10 small business investment companies. The debentures are guaranteed by the Small Business Administration, and mature in 3 years and 10 years, with interest rates of 8.575% and 8.595%, respectively.

FFB purchased the following General Services Administration Purchase Contract Participation Certificates:

Series	Date	Amount	Maturity	Interest Rate
M-036	8/9	$7,615,757.26	7/31/03	8.582%
L-045	8/14	1,551,744.48	11/15/04	8.629%
K-011	8/30	1,797,745.46	7/15/04	8.560%

FFB made 26 advances on existing loans to 15 governments totalling $55,998,163.48 under the foreign military sales program. These advances are guaranteed by the Department of Defense. FFB also entered into a new $10 million loan agreement with the Government of Ecuador.

Under notes guaranteed by the Rural Electrification Administration, FFB advanced a total of $235,060,338 to 24 rural electric and telephone systems. Details of individual advances are included in the attached table.

FFB provided Western Union Space Communications, Inc., with $7,950,000 on August 21 and $3.6 million on August 31 at annual interest rates of 8.806% and 8.782%, respectively. These advances are part of the FFB's $687 million financing of a satellite tracking system to be constructed by Western Union and used by the National Aeronautics and Space Administration. Repayment of these advances is guaranteed by NASA.

Department of Transportation (DOT) Guaranteed Lending

Under Section 511 of the Railroad Revitalization and Regulatory Reform Act, the FFB advanced funds to:

	Date	Amount	Maturity	Interest Rate
Chicago & North Western Trans.	8/1	$1,974,806.00	3/1/89	8.875% annually
Trustee of The Milwaukee Road	8/2	3,684,000.00	11/15/91	8.888% annually
Missouri-Kansas-Texas RR	8/3	1,112,028.00	11/15/97	8.54% quarterly

Under Note #15, which matures October 1, 1978, FFB lent the following to Amtrak:

Date	Amount	Interest Rate
8/8	$5,000,000.00	7.034%
8/15	6,000,000.00	7.231%
8/17	5,000,000.00	7.394%
8/21	1,500,000.00	7.337%

On August 30, the FFB advanced $414,000 to the United States Railway Association at an interest rate of 8.408%. This advance was against Note #8, which matures April 30, 1979.

Agency Issuers

On August 7, the FFB purchased a $695 million Certificate of Beneficial Ownership from the Farmers Home Administration. This CBO will mature on August 7, 1983, and carries an interest rate of 8.61% on an annual basis.

The Tennessee Valley Authority sold a $555 million note to the FFB on August 31. The note matures November 30, 1978 and carries an interest rate of 7.855%.

In its weekly short-term FFB borrowings, the Student Loan Marketing Association, a Federally-chartered private corporation which borrows under a Department of Health, Education and Welfare guarantee, raised $20 million in new cash and refunded $290 million in maturing securities. FFB holdings of SLMA notes now total $725 million.

FFB Holdings

As of August 31, 1978, FFB holdings totalled $46.7 billion. FFB Holdings and Activity Tables are attached.

FEDERAL FINANCING BANK HOLDINGS
(in millions of dollars)
August 1978

Program	August 31, 1978	July 31, 1978	Net Change (7/31/78-8/31/78)	Net Change-FY 1978 (10/1/77-8/31/78)
On-Budget Agency Debt				
Tennessee Valley Authority	$ 5,010.0	$ 4,960.0	$ 50.0	$ 1,130.0
Export-Import Bank	6,132.3	6,132.3	-0-	208.8
Off-Budget Agency Debt				
U.S. Postal Service	2,114.0	2,114.0	-0-	-67.0
U.S. Railway Association	356.8	356.4	0.4	46.4
Agency Assets				
Farmers Home Administration	22,275.0	21,580.0	695.0	7,660.0
DHEW-Health Maintenance Org. Loans	50.0	43.0	7.0	20.2
DHEW-Medical Facility Loans	163.7	163.7	-0-	11.5
Treasury-New York City	-0-	-0-	-0-	-1,157.2
Overseas Private Investment Corp.	40.1	40.1	-0-	-4.3
Rural Electrification Admin.-CBO	450.7	450.7	-0-	97.0
Small Business Administration	114.1	115.2	-1.0	-18.9
Government Guaranteed Loans				
DOT-Emergency Rail Services Act	17.5	17.5	-0-	2.9
DOT-Title V, RRRR Act	34.2	27.4	6.8	29.0
DOD-Foreign Military Sales	3,719.2	3,664.6	54.7	1,203.6
General Services Administration	263.2	252.3	10.9	121.1
Guam	36.0	36.0	-0-	-0-
DHUD-New Communities Admin.	38.5	38.5	-0-	-4.0
Nat'l. Railroad Passenger Corp. (AMTRAK)	536.3	518.9	17.5	-22.7
NASA	227.6	216.0	11.6	171.1
Rural Electrification Administration	3,918.6	3,683.5	235.1	1,536.2
Small Business Investment Companies	246.5	236.2	10.3	70.6
Student Loan Marketing Association	725.0	705.0	20.0	215.0
Virgin Islands	21.8	21.8	-0-	-.2
WMATA	177.0	177.0	-0-	-0-
TOTALS	$46,668.0*	$45,549.9*	$1,118.1*	$11,250.1*

Federal Financing Bank September 11, 1978

*totals do not add due to rounding.

