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STATEMENT OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

Mr. Chairman. I am very pleased to appear before this Subcommittee to present the Administration's appropriations request for the multilateral development banks.

U.S. participation in these banks serves a broad range of foreign policy and national security interests. It provides significant economic and financial returns to the United States. It supports institutions which are effective in promoting economic growth and development in less developed countries. It permits us to share the burden of furnishing foreign economic assistance with other donor countries. These are the principal reasons why we believe U.S. participation in the multilateral development banks is both necessary and cost effective.

I have a comprehensive statement which discusses these considerations and other issues in detail. I would like to submit that statement for the record and begin today's discussion by summarizing its main points. This year we are requesting budget authority of $3.6 billion for the development banks. This consists of two parts: $1,842 million for paid-in capital subscriptions and for contributions to the concessional windows of the banks, which will eventually result in expenditures and $1,782 million for callable capital subscriptions to the banks, which will not result in actual expenditures.

The request breaks down as follows:

-- $1,026 million for U.S. subscriptions to the World Bank's capital. Ten percent of this amount, or $102.6 million would be paid-in. With this subscription, and those of other member countries, the Bank is able to borrow on private markets and relend the funds for development assistance projects at market rates of interest. The Bank has never had a default on its loans and earns money each year.

-- $1,092 million for U.S. contributions to the fourth and fifth replenishments of the International Development Association. IDA is the concessional loan facility of the World Bank. It lends money only to the poorest countries of the world. Of this total, $800 million is for this year's installment to IDA V, and $292 million is needed to complete the final installment of the U.S. contribution to the fourth replenishment, which was negotiated by the previous Administration. This year's total IDA request is $166 million less than what Congress actually appropriated for this institution last year.

-- $33.4 million for the third and final installment of U.S. contributions to the International Finance Corporation, the World Bank affiliate that encourages the growth of productive private enterprise in developing countries.

-- $687 million for the first installment of the U.S. subscription to the capital of the Inter-American Development Bank. Of this amount, 7.5 percent or $51.5 million is paid-in. The Bank is a primary source of development lending in the hemisphere and the United States is its leading shareholder.

-- $325 million for U.S. contributions to the Fund for Special Operations of the IDB, the Bank's soft loan window. $175 million is for the first of four annual installments to the new replenishment, each of which calls for a lower U.S. contribution than was pledged to the previous replenishment. The remaining $150 million is for the final part of our contribution to the prior replenishment, which was negotiated by the previous Administration.

-- $248 million for subscriptions to the capital of the Asian Development Bank. Ten percent, or $24.8 million of this subscription will be paid-in. This Bank has established an excellent record and Japan has taken the lead in providing for its financing. Furthermore, European members have increased their proportionate share in providing funds.

-- $171 million for U.S. contributions to the Asian Development Fund, the soft loan window of the Asian Development Bank. $111 million is for the first installment of our contribution to the new replenishment and $60 million is for the final installment of our contribution to the present replenishment, which was negotiated in 1975.

-- $42 million for the first of three annual installments to the African Development Fund. This request will enable the United States to provide a reasonable share of funding for concessional lending to the poorest African countries. It reflects our objective of taking a more active role in encouraging economic and social development in Africa.

This request of $3.6 billion in budgetary authority for the multilateral development banks is slightly more than last year's request of $3.5 billion. However, putting aside callable capital, the request would result in expenditures that would be $286 million less than the expenditures which would have resulted from last year's request.

Compared to last year's appropriation, expenditures resulting from this year's request would be up by $211 million, or 13 percent. This increase is the result of unfunded requests from prior years, which account for almost $500 million in expenditures (deriving from almost $1 billion of total budget authority). If we could clear up these unfunded amounts, the budgetary outlook for U.S. contributions to the multilateral development banks over the next few years would result in a fairly constant level of expenditures in nominal terms and a reduction in real terms.

Our request is for a substantial sum. I believe that it is necessary and that it would be well spent for the four reasons I cited earlier.

First, helping the developing countries through participation in the banks advances important U.S. foreign policy and security interests. Our interests require the successful social and economic development of these countries. Many of these interests are shared by other industrial countries, and most importantly by many developing countries as well. These shared interests are the foundation for effective multilateral cooperation through the banks.

The United States has a great deal at stake in these countries. As recent events have clearly demonstrated, some occupy strategic geographic positions, and possibilities exist for unrest and conflict, which could carry dangers for many countries, including the United States. Furthermore, we need the cooperation of the developing world if we are to achieve such objectives as: halting the proliferation of nuclear weapons, limiting conventional armaments, combatting international terrorism, suppressing international drug traffic, controlling illegal migration, promoting human rights and protecting the global environment.

Our economic interests in the developing world are large and growing. As a group, these countries were a market for 25 percent of our exports in 1977, including $6.7 billion in agricultural commodities. They were the source for 24 percent of our imports in 1977, including tin, bauxite, rubber, manganese, and other critically needed raw materials. To ignore the developing countries is to ignore our own interests.

Second, we derive significant economic and financial benefits from the activities of the multilateral banks, which more than offset the budgetary burden of our contributions. In short we earn a good return on our investment.

These direct financial and economic benefits include contracts awarded to U.S. firms resulting from development projects financed by the banks, the purchase of other goods and services in this country derived from bank activities, and interest paid to U.S. holders of bank bonds. On a cumulative basis, the banks have returned in these kinds of benefits substantially more than the amounts which have been paid in by the U.S. Government. Thus our contributions to the banks have not been a problem for the balance of payments or a source of trouble for the dollar. Indeed, they have provided benefits for the U.S. economy in terms of jobs and our economic growth.

Looked at more broadly, the multilateral development banks have played a very constructive role in sustaining a smoothly functioning and growing world economy which in turn has helped our trade and employment. They are a central part of the system for economic cooperation which the United States worked hard to establish after World War II and which we must continue to support strongly today. We live in an economically interdependent world, and we need to encourage and extend international cooperation on development, as well as trade and finance, if we are to deal successfully with our own economic problems.

<u>Third, the banks have been effective instruments for promoting economic and social development and thus are contributing to a more tolerable world environment for this and coming generations</u>.

Essentially these institutions apply banking principles to the achievement of development purposes. In this they are unique instruments in the annals of economic change, and they work. The projects they finance are soundly conceived, carefully supervised and well executed. Of course there have been exceptions, but they are comparatively few and the average quality has been high indeed.

One of the principal U.S. objectives in the banks is to encourage and expand the use of resources to assist the poor -- not to finance a welfare program, but to raise productivity and increase employment opportunities. This requires the financing of the right mixture of projects to enlarge basic infrastructure, raise agricultural productivity, provide the basis for expanded employment in urban areas and provide the foundation for the extension of essential social services.

The World Bank has been a leader in the effort to reach the poor, and progress is continuing. During the Bank's last fiscal year, 31 IDA projects amounting to $867 million were approved for rural development lending alone, with benefits going mostly to small farmers, tenants, and landless laborers. Emphasis is being placed on helping the urban poor through projects which provide sites and services for housing and through the encouragement of labor intensive industries.

This Committee has expressed concern about the use of concessional resources from the Fund for Special Operations of the Inter-American Development Bank. The recently negotiated replenishment agreement explicitly provides that 50 percent of all Bank lending -- conventional and concessional -- will benefit low income groups. In addition, the agreement requires that concessional resources from the Fund for Special Operations be increasingly targeted at the poorest countries and the poorest people of the hemisphere.

While we have devoted a great deal of effort to encourage movement in this direction, we recognize that the banks must maintain a balanced approach to growth and development. Lending for transportation, communications and electric power will continue to have high priority. Infrastructure and basic needs projects depend on each other.

We strongly support and give high priority to the expansion of Bank lending for energy development. In response to a request made at the Bonn Summit Meeting, the World Bank explored new approaches to help solve the growing energy problems of developing countries and proposed an expanded lending program to do this. The United States has endorsed the general provisions of that program, including Bank financing for geological and geophysical surveys and exploratory drilling, and an acceleration in lending for projects to develop and produce gas and oil. By 1983, the World Bank Group expects to be lending $1.5 billion a year for this program, which would amount to more than 10 percent of its total lending. Over the next few years, the Inter-American Development Bank will be devoting a large proportion of its lending to help finance hydroelectric, geothermal and other aspects of energy development in Latin America, and the Asian Development Bank has also embarked on a large lending program to finance the production of primary energy fuels. These Bank funds, moreover, will facilitate additional private investment in this critical area, thus helping to meet urgent requirements in the developing countries, and improving the oil supply and demand balance for the world as a whole.

Fourth, the Banks are an unusually effective means for sharing the development assistance burden among the better-off countries.

Currently the United States provides one-fourth of the total funding requirements for these institutions, while other countries provide three-fourths. In contrast, the United States, twenty-five years ago, provided about two-thirds of total foreign economic assistance. Countries that once received assistance are now major sources of assistance, and this encouraging process continues today.

Consequently, our participation in the multilateral development banks has proven to be increasingly cost effective. Our foreign assistance dollar is stretched much further; it has greater impact and does more good for us and the developing countries as a result of our participation in the banks. These substantial benefits, however, require that the United States contribute its fair share of total resources. For example, if we do not contribute $800 million to this year's installment for IDA V, other countries' shares would not become available for commitment and IDA lending would have to stop. In the case of the remaining U.S. share of IDA IV, funds are needed to meet disbursement requirements on past commitments. Under the replenishment arrangements in the Inter-American Development Bank, the Asian Development Fund and the African Development Fund, other countries may reduce their contributions if we do not provide ours in full.

Direct budgetary costs are even more greatly reduced by the banks' extensive use of callable capital for subscribing to new shares. This type of capital is not paid in to the banks. In the case of the United States, it never leaves the Treasury Department and does not result in any budgetary outlay. These subscriptions, however, serve as backing that enables the banks to borrow in the world's private capital markets. Callable capital would result in a budgetary outlay only in the event it were needed to cover a bank default on an obligation to bondholders. Such a call has never taken place in the past. In view of the banks' excellent financial record, their paid-in capital, and their large reserves from past earnings, the possibility of a call taking place in the future is remote.

Under typical capital replenishment arrangements, nine out of ten dollars for conventional lending are raised by the banks in this way, enabling us to achieve very large budgetary savings without restricting the flow of needed resources to developing countries. In the case of the World Bank, total U.S. paid-in capital contributions of $884 million have generated more than $45 billion of lending, a leverage factor of 50 to 1. Moreover, the value of our shares is not only still intact, but it has been increased as a result of past earnings.

In the next subscription to the Inter-American Development Bank, the paid-in portion will be reduced from 10 percent to 7-1/2 percent. This will provide additional leverage in the use of U.S. budgetary expenditures to help finance this Bank. It is our intention to seek further reductions in the paid-in portions of future capital subscriptions of other banks, consonant with their growing financial strength.

Have domestic social programs suffered as a result of our foreign assistance program? I do not believe so. Only one-fourth of one percent of our Gross National Product goes for foreign economic assistance, including our participation in the multilateral development banks. This figure has declined in recent years and is now lower than the corresponding GNP shares for twelve of the seventeen countries in the Development Assistance Committee of the OECD.

On the other hand, U.S. budgetary expenditures for domestic social programs have risen rapidly over the past decade. In 1965, expenditures for these programs amounted to $6 for each dollar of foreign aid. By 1969, this multiple had risen to $18 and by 1979 to $46. Funding for foreign economic assistance has not taken place at the expense of domestic social priorities. The question is not whether the United States can afford to fund foreign assistance programs, but rather can we afford not to. The answer clearly is no.

I turn now to report to you briefly on several matters on which the Congress has expressed special interest or concern.

Salaries. A great deal of work has been done in constructing a rational and objective system for determining World Bank and IMF salaries. A set of recommendations to this end has been made by a Joint Committee of these two institutions after one and a half years of study, which included the employment of professional compensation firms. These proposals are now being considered by the Boards of the two institutions, and we are working with other member governments to resolve this issue.

Encouraging capital saving technology. There is a growing emphasis in the banks on encouraging the use of capital saving technologies. Use of such technologies is stimulated in the first instance by efforts to induce developing countries to adopt more realistic exchange rates and interest rates, thus eliminating an artificial premium on the use of capital rather than labor. What can be done on the individual project level has to be adapted to the differing circumstances in individual countries. In many cases these technologies are closely linked to the success of projects which are designed to benefit the poor directly. One example is a recently approved IDB loan to El Salvador for community development in the economically deprived northwest region of the country. Its objective is to increase incomes and improve living conditions for 144,000 people in 300 small rural communities through self-help construction of small scale public works. The cost per beneficiary is not expected to exceed $80. Another example is an IDA credit to Upper Volta which is directed at rural and urban artisans and small scale entrepreneurs to encourage production of bricks, farm implements, wooden utensils, and pottery. The average cost per job is estimated to be less than $200.

Human Rights. We have sought to encourage greater regard for human rights in bilateral discussions with other countries, and in our actions in the multilateral banks. We have consulted with other member countries on human rights problems, and we have opposed, by voting against or abstaining on 50 loans to 15 countries.

We have also taken steps to implement the provision of last year's Appropriations Act which calls upon the Administration to seek adoption of human rights amendments to the banks' charters. In order to generate support for such amendments, we have consulted with countries that share our human rights concerns. Thus far, their reaction to this proposal has been negative. They believe that the introduction of such amendments would be divisive, and that such amendments would not obtain the broad support required for their adoption. We are undertaking additional consultations to pursue this approach and to achieve the objectives of the legislation.

I would like to stress that the human rights provisions in current law are being carried out conscientiously. I see no need for change in the legislation. Indeed, as I have stated in the past, legislation prohibiting the use of U.S. contributions to the banks for loans to specific countries would mean that the contributions would have to be rejected by the institutions. This would jeopardize our continued participation in the banks at the expense of our human rights concerns and at enormous cost to our other foreign policy objectives.

Accountability. We have greatly increased the flow of information to the Congress on the activities of the banks, and we have encouraged greater public dissemination of bank documents. During the past year, the General Accounting Office completed studies of evaluation and review units within the banks and generally found them to be effective.