FEDERAL FINANCING BANK

August 1978 Activity

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST RATE (other than s/a)
Department of Defense					
Greece #9	8/1	$ 10,379,659.00	5/3/88	8.661%	
Malaysia #3	8/2	1,683,500.00	3/20/84	8.585%	
Ecuador #2	8/3	64,836.80	8/25/84	8.516%	
Peru #2	8/4	37,879.00	4/1/84	8.447%	
Peru #3	8/9	114,345.00	4/10/84	8.367%	
Korea #8	8/9	1,597,447.00	12/31/86	8.438%	
Thailand #2	8/10	96,015.00	6/30/83	8.329%	
Spain #1	8/11	443,751.44	6/10/87	8.418%	
Israel #6	8/15	1,150,000.00	1/12/08	8.669%	
Liberia #2	8/15	347,414.00	6/30/83	8.417%	
Spain #1	8/15	308,131.00	6/10/87	8.485%	
Indonesia #3	8/16	92,028.37	9/20/86	8.508%	
Ecuador #2	8/18	17,624.91	8/25/84	8.592%	
Jordan #3	8/18	283,136.38	12/31/86	8.609%	
Panama #2	8/18	4,247.40	3/31/83	8.581%	
China #3	8/22	13,212.42	12/31/82	8.555%	
Spain #1	8/22	2,619,822.00	6/10/87		
Indonesia #3	8/23	· 1,298,201.00	9/20/86	8.570%	
Malaysia #3	8/28	2,911,506.01	3/20/84	8.499%	
Israel #6	8/29	29,731,541.62	1/12/08	8.577%	
Peru #2	8/29	393,132.00	4/1/84	8.502%	
Colombia #1	8/29	101,340.02	6/30/83	8.506%	
Korea #8	8/30	71,531.60	12/31/86	8.541%	
Jordan #2	8/31	1,041,208.80	11/26/85	8.593%	
Jordan #3	8/31	942,262.71	12/31/86	8.590%	
Turkey #6	8/31	254,390.00	6/3/88	8.596%	
Farmers Home Administration					
	8/7	695,000,000.00	8/7/83	8.432%	8.610% annually
General Services Administration					
Series M-036	8/9	7,615,757.26	7/31/03	8.582%	
Series L-045	8/14	1,551,744.48	11/15/04	8.629%	
Series K-011	8/30	1,797,745.46	7/15/04	8.560%	
National Railroad Passenger Corp. (Amtrak)					
Note #15	8/8	5,000,000.00	10/1/78	7.034%	
Note #15	8/15	6,000,000.00	10/1/78	7.231%	
Note #15	8/17	5,000,000.00	10/1/78	7.394%	
Note #15	8/21	1,500,000.00	10/1/78	7.337%	
Rural Electrification Administration					
United Power Assn. #6	8/1	3,200,000.00	8/1/80	8.654%	8.554% quarterly
Alabama Elect. Coop. #26	8/1	1,000,000.00	8/1/80	8.654%	8.554% "
United Power Assn. #67	8/1	8,200,000.00	8/1/80	8.654%	8.554% "
San Miguel Elect. Coop. #110	8/1	128,309,000.00	8/1/80	8.654%	8.554% "
East Ascension Tele. Co. #39	8/4	384,064.00	8/4/80	8.435%	8.348% "
Dairyland Power Coop. #36	8/7	10,000,000.00	12/31/12	8.582%	8.492% "
Hillsborough & Montgomery Tele.#27	8/10	157,000.00	12/31/12	8.565%	8.475% "
Allied Tele. Co. of Arkansas #48	8/10	125,274.00	12/31/12	8.565%	8.475% "
Allegheny Elect. Coop. #93	8/10	3,107,000.00	12/31/12	8.565%	8.475% "
Northern Michigan Elect. Coop.#101	8/10	20,000.00	8/10/80	8.345%	8.260% "
Wabash Valley Power Assn. #104	8/10	3,444,000.00	12/31/12	8.565%	8.475% "
Cooperative Power Assn. #70	8/14	14,000,000.00	12/31/12	8.646%	8.555% "
Tennessee Telephone Co. #80	8/14	2,500,000.00	12/31/12	8.646%	8.555% "
Arizona Elect. Power Coop. #60	8/15	3,897,000.00	12/31/12	8.679%	8.587% "
Arizona Elect. Power Coop. #103	8/15	1,203,000.00	12/31/12	8.679%	8.587% "
Sierra Telephone Co. #59	8/15	375,000.00	12/31/12	8.679%	8.587% "

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST RATE (other than s/a)
Rural Electrification Administration (continued)					
Glacier State Tele. Co. #29	8/15	$ 1,166,000.00	8/15/80	8.465%	8.377% quarterly
Central Iowa Power Coop. #51	8/16	1,435,000.00	12/31/12	8.693%	8.601% "
Western Farmers Elect. Coop.#64	8/16	2,400,000.00	12/31/12	8.693%	8.601% "
Big River Elect. Corp. #58	8/21	3,426,000.00	8/21/80	8.675%	8.583% "
Colorado-Ute Elect. Assn. #78	8/21	881,000.00	12/31/12	8.692%	8.600% "
Big River Elect. Corp. #91	8/21	1,948,000.00	8/21/80	8.675%	8.583% "
So. Mississippi Elect. Coop. #3	8/23	125,000.00	8/25/80	8.645%	8.554% "
So. Mississippi Elect. Coop. #90	8/23	822,000.00	8/25/80	8.645%	8.554% "
Gulf Telephone Co. #50	8/24	109,000.00	12/31/12	8.575%	8.485% "
East Kentucky Power Coop. #73	8/24	5,782,000.00	8/24/80	8.595%	8.505% "
Northwest Generating Co. #118	8/28	17,405,000.00	12/31/12	8.593%	8.503% "
Buckeye Power Corp. #123	8/30	11,079,000.00	12/31/12	8.609%	8.518% "
Tri-State Gen. & Trans. #89	8/31	6,075,000.00	12/31/80	8.625%	8.534% "
Southern Illinois Pwr. #38	8/31	870,000.00	8/31/80	8.655%	8.563% "
Powell Telephone Co. #41	8/31	613,000.00	12/31/12	8.631%	8.54% "
Arkansas Electric Coop. #77	8/31	1,003,000.00	12/31/12	8.631%	8.54% "
Small Business Investment Companies					
CSRA Capital Corp.	8/23	1,100,000.00	8/1/81	8.575%	
Tappan Zee Capital Corp.	8/23	300,000.00	8/1/81	8.575%	
Bohlen Capital Corp.	8/23	500,000.00	8/1/88	8.595%	
DeSoto Capital Corp.	8/23	400,000.00	8/1/88	8.595%	
First Texas Investment Co.	8/23	500,000.00	8/1/88	8.595%	
First Women's SBI Corp.	8/23	1,450,000.00	8/1/88	8.595%	
Lloyd Capital Corp.	8/23	1,000,000.00	8/1/88	8.595%	
Royal Business Funds Corp.	8/23	2,540,000.00	8/1/88	8.595%	
Vega Capital Corp.	8/23	2,000,000.00	8/1/88	8.595%	
Venture SBIC, Inc.	8/23	500,000.00	8/1/88	8.595%	
Student Loan Marketing Association					
#155	8/1	70,000,000.00	10/31/78	7.240%	
#156	8/8	70,000,000.00	11/7/78	7.149%	
#157	8/15	70,000,000.00	11/14/78	7.232%	
#158	8/22	60,000,000.00	11/21/78	7.632%	
#159	8/29	40,000,000.00	11/28/78	7.689%	
Tennessee Valley Authority					
#81	8/31	555,000,000.00	11/30/78	7.855%	
Department of Transportation-Sec. 511 Loans					
Chicago & North Western Trans.	8/1	1,974,806.00	3/1/89	8.686%	8.875% annually
Milwaukee Road	8/2	3,684,000.00	11/15/91	8.699%	8.888% annually
Missouri-Kansas-Texas RR	8/3	1,112,028.00	11/15/97	8.631%	8.54% quarterly
United States Railway Association					
Note #8	8/30	414,000.00	4/30/79	8.408%	
Western Union Space Communications (NASA)					
	8/23	7,950,000.00	10/1/89	8.620%	8.806% annually
	8/31	3,600,000.00	10/1/89	8.597%	8.782% annually

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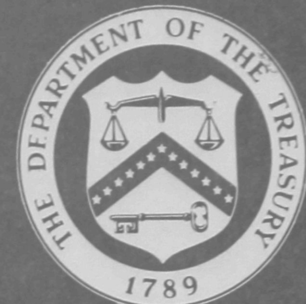

FOR RELEASE AT 4:00 P.M. September 13, 1978

TREASURY TO AUCTION $2,684 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $2,684 million of 2-year notes to refund the same amount of notes maturing September 30, 1978. The $2,684 million of maturing notes are those held by the public, including $709 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $511 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders. Additional amounts of the new securities may also be issued at the average price, for new cash only, to Federal Reserve Banks as agents for foreign and international monetary authorities.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

(over)

B-1163

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED OCTOBER 2, 1978

September 13, 1978

Amount Offered:

To the public	$2,684 million

Description of Security:

Term and type of security	2-year notes
Series and CUSIP designation	Series T-1980 (CUSIP No. 912827 JB 9)
Maturity date	September 30, 1980
Call date	No provision
Interest coupon rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	March 31 and September 30
Minimum denomination available	$5,000

Terms of Sale:

Method of sale	Yield auction
Accrued interest payable by investor	None
Preferred allotment	Noncompetitive bid for $1,000,000 or less
Deposit requirement	5% of face amount
Deposit guarantee by designated institutions	Acceptable

Key Dates:

Deadline for receipt of tenders	Wednesday, September 20, 1978, by 1:30 p.m., EDST
Settlement date (final payment due)	
a) cash or Federal funds	Monday, October 2, 1978
b) check drawn on bank within FRB district where submitted	Thursday, September 28, 1978
c) check drawn on bank outside FRB district where submitted	Wednesday, September 27, 1978
Delivery date for coupon securities	Monday, October 2, 1978

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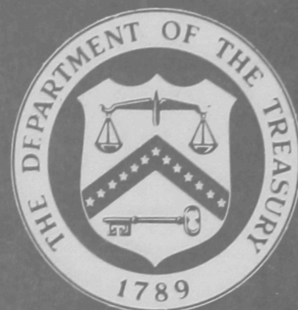

FOR IMMEDIATE RELEASE

September 13, 1978

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,037 million of 52-week Treasury bills to be dated September 19, 1978, and to mature September 18, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	91.972	7.940%	8.57%
Low -	91.948	7.964%	8.60%
Average -	91.958	7.954%	8.59%

Tenders at the low price were allotted 38%.

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

Location	Received	Accepted
Boston	$ 44,030,000	$ 14,030,000
New York	4,917,030,000	2,629,415,000
Philadelphia	21,545,000	21,545,000
Cleveland	149,875,000	81,875,000
Richmond	35,290,000	6,290,000
Atlanta	84,245,000	51,245,000
Chicago	237,655,000	58,155,000
St. Louis	27,205,000	4,965,000
Minneapolis	49,040,000	7,040,000
Kansas City	16,605,000	11,005,000
Dallas	11,645,000	5,645,000
San Francisco	456,240,000	142,240,000
Treasury	3,450,000	3,450,000
TOTAL	$6,053,855,000	$3,036,900,000

The $3,037 million of accepted tenders includes $112 million of noncompetitive tenders from the public and $1,259 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 $311 million of the bills will be issued to Federal Reserve Banks as agents of foreign and international monetary authorities for new cash.

B-1164

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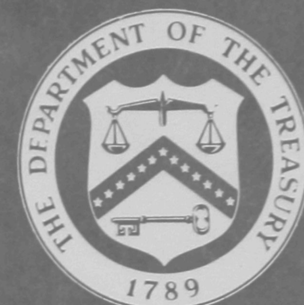

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SEP 15 '78
TREASURY DEPARTMENT

FOR RELEASE UPON DELIVERY
EXPECTED AT 10:30 A.M.
THURSDAY, SEPTEMBER 14, 1978

REMARKS BY THE HONORABLE DANIEL H. BRILL
ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY
BEFORE THE
1979 BUSINESS OUTLOOK SESSION OF THE CONFERENCE BOARD
NEW YORK, NEW YORK

In the last full fiscal year of the Administration preceding ours, the budget deficit was over $66 billion. For the fiscal year ending in two weeks--approximately the second year of this Administration--the deficit will likely be around $50 billion. For the fiscal year ahead (1979), the deficit will be in the low $40 billions. For the fiscal year following--1980--it will be significantly below $40 billion. And we intend to keep going in this direction, at a prudent pace consistent with further reduction in unemployment and abatement of inflation, until the budget is balanced.

I suspect that's about as succinct a description of this Administration's budgetary policy and the budget outlook as I can give. Perhaps I should quit while I'm ahead.

But I won't. There are many dimensions to the budget, and they must be explored to appreciate how powerful an economic tool we have in budgetary policy, but how difficult it is to control the use of this tool.

In thinking about this speech, I was struck by the fact that I, a life-long, card-carrying Democrat, am taking pride in fiscal policies that will lead to a balanced budget, while at the same time, some Washington luminaries

B-1165

of that other party are loudly advocating fiscal policies that would yield mammoth deficits for the next several years. One of us has seen the light!

Why our dedication to eliminating the budget deficit? It offends many economists to focus so much on deficits, since it implies some direct and powerful links between deficits, per se, and inflation. The links are not that tight. There can be budget balance at such a high level of government spending and taxation that the government is nonetheless adding to strains on resources. Conversely, there can be large deficits which fail to take up sufficient slack in the economy. The appropriateness of budget deficits can be evaluated properly only in the context of the level of private demands and of resource availability, of inflation and inflationary expectations, and of the composition of outlays and the sources of revenues.