Commodity Issues. Current law requires that the United States oppose use of MDB funds for the production of any commodity for export if it is in surplus on world markets and if substantial injury would be caused to U.S. producers of the same, similar or competing products. It also provides that the President shall initiate international consultations to develop standards governing the allocation of development assistance for production of commodities in surplus on world markets where increased exports would cause substantial harm to other producers.

As a matter of fact, the banks have been making very few loans that could fall under these provisions. This is understandable because the banks themselves believe that loans to finance commodities in prospective world surplus would be a wasteful use of development assistance resources. To carry out the legislative requirements, we have established criteria to determine the economic impact of commodity loans on the world markets. No loan proposals thus far this year have required special action. We have also raised internationally the question of establishing standards governing the use of development assistance resources for commodity loans and will report to you further on this matter.

I do not believe additional legislative action on commodity issues is warranted. In particular, legislation to prohibit the use of U.S. appropriations to the banks to finance specific commodity projects would, as in the case of country restrictions, not be legally acceptable to the banks. Such a provision in U.S. law would seriously damage U.S. interests.

I would like to conclude, Mr. Chairman, by asking that we step back for a moment and consider these institutions from still another vantage point. The evidence shows that they are one of the great success stories of the entire post-war period, stretching from Bretton Woods to the present. Even now they are continuing to improve on this impressive record. They give us good value for our money, their net impact on the budget is small, and they bring substantial economic and political benefits. I ask for your support in making it possible for this good work to continue.

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In my statement, I will discuss these considerations in detail. The Committee has expressed particular interest in several other issues including bank lending to benefit the poor, salaries and administrative costs. I will also report to you on these matters.

Let me begin by summarizing the individual requests and briefly discussing their budgetary effect.

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This year we are requesting budget authority of $3.6 billion for the development banks. This consists of two parts: $1,842 million for paid-in capital subscriptions and for contributions to the concessional windows of the banks, which will eventually result in expenditures; and $1,782 million for callable capital subscriptions to the banks, which will not result in actual expenditures.

The request breaks down as follows:

-- $1,026 million for U.S. subscriptions to the World Bank's capital. Ten percent of this amount, or $102.6 million would be paid-in. With this subscription, and those of other member countries, the Bank is able to borrow on private markets and relend the funds for development assistance projects at market rates of interest. The Bank has never had a default on its loans and earns money each year.

-- $1,092 million for U.S. contributions to the fourth and fifth replenishments of the International Development Association. IDA is the concessional loan facility of the World Bank. It lends money only to the poorest countries of the world. Of this total, $800 million is for this year's installment to IDA V, and $292 million is needed to complete the final installment of U.S. contribution to the fourth replenishment, which was negotiated by the previous Administration. This year's total IDA request is $166 million less than what Congress actually appropriated for this institution last year.

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-- $325 million for U.S. contributions to the Fund for Special Operations of the IDB, the Bank's soft loan window. $175 million is for the first of four annual installments to the new replenishment, each of which calls for a lower U.S. contribution than was pledged to the previous replenishment. The remaining $150 million is for the final part of our contribution to the prior replenishment, which was negotiated by the previous Administration.

-- <u>$248 million for subscriptions to the capital of the Asian Development Bank</u>. Ten percent, or $24.8 million of this subscription will be paid-in. This bank has established an excellent record and Japan has taken the lead in providing for its financing. Furthermore, European members have increased their proportionate share in providing funds.

-- <u>$171 million for U.S. contributions to the Asian Development Fund, the soft loan window of the Asian Development Bank</u>. $111 million is for the first installment of our contribution to the new replenishment and $60 million is for the final installment of our contribution to the present replenishment, which was negotiated in 1975.

-- <u>$42 million for the first of three annual installments to the African Development Fund</u>. This request will enable the United States to provide a reasonable share of funding for concessional lending to the poorest African countries. It reflects our objective of taking a more active role in encouraging economic and social development in Africa.

This request of $3.6 billion in budgetary authority for the multilateral development banks is slightly more than last year's request of $3.5 billion. However, putting aside callable capital, the request would result in expenditures that would be $286 million less than the expenditures called for in last year's request.

Compared to last year's appropriation, expenditures resulting from this year's request would be up by $211 million, or 13 percent. This increase is the result of unfunded requests from prior years, which account for almost $500 million in expenditures (deriving from almost $1 billion of total budget authority). If we could clear up these unfunded amounts, the budgetary outlook for U.S. contributions to the multilateral development banks over the next few years would show a fairly constant level of expenditures in nominal terms and a reduction in real terms.

Our request is for a substantial sum. I believe that it is necessary and that it would be well spent for the reasons I cited earlier.

<u>First, helping the developing countries through participation in the banks advances important U.S. foreign policy and security interests</u>. Our interests require the successful social and economic development of these countries. Many of these interests are shared by other

industrial countries, and most importantly by many developing countries as well. These shared interests are the foundation for effective multilateral cooperation through the banks.

The U.S. has a great deal at stake in these countries. Some occupy strategic geographic positions and possibilities exist for unrest and conflict, which could carry dangers for many countries, including the United States. Furthermore, we need the cooperation of the developing world if we are to achieve such objectives as: halting the proliferation of nuclear weapons, limiting conventional armaments, combatting international terrorism, suppressing international drug traffic, controlling illegal migration, promoting human rights and protecting the global environment.

Our economic interests in the developing world are large and growing. As a group, these countries were a market for 30 percent of our exports in 1977, including $6.7 billion in agricultural commodities. They were the source for 24 percent of our imports in 1977, including tin, bauxite rubber, manganese and other critically needed raw materials.

<u>Second, we derive significant economic and financial benefits from the activities of the multilateral banks, which more than offset the budgetary burden of our contributions. In short we earn a good return on our investment</u>.

These direct financial and economic benefits include contracts awarded to U.S. firms resulting from development projects financed by the banks, the purchase of other goods and services in this country derived from bank activities, and interest paid to U.S. holders of bank bonds. On a cumulative basis, the banks have returned in these kinds of benefits substantially more than the amounts which have been paid in by the U.S. Government. Thus our contributions to the banks have not been a problem for the balance of payments or a source of trouble for the dollar. Indeed, they have provided benefits for the U.S. economy in terms of jobs and our economic growth.

Looked at more broadly, the multilateral development banks have played a very constructive role in sustaining a smoothly functioning and growing world economy which in turn has helped our trade and employment. They are a central part of the system for economic cooperation which the United States worked hard to establish after World War II and which we must continue to support strongly today. We live in an economically interdependent world, and we need to encourage and extend international cooperation on development, as well as trade and finance, if we are to deal successfully with our own economic problems.

Third, the banks have been effective instruments for promoting economic and social development and thus are contributing to a more tolerable world environment for this and coming generations.

Essentially these institutions apply banking principles to the achievement of development purposes. In this they are unique instruments in the annals of economic change, and they work. The projects they finance are soundly conceived, carefully supervised and well executed. Of course there have been exceptions, but they are comparatively few and the average quality has been high indeed.

One of the principal U.S. objectives in the banks is to encourage and expand the use of resources to assist the poor -- not to finance a welfare program, but to raise productivity and increase employment opportunities. This requires the financing of the right mixture of projects to enlarge basic infrastructure, raise agricultural productivity, provide the basis for wider employment in urban areas and provide the foundation for expanding essential social services.

The World Bank has been a leader in the effort to reach the poor and progress is continuing. During the Bank's last fiscal year, 31 IDA projects amounting to $867 million were approved for rural development lending alone, with benefits going mostly to small farmers, tenants, and landless laborers. Emphasis is being placed on helping the urban poor through projects which provide sites and services for housing and through the encouragement of labor intensive industries.

This Committee has expressed concern about the use of concessional resources from the Fund for Special Operations of the Inter-American Development Bank. The recently negotiated replenishment agreement explicitly provides that 50 percent of all Bank lending -- conventional and concessional -- will go to low income groups. In addition, the agreement requires that concessional resources from the Fund for Special Operations be increasingly targeted at the poorest countries and the poorest people of the hemisphere.

While we have devoted a great deal of effort to encourage movement in this direction, we recognize that the banks must maintain a balanced approach to growth and development. Lending for transportation, communications and electric power will continue to have high priority. Infrastructure and basic needs projects depend on each other.

Another high priority that we strongly support is the expansion of Bank lending for energy development. In response to a request made at the Bonn Summit Meeting, the World Bank explored new approaches to help solve the growing energy problems of developing countries and proposed an expanded lending program to do this. The United States has endorsed the general provisions of that program, including Bank financing for geological and geophysical surveys and exploratory drilling, and an acceleration in lending for projects to develop and produce gas and oil. By 1983, the World Bank Group expects to be lending $1.5 billion a year for this program, which would amount to more than 10 percent of its total lending. Over the next few years, the Inter-American Development Bank will be devoting a large proportion of its lending to develop geothermal and hydroelectric potential in Latin America, and the Asian Development Bank has also embarked on a large lending program to finance the production of primary energy fuels. These Bank funds, moreover, will facilitate additional private investment in this critical area, thus helping to meet urgent requirements in the developing countries, and improving the oil supply and demand balance for the world as a whole.

<u>Fourth, the Banks are an unusually effective means for sharing the development assistance burden among the better-off countries</u>.

Currently the United States provides one-fourth of the total funding requirements for these institutions, while other countries provide three-fourths. In contrast, the United States, twenty-five years ago, provided about two-thirds of total foreign economic assistance. Countries that once received assistance are now major sources of assistance and this encouraging process continues today.

Consequently, our participation in the multilateral development banks has proven to be increasingly cost effective, providing a multiplier effect to the use of our development assistance appropriations. This substantial benefit, however, requires that the United States contribute its fair share of total resources. For example, if we do not contribute $800 million to this year's installment for IDA V, other countries' shares would not become available for commitment and IDA lending would have to stop. In the case of the remaining U.S. share of IDA IV, funds are needed to meet disbursement requirements on past commitments. Under the replenishment arrangements in the Inter-American Development Bank, the Asian Development Fund and the African Development Fund, other countries may reduce their contributions if we do not provide ours in full.

Direct budgetary costs are even more greatly reduced by the banks' extensive use of callable capital for subscribing to new shares. This type of capital is not paid in to the banks. In the case of the U.S., it never leaves the Treasury Department and does not result in any budgetary outlay. These subscriptions, however, serve as backing that enables the banks to borrow in the world's private capital markets. Callable capital would result in a budgetary outlay only in the event it were needed to cover a bank default on an obligation to bondholders. Such a call has never taken place in the past. In view of the banks' excellent financial record, their paid-in capital, and their large reserves from past earnings, the possibility of a call taking place in the future is remote.

Under typical capital replenishment arrangements, nine out of ten dollars for conventional lending are raised by the banks in this way, enabling us to achieve very large budgetary savings without restricting the flow of needed resources to developing countries. In the case of the World Bank, total U.S. paid-in capital contributions of $884 million have generated more than $45 billion of lending, a leverage factor of 50 to 1. Moreover, the value of our shares is not only still intact, but it has been increased as a result of past earnings.

In the next subscription to the Inter-American Development Bank, the paid-in portion will be reduced from 10 percent to 7-1/2 percent. This will provide additional leverage in the use of U.S. budgetary expenditures to help finance this Bank. It is our intention to seek further reductions in the paid-in portions of future capital subscriptions of other banks, consonant with their growing financial strength.

Have domestic social programs suffered as a result of our foreign assistance program? I do not believe so. Only one-fourth of one percent of our Gross National Product goes for foreign economic assistance, including our participation in the multilateral development banks. This figure has declined in recent years and is now lower than the corresponding GNP shares for twelve of the seventeen countries in the Development Assistance Committee of the OECD.

On the other hand, U.S. budgetary expenditures for domestic social programs have risen rapidly over the past decade. In 1965, expenditures for these programs amounted to $6 for each dollar of foreign aid. By 1969, this multiple had risen to $18 and by 1979 to $46. It is clear from these figures that funding for foreign economic assistance has not taken place at the expense of domestic social priorities.

In justifying the appropriations request I have emphasized four factors which constitute the rationale for continued U.S. participation in the banks: foreign policy and national security considerations, economic and financial benefits, the overall effectiveness of the banks in lending to promote growth and reach the poor, and the cost effectiveness of our subscriptions and contributions. At this time, I would like to discuss each of these matters in more detail and then report to you further on several other issues including use of salaries, capital saving technologies, human rights, accountability, and commodities.

FOREIGN POLICY AND NATIONAL SECURITY CONSIDERATIONS

The more than one hundred developing nations contain the great majority of the world's population. They differ greatly among themselves in terms of culture, history, political systems and the level of economic development that they have attained. Nevertheless, they all share one major aspiration: economic growth and development and material improvement in the lives of their people.

The less developed countries have moved to the forefront of world affairs. They are increasingly active in international political and economic organizations and more effective in pursuing their national and regional interests. Collectively, and in some cases individually, they have assumed a much greater importance in U.S. foreign policy and national security considerations:

-- They are an important source of raw materials which are critical to the economies of the United States and other industrial countries.

-- They occupy strategic geographical positions.

-- They are growing users of atomic energy for peaceful purposes and a number of them have the capability for developing nuclear weapons.

-- They have military capabilities which can be used to initiate military conflicts affecting U.S. interests and having the potential of escalating into great-power confrontation.

-- Their growing populations and aspirations place greater demands on the earth's resources and environment on which we too must depend.

Negotiations toward the solutions to these problems are complex and difficult, requiring a balancing of interests and a sensitivity to the requirements of developing countries. In implementing non-proliferation policy, for example, it is necessary to recognize that less developed countries have a legitimate and expanding requirement for energy. In this particular respect, the IBRD Report on Energy and the recommendations it contained for project financing in this sector, have been very helpful. In order to combat international terrorism effectively, we must be able to count on the support of less developed countries in multilateral organizations such as the U.N. and in dealing directly with individual situations as they may arise. The Law of the Sea Conference now going on under the auspices of the United Nations requires the cooperation of less developed countries on a number of issues if we are to reach agreement and still protect interests of the United States relating to navigation, marine research, protection of the environment and exploration and exploitation of deep seabed mineral resources.

In this general context of competing and conflicting interests on major international issues, the multilateral development banks provide the United States with a practical and effective way to work cooperatively with developing countries to help them meet their most basic aspirations. However, our relationships with less developed countries are also important on an individual basis. The following four examples illustrate how multilateral development bank activity contributes to the achievement of U.S. policy objectives in specific countries.

Thailand

Thailand has a central position in southeast Asia and has maintained a close relationship with the United States. It is in our national interest to support the stability and independence of Thailand because it is a key element of regional progress and balance in southeast Asia. Thailand's cooperation is essential if we are to have an effective narcotics suppression program. It has also provided a country of first refuge for Indo-Chinese refugees. Thailand is important as an expanding market for U.S. exports including cotton, tobacco, machinery, fertilizers, iron, and steel. It is also a reliable supplier of critical raw material imports such as tin, tungsten and rubber.

Economically, Thailand has grown at a rate matched by few developing countries. From 1960 to 1976, GNP growth averaged 7.6 percent a year. A high and rising level of investment has been maintained, exceeding 20 percent of GNP and largely financed by domestic savings. Per capita income doubled over the 1960-1976 period. Inflation has been kept under control by conservative fiscal policies, although price pressures have recently intensified.

In the past, economic policies have tended to favor Bangkok, other urban areas and the relatively better off farmers of the central plains. A large proportion of the rural population, particularly in the northeast, has not shared equitably in the benefits of economic growth. Failure to remedy the growing disparity has fostered insurgency and hindered political stability.

The present government in Thailand is beginning to reorient economic policy more in favor of these elements of the rural population. The Prime Minister has declared 1979 the "Year of the Farmer" and has stated his government's intention to direct far greater resources to rural areas. The revised Five-Year Development Plan for 1977-1981 calls for external borrowing of about $1 billion per year to finance rural and infrastructure development to bring services and improved agricultural technology to the rural poor.

For 1979, the proposed borrowing program includes $314 million from the IBRD and $324 million from the ADB. It is in our interest that the flow of financing continue to Thailand. Our participation in the banks will help assure that the country will be able to sustain its growth and carry out needed changes in its overall economic policies.

Mexico

Mexico provides another example of how a country which is critically important to the United States benefits from multilateral development bank activities.

Mexico's importance to the U.S. stems primarily from its geographical proximity to this country, and the influence which this proximity can have on the political, economic, social, environmental and security aspects of American society. Two fundamental U.S. policy objectives which flow from this basic fact of life are:

-- Political stability and economic growth in a Mexico which is friendly to the United States.

-- Control of migration which if not controlled, has potentially disruptive effects for the United States.

In addition, the development of Mexico's hydrocarbon resources will increase the free world's supply of oil and provide Mexico with the revenue to increase domestic employment, thus reducing migration pressures on the United States. Finally, cooperation between our two countries is necessary for narcotics control and other border issues including sanitation, pollution control, and law enforcement.

Mexico does not receive concessional lending from either the IBRD or the IDB. It has become, in fact, a donor to the Fund for Special Operations of the IDB. It continues, however, to receive substantial amounts of market rate financing from the banks. In their most recent fiscal years, World Bank loans to Mexico amounted to $469 million while those of the Inter-American Development Bank were $238 million. President Carter, during a recent trip to Mexico, visited an integrated rural development project which is being financed jointly by the banks. The purpose of the project is to increase incomes and employment opportunities for poor people in rural areas of the country. The banks thus play a very useful financial intermediary role in Mexico, and they provide a source of advice on investment plans which may help Mexico to use petroleum revenues most effectively to solve unemployment and under-employment and redress social and economic imbalances.

Tanzania

Tanzania is one of the world's poorest countries. However, it has taken a prominent position in regional and international organizations and is recognized as a leader in Africa and in the Non-Aligned Movement. President Nyerere is Chairman of the Front Line States and U.S. officials have worked with him concerning very sensitive problems relating to Rhodesia and Namibia.

President Nyerere and his government have advanced a national development strategy which emphasizes "self reliance". Their philosophy has entailed the organization of the rural population into "ujamaa" villages, and attempting to provide education and other services on a limited but equitable basis. The World Bank has worked closely with Tanzania in devising and implementing its rural development strategy which is aimed at reaching the poor and helping to meet basic human needs. On a cumulative basis, it has committed $605 million to Tanzania, including $353 million on concessional terms.

ECONOMIC AND FINANCIAL BENEFITS

U.S. participation in the multilateral development banks is a long-term investment in the future of the developing world. Although the most important benefits to the United States are long-term, we clearly derive short-term benefits as well.

Increased financing to the developing countries permits them to increase their imports of investment goods from the United States and other developed countries directly. As a result of the increased investment, the developing countries are able to improve their living standards more rapidly, providing a growing market for the United States and other exporters.

This investment also helps developing countries produce raw materials the United States must import in order to prosper.

Exports to developing countries resulting directly from multilateral development bank loans and from the more rapid expansion of living standards are a growing source of demand for U.S. goods and services. This provides jobs, income, profits, and tax revenue in the United States.

From the time of the banks' inception in 1946 to the middle of 1978, direct accumulated receipts by all segments of the U.S. economy have exceeded outflows to the MDBs by $2.4 billion. In addition, an econometric analysis which we have made shows that real GNP increased annually between $1.2 billion and $1.8 billion as a result of exports of U.S. goods and services to markets directly created by MDB financed projects in developing countries. This means that every U.S. dollar paid into the MDBs generated between $2.39 and $3.38 in real U.S. economic growth annually over the period.

U.S. participation in the multilateral development banks is not motivated primarily by these kinds of benefits. But it is a mistake to view outlays to the multilateral development banks as an economic loss to the United States.

A large proportion of the direct economic and financial benefits that have accrued to the United States have been in the form of contracts awarded to U.S. firms for loan projects financed by the banks overseas. As a general matter, our cumulative procurement shares from the banks have been in line with our share of contributions: 25 percent in the World Bank, 50 percent in the Inter-American Development Bank and 8 percent in the Asian Development Bank.

In the case of the Asian Development Bank, procurement has been less than the level of our expectations. Consequently, we established an inter-agency working group to study the reasons for the disparity and to take appropriate actions. The working group, consisting of representatives from Treasury, Commerce and the State Department's East Asia and Economic Bureaus, took the following actions:

-- Distributed a questionnaire to 300 U.S. consulting firms eliciting information on weaknesses in the system for providing information about upcoming contracts

-- Conducted a bid-by-bid review of the award of 1500 contracts let by the Asian Development Bank. The review indicated that U.S. firms bid on 300 of these contracts, a bid rate of 20 percent, and that they won 100 of the contract awards for which they had bid, an award rate of 33 percent.

-- Arranged for a meeting of regional economic and commercial counselors which is to take place in Manila to be built around the theme of increasing U.S. ADB procurement.

-- Promoted a series of ADB staff visits to U.S. Chambers of Commerce, mainly on the west coast, to advise U.S. firms of procurement opportunities in the ADB.

-- Sought additional opportunities for U.S. Government officials to talk to business groups about ADB activities. A Treasury official in recent months has briefed both business and trade groups in Georgia and Michigan on ADB procurement.

-- Persuaded ADB Management to provide copies of the Monthly Operations Report directly to interested businesses on a subscription basis.

-- Persuaded ADB management to publish all procurement notices in "Development Forum," published monthly by the U.N. as well as in the individual trade publications.

-- Established pilot programs for Economic and Commercial Counselors to monitor the preparation of specific project proposals.

As a result of the study, we have assured ourselves that the lending procedures of the ADB are fair to U.S. suppliers and that there is no institutional bias within the Bank which limits the success of U.S. suppliers. We see the problem as one of encouraging U.S. suppliers to bid more aggressively. Our role in solving this problem is making sure that potential U.S. suppliers have enough information as early as possible.

A system has been established within the office of the U.S. Director at the ADB to increase the flow of information to U.S. suppliers. Prior to Board consideration of each loan, a cable incorporating procurement information is sent to the U.S. Economic or Commercial Counselor in the recipient country and to the Commerce Department in Washington for dissemination to U.S. firms, including publication in Commerce Department periodicals such as Business America. We look forward to seeing improvement in U.S. procurement from ADB-financed projects as a result of the effort we are now making and as a result of currency realignments which should make American exports generally more competitive.

Within the Inter-American Development Bank, we are now pursuing a parallel program to increase U.S. procurement. A team of Commerce Department officials has consulted with the U.S. Executive Director and arrangements are being made for establishing a reporting system to advise U.S. Embassy economic counselors in Latin America of upcoming bank contracts similar to that which has been established for the Asian Development Bank. In recent months, the U.S. Alternate Executive Director of the IDB has participated in a number of meetings to advise U.S. businesses of procurement opportunities in Latin America through the Inter-American Development Bank and to assist U.S. businessmen in doing business through the bank.

A number of other actions have been taken which should be helpful in promoting U.S. procurement in the banks. A brochure outlining procurement opportunities and procedures and practices in all the banks has recently been revised and reissued. The banks themselves have prepared and provided detailed information on their lending activities and procurement eligibility requirements. This material is available directly from the banks or through the U.S. Executive Directors' offices. The Monthly Operations Report is now available on a subscription basis from the ADB as it has been for some time from the World Bank Group and we are hopeful that the Inter-American Development Bank will provide this material on a similar basis in the near future. The offices of the U.S. Executive Directors in all of the banks are extremely active in assisting U.S. businessmen and we have encouraged them to do more in this regard.

In the World Bank Group, recent examples of contracts awarded to U.S. firms include: $4.6 million to Ingersoll for miscellaneous goods and services in Korea, and $1.2 million to Southwire for electrical equipment in Brazil. Disbursements made between July 1, 1977 and June 30, 1978 on all World Bank Group contracts awarded to U.S. firms amounted to $1,447 million. Examples of contracts awarded from the Asian Development Bank include $7.2 million to the Vinnell Corporation for construction work in the Philippines, and $2.1 million to Phillips Brothers for copper wire. Examples from the Inter-American Development Bank include: $1.1 million to the Robins Company for equipment in Brazil and $2.0 million to the R.J.L. Hoste Company for construction in Guatemala. Smaller firms also benefit from awards of contracts for bank-financed projects.

REACHING THE POOR

The World Development Report, released by the World Bank last August, estimated that more than 800 million people of the developing world continue to live in conditions of absolute poverty -- that they are inadequately sheltered, malnourished, illiterate and diseased, with infant mortality rates in low income countries running far in excess of 100 for every thousand live births and life expectancies estimated at less than 44 years.

The very impressive growth rates of less developed countries in the last 25 years have not resulted in commensurate improvement in the lives of the absolutely poor. There has been increasing concern that much greater efforts must be made by the multilateral development banks and by other development assistance agencies to reach these people more directly and to involve them more productively in the development process. This Administration supports greater efforts by all the development assistance organizations to reach the poor in recipient countries. We have urged the World Bank and the regional development banks to take a number of actions to improve appraisal, implementation and evaluation of projects designed to reach the poor.

At the same time we recognize that a great deal of progress has already been made. During the Annual Meeting of the World Bank Group in Nairobi in 1973, a number of objectives were established to change the Bank's lending practices over the following five year period: lending in the agricultural sector was to be increased by 40 percent and a minimum of 70 percent of all agricultural loans were to benefit small farmers. Both of these goals have been met and surpassed. Agricultural lending in the five year period 1974-78 was up 145 percent over the preceding five year period. Of 363 agricultural projects approved by the Bank in 1974-78, 75 percent contained a component explicitly directed at assisting small farmers. In more than 200 of these 363 projects, over half of the direct beneficiaries were expected to be members of the rural poor. Bank experts now estimate that as a result of these loans the incomes of over 10 million rural families will at least double.

The World Bank has also established a set of goals for addressing the problems of the urban poor and a number of projects have already been approved to provide sites and services for urban housing and to create additional employment opportunities. For the period 1976-80, the Bank intends to finance 50 urban projects and by 1981 to substantially increase the proportion of its lending through industrial development finance institutions which directly benefits the urban poor. Additional emphasis is being placed on labor intensive industries and finding ways to encourage artisan and cottage industries. The use of labor intensive methods and practices has been mandated where appropriate in the implementation of Bank projects and encouraged throughout the construction industries of recipient countries.

In spite of the progress that has been made and that which is programmed, there is no disagreement that the problems of absolute poverty will be with us far into the future. Indeed the World Bank itself estimates that it would take a massive effort to reduce the number of people in absolute poverty to the level of 400 million by the year 2000. We are convinced, however, that much more can be done to raise the productivity of poor people to increase their incomes and to provide them with improved access to public services.

We have worked along two basic tracks to promote this result. We have sought basic changes in the policies of the banks to ensure that they will devote an increasing share of their loans to help the poor directly. In the recently negotiated replenishment of the Inter-American Development Bank for example, it was agreed that one-half of all lending over the next four years benefit low income groups in recipient countries. It was also agreed that the concessional resources of the FSO should be better targeted toward poor people and poor countries. In the first and second years of the replenishment, 75 percent of these scarce concessional foreign exchange resources must go to the poorest countries in the hemisphere. In the third and fourth years, this figure must be increased to 80 percent. Any of the remaining FSO funds which go to other countries must be used only for projects which demonstrably benefit low income groups.

To assure that these results are achieved, the Board of Governors of the Bank has directed that the Board of Executive Directors prepare and submit by this June a report which will define precisely the groups which are to be benefitted with these resources. In addition, it should be noted that Bank management has already taken a number of steps to improve its capacity to reach low income groups. A clear statement of the intended beneficiaries of each project, the justification for the use of FSO resources and a description of land tenancy, in the case of agricultural loans, is now required in all loan documents. The Bank has also established a Small Project Financing Program which will enable it to respond to the needs of low income groups on a pilot basis and in innovative ways outside the regular lending program constraints.