In the current economic context, large deficits are inappropriate. I don't have to recite for this group the current and recent numbers on inflation. Even with the long-anticipated cooling off in food prices, the basic inflation rate persists at an unacceptably high level. While the economy is not yet fully stretched, it is getting closer to the point where tautness in some goods and services markets is contributing to inflation.

This tautness is not readily apparent in the aggregate statistics. For example, the overall unemployment rate is still uncomfortably high--almost 6 percent--and far from any reasonable definition of full employment. But it is down one-third--three percentage points--from its recession peak, and for the components of the labor force that in the past have shown the closest relationship between unemployment and wage pressures--adult males--the unemployment rate is down to 4.1 percent, almost half its recession peak. On the other hand, the unemployment rate for teenagers--at a distressingly high level of 15.6 percent is only one-fourth lower than its recession peak. Given the acceleration in wages and prices over the past year, improvement in the situation for those segments of the population which have not fully shared in the recovery cannot depend on pumping up the economy at the macro level. As far as fiscal policy

is concerned, what is called for is not bigger deficits, but specifically-targeted training and employment programs.

While the utilization of industrial plant is also not high by historical standards, it has risen substantially since the recession trough. Moreover, spotty signs of capacity shortages are emerging, e.g., cement, certain types of industrial machinery, and these signals must be respected in formulating near-term budget policy. Inflationary pressures when the overall capacity utilization rate is as moderate as 84 percent suggests to me the need to re-evaluate the efficiency of our capital stock, and to take actions not only to add to the size of the stock but also to improve its effectiveness by encouraging adoption of technology reflecting the best state of the art.

It's worth repeating that the relationship between the budget and the health of the economy is a two-way street. It is important to keep a tight rein on budget deficits in order to avoid an acceleration of inflation, but it is also necessary to reduce the rate of inflation without endangering the economic recovery. The size of the budget deficit itself depends upon the pace of economic growth. Slow growth tends to increase budget deficits, as outlays for unemployment insurance, welfare payments, food stamps, and public service jobs increase and decrease tax receipts as a result of lower levels of profit and personal income.

Thus, we have a delicate balancing act to perform: we must sustain the recovery and at the same time bring inflation under control; neither objective can be fulfilled without the other. The record of the past decade shows that although an overheated economy will accelerate inflation, a sluggish economy will not cure it, except very slowly, and at great cost--not only to the young, the poor, and minorities with still very high unemployment rates, but to businesses who would suffer from reduced profits, sales, and opportunities to invest.

The deficit projections for 1979 and 1980 I cited earlier do recognize the current and prospective economic situation and requirements, particularly the dangers of accelerating inflation. But these budgets reflect more than

just a preoccupation with near-term economic developments; they reflect the basic philosophy that proper fiscal policy should achieve at least three fundamental objectives:

- Reduce the share of real and financial resources absorbed by the Federal government.

- Stimulate the private sector to utilize the freed resources.

- Meet our pressing social and international needs.

The outlay numbers in these budgets are large, and I realize that it is difficult for many of us to conceive of scheduled expenditures of near $500 billion as being consistent with "tight" budgetary policy. But in a country of over 200 million citizens, with a GNP of over $2 trillion, even the most prudent fiscal approach will result in box-car outlay numbers that are hard, at least for my generation, to put into proper context.

Even reducing the numbers to intellectually manageable proportions, by relating the budget to GNP, is not too comforting. In current dollars, federal outlays increased at a faster rate than GNP during the decade through 1976. As a consequence, budget outlays as a share of nominal GNP increased from 20.4 percent in FY 1967 to 22.5 percent in 1976.

But a more appropriate measure of the impact of federal spending on resource availability for the private sectors requires expressing this ratio in real terms. Inflation has been more rapid in the Federal budget sector than in the economy as a whole. This reflects, primarily, the fact that prices of services rose faster than the prices of goods over this period, and much of federal spending other than transfer payments is for purchases of services. It also reflects the fact that costs of construction projects--a major Federal budget outlay--have also risen more than other costs. Thus, while federal outlays in the 1967-76 period increased as a share of <u>nominal</u> GNP, when expressed in real terms, the ratio of outlays to GNP remained about unchanged.

The Carter Administration budget policy is directed not just to maintaining but to reducing the government's drain on real resources. The ratio of real federal outlays to real GNP has declined from 21.4 percent in 1976 to 20.8 percent in 1978. Moreover, by continuing to exercise fiscal restraint and carefully applying zero based budgeting, we intend to reduce further the government's preemption of real resources in 1980 and beyond.

If anyone is tempted to dismiss the record of budget restraint to date as only a minor improvement, he has not had the traumatic experience of budget-cutting in the context of existing law, special interest groups or the bureaucracy. Uncontrollable outlays--those where the spending level for any given fiscal year is fixed by existing statute or prior contracts--now account for over three-fourths of total budget outlays, up from 60 percent only a decade ago. Of the $500 billion originally proposed as FY 79 outlays, only $130 billion, or one-fourth, were within the President's discretion to modify, and over half of the so-called controllables relatedto national defense programs. Thus, the opportunities to make significant changes in the thrust of budget policy come in small doses, and yield significant results only if pursued persistently over a period of years.

Paradoxically, it is as hard to achieve approved spending levels as it is to moderate prospective spending plans. The tendency of government agencies to spend less than their authorized budgets--the so-called underrun problem--has been with us in every year but one since 1970.

In the current economy, however, the problem becomes a blessing. For management purposes, it would obviously be preferable to have accurate spending forecasts, and the OMB continues to make progress in improving the estimating procedures. But if there are to be deviations from plan, it's much more acceptable if the deviations are in a favorable direction. I learned in my business career that exceeding a sales and profit plan by a substantial margin still brought admonitions to adhere to company plans, but these admonitions were by a bonus. Given our objective of reducing the government's impact on the economy, I suggest we deserve the equivalent of a bonus for capitalizing on the good breaks.

As noted earlier, reducing the Federal government's demands on current output is a laudable objective but, in the context of a not fully utilized economy, only when coupled with incentives to insure that the private sectors pick up any resulting slack in demands. The tax program submitted by the President earlier this year was designed precisely to achieve this objective. In particular, it includes powerful incentives for business investment, needed not only for the economic stimulus these capital outlays provide in the near term but, even more importantly, for the encouragement they would lend to expansion and modernization of our capital stock.