In the Asian Development Bank, we took a very active role in seeing that the Bank's Board of Directors adopted an Agricultural Sector Paper based on the results of the Second Agricultural Survey which was carried out last year at Bank initiative and expense. Among other things, the paper provides the following guidance for future lending in agriculture: improved design of projects to assure more rural employment opportunities, concentration on rural infrastructure including feeder road networks; better support facilities for rural credit programs and improved arrangements for providing inputs and for marketing production; establishment and upgrading of extension services for rural women; strengthening small scale enterprises and better provision for health, nutrition and family planning assistance. In addition, it calls for more of an orientation toward helping to meet basic human needs of the rural poor, encourages the participation of the under-employed in bank-financed projects, and requires that projects emphasize cost-reduction through calculations of project-cost per beneficiary.

The banks have proceeded along three lines toward the objective of further benefitting the poor.

First, the banks are using their considerable aid leverage to promote policy changes in the borrowing countries to improve the lot of the poor. As part of this approach, much greater effort is currently being made to involve the poor themselves in the planning and implementation of development projects. Examples of these efforts exist in all the multilateral development banks.

In February 1978, the International Development Association approved an $8.5 million credit to Cameroon for integrated rural development in the economically deprived eastern province of the country. This loan, which is to provide assistance through a provincial development organization (ZAPI), places particular importance on getting the full cooperation and participation of local farmers in all aspects of the project. ZAPI itself has set a long-term objective of eventually enabling the farmers to take charge of local development actions and has adopted a strategy aimed at creating a farmer controlled and operated cooperative structure. To this end, a system of farmer committees has been established to organize village marketing and to oversee disbursement and recovery of credits as well as to provide the farmers with a mechanism for influencing policy, planning and coordination of rural development activities in the province.

In September 1978, the Asian Development Bank made a loan of $18 million to Indonesia for an irrigation project. This loan also emphasizes the need for active involvement of farmers through local irrigation associations which are called Subaks. These organizations are traditional in some rural areas of Indonesia and include in their membership all cultivators who own, sharecrop or rent land receiving water from a single source. Each member of the Subak has an equal vote and the leadership is democratically elected by majority vote or consensus. The ADB loan agreement specifically requires that the Subaks be directly involved in the allocation of water between Subaks and in the settlement of inter-Subak water rights disputes.

A third example of involvement by the poor is an IDB loan of $13.2 million to El Salvador for community development. This loan, which was approved in November 1978, has been designed to benefit low income groups in the northwestern region of the country. It includes a sub-program of credits for production purposes to individuals or cooperative organizations and a sub-program of small scale public works such as school repairs and construction of feeder roads, bridges, community halls, public baths, washrooms and latrines. A central element of the project is the provision for beneficiary participation in setting priorities for the small scale public works and for giving the beneficiaries the opportunity to work on the implementation of these works.

Second, the multilateral development banks have shifted the sectoral composition of their lending activity to favor projects which directly meet the needs of the poor. For example, World Bank Group lending for rural development increased over sevenfold from FY 1973 to FY 1978 from $247 million to $1,728 million. Similar sectoral changes are occuring in the regional banks as well.

In the Asian Development Bank, for the year 1977, the percentage share of agricultural projects was 29 percent, up from 26 percent in 1976. In 1978 more than 53 percent of the bank's concessional lending to the poorest countries of the region was for agricultural purposes. In the IDB at the end of 1977, bank lending going directly for agricultural purposes accounted for 23 percent of the total loan portfolio. In 1978, there was an increased concentration on approval of integrated rural development projects which are mandated to rise in the period 1979-1982 since, under the upcoming replenishment, between 30 and 35 percent of bank lending has been expressly designated for rural development projects. A further 10 to 15 percent is targeted for urban development projects.

Third, the MDBs are changing the emphasis of their more traditional projects to assure that their benefits are shared by the rural and urban poor. In the design of water supply, electrification and road projects, for example, the benefits accruing to poorer groups have been considerably expanded.

Two specific recent examples come to mind. An IDB loan of $12.2 million to Ecuador for a rural water supply system has been aimed at several communities in El Oro province where 90 percent of the population have incomes less than the national average income. An ADB loan of $24.0 million to the Philippines has been designed to support construction of secondary and feeder roads in the island of Mindanao, a particularly disadvantaged area of the country. It has been estimated that, in addition to net value added through incremental agricultural production and user cost savings, the project will also benefit 42,000 families with a population of 270,000 in the area of influence through improved availability of governmental social and administrative services, a favorable effect on school enrollments and greater access to health services.

An important problem is how best to develop a capacity to discover "who actually benefits" from MDB projects. Considerable effort has been made by the banks in the last several years to improve the data gathering procedures and statistical analysis capabilities of the borrowing countries. This effort is a vital ingredient of the banks' programs to know whether they are in fact better reaching the poor, and how to assure that they will do so in the future. These statistical and analytical techniques are now receiving greater attention, along with shifts in sectoral priorities and redesign of traditional projects.

There is substantial evidence that the multilateral development banks have made considerable progress in recent years in better reaching the poor.

The most recent statistics for IDA indicated that during FY 1978 50 agricultural projects amounting to $1,341 million were approved, accounting for nearly 58 percent of total IDA lending. Of these projects, 31 amounting to $867 million were for rural development lending in which a majority of the direct benefits go to small farmers, tenants and landless laborers. Approximately 6.6 million rural families are expected to benefit directly from these 50 agricultural and rural development loans and of those families, two-thirds or 4.4 million, are either absolutely poor or in the lower third of the income levels for their particular countries. In addition to the direct beneficiaries, the World Bank staff estimated that 13 million other farm families should benefit from the projects through advances such as improved research, storage, seed supply, and marketing facilities as well as from increased employment opportunities or from the provision of health and education services or improved transportation and other rural infrastructure.

These efforts to reach the poor are essential. At the same time, we believe that the multilateral development banks must also continue to pursue a multiplicity of goals if they are to be effective catalysts for development. The banks must preserve their recognized strengths in project design, sectoral and country programming, macro-policy leverage and infrastructure support. We would not want them to abandon these programs.

Infrastructure projects are still key in many less developed countries because they provide the necessary economic context for other assistance programs, including those to benefit directly the poor. For example, feeder roads serving small farmers in isolated parts of Africa must lead eventually to a principal road if inputs are to get in and production is to get out. Adequate port facilities are needed if fertilizers and other inputs from abroad are to reach these smallholders and if their coffee or cocoa or other production is to have an export market. The smallholders themselves recognize that an improved transportation infrastructure is essential to reduce the disparities between farmgate and market prices. Indeed, the success of projects designed to meet basic human needs are often dependent upon these kinds of infrastructure projects. Hydroelectric power projects provide another example of projects which are critical if less developed countries are to meet expanding energy requirements and reduce their reliance on expensive imported fuels. The banks must combine projects such as these with the new emphasis on reaching the poor throughout the developing world in ways which promote both productivity and equity.

THE EFFECTIVENESS OF THE BANKS

The banks are very effective in promoting the economic growth and development of recipient countries. They raise resources for both concessional and near market lending operations from many donor countries. As a consequence, they are able to operate on a significant scale and across the range of economic sectors. Supported by a well qualified and experienced staff from more than 100 member countries, they have established a reputation for rigorous and detailed appraisal of project proposals and programs. The volume and range of their operations, and the expertise they can bring to bear, enable them to play a unique role in promoting economic growth and development. They have a capability and impact which is greater than that which any individual donor country can muster.

The multilateral development banks have become the leading institutions in the field of international economic development. They are now the largest source of official assistance to developing areas, last year making commitments for approximately $11 billion for over 400 projects in recipient countries. Actual disbursements exceeded $5.5 billion. This level of lending gives the banks important influence in recipient countries. Because of their apolitical character, and the fact that they operate on the basis of economic and financial criteria, the banks are able to encourage the adoption of appropriate economic policies.

They finance programs of technical assistance, to strengthen local institutions and provide training for local officials. They encourage coordination of the resource flow to developing countries and promote cooperation among official lenders by chairing aid coordination groups for particular countries. They also support research and development organizations, particularly in agriculture, and sponsor seminars and research on developmental problems, making the results available to interested individuals and groups.

In its most recent fiscal year, the World Bank Group approved total loans and investments amounting to $8,749.1 million. Of that amount, $6,097 million were for loans on near market terms, $2,313 million were for loans on concessional terms and $338.4 million were for investments by the International Finance Corporation. Disbursements from the Bank and IDA made during the year were $3,849 million. Technical assistance operations financed by the Bank included two loans amounting to $20.3 million and components of 151 other operations which amounted to an additional $230 million.

The Bank also maintained a leading role in the organization and operations of various aid coordination mechanisms. Under the auspices of the Bank, the Caribbean Group for Cooperation in Economic Development was established and held its first meeting in 1978. Formal meetings of ten other aid coordinating groups were held under Bank auspices during the year including groups for Bangladesh, Bolivia, Burma, Egypt, India, Nepal, Pakistan, Philippines, Sri Lanka, and Zambia. In addition the Bank participated in a meeting of the Inter-Governmental Group on Indonesia and hosted a meeting of donor agencies to discuss improving cofinancing and coordination of operations in the population sector.

In order to promote better inter-agency coordination, the Bank also entered into a formal agreement with the recently established International Fund for Agricultural Development (IFAD) on a working arrangement between the two organizations. The Inter-American Development Bank and the Asian Development Bank have entered into similar agreements with IFAD.

In addition, the World Bank became a co-sponsor for Research and Training in Tropical Diseases and IDA agreed to administer the Special Action Account of $385 million for the European Economic Community to provide quick-disbursing assistance to the poorest developing countries. A number of ongoing programs and relationships were maintained with various U.N. agencies including the Food and Agriculture Organization, the World Health Organization, United Nations Industrial Development Organization, the International Labor Organization and the United Nations Education, Scientific and Cultural Organization.

During 1978, the World Bank also continued its support for eleven international agricultural research organizations providing $8.7 million to help finance the programs of organizations such as the International Institute of Tropical Agriculture in Nigeria, the International Livestock Center for Africa in Ethiopia, and the International Potato Center in Peru.

Eighty-seven economic research projects and studies were also underway in the IBRD during 1978. The results of these studies are available to the international research community and the public as well as to policy makers within the Bank and member countries. Examples of studies currently in process include strategies for control of tropical diseases such as schistosomiosis and the use of low cost technologies to provide safe drinking water and sanitation facilities. In addition, examinations are being made of small scale enterprises in selected countries and a number of surveys and studies are being conducted to provide a better analytical framework for providing rural development assistance.

The World Bank has also continued efforts to improve its systems for evaluating loan operations. In 1978, the Bank published an Operations Evaluation Department review of project performance audit results. The system for providing feedback to the operating departments from the audit process was strengthened through improvement in annual and semiannual procedures for reviewing completed and on-going projects. All Bank loans now require the borrower to complete a project completion report as a standard feature and in more difficult sectors -- such as agriculture, education and urban development -- the establishment of special monitoring units is required. In 1978, the Bank also sponsored a seminar on post-evaluation and review for senior officials of several African countries. As a result, discussions are continuing with those countries regarding establishing national agencies to evaluate public investment projects and similar seminars are planned for other regions.

Similar functions and activities are carried out by the regional development banks. For example, during 1978, the Presidents of these banks held one of their regular meetings at the headquarters of the Inter-American Development Bank to discuss major economic and financial issues facing developing countries. At this meeting they were joined by representatives from the World Bank, the International Monetary Fund, the European Economic Community, the European Investment Bank, the OPEC Special Fund and the Islamic Development Fund. During 1978, the IDB initiated joint financing with OPEC countries and organizations for development projects in Haiti, Bolivia, and Honduras. The Bank also sponsored symposia on the application of capital saving technologies and the prospects for greater use of solar energy. Last year, the Asian Development Bank held a seminar for regional development banks promoting improved appraisal and implementation of public and private investment projects. The Bank also completed a survey on South Pacific agriculture and sponsored a seminar on irrigation development and management.

COST-EFFECTIVENESS

The cost-effectiveness of U.S. participation in the multilateral development banks is based on three factors:

(1) Equitable sharing of the burden for providing economic assistance with other donor countries;

(2) Leveraging paid-in capital contributions to the banks by borrowings in private capital markets, based on callable or guarantee capital;

(3) Extending bank resources through cofinancing arrangements made with other official sources, including OPEC countries, and with private banks.

As I indicated at the beginning of my testimony, the United States has been able progressively to reduce its share of subscriptions and contributions to the banks and the shares of other participating countries have been correspondingly increased. This process is continuing today. It reflects the growing economic strength of other countries and their increased capability to provide more resources for development. These countries include industrial countries such as Germany and Japan, the OPEC countries and some of the relatively more advanced developing countries such as Brazil and Mexico which have increased their convertible currency contributions to the Inter-American Development Bank.

During the past two years, this Administration has negotiated replenishment agreements for the International Development Association, the Inter-American Development Bank, the Asian Development Fund and the African Development Fund. In all of these agreements, except that for the African Development Fund, where the United States had hardly participated at all, the share of the United States has declined and the shares of other countries have increased.

As finally agreed in the spring of 1977, the fifth replenishment of IDA provided for a reduction in the U.S. share from 33.32 percent to 31.42 percent. Countries which increased their contributions to IDA V were Saudi Arabia, the United Arab Emirates and Kuwait. Germany and Japan, which had substantially increased the level of their contributions to the fourth replenishment, maintained this increased level during the fifth replenishment.

Subsequently, during the course of 1977 and 1978, a number of countries announced increases in their contributions to IDA V including Saudi Arabia, Kuwait, the Netherlands, Norway, and the United Kingdom. Altogether, these increased contributions amounted to $145.5 million with the largest sums coming from Saudi Arabia which contributed $100 million and Kuwait which contributed $20 million. As a result of these additional increased contributions the U.S. share of IDA V declined further to the level of 31.2 percent. In preliminary discussions for the sixth replenishment of resources, we are pursuing a sizable further reduction in line with the Sense of the Congress Resolution on shares contained in Title III of Public Law 95-481.

More equitable burden-sharing was one of the key elements in the recently completed agreement to replenish the resources of the Inter-American Development Bank, where our share is the largest because we are the only sizable industrial country in the hemisphere. Under the original terms of their entry into the bank in 1974, the non-regional members of Western Europe and Japan provided 4.4 percent of the Bank's total capital. In the agreement just negotiated, they raised the percentage share of their subscription to the increase by more than two and one-half times to 11 percent, pledging a total of $876 million in paid-in and callable capital which serves as backing on the Bank's borrowing operations. Under the agreement, Canada and Venezuela are contributing $310 million and $467 million respectively in paid-in capital and completely convertible backing for the Bank's borrowing operations. In addition, all of the recipient member countries of the Bank are making two-thirds of their paid-in capital fully convertible, thus mobilizing $178 million in convertible resources, including $43.5 million from Argentina, $43.5 million from Brazil and $28 million from Mexico, or a total of nearly $115 million from these three countries.

In the Fund for Special Operations, the Bank's concessional lending facility, the non-regional member countries maintained their entry share of 30 percent and increased their contributions from $450 million to $525 million. Canada, Venezuela and Trinidad and Tobago agreed to make all of their contributions fully convertible, providing $58.1 million, $70 million and $3.9 million respectively for a total of $132 million to these resources which are lent to the poorest countries in the hemisphere.

The three largest developing countries in the hemisphere, Argentina, Brazil and Mexico, agreed to make the equivalent of three-quarters of their FSO contributions convertible; thus they are contributing $72 million, $72 million and $46.5 million respectively. They have also agreed to continue not to borrow these convertible FSO resources. These three countries and Venezuela are all former recipients of FSO resources. They are now making convertible contributions to those resources of $260 million.

As a result of these contributions and those of the non-regional countries, the U.S. share of convertible FSO resources has dropped from 57 percent in the last replenishment to 45 percent in the new replenishment. In terms of absolute amounts, the annual level of U.S. contributions to the FSO will fall from $200 million under the last replenishment to $175 million under the new one, a reduction of 12.5 percent or $25 million per year in paid-in contributions to the concessional lending fund of the IDB.

In the Asian Development Fund, negotiations were completed last spring for a replenishment of resources of $2.0 billion, with the United States contributing $445 million, or 22.25 percent, and meeting the share standard established in last year's appropriations legislation. In addition, other donors agreed to make supplemental contributions of $150 million, thus effectively reducing the U.S. share to 20.7 percent, significantly below the standard set in last year's legislation.

Other donor countries have increased their percentage shares of contributions to the Fund. Japan, for example, originally on a par with the United States in contributions to the Fund, is contributing $673 million under the basic agreement and a supplementary amount of $118.3 million, for a total of $792 million or 36.8 percent of the total compared with our 20.7 percent. The Netherlands and Sweden also made marginal increases in their previous contributions and France, joining the Fund for the first time, provided an additional $104.8 million.

The other replenishment agreement negotiated by the Administration last year was for the African Development Fund. This Fund is relatively small and U.S. contributions in the past have been very minor, amounting to $50 million or well under ten percent of total Fund resources. In this particular case, the Administration agreed to a very substantial increase in the percentage share of our contributions to somewhat under eighteen percent although it is still a small amount in dollar terms ($125 million over a 3 year period) because the AFDF is still quite small itself.

We consider that this increase is fully justified on the grounds that Africa is the least developed continent, that it contains some of the poorest and least advantaged countries in the world, and that the African Development Fund has been steadily improving its administrative and technical capabilities. In the last two years, Africa has also assumed a much greater importance than before in the overall foreign policy of the United States. The announcement of the $125 million for contributions to the Fund was made last year at the time of President Carter's visit. It has been widely publicized in Africa and favorably interpreted as an indication of increasing U.S. interest.

USE OF CALLABLE CAPITAL

The second factor contributing to cost-effectiveness is the ability of the banks to use callable capital backing for bond issues, thereby permitting them to raise private capital for conventional lending, and avoiding budgetary outlay by the United States or other member countries. The ability of the banks to leverage limited paid-in contributions in this way has grown to the point where today, only one dollar in ten has to be paid-in and in the case of the IDB it is even less, as a result of the recent replenishment.

When the World Bank was first established in 1946, 20 percent of the capital was paid in and 80 percent was callable. The higher proportion of paid-in capital was necessary to cover start-up expenses, provide acceptable financial ratios and to secure confidence and support for the institution from private capital markets. As the Bank developed, it established a record for prompt collection and a reputation for financial prudence. It was possible to reduce the paid-in portion without damaging the Bank's ability to raise private funds at an acceptable cost. On a cumulative basis, the U.S. has paid in $884 million to the capital of the World Bank and, as a result of burden-sharing and leverage, supported a total lending program of over $45 billion. On this basis, each dollar of U.S. paid-in capital has been able to support approximately $50 in Bank lending. This pattern has been followed by the Inter-American Development Bank and the Asian

Development Bank, although because these institutions were not established until 1959 and 1966, and have different capital structures, the leverage factors have been lower.

In the case of the World Bank, we are now at the point when we can consider whether or not it is, in fact, necessary to continue to have 10 percent of the capital paid into the Bank under the next general capital increase. The final answer to this question depends, of course, on the views of all members and on the attitudes of private capital markets to this prospect. We ourselves would want to consider very carefully the implications that such a step might have for the Bank's financial strength, its cost of capital and the lending rate policy that it will follow in the 1980's. In any event, I am confident that it will be possible to reduce the paid-in portion of the next general capital increase below the ten percent level.

In the recently negotiated increase in capital of the Inter-American Development Bank, the financial strength of the institution made it possible to reduce the proportion of capital to be paid in. Under the terms of the agreement reached last December, the proportion of paid-in capital was reduced to seven and one-half percent.

On a cumulative basis, the U.S. has paid in \$482 million to the IDB and supported a total capital lending program of nearly \$7.0 billion, a combined leverage factor based on both burden-sharing and use of callable capital of 14 to 1. This is much lower than the multiple for the World Bank, but it reflects the fact that the Bank was not established until 1959 and that the United States until the 1970's was the only developed member country. The entry of the non-regionals and the increase in their capital shares in combination with a reduced paid-in portion will cause this multiple to become even larger in the future.

In the Asian Development Bank, the cumulative paid-in capital contributions of the United States amount to \$242 million and they support a total lending program in excess of \$3.8 billion, a leverage factor of 15 to 1.

COFINANCING

A third way in which our participation in the multilateral development banks is cost effective is through cofinancing or complementary financing arrangements made with private banks or other public and private organizations. The banks have been able to sell to commercial banks "participations" in the early maturities of their individual loans. These sales have been made without recourse and originally at the fixed interest rate set in each individual bank loan contract. This procedure had the advantage -- since it was done without recourse -- of freeing up Bank resources for additional lending. However, with the general rise and increased volatility of interest rates that has occurred during the 1970's, it has not been possible to continue these particular programs on the basis of a fixed rate.

As a result, the Inter-American Development Bank modified its participation program, introducing a variable interest rate feature. In the case of the World Bank, a parallel lending program was established with a cross-default clause to provide additional security for the commercial lender portion of the loan. This clause permits but does not make mandatory suspension of the entire loan, including the World Bank portion, if there should be a default on the portion of the loan held by the commercial bank. Under its new program, the World Bank had mobilized a total of $469 million in additional lending resources from private banks as of the end of calendar year 1978.

The figure of $469 million does not include the International Finance Corporation, which is also a member of the World Bank Group and which, under its mandate to encourage private enterprise in less developed countries, is very active in cofinancing. As of June 30, 1978, the IFC held investments amounting to more than $1,315 million of which $332 million or 25 percent were held for private purchasers and participants. On average, IFC financing in individual projects is held to 25 percent or less of total project costs and other resources have necessarily been mobilized including additional private or public capital from developed countries or from the recipient country itself.

IFC operations in the past have been most successful in middle income countries and in companies that have been in operation for some time. Following the recent increase in resources, however, it has been planned that operations in the poorer recipient countries will be increased. IFC will, therefore, perform a very useful role in putting together proposals which can attract additional private financing to countries, particularly in Africa and Asia, which have had difficulty in this respect in the past.

In the Inter-American Development Bank there is a complementary or cofinancing program based on sales of participations. There is no need for a cross-default clause, since the Bank administers the commercial bank portion of the loan, acting as disburser and collector. The Bank has had no difficulty in attracting commercial bank participation at interest rates which are agreeable to the borrowing countries and marginally lower than they would have received in the absence of the program, i.e., on a straight commercial loan basis. Since 1976, the Inter-American Development Bank has mobilized $278 million in additional lending resources through its complementary financing program. In both the World Bank and the Inter-American Development Bank, we anticipate that the amounts of money raised in this manner will rise in the future.

Participation in the cofinancing programs has not been limited to U.S. banks. Major banks from Germany, Japan, Switzerland and Canada, among other countries, have taken significant portions of individual loans. In addition to the resource extending beoefit, which is helpful to us for domestic budgetary reasons, there are other very definite advantages to the cofinancing programs. They provide a mechanism for introducing commercial bank lending in developing countries whose international credit standing has not been firmly established, thereby permitting these countries to enter the world financial system and pave the way for reducing still further, over time, the need for public aid. They also enable the multilateral development banks to lend in a larger number of sectors and for more projects, permitting a greater concentration of both conventional and concessional resources on projects which reach the poor, without requiring that critical infrastructure needs of recipient countries be abandoned or left unmet.

The Asian Development Bank has made less progress thus far than the World Bank and the Inter-American Development Bank in revising and expanding its private cofinancing program. At a recent Board of Directors meeting which considered a management proposal to take such action, the U.S. Director urged that greater emphasis be placed by the Bank on this cost-effective way of mobilizing additional resources for its developing member countries.

The Asian Development Bank has been more successful, however, in arranging cofinancing arrangements with other official sources such as the OPEC Special Fund, the Islamic Development Fund and individual OPEC countries. As of the end of calendar year 1978, the ADB had raised a total of $343 million in this manner. The Inter-American Development Bank has also helped the Venezuelan Government to establish a special Venezuelan Trust Fund of $500 million which is administered by the IDB for lending to other developing countries in the hemisphere. This Fund is in addition to Venezuela's regular contributions to the Bank's capital and to the Fund for Special Operations. World Bank figures show that cofinancing with OPEC countries and agencies amounted to $1.4 billion at the end of 1977, the most recent period for which data are available. Because its membership has been limited to the region, the African Development Bank has not tapped the international bond markets or sought to establish cofinancing relationships with commercial banks. If non-regional countries join the bank, which is a matter now under negotiation, however, the AFDB in the fuuure should be able to begin modest bond offerings based on the paid-in and callable capital contributions of developed member countries and may look toward the establishment of cofinancing relationships with commercial banks.

The United States has benefitted from increased burden-sharing and the mobilization of additional capital through bond offerings and cofinancing. As other countries have increased their contributions to the multilateral development banks, it has been possible for our overall share of contributions to decline. As the banks have established themselves in private capital markets, it has been possible fot our overall paid-in capital contributions to be reduced from fifty percent in some cases to less than ten percent.

In comparison, the use of cofinancing has been more limited. I am hopeful that the World Bank and the Inter-American Development Bank will continue to expand their operations during this year and that the Asian Development Bank will be able to launch a new cooperative financing program with private banks as well as continue its relationships with public entities in the OPEC countries.

SALARIES

A major issue that has been of concern to both the Congress and the Administration is that of salaries, benefits, and administrative costs within the multilateral development banks. Of these issues, the predominant one has been staff salaries. With the strong support of the United States, the management of the World Bank and the IMF formed a Joint Committee of Executive Directors on Compensation Issues. This Committee was given responsibility to study the compensation situation of all IMF/IBRD employees and to make appropriate recommendations to the Executive Boards of the two institutions. The Committee met on numerous occasions throughout 1977 and 1978, employed professional compensation firms to obtain necessary data for comparative purposes and finished its work in late December. Its final report has been printed, and copies were sent to the Congress on February first.

This report and its recommendations provide the framework for an objective determination of salaries based on public and private salary levels in member countries.

It advances three basic recommendations:

-- salaries in the main professional grades will be determined as the average of those in the U.S. private sector and the U.S. Civil Service, plus a premium of ten percent. This premium is necessary to adjust for regional differences of pay within the United States and to make the salaries competitive on an international as well as an East Coast basis. Data from the U.S. private sector were used because the costs involved are U.S. costs and the necessary data were available.

-- salaries in the management levels will be determined by setting a moderate differential for each successive grade over the preceeding grade, to arrive at a rational management structure.

-- tax reimbursement paid American staff will be calculated from the net salaries, using the average deduction for that income level, rather than the standard deduction as heretofore.

The net effect of these recommendations would be to bring Bank and Fund salaries more closely into line with comparable public and private sector salaries, as directed in Section 704 of Public Law 95-118. We will be working with other countries to obtain adoption of the new compensation system by the Boards of the Bank and the IMF.

CAPITAL SAVING TECHNOLOGIES

Another U.S. objective in the banks has been to promote projects which more directly and effectively reach the poor within beneficiary countries. One important means to help achieve this objective is to promote the utilization of capital saving technology in order to increase the productivity and incomes of poor people to insure that the greatest number of people benefit from bank projects, and to promote the most efficient use of scarce development resources.

Capital saving technologies involve the productive and often innovative use of small-scale and labor-intensive processes, techniques, equipment and tools which are less complex and costly than those usually employed in the developed countries. As a result, their application promotes the efficient use of available resources by substituting abundant unskilled labor for scarce investment funds. The approaches, activities, and techniques they embody also permit a focus on reaching the maximum number of beneficiaries at relatively modest assistance costs.

The United States has sought policy decisions through which the banks will place increased emphasis on the use of capital saving technologies in their projects. In November 1976, the Inter-American Development Bank adopted a policy to promote the use of light capital technology by making it a significant component of development strategy.