The need for investment incentives--not wasteful capital gains subsidies of remote significance to real productive investment, but rather proven inducements for increasing capital formation--is still strong. Business capital investment is expected to rise about 8 percent in real terms this year, down from the 9 percent increase in 1977 and still below the growth rate we need to maintain if we are to equip our production system properly.

In addition, personal taxes must be cut to maintain purchasing power by offsetting the adverse effects of higher social security and income tax liabilities. Calendar year 1979 social security tax liabilities will be $11 billion greater than in 1977, and almost $6 billion of this increase falls on employees and self-employed individuals. Higher individual income tax liabilities will result from higher real incomes and from inflated incomes pushing people into higher tax rate brackets.

In the absence of the currently proposed tax cuts, the share of personal income absorbed by federal personal income taxes and the contribution of employees and the self employed to social security would rise from 12.7 in 1977 to about 14.2 percent in 1979. The proposed tax cut would moderate, but not completely eliminate this increase.

While the components of the proposed tax program are still sorely needed, the overall magnitude of the original program is not. In particular, the persistence of an unacceptably high underlying rate of inflation has argued for moderating stimulus from the revenue as well as from the outlay side of the budget. The Administration has therefore pruned about $10 billion from the originally proposed tax cut of $24 billion for FY 1979--about $5 billion in the size of the cut and about $5 billion more by recommending postponement of the effective date until January 1, 1979 instead of the October 1, 1978 date

recommended earlier. It should be clear, therefore, that we are committed to as prudent a course in taxes as in outlays. We're vigorously working both sides of the ledger to moderate inflationary pressures. While one cannot characterize the recent and current inflation as one of excess demand--if it can be labelled at all, it is more of a tail-chasing wages-chasing-prices-chasing wages syndrome--the Administration's fiscal efforts are designed to avoid reinforcing these inflationary pressures.

While we are exerting pressure to hold total outlays in check, we have attempted to reallocate scarce budgetary resources so as to get more for our money and achieve the highest priority national and social objectives. As you might anticipate, reordering priorities to meet urgent domestic needs, while being sure not to short-change defense and other vital international program commitments, is at least as difficult as keeping down the outlay total itself. However, we have made some noticeable progress along these lines.

For example, estimated outlays in FY 1979 as shown in the January budget include:

- $15.2 billion for training, employment, and labor services, an increase of $6.0 billion or 66 percent over FY 1977. These programs are now more focused on the poor and structurally-unemployed youth and members of minority groups. In addition, they are more oriented toward placing workers in private sector jobs and furthering their permanent attachment to the private sector work force.

  Included in this effort, for example, is a new program which directly involves the private sector in locally crganized on-the-job training for the structurally unemployed.

  On the revenue side of the ledger, we have proposed an employment tax credit which is targeted on youth and would replace the more cumbersome existing untargeted jobs tax credit.

- $63.4 billion for health programs, an increase of $13.8 billion or 28 percent over FY 1977.

- $12.3 billion for environmental programs, an increase of $3.1 billion or 34 percent FY 1977.

All of these programs of high social priority are scheduled to rise more than the increase in the total budget, indicative of how the Administration is reordering the budget's priorities to meet major national goals. It is important to emphasize, moreover, that these priorities are <u>not</u> being implemented at the expense of our national security. National defense and international affairs outlays are projected for FY 79 to be $125.4 billion or 22 percent higher than in 1977. The long decline in the share of the budget allocated to meeting our international responsibilities is over.

In summary, our budget plans are for tight constraint on the growth of expenditures, a change in the composition of spending to focus on the highest priority needs of our society, and a reduction in taxes to permit and encourage the private sector to utilize the resources which would otherwise have been preempted by government.

Will this indeed be the pattern of fiscal policy next year? The signs are encouraging for a convergence of Administration and Congressional views, at least on the broad outlines of policy. The 2nd Congressional Budget Resolution, due tomorrow (September 15) will set the spending level for outlays, the floor for receipts, and the estimated deficit. As the Senate and House Budget Committees go to conference they are in virtual agreement on outlays at nearly $490 billion. In his July 31 testimony before the House Budget Committee, OMB Director McIntyre stated that the Administration viewed a target of about $491 billion in outlays as appropriate. Thus, there is only a minor difference on the proposed outlay figure, and part of the difference is definitional.

There is a bit more play on the receipts side, because the House and Senate differ on the size of the tax cut on which they base their respective recommendations. The House assumes a cut of $10.1 billion for FY 1979 whereas the Senate assumes $14 billion, much closer to the Administration's proposed reduction. The House goes to the Conference with receipts of $450 billion and a $39.6 billion deficit, whereas the Senate has receipts of $447.2 and a deficit of $42.3 billion. The Administration's Mid Session Review estimate for receipts was $448.2 billion, in between those of the Congressional proposals. The important point is that the range of differences among the budget players is quite narrow. As you factor budget policies into your own economic forecasts for next year, it seems safe to assume that fiscal policies will not be exacerbating pressures in either financial or nonfinancial markets.

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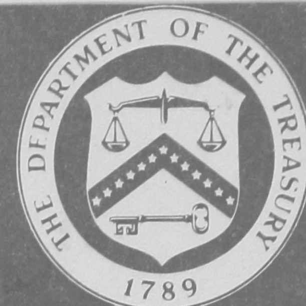

FOR RELEASE UPON DELIVERY
September 14, 1978

REMARKS BY THE HONORABLE
BETTE B. ANDERSON
UNDER SECRETARY OF THE TREASURY
BEFORE THE
WASHINGTON PRESS CLUB
WASHINGTON, D.C.
SEPTEMBER 14, 1978

I am delighted to be here today, but I have a hunch that some of you may be surprised that my subject is law enforcement. Unless you have covered the Treasury Department or criminal justice, you probably are not aware that about 80 percent of Treasury personnel have law enforcement duties.

We administer a wide range of laws ranging from gun control, busting of illegal stills, bombings, and narcotics smuggling to the Bank Secrecy Act, with all the ramifications involving organized crime. As Under Secretary of the Treasury, I have responsibility for the Secret Service, Customs Service, Bureau of Alcohol, Tobacco and Firearms, to mention only a few of our larger bureaus.