In 1977, the Asian Development Bank incorporated an enumeration and assessment of light capital technologies into its project identification and evaluation procedures so as to examine relevant technological alternatives as an ongoing part of its project selection process.

The World Bank's policy guidelines on the use of technologies are included in sector policy papers. For example, one of the major recommendations of the Bank's 1978 paper, Employment and Development of Small Scale Enterprises was that the Bank should urge recipient governments to correct policies and regulatory measures that have the effect of encouraging undue capital intensity in investments. The paper points out that larger firms may benefit more than smaller enterprises from credit programs with artificially low interest rates or from the subsidization of public services such as power, transportation and water supply. It concludes that these policies can be modified and that additional incentives can be provided in other ways such as reserving public procurement of certain items to smaller firms, encouraging subcontracting, and broadening the sectoral coverage of development finance companies.

We have also sought to maximize the use of capital saving technologies in our review of individual loans. The Executive Directors in all of the banks, backstopped by Treasury staff, examine all loan proposals specifically to assure that this criterion is properly taken into account. They endeavor to promote the use of capital saving technologies in their contacts with other Board members, in communications with bank management and in discussions with technical staff. The U.S. concern for the application of capital saving technologies has been emphasized by our requesting clarification on the technological aspects and implications of individual projects presented to the Boards. For example, in connection with a fisheries loan to Ecuador, the United States Executive Director of the IDB sought and received assurance from the Bank that the crafts to be used in the project were the most appropriate, least capital intensive alternative. In a feasibility study for a dam in the Dominican Republic, the Executive Director made sure that the guidance given to the consultants by the Bank included instructions to specifically take into account the possibilities for using light capital technologies in designing the project.

The banks, with U.S. support, are making increased efforts at the preinvestment stage to achieve a more effective application of capital saving technologies. By strengthening their project appraisal activities, the banks facilitate the selection of projects incorporating techniques that are most appropriate to the circumstances and requirements of the borrowing countries. In a large number of cases this leads to the utilization of light capital technologies.

The results of efforts to introduce capital saving technologies in appropriate instances can be seen in their increasing use in individual bank projects. An example is the recent IDB loan of $13.2 million mentioned earlier to support community development in the economically depressed northwest region of El Salvador. The objective of the project is to help bring about an improvement in the living conditions and incomes of approximately 144,000 people living in about 300 small rural communities through self-help construction of small scale works (roads, schools, bridges, potable water supply systems) and the granting of credit to approximately 48,000 low income people to increase their agricultural, agro-industrial and crafts production, facilitate the marketing of their products, and to meet other basic family needs.

The construction methods for the works subprogram will be labor intensive and use a high proportion of local materials. It is planned to limit the use of construction equipment to the minimum amounts necessary to assure a satisfactory output. In the credit assistance subprogram, the use of machinery will be limited to equipment that can be manually or easily operated, such as knapsack pumps, manual sprayers and sprinklers, and animal drawn plows. As a result of making this extensive use of local labor and materials in the works subprogram, the cost per beneficiary will not exceed $80.

An IDA credit for artisan small and medium scale enterprises in Upper Volta is an example of the World Bank's efforts to create employment by working through artisan groups and small scale enterprises. The project has three major components and all are expected to have important employment creation and institution building effects. One of these is for credit-in-kind and extension services to artisans. It amounts to $820,000 or 21 percent of the total credit and is based wholly on the provision of capital saving technology. The credit-in-kind will be largely raw materials such as wood, metal, and cement, and equipment such as wheelbarrows, shovels, axes, saws, molds and other basic tools. The average loan size is expected to be $400 with a range from a few dollars for working capital to a maximum of $8,000 for artisans. Extension officers will distribute raw materials and assist in planning and implementing investments as part of their regular supervision visits to artisans. Artisan production will be bricks, farm implements, wooden utensils and probably pottery. Technical assistance to be provided for the artisans will include basic skill training, accounting for illiterates, general advice and direct marketing. The target group of recipients are rural and urban artisans with annual incomes of less than $400. Since a total increase in direct employment of 1,500 is projected, average investment cost per job will be less than $200.

The El Salvador and Upper Volta projects are two examples of efforts to reach the poor through capital saving technologies. The information for a detailed account of current efforts is presently being collected and will be included in our 1979 report to the Congress on the use of light capital technologies in MDB activities.

HUMAN RIGHTS

The Administration and the Congress share a firm commitment to a foreign policy which gives high priority to enhancing respect for human rights throughout the world. In December of last year, President Carter vigorously reaffirmed this commitment on the occasion of the 30th anniversary of the Universal Declaration of Human Rights.

Our policy in the banks has been aimed at inducing improvements in specific problem situations. We believe this objective can be achieved by demonstrating to human rights violators that there are costs attached to continued oppressive practices, and conversely by demonstrating that there are benefits to those governments which promote human rights.

In a report submitted to the Congress in October 1978, the Secretary of State and I described in detail how this policy has been implemented in the last 18 months. As that report indicated, we have pursued our human rights policy across the range of our relationships with other countries. In the foreign assistance area, our bilateral program has been governed by this principle and the related concerns of reaching the poor and meeting basic human needs. We define human rights to include, beyond freedom from governmental violations of the person, basic economic and social rights such as adequate food, housing, clothing, health care and the opportunity to play a productive role in society. The banks enhance respect for human rights in the developing world by increasingly shifting the emphasis of their lending programs toward reaching the poor and meeting basic human needs.

We have encouraged the banks in this shift of emphasis to projects which reach the poor and help meet basic human needs, and we usually support projects for those countries with human rights problems if they benefit the poor and meet basic human needs, in order not to penalize the people for the abusive policies of their governments.

We have undertaken consultations with other countries on human rights problems, and we have raised human rights concerns in the banks by opposing, through "no" votes or abstentions, 50 loans to 15 countries where we considered the human rights situations severe.

We have also taken steps to implement Section 611 of the FY 1979 Appropriations Act, which calls on the U.S. Governor to "propose and seek adoption" of a charter amendment in the banks that would establish human rights standards to be taken into account in connection with each loan. In an effort to generate support for such an amendment, and to ensure its best chances for adoption, we have consulted other governments who share our human rights concerns and sought their views and agreement with this proposal.

Thus far, the reactions of other governments to the proposal of an amendment have been negative. They believe the introduction of such amendments would be unnecessarily divisive and that they would not obtain the broad support required for their adoption. In view of such reactions we are undertaking additional consultations to pursue this approach and to achieve the objectives of the legislation.

In light of existing legislation which requires the United States to vote against loans to countries that are found to violate human rights consistently, I see no need for special legislation aimed at restricting multilateral development bank lending to particular countries. In accordance with Section 701(f) of Public Law 95-118 and the Administration's policy, we have voted against or abstained on 50 loans to 15 countries. The present legislation is being implemented conscientiously, and I believe that no change is necessary at this time.

Indeed, as I have stated in the past, contributions made under legislation prohibiting the use of U.S. contributions to the banks for loans to specific countries would have to be rejected by the institutions. Under their charters, the banks cannot accept funds from the United States or from any other member which are restricted on country grounds. Any provision in U.S. law which would prohibit the use of appropriated funds for multilateral development bank lending to selected countries would seriously jeopardize continued U.S. participation in the banks at the expense of our human rights and other foreign policy objectives.

ACCOUNTABILITY

A number of steps have been taken during the past two years to strengthen procedures for accountability of the multilateral development banks and to increase the flow of information on their activities which is available to the Congress and to the public. We are continuing to follow the activities of the banks closely to assure ourselves that audit and evaluation mechanisms within the banks are functioning adequately.

Each of the banks is audited by well-known auditing firms. The results of these audits are published in the annual reports. They are also required to file specific financial information with the Securities and Exchange Commission in order to issue bonds in the U.S. capital market. This information is available to the public. In addition, the banks have made available to the public, on a subscription or referral basis, their Monthly Operational Summaries which list all projects under consideration for financing and show their status, and statements of loans and press releases on each loan which is approved. They also publish many of their country economic reports, research papers related directly or indirectly to their operational lending programs, other occasional papers, and a wide variety of statistical reports on all aspects of their operations. The World Bank makes available to the public its Catalogue of Publications briefly describing its research and occasional papers from which the public may order documents. Similarly, the IDB makes available to the public papers prepared for seminars and roundtable discussions as well as many of their country economic reports. I might also add that information from the loan documents is available on request, after Board consideration, to businessmen and other members of the public.

The Treasury Department routinely transmits to the Congress and the General Accounting Office numerous documents in compliance with various legislative provisions as well as to meet special requests. Included in the documentation which goes to various offices are the Monthly Operational Summaries listing loan proposals under consideration or appraisal in the banks, Statements of Approved Loans for the banks, statements of income and financial condition, status of negotiation notices, brief loan analyses prepared bi-weekly by Treasury Department staff, project evaluation reports, and various sector and policy papers and reports. In addition, the U.S. Executive Directors and members of the Treasury staff are available to talk with Congressional members and staff regarding any other material they may wish to know about the bank or its activities.

During the past year we have continued to press the banks to review their classification systems and to declassify as many documents as possible. The World Bank has declassified the World Development Report, the Energy Report and its Commodity Price Report. It has also made public project performance audit reports. In the IDB, the Monthly Operational Summaries have been declassified during the past year.

All of the banks now make available to the public Monthly Operational Summaries on the status of future projects. It is now possible for businessmen and other members of the public to subscribe to these reports on a monthly basis from the World Bank and the Asian Development Bank. In the case of the IDB, the Monthly Operational Summaries are available to businessmen and the public through the U.S. Commerce Department, although we are working with the bank to get it to provide this material directly and on the same basis as the other banks.

With regard to the question of financial controls and reporting requirements, the Articles of Agreement for all of the Banks contain explicit provisions that the Banks shall ensure that the proceeds of any loan are used only for the purpose for which the loan was granted. To carry out this provision, the Banks include a number of requirements either in the loan document itself or in other agreements made with the borrowers. Each borrower is required to have his overall financial position audited by independent outside auditors approved by the Banks. In addition, each project in which the Banks participate is either subject to independent audit or to a requirement that books be kept open to the Banks for inspection.

Each of these banks has an independent operations evaluation unit whose personnel are responsible to management and, in the case of the World Bank and the Inter-American Development Bank, directly to the respective Boards of Executive Directors. In the Inter-American Development Bank, programs are evaluated by a three-member "Group of Controllers" and its staff. This group was established in 1968 and its members are appointed from outside the bank for non-renewable three-year terms and report directly to the Bank's Board of Executive Directors.

In the World Bank Group, projects are evaluated by the Operations Evaluation Department. It is headed by a Director-General who reports directly to the Executive Directors. The Operations Evaluation Department uses "Project Completion Reports" and Project Performance Audits to evaluate the impact of the Bank's development projects. In the Asian Development Bank, selective project evaluations are conducted by both the bank's own Economic Department and by independent outside evaluators from various countries. The African Development Fund is currently establishing a system for evaluating projects.

During the past year, the General Accounting Office completed studies of these independent review and evaluation units and made a number of positive findings with regard to their operations and effectiveness.

In the case of the IBRD, the GAO auditors indicated that the World Bank Group has made considerable progress toward developing an independent and continuous selective examination, review, and evaluation of the Bank's programs and activities.

With regard to the IDB, they said that the effectiveness of the Group of Controllers has improved steadily since its creation and that its reports have contained many recommendations for improving Bank operations. They noted that most of the recommendations have been adopted by the Board of Executive Directors and that Bank management has taken specific actions to implement them.

With regard to the ADB, the auditors said that some progress had been made in improving the review and evaluation of projects assisted by Bank financing, but that the expanding volume of Bank lending made more independent and wider-range review and evaluation necessary and desirable. They made several recommendations in each report for improving the systems in the respective banks. These recommendations cover, among other matters, the scope of some of the individual reports and the need for maintaining or strengthening the independence of the evaluation units.

Specific requirements with regard to procurement procedures and the disbursement of funds are set forth in loan agreements with individual borrowers and in operating manuals and instructions of the banks. Procurement is either by international competitive bidding, international shopping, or local procurement. All of these procedures must meet detailed bank requirements. Depending on the exact disbursement procedure followed, the borrower is required to present any or several of the following types of supporting evidence for substantiating withdrawals from the loan account: the contract or confirmed purchase order and evidence that the payment has been made, such as suppliers' invoices and bills of lading, consultants' invoices in case of consultancy services, contractors' invoices and borrowers' certificate of work progress in case of civil works, letters of credit against which the banks' commitments are being sought, and negotiating banks' reports of payment accompanied by suppliers' invoices.

Each borrower is also obliged to meet a number of other reporting requirements. He must keep records relating to the progress of the project and the cost of carrying it out. He must permit Bank representatives to visit the project site, inspect the works being carried out and the records related to it. He must also be prepared to submit to the Bank on request any additional information concerning the progress of the project and his operational and financial conditions.

All of the banks maintain supervision systems to oversee the fulfillment of the established requirements. The IDB has a resident mission in each recipient country which monitors the progress of projects and checks for compliance with provisions of the loan agreement. The World Bank and the ADB do not have representatives in all recipient countries.

However, members of the staff visit the borrowers and the project sites, generally once a year, but more often if it is necessary. In addition, staff members at the banks headquarters regularly review procurement documents and the recommendations for bid awards. In the case of credit projects, they review and approve subloans above certain minimal amounts. They also review progress reports submitted by the borrowers for all projects and correspond with them on a wide range of project implementation issues.

We are working to carry out the recommendations of the General Accounting Office. We are also committed to strengthening the accountability of the banks and to increasing the flow of information on their activities. Complete disclosure of all bank information, however, is neither feasible nor desirable. We have to balance our oversight responsibilities with the confidential nature of the banks relationships with its borrowers, especially concerning economic policy advice which may be sensitive in recipient countries.

COMMODITY LEGISLATION

Following passage of the appropriations legislation last October, procedures have been established to implement two provisions in the legislation dealing with commodities. The legislation requires that the United States oppose use of MDB funds for the production of any commodity for export if it is in surplus on world markets and if substantial injury would be caused to U.S. producers of the same, similar or competing products. It also provides that the President shall initiate international consultations designed to develop standards governing the allocation of development assistance for production of commodities in surplus on world markets where increased efforts would cause substantial harm to other producers.

As a matter of fact, however, the banks have been making very few loans that could fall under these provisions. To carry out the legislative requirements, we have carefully analyzed these loans to determine the economic impact of production on the world markets. No loan proposals thus far this year have required special action because the commodities to be produced either were for domestic production or would not be in surplus or result in substantial injury to U.S. suppliers.

Essentially, our approach is based on the principle that loans for projects that will result in the increased production of commodities in prospective world surplus will prove to be a wasteful use of development assistance resources. Fortunately, our approach is also followed by the banks in identifying and appraising projects.

With regard to the second provision of the legislation, the United States has raised internationally the issue of allocation of assistance for the increased production of commodities in surplus. We are seeking agreement among the OECD countries on general principles that such an allocation of assistance can be disruptive to producers in developed and developing countries alike, that it may prove counter-productive to bilateral and multilateral development efforts, that international standards should be developed generally to avoid assistance for surplus commodities while taking into account world-wide comparative advantages in commodity production.

There is no need for additional legislation aimed at restricting uses of U.S. funds by the banks for the financing of special commodities on products. As I have noted with regard to country restrictions, the banks could not legally accept contributions on those terms. Any such provision in U.S. law would seriously jeopardize continued U.S. participation in the multilateral development banks.

CONCLUSION

In my testimony to this Subcommittee last year, I expressed the hope that Congress and the Administration would work out a consensus or common view of our objectives in the multilateral development banks. I suggested that the consensus might include agreement on our basic goals within the banks such as reaching the poor more directly and effectively, promoting human rights, assuring accountability, and rationalizing administrative costs.

In my testimony today, I have dealt at some length with these matters and with other issues which have been of concern to the Congress and the Administration including rationalizing salaries and other administrative costs and limiting bank financing for production of certain commodities. Over the past year, we have made progress on these issues. We have not been able to prevail in every instance or have every issue resolved exactly as we might have wished. Other countries contribute to the banks and their views have to be taken into account. That is a limitation of the multilateral approach but it has been more than offset by the many advantages we have derived from our participation in these institutions.

I am hopeful, as a result of the progress that has been made over the past year, that Congress and the Administration will agree on providing our share of subscriptions and contributions to the multilatral development banks for FY 1980 and that we can continue to effectively pursue our interests in the banks.

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Transcript of the Remarks of
The Honorable W. Michael Blumenthal
Secretary of the Treasury
before the
Washington Press Club, Washington, D. C.

March 15, 1979

I am delighted to have this opportunity, really for the first time since my return from China, to report to you about my impressions and experiences. I do recognize that you may wish to ask questions relating to other topics, and I'll be happy to answer those to the extent that I can.

But I would like to just very briefly, in order to allow you the maximum time for questions, say a few words about China.

As to what we did, apart from representing the President and the elevation of the liaison office to full Embassy status,which was in itself an important, symbolic and historic effort, we did manage to settle the claims assets issue. We settled it on the basis of 41 cents on the dollar. That represents a fair and equitable settlement, I believe, for both sides. It compares favorably with similar settlements previously made with other countries, with whom we had issues of this kind.

Moreover, the important things from the U.S. side is that that settlement will be fully liquidated in cash over a five-year period, beginning in October of this year. In other words, the Chinese will make their first payment in October of this year, and then pay us the remainder of it in five equal installments thereafter. That is a good settlement, from our point of view. Previous settlements with other countries have involved periods as long as 20 years. And even when the amounts involved -- in this case we agreed on $80.5 million -- were smaller than this. Moreover, we do not have to go into the issues of litigating on the assets of China that were blocked here, that are now going to be unblocked. That is a responsibility for the Chinese.

So, clearly, from our point of view, that was a good arrangement. I think it was a good arrangement from the point of view of China too, because without the settlement of that issue, it would not have been possible to develop a full-blown economic relationship between the United States and China, which the Chinese hope and expect will manifest itself in the form of expanded trade; in the form of providing technical advice, technology transfer, assistance with management and know-how, joint ventures; equity investments, a shipping agreement and decisions in the context of a trade agreement on how to treat such things as proprietary rights by Americans on patents, trade-marks, things of that kind. All of that really would not have been possible to move on without settling the question of claims assets. So from the point of view of the Chinese, they removed a major roadblock in the way of the full normalization of our economic relations. We agreed we would move forward in the negotiation of a trade agreement and we have already begun that process.

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We've agreed on what it will cover, and agreed on a timetable for getting on with that job. The question of Most Favored Nation treatment for China is going to be dealt with, and we informed the Chinese it was the intention of the President to recommend to the Congress, and in the context of a satisfactory trade agreement, that that MFN status be granted. And, of course, the Chinese also are interested in becoming eligible for Export-Import Bank credit. And that, too, is something we will consider.

That will require, again, different types of legislation by Congress. So all that is now beginning to move forward.

Thirdly, we set up a U.S. - China joint economic committee, chaired on the Chinese side by Vice Premier Yu Qiuli, and on the U.S. side by myself, which will on both sides bring together the principal senior government officials. In our case, it is a number of Cabinet officers. On the Chinese side, it is the analogous group of senior officials who will work together on all of these different elements of the economic relationship that now has to be established.

So much more of what we did in the climate that was created was a good one, and I think we can move forward. Now, as to the opportunities for a mutually beneficial economic relationship. There are those who think of the billion or so people in China, and who have visions of a huge market with tremendous potential for the United States or other countries, like Japan, Western Europe, a huge market to be tapped: those dreams are really no different than they were 30 or 40 years ago. I remember when I came to China in 1939 as a young boy, one of the books that I read,maybe one of the first books I read in English, was a book by a man named Carl Crow, an American, the title of which was Four Hundred Million Customers. That's significant, because we now are only 40 years later up to a billion. He had this vision of 400 million eager customers lining up for whatever we had to sell. And there are those who feel similarly today. There's another school of thought, the cynics, who take the position that that is really a lot of nonsense; that in fact the lack of purchasing power, the low per capita income in China, and the lack of foreign exchange make all that illusory, and that in fact the Chinese have nothing to sell, and, therefore, nothing to buy anything with, and, therefore, this is all a lot of hot air.

As in most matters, here, the truth and justice lie somewhere in the middle. It is indeed true that we do not have a huge market to be tapped. It is also equally true that there are good opportunities, developed properly and gradually, good opportunities over a period of time for a mutually profitable and growing economic relationship between China and the United States, and of course, also between China and a number of other countries.

The Chinese do have some things to sell. They can develop some of their raw materials - oil, tin, manganese, antimony, coal, and metals of various kinds. They do have an opportunity as light manufacturers to enter the world market. And even though light manufacturing is a sector in which trade problems appear most chronically in the developed countries, with such things as textiles, there are many products and product groups in which the Chinese can expand their share of the market that is available. We visited a bicycle factory in Shanghai. I went there for any number of reasons, but one of them was because bicycles are a good case in point. The United States does not produce bicycles any more in this country, except for some specialty bikes. They are virtually all imported from Taiwan, from Korea, and a number of other places.

Clearly, it is possible for China to begin to compete, and to get into the American market with bicycles made in their country. So I think one could identify a number of product areas in which it is possible for the Chinese to develop exports. Similarly, the Chinese have indicated that they have an attitude of great flexibility with regard to the implementation of a basic goal that they have decided on. And that is really a very, very major change in their thinking.

They are determined to embark on a strategy of economic development for their country, a strategy which is not too dissimilar from the kind of economic development efforts that have been undertaken with varying degrees of success by any number of developing countries throughout the world over the last 20 or 30 years. They have, of course, very special problems, great problems to overcome, with the large number of people on a limited land base, and a variable land base.

Nevertheless, they have said that's what they're going to do. And they have indicated to me their great flexibility in the methods they're willing to use to accomplish this, going all the way from compensation deals where they make a contract with a foreign government to come in to provide capital and to be paid out of the resulting product or raw materials. Oil is a good case in point that emerges from the product to actual joint ventures with equity investments by foreign companies, up to 49 percent, which require, amongst other things, developing the concept of profit, at least for that enterprise, a formula for profit, the sharing of profit, paying for the technology that is involved, paying for the management knowhow that would have to be provided, and presumably an arrangement as to the division of the production that goes to domestic and to export purposes.

Obviously, when you look at the potential for exports, when you look at the flexibility that they're willing to employ, when you look further at the opportunities that exist for certain service-type activities in which the Chinese would capitalize on the resource that they have in greatest abundance, namely people, I think one can see not a huge unlimited amount of resources, but a growing amount of resources available to fund a progressive development program.

In the service industry, two possibilities come to mind. One is the use of China as a base for the assembly of certain products, where raw materials and various components get shipped in, put together, and then re-exported as other countries -- Japan and later Iran, Singapore and Hong Kong have done many years ago. There's no reason why the Chinese could not do that.

And, secondly, of course, such other service industries as the tourist business. I would think that the pent-up demand throughout the world to see the wonders of China is considerable. The beauty, again, is that tourism is a service industry with the emphasis on the word "service." You can provide very good service if you have enough people. The Chinese have them.

Moreover, they are most gracious, polite, and happy people, and do a great job in that area. And the capital requirements to develop the necessary facilities are relatively small in relation to the returns that can be earned.

So, clearly, when you add all this together, there are opportunities, in my judgment. It's not an all or nothing situation.

I could, of course, spend a lot of time discussing other general impressions having to do with the changes that have occurred compared to the period when I lived there, which are tremendous, or as compared to 1973 when I first went back to China, which are also considerable. I will not go into them in detail except to say that there is a much more pragmatic attitude on the part of the government, a sense of great diversity, of hope and ferment among the people, and a great emphasis on raising the level of consumption.

There is, in industrial enterprises, a growing emphasis on rewarding effort, rather than looking at everything in egalitarian terms. Bonuses have reappeared in many of the enterprises. And all of that represents great change. You see it in the way the people are dressed. You see it in the freedom with which they approach you, and talk about some of those things. You see it in many, many different ways.

The interest in the United States and in learning from others, and the expectation of being able to do business with the United States and learning from Americans is quite different than it was five or six years ago. I was always surprised when I first went there -- and I went to a lot of factories in 1973 -- that the Chinese were always proud to show me what they had.

But even though they knew I came there as a chief executive of a large corporation with many factories, whenever I commented about what we did, even if I looked at the production of the same kind of product, there was a polite nod. But there was an apparent lack of interest. I remember going to look at a factory that made grinding machines. After they gave me all the statistics on how many grinding machines they produced and what the sizes and what the problems were; I said, "You know, I make grinding machines in my factories. Let me tell you, let's compare."

The interest level was very low. Today, they're willing to compare and to ask questions and to ask opinions. And that, I think, is a reflection of the different policy that the government has enunciated. It reflects the basic desire of the people to learn and develop their country in this way.

What are the prospects? None of us, of course, can tell that. And, certainly, no one who has made a short trip such as we did would really be wise to speculate about the future. It's clear that there are tremendous problems. China remains a very poor country, a country in which communication between the center and the provinces is by no means perfect.

There is much heterogeneity among the different regions. Orders which are laid down at the center are frequently carried out imperfectly in the outlying regions and the provinces, where the primary emphasis must always be on providing the bare essentials in the way of food and clothing for that large a number of people. Whether or not a process of development once underway could ever be stopped; whether or not a political line of this basic nature once embarked on can ever be reversed; whether or not the people will have the patience to stay the course and to accept the reverses that will be inevitable in this process without political eruptions, no one, of course, knows.

I would say in conclusion that the opportunity for the United States to develop a fruitful relation after so many years of interrruption is considerable. It is made possible by the breakthrough that the President achieved in the normalization of the political relationship. It is, I think, in the interests of both countries that that opportunity be pursued. It is equally, it seems to me, in their interests and in our interests that we do that with a sense of realism and with a sense of proportion and in a gradual way, and that we do not hide difficulties that we have, or problems that we see for ourselves or for the Chinese, so that misunderstandings do not arise, and that we can counsel them in their economic development efforts, based on the experience that we have had over the years in watching that process take place, successfully and otherwise, in many different situations and many different parts of the world.

I think I should stop here, and just take the next 30 minutes or so with questions on this, or any other topic.

QUESTION: Mr. Secretary, you also visited Japan on this trip. And I wondered if you could brief us on the impressions you got from the talks with the Japanese officials there. I am particularly concerned as to whether Japan is going to continue to run these large trade surpluses for apparently as long as they wish, and whether or not they're going to allow the United States to compete in their government procurement?

SECRETARY BLUMENTHAL: We had something like a 24-hour stay in Japan. And I had an opportunity to meet with the Prime Minister, Foreign Minister, and Finance Minister, and other senior ministers responsible for Japan's international economic relations. I detected a change, perhaps subtle, but nevertheless a clear change in the climate on this problem that you referred to, and in the attitude of the political leaders that I met with.

I think that there is a clear commitment on the part of these leaders to bring about a better balance in their external accounts. Japan will always have to run a trade surplus, but certainly cannot and should not run a current account surplus. The current account surplus has been too large because the trade surplus has been very big.

So achieving balance in the current account and substantial reduction of the surplus in the trade account clearly has to be an important goal. We made it very clear that we thought it was absolutely essential that this was going to happen--not on an ad hoc, one-shot basis, but as a permanent policy and that in the absence of that, the risk of unilateral action by the Congress, whether the Administration wanted it or not, was overwhelming. And I think the Japanese are aware of this, and are very concerned about it. It is also true that although they desire to actually effectuate a reduction of this surplus, it is not easy for them in the very short run. There are some short run things that can and must be done. They have to continue to exercise great restraints, voluntary restraints, on the volume of their exports. They can continue and perhaps should continue their program of emergency imports, simply to keep these numbers from getting totally out of hand in the foreseeable and immediate future. And, clearly, the Japanese have to make certain decisions that are still outstanding in the multilateral trade negotiations now being completed with regard to the nature of their tariff cuts, and certain other non-tariff agreements which are in the final throes of negotiation.