This is a difficult time to be involved in law enforcement business. Past abuses, both real and imagined, have changed the atmosphere drastically from that of the automatic "good guys." Although there is an understandable tendency to long for those good old days, the new reality is not without some important benefits. I feel strongly that law enforcement should have to explain why it needs certain tools; it should have to hold itself accountable for its performance.

For example, take the area of hiring women and minorities. For years, law enforcement dragged its feet, preferring to draw upon the usual recruitment pools. However, in the past five years -- partly as a result of public criticism -- we have improved our hiring records of minorities and women, and, as a result, I believe we have improved our law enforcement operations.

It is a cornerstone principle of democracy that the acceptance of government authority requires that people have a sense that the government truly represents them. This is particularly true of law enforcement. Its acceptance in the

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community depends on a belief that it reflects the community it serves. To gain and sustain this acceptance, we must see that our agencies do in fact reflect the communities they serve and include blacks, hispanics, women, and other minorities.

I also think that the general public distrust of too much government, as witnessed most recently by Proposition 13, also presents major challenges to those of us involved in setting law enforcement policy. There are many times when we could impose a regulation or enforce a law in such a way as to impose unfair burdens on the general population just because we are eager to catch the criminals. We must constantly guard against this natural tendency and try to strike the best balance.

Nowhere do we see this tension more than in the conflicting purposes of the Freedom of Information Act and the Privacy Act. While many of us would agree in principle with both of these Acts -- in practice, both can be seriously abused. We hear about criminals, some of whom are in jail, putting in freedom of information requests so they can get information on who turned them in. On the other hand there are some who would like to prohibit law officers who are working on such important matters as protecting the President from obtaining intelligence that could provide needed information on a suspect.

Nowhere do we see these complex tensions become more emotional than in the areas which touch upon, either directly or indirectly, gun control. I think it is very unfortunate that the debates which surround the gun control issue inevitably turn into vindictive, ugly, emotional arguments in which the facts somehow get buried. Yet, in order to accomplish anything significant in the area, we have to recognize the tension. Many people do fear that the government wants to take away their right to bear arms, while others fear that they may become the next victim of a crime committed with a firearm. These fears are real, and, yet, for those of us who try to represent the public interest at large, they make our job difficult.

As many of you may be aware, Treasury did propose some firearms regulations last spring which had been developed to help Federal, state and local law authorities trace more efficiently guns used in crimes and to identify those selling guns to criminals. Unfortunately, however, instead of discussion of our proposals, the debate quickly involved claims that we were seeking a "first step" to registration of firearms and the eventual confiscation of all firearms. Well, this was not at all our intention. We had even taken special care to write the regulations so that the names and address of private owners or purchasers were not to be reported. Nevertheless, the debate degenerated into a series of accusations and denials.

Thousands and thousands of letters were written both to us and to Congressional representatives and senators. We are now evaluating the comments we have received in connection with these regulations.

We are also in the midst of another issue which we see as important for law enforcement. This is the issue of tagging explosives so that after a bomb has exploded it might be identified and traced or so that it will be possible to detect the presence of a bomb before it explodes. While some have tried to categorize this as another step toward gun control, our tagging proposal involves very broad and important issues of public safety.

Experts from both inside and outside the government have testified as to the soundness of the tagging program recommended by Treasury. Explosives tagging involves placing a particle -- called a taggant -- in explosive materials. The taggant would remain intact after a bomb exploded so that the explosive might be identified and traced. Without taggants, it is sometimes impossible after a bombing to even get one clue as to who made the bomb, since all of the evidence is blown to bits. That is why, after nearly three years and more than a million investigative work-years, we don't even know the type of explosive used in the bomb that exploded in LaGuardia Airport, killing eleven innocent bystanders. The tagging program would change that.

Unfortunately, an effort is being made to exclude black and smokeless powder from the tagging program. These materials are also used to load certain kinds of guns and concern has been expressed that taggants might adversely affect the quality of the powder. But we suggested legislative provisions which require tests to show this was not so before the taggants were added.

Nevertheless, the controversy is alive and is expected to reach the Senate floor very soon.

A lot less controversial to everyone except organized crime figures is the Bank Secrecy Act. That Act provides valuable support to law enforcement officers in their investigations of the financial aspects of crime.

As you may be aware, the statute requires that:

-- banks and other financial institutions report unusual currency transactions in excess of $10,000 and maintain certain basic records;

-- travelers and others report the importation or exportation of currency and other bearer instruments in excess of $5,000; and

-- all U.S. citizens file reports concerning the ownership or control of foreign financial accounts.

That Act assigns the responsibilities for compliance to the Secretary of the Treasury, and he has delegated them, in turn, to my office.

For many years prior to the passage of the Act in 1970, Federal law enforcement officials had been frustrated by the use of secret foreign bank accounts to conceal the financial activities of sophisticated criminals. They were unable to gain access to the foreign records of international transactions, and U.S. bank records were often inadequate. The Bank Secrecy Act was intended to help overcome some of these obstacles and to deter the use of foreign banks to facilitate crime in the United States.

All of the Federal bank supervisory agencies, the Securities and Exchange Commission, the Customs Service, as well as the Internal Revenue Service, have responsibilities for enforcing the Act. So, as you can see, I have had a lot of help.

We believe that the Act has been a major factor in the fight against white collar crime and political and commercial corruption.

For example, during the 12 month period that ended on June 30 of this year, we provided Federal drug enforcement investigators with more than 1,700 currency-transaction reports covering more than $200 million. Many of them described deposits of currency totaling hundreds of thousands of dollars. I understand that, in some instances, they were delivered ito the bank in cardboard boxes by young men in T-shirts and blue jeans.

The currency transaction reports have been valuable in other ways, too. Each one is screened by the IRS, and a number of them have been used by the Department of Justice and Congressional investigators.

The Customs Service has had increasing success in using the Act to make cases against drug traffickers and other criminals.

For example, in one case, a joint investigation by Customs, the Drug Enforcement Administration, and foreign police, Customs seized 2,000 pounds of hashish, $19,000 in currency, and $130,000 in bank drafts. Further investigation disclosed other reporting violations and resulted in freezing more than $800,000 in various bank accounts. Three of the defendants were fined $500,000 each, the maximum amount possible under the Bank Secrecy Act, and given substantial jail terms.

We plan to increase our efforts to improve the implementation of the Act so that it will be even more helpful to other Federal law enforcement and regulatory agencies.

In addition to the Bank Secrecy Act, Customs is also involved in enforcing various economic embargoes, guarding the country against smugglers and those who would export illegal weapons, and those who would defraud the government by not declaring goods taken into the United States. Last year, the Customs Service processed more than 263 million persons, 77

million vehicles, 154 thousand ships, and 370 thousand aircraft arriving in the United States. The Service collected a record $6 billion in duty and taxes and seized almost $1.2 million worth of merchandise including illicit drugs.

One of the challenges for those who work at Customs is the sophistication of those who seek to break the laws. Today, we are confronted with smugglers armed with modern electronic devices and up-to-the-minute anti-detection techniques.

Nowhere is this more evident that on the isolated areas along the U.S.-Mexican border, today's most fertile field for narcotics smuggling and other crimes.

To combat this threat, Customs is beefing up its Air Support Unit with some of Uncle Sam's most sophisticated and effective avionics.

Moves are being made to implement a unique agreement between our agency and the Air Force under which the intercept capability of the Air Force Airborne Warning Control System (AWACS) will be made available to the Customs Air Unit pursuing modern, low-flying smuggler aircraft.

Our Air Unit is already using NORAD, the North American Radar Defense/FAA long-range radar system through the cooperation of the Federal Aviation Administration.

In addition, a first-class communications line provides us with constant referral information on gun running and other neutrality violations closely associated with the smuggling of narcotics.

In a recent classic case of "guns for dope," four Texans were arrested in Tuxpan, Vera Cruz, Mexico, leading to the further arrest and indictment of seven defendants. Through the cooperation of Mexican officials, U.S. Customs, and the Bureau of Alcohol, Tobacco and Firearms, nine weapons, intended to be traded for marijuana were seized.

By improving the efficiency of our interdiction efforts on the border, we feel we can force smugglers to come through legal ports of entry where we have more manpower to assist in their interdiction.

Looking further ahead, I see tomorrow's Customs inspectors operating, not only with expanded enforcement, communications, and interception capabilities, but also with ingenious new technology. This will include hand-held devices to detect drugs, explosives, gems, and other contraband on the person of would-be smugglers; advanced x-ray machines that develop layers of images which equate to a 100 percent search, and a satellite communications system connecting the entire Customs network with data and voice channels. By the 1980's, I predict, we will have down-looking radar on our interceptor aircraft, enabling one Customs plane to screen the entire Mexican border.

As you can see, enforcement of the laws of our country is as complex as the ingenious schemes concocted by those who break them. Sometimes we feel like so many greyhounds endlessly pursuing a mechanical rabbit. We don't always catch it, but chase we must.

I hope I've been able to give you some idea of Treasury's law-enforcement responsibilities and operations, and I'll be happy to answer any questions you may have.

Thank you.

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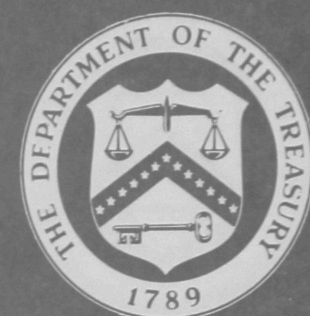

FOR IMMEDIATE RELEASE September 14, 1978

DANIEL I. HALPERIN APPOINTED DEPUTY ASSISTANT SECRETARY FOR TAX POLICY

Secretary of the Treasury W. Michael Blumenthal today announced the appointment of Daniel I. Halperin as Deputy Assistant Secretary of the Treasury for Tax Policy. The appointment is effective August 22, 1978.

Mr. Halperin serves as deputy to Assistant Secretary Donald C. Lubick, who has principal responsibility for formulation and execution of United States domestic and international tax policies.

Mr. Halperin, 41, has been serving as Tax Legislative Counsel since June 7, 1977. Prior to joining the Treasury Department, he had been Professor of Law at the University of Pennsylvania since 1970.

Mr. Halperin previously had served in the Treasury Department, Office of the Tax Legislative Counsel, from 1967-70, and had been Deputy Tax Legislative Counsel from 1969-70. Before joining the government, Mr. Halperin had been an Associate in a New York law firm.

A native of Brooklyn, New York, Mr. Halperin attended the City College of New York, graduating magna cum laude with the B.B.A. degree in 1957. He received his law degree from Harvard Law School in 1961, graduating magna cum laude.

Mr. Halperin has published a number of articles and has been a frequent speaker in the field of Federal taxation.

Mr. Halperin is married to the former Marcia Hellman of Beacon, New York. They have three children and reside in the District of Columbia.

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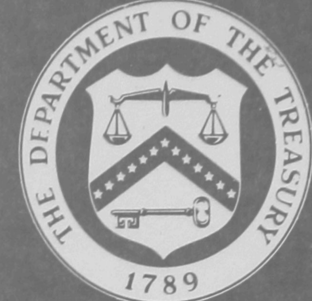

FOR RELEASE UPON DELIVERY
Expected at 9:30 a.m.
September 15, 1978

STATEMENT OF
DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES
OF THE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the four miscellaneous bills under current consideration by the Subcommittee. The Treasury Department position on each of these bills is summarized in Exhibit A to this statement.

H.R. 13977 (sponsors of cooperative housing)

Under this bill, the sponsor of cooperative housing may, under certain circumstances, be considered a tenant-stockholder in the cooperative housing corporation even though he does not have an unrestricted right to occupy a unit in the residence. In general, section 216 of the Code allows a tenant-stockholder in a cooperative housing corporation to obtain an allocable portion of the deductions for taxes and interest which are formally the obligation of the cooperative housing corporation. One of the requirements of section 216 is that 80 percent of the gross income of the corporation be derived from tenant-stockholders. In general, the Code requires that a tenant-stockholder be an individual who is entitled to occupy a house or apartment in a building owned by the cooperative housing corporation.

It has been recognized in the past that this rule limits the ability of tenant-stockholders to obtain financing for their cooperative units. If a bank which lends to a purchaser

of stock in a cooperative housing corporation were forced to foreclose on the stock, it could not qualify as a tenant-stockholder because it is not an individual. Accordingly, in the 1976 Tax Reform Act, section 216(b)(5) was added to the Code to allow a bank or other lending institution which acquires stock by foreclosure to be treated as a tenant-stockholder for a period not to exceed three years from the date of acquisition. H.R. 13977 extends this rule to the sponsor of a cooperative housing project. Such an extension is appropriate. However, the extension, unlike the provision relating to banks and lending institutions, does not provide a three-year time limit on the treatment of the developer as a tenant-stockholder. Such a time limit is needed so that the relaxation of the definition of tenant-stockholder does not upset the general structure of cooperative housing corporations as corporations in which the stockholders are also the residents of the cooperative housing. Accordingly, we would recommend that a three-year time limit be added to this provision.

H.R. 12982 (withholding on sick pay and disability retirement benefits)

H.R. 12982 is a bill which improves the administration of the tax laws both for the IRS and for taxpayers. Under current law, there is no requirement that a third party withhold on payments made under sick pay and disability retirement plans. While this was less of a problem when payments under such plans were not fully taxable, the change of their status as a result of the Tax Reform Act of 1976 makes it appropriate that there be withholding on such payments. Under the proposal, withholding by third parties on sick pay will be on the same basis as withholding by employers on wage payments. Since sick pay is now fully taxable, and the taxpayer will generally be earning money throughout the full year, this is an appropriate result. On the other hand, the bill provides for withholding by third parties at a 10 percent rate when the taxpayer receives disability retirement benefits. We believe this is appropriate because disability retirement benefits are not fully taxable. It would also be appropriate to have reduced withholding where the employer was making disability retirement benefit payments. In this connection, we note a more general issue. We believe the IRS should be given

more administrative flexibility to promulgate exceptions to the withholding tables and to make changes in the withholding tables without the need for specific legislation. This concern was reflected in H.R. 12078, which embodied the President's tax reform proposals (see section 211(c) of that bill). We continue to believe that such flexibility should be given to the IRS.

<u>H.R. 13732</u> (advance payments accrued by life-care communities)

H.R. 13732 raises a thorny issue. Certain life-care communities for older persons receive lump-sum payments from residents when the residents enter the life-care community. Those amounts are determined, in part, by the life expectancy of the person entering the life-care community. The monthly payments that must be made by the residents of the community thereafter are reduced as a result of the initial lump-sum payment.

Under the tax law, an accrual method taxpayer who operates a life-care community must include the full lump-sum payment in income. Under financial accounting practices, this amount would not necessarily be included at once in the taxpayer's income since it relates to care which will be provided over the remaining life of the resident. This reflects a general difference between tax and financial accounting which has been developed in a number of Supreme Court decisions. Because the tax laws embody a pay-as-you-go tax collection system, it is particularly important that income be reported where a taxpayer has received an actual cash payment. Otherwise, the funds may be dissipated and there will be no money available to pay the tax.

It has been argued that the rules which include the full lump-sum payment in income create hardships for taxpayers. However, we believe that any solution to their problem must be made in the context of a general consideration of the broad issue of deferral of income when cash prepayments are received. We have discussed with this Committee over the past several months a number of issues which generally affect the timing of income and deductions and conformity between financial and tax accounting. As we have indicated, we expect to undertake a review of this area shortly.

H.R. 13294 (transfer of proven oil or gas properties to a wholly-owned corporation)

The fourth bill for your consideration today involves the transfer by an individual of a proven oil or gas property to a wholly-owned corporation. In general, a transferee of a proven oil or gas property is not permitted to take percentage depletion. However, under current law, when a proven oil or gas property is transferred to a controlled corporation, the corporation generally can take percentage depletion. This rule does not apply, though, when an individual transfers the proven oil or gas property to a wholly-owned corporation.

The legislation before you would allow the benefits of percentage depletion to the controlled corporation as long as all the stock of the corporation is owned by the individual who transfers the oil or gas property to the corporation. Although section 613A of the Code was drafted to limit the proliferation of the use of percentage depletion for oil and gas, we believe a properly circumscribed rule of this nature is acceptable. Since corporations are permitted to transfer oil or gas properties to controlled corporations, it is appropriate to provide similar rules for individuals. We do believe, though, that the bill should be amended to indicate explicitly that the transfer qualifies under the general rule in the Code which deals with transfers to controlled corporations, section 351. Otherwise, this rule might apply even where an individual sells oil and gas property to a wholly-owned corporation or otherwise engages in a transaction as to which tax attributes are not normally transferred. In addition, we believe the bill as drafted may contain some technical problems which we think can be worked out with the staff of the Joint Committee.

I would be glad to answer any questions you may have for me at this time.

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EXHIBIT A

H.R. 12982 - Support.

H.R. 13294 - Support, if the provisions of section 351 of the Code are complied with in the transaction.

H.R. 13732 - Oppose.

H.R. 13977 - Support, if the provision applies only for three years after the purchase or foreclosure.

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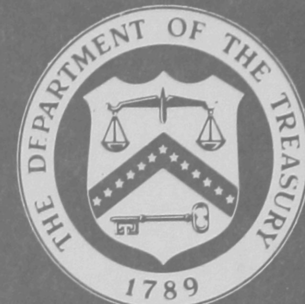

FOR IMMEDIATE RELEASE September 15, 1978

JOHN M. SAMUELS APPOINTED TAX LEGISLATIVE COUNSEL AT TREASURY

Secretary of the Treasury W. Michael Blumenthal today announced the appointment of John M. Samuels as Tax Legislative Counsel. He replaces Daniel I. Halperin, who earlier this week was appointed Deputy Assistant Secretary of the Treasury for Tax Policy.

Mr. Samuels, 33, has been serving as Deputy Tax Legislative Counsel since August 29, 1977, and had been a special consultant to the Treasury Department since June 1977. Prior to joining Treasury, he had been a partner in the New York law firm of Dewey, Ballantine, Bushby, Palmer & Wood. Mr. Samuels also was an adjunct professor of law at New York University.

As Tax Legislative Counsel, Mr. Samuels will be principal legal advisor to Assistant Secretary for Tax Policy Donald C. Lubick in the formulation of policy, legislation, and regulations on domestic tax matters. The Office he heads is one of four major units under the Assistant Secretary for Tax Policy. The other units are the Office of International Tax Counsel, which has corresponding responsibilities for international tax matters; the Office of Tax Analysis; and the Office of Industrial Economics.

A native of Hollywood, Florida, Mr. Samuels received a B.A. degree from Vanderbilt University in 1966 and a J.D. degree from the University of Chicago Law School in 1969. He received an LL.M. (in Taxation) degree from New York University School of Law in 1975.

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