But those are immediate issues. In addition, the longer run goal of bringing a better balance into the current account does involve structural adjustments in the Japanese economy --structural adjustments which, essentially, tend to bring about a larger domestic demand, shifting production in Japan to servicing more the domestic market plus the export market, and an opening up of the Japanese economy to foreign competition, particularly manufactured products.

The Japanese have always been free, obviously, in the import of raw materials and foodstuffs, but have continued to be cautious and protectionist, more than we would like, with regard to imports of manufactured products. A structural shift is needed there that, clearly, is not easy for them politically.

We know in our own country such changes are not easily made in a political setting where legislatures have to act and interest groups have to be accommodated. But the Japanese believe and know that it has to be done. I think, therefore, they are working actively on that problem.

The key question is whether they will be able to move fast enough. And I think certainly we left them with very little doubt that speed is of the essence.

QUESTION: Not too long ago, there was a story in the Washington Post that a $2.5 billion deal between Japan and China had been suspended. And I believe it was for plant manufacturing equipment. Do you know anything more about that? And do you think there's any chance the U.S. would be eligible to get that business?

SECRETARY BLUMENTHAL: I read in some of the Japanese papers that there were rumors that the reason it was suspended had to do with the fact I was visiting in China at the time. That describes a degree of influence and power which, even if we had it, and wanted to exercise it, it probably would not work. Of course, it had nothing to do with that visit.

I know only little more than that. The Chinese did point out to me that it was not a cancellation--it was indeed a suspension; that these agreements had been negotiated by several ministries, subject to approval at the top;

that upon review at the top, it had been decided to seek a renegotiation of those contracts with regard to some of the terms and conditions related thereto; that that's what was going to happen, and that they simply didn't like some of the terms.

So whether that is the actual story or not, whether the process of coordination between the different ministries perhaps has not yet been perfectly worked out, and that something slipped between the cracks there, I really don't know. But I'm satisfied that they had, as they put it, the basis for doing so, subject to disapproval, and those negotiations will take place.

QUESTION: Mr. Secretary, in your remarks you implied that the granting of Most Favored Nation treatment to China would require legislation. Does this mean the Administration of which you're a part is going to seek amendments, the Jackson-Vanik Amendment?

SECRETARY BLUMENTHAL: No, we have not made the decision on the Jackson-Vanik Amendment, and how we will deal with it. It does not mean that. What is required is that an agreement between the United States and China be approved by the Chinese. And, of course, the trade agreement has to deal--probably, in Article 1--with the reciprocal treatment of discrimination and non-discrimination of each other's products in each other's markets. And it is in that context that the Congress will get a crack at it. But my statement does not imply a decision one way or the other as to dealing with the action.

QUESTION: Mr. Secretary, in what sense did you have any fears, amongst either the Chinese people or their leaders, about the Soviet Union militarily and in any sense that you might have had of efforts to use us in that relationship?

SECRETARY BLUMENTHAL: I don't know about using us. I really can't comment on that. I think it's clear to anyone who talks to responsible Chinese officials and Chinese government leaders, that their attitude towards the Soviet Union is not positive. They are concerned in a variety of ways. And they have no hesitation about expressing their views on that to any of you who are going to China, I'm sure. That will be made perfectly clear. I can't really go beyond that.

I think they are primarily concerned about establishing a relationship with us which is a political and economic one, and that the economic component of it is critically important.

QUESTION: Mostly, the economics would be involved in science and technology. That's what they really want. There was word about some 110 nations who had recognized China before we did. Therefore, each nation wants to do business with China. How will we fit into that setup, where they all want to do business with China, and to what extent?

SECRETARY BLUMENTHAL: Well, we will fit into it in a way we fit into it in any other foreign market. We will be competing with all those other countries who are in the market for a particular product. Those 110 nations include both large and small, economically strong and not so strong. Obviously the United States, given our size and our resources, is a formidable competitor and probably ranks somewhat above the 110 in terms of the possibilities for competition.

I would say, however, that the United States is interesting to the Chinese for more than just science and technology.

QUESTION: What else do they want?

SECRETARY BLUMENTHAL: I think the United States is interesting to the Chinese because of our management know-how, simply because of our proven ability for knowing how to run things. And I think you'll see Chinese students eventually in business schools in the United States. I was in one meeting where the senior officials got into a very interesting discussion on such questions as dic-counted cash flow and similar esoteric subjects that are of interest to businessmen, but that I'm not sure had been previously discussed at that much length among officials within China. On things of that kind, we can help them a lot. In addition, we're interesting to the Chinese because we are a very large market. Among those 110 countries, there are some that have a market with a population the size of a fraction of just the municipality of Shanghai.

That's different than when you're 220 million people, with a very high per capita income. So that's very important to them.

QUESTION: Mr. Secretary, when you were away in China, there were some disturbing crisis and economic indicators that came out. I wonder if you could tell us, does this mean the Administration's game plan for slowing the economy and checking and decelerating inflation now has to be rethought: Is it not working?

SECRETARY BLUMENTHAL: It's clear that the statistics on inflation are bad. It is equally true that the anti-inflation program -- the thrust of the anti-inflation program, as the President announced it in late October and on November 1 -- is such that one could not reasonably have expected that the inflation statistics to reflect the impact of those programs by January or February.

And the statistics we're talking about are the statistics of January and February. Those programs involve a very stringent fiscal policy, a commensurate tight monetary policy, a strong effort to move the budget as close as possible toward balance and as quickly as possible, and a program of voluntary wage and price guidelines, rather than the institution of controls which would not work, with a strong effort to induce business and labor to cooperate and to comply with those guidelines.

That is the Administration's game plan. That game plan has not been altered. The statistics are bad. They are worse in some ways than we thought. There are reasons for that. Obviously, the food prices have been very high. Some of that has to do with the weather that we've been having. Those things are temporary. We expect them to improve. Obviously, the energy situation is worse than anyone could have expected, given the events in the Middle East and in Iran, and that has added to the problems.

We expect those to be temporary. So I would not say at all that the game plan has to be scrapped. I think it is correct. I think the questions that the President faces have to do with implementing it further in such a way as to bring about, as quickly as possible and as fairly as possible for all the different groups in our country, the desired result, which is the reduction of inflation while maintaining sufficient growth in the economy to avoid high levels of unemployment.

We don't want to solve inflation with high unemployment.

QUESTION: Do you still expect to stay with -- considering the energy problems, the seven and a half inflation rate for the year that was part of the game plan?

SECRETARY BLUMENTHAL: We have not changed our official forecast.

QUESTION: Mr. Secretary, is China going to bring the U. S. out of the recession in 1980?

SECRETARY BLUMENTHAL: No.

QUESTION: No?

SECRETARY BLUMENTHAL: Well, let me explain that. We are not going to say there's going to be a recession in 1980. So when I say no, I say no because the assumption is incorrect, and the conclusion is incorrect because the assumption is incorrect. We expect a slowdown in the economy. What we do not expect is a recession.

Secondly, the development of economic relations and trade relations with China, as I indicated, is going to be a gradual process, and, clearly, will not have a major impact one way or the other on the U. S. economy, whatever the level of economic activity of the United States in 1980.

QUESTION: Mr. Secretary, American businesses, both on the export and import side, might be interested in doing business in China. Of course, they are very interested in opening offices in China. Could you give us your impression on how willing the Chinese will be to permit U. S. companies to open up offices? And what kind of a timetable do you see?

SECRETARY BLUMENTHAL: That's part of the trade agreement that has to be negotiated under the heading of "business facilitation." And we will know a lot more specifically on the subject as the negotiation is pursued. That is a very important element which I expect Secretary Kreps, who is the next Cabinet officer to go to China, to hopefully, or possibly, be able to agree on in the time she has set out. It's obviously very important in order to facilitate the kinds of contracts I have discussed.

My impression from talking to the Chinese is that they are prepared and willing to allow American businessmen to locate there, where that is needed; that the limitations, in my judgment, are not really political; that the limitations, where they exist, are essentially logistic in nature. The Chinese simply do not have facilities in the major places where U. S. businesses would have to locate to put up and accommodate a lot of people. And a lot of preparation will have to be done.

So I suspect it will be a gradual process. If you turn to the press, for example, I gather they have now allowed some of the wire services in, and told them they have to work out of their hotel rooms. There simply is no place for them. And all of that has to be developed and built. It takes time and money.

QUESTION: Did you get the feeling they were working on that; that this is something they're --

SECRETARY BLUMENTHAL: It's on their minds. How actively they've begun implementing it, I don't know.

QUESTION: Mr. Secretary, is there any significance in the fact that the claims agreement you initialed about two years ago is not available in Washington, the text?

SECRETARY BLUMENTHAL: There's no significance to that. That will be made public when it's signed, and we expect it to be signed very shortly.

QUESTION: You mentioned, in terms of trade with China, two sets of possibilities. One, the development of their natural resources in the country: manganese, zinc, and things of this sort. And secondly, light industry such as textiles. So the two points of my question are with regard to the development of natural resources. Is the government prepared to support the investment, the money that would be required to bring the Chinese metals to the market? And, secondly, with regard to textiles and other light industries, I tend to think there was considerable concern for the present trade and the disproportion that the impact that they might have on some segments of the population, on account of the fact you do have countries such as China that can only furnish us goods in certain categories which happen to be the areas in which minorities and women are disproportionate to employees.

I wonder to exactly what extent the Administration has a program that will be effective in terms of lifting the harm in that area, and what do you propose to be done?

SECRETARY BLUMENTHAL: Let me deal with both of those questions. In the first one, you asked if the government was willing to support these investments. You mean, the U. S. government?

QUESTION: Yes, guarantees or whatnot, because it's a considerable amount of money.

SECRETARY BLUMENTHAL: At the moment, the U. S. government has no legal authority to provide any of those resources. The only way we could -- and that would be in a very limited way -- would be through Ex-Im Bank credits. Essentially, the raw material resources would have to be done through private arrangements. The obvious and most immediate case is oil. I do not have the impression from talking to the large number of oil companies with whom the Chinese have had preliminary discussions, all of whom have been in to see me, that that's going to be a problem. The question is, what kind of a contract is negotiated. But the large oil companies are quite willing to make arrangements to provide the resources, providing they can get a kind of contract that allows them to have access to the product that emerges. They're willing to take the risks inherent in this.

So the answer is, don't look for the U.S. government to provide a lot of resources. And, beyond that, I don't think it will be necessary anyway.

As to the second question, I'll try to address myself a little bit to that. Obviously, we have to be very honest with them, and let me tell you, we are being very honest with them. Certainly, Ambassador Strauss, in his negotiations on the textile problem, is being honest and saying we have bilateral agreements under the Multi-Fiber Arrangement in effect with many countries under which the amounts, or the quantities of textiles, imported into the United States, are limited by import ceilings on many categories of textile and apparel products.

I don't know how many controlled categories there are now. Years ago there used to be 64 controlled cotton categories. Now there are over 100 such categories covering cotton, wool and man-made fibers products. We have told the Chinese that they're going to have to fit into this structure. The amount of square yard equivalent lengths imported into the United States has risen steadily over the past 20 years. As the total market in the United States for textiles has risen, so has the percentage of imports to the domestic market. There is no reason, however, why it is not possible to develop a scheme -- even for textiles which are in a most sensitive category -- that would provide reasonable opportunity for Chinese textile exports. It's not going to be large. That's not what is going to fund the development requirements of China. But there's no reason why China has to be excluded from the U.S. textile market.

The problem of textiles is really an overall problem of the U.S. economy. Providing reasonable Chinese entry into this market is not going to affect it one way or another, because we have some global notions in mind of what we can accept. To answer the second part of that question, we have, of course, a variety of programs other than the MFA which provide adjustment assistance to workers, minorities, women, or other workers, such as older workers, who are adversely affected by shifts away from the production of such products.

But basically, it has been, I think, the policy of the U.S. government over the years, under various Administrations, to insure that the U.S. market for domestically produced textiles remains at appropriate levels within the United States. There are similar cases for other labor-intensive goods.

On the other hand, I picked out the example of bicycles earlier, because I thought here was a good case where we don't have that problem, because for all practical purposes there isn't a production base in the United States at this point.

QUESTION: Can you indicate the amount of progress that China has made on drafting a commercial code?

SECRETARY BLUMENTHAL: Really, I don't know. I think they have begun. They're working on it, but I don't know the details of that, or just how far along they are.

QUESTION: Isn't it true that in order to grant China these export-import loans that they need so badly, we must first give them Most Favored Nation status, which requires Congressional action? I wanted to ask you really what your candid assessment is, as to whether Congress will give them the Most Favored Nation status. And if they do not get it, do you have any plans to suggest any other ways, legislatively perhaps, that they can get these export-import loans?

SECRETARY BLUMENTHAL: The granting of Export-Import Bank credits is restricted by two pieces of legislation. One is the Jackson-Vanik Amendment. The other one is the Stephenson Amendment. We have to deal with both of those in an effort to extend official credit. Credits will not be part of a trade agreement, but there will be a subsequent consideration of that, I'm sure.

What the chances of success are, I cannot tell you, candidly or otherwise. I really don't know. I think that there is a general recognition from Congress that it is logical and proper for us to try to work out a way to do that now that political normalization has been achieved. And I am not pessimistic about the possibility that something can be worked out. I'm optimistic. That's why I thought it was proper for me to indicate to them that was our intention to do so. And I think one can optimisticall expect that it can be worked out. But I can't guarantee it.

QUESTION: You haven't talked at all about your visit to Shanghai. I'm interested in hearing how you compare it to the 40's, when you left, and to 1973, when you went.

SECRETARY BLUMENTHAL: I could take a long time to talk about that. Obviously, apart from the fact it was a very important personal experience for me, in comparing it to the period which I lived there I would say all the obvious things, only perhaps I would say them with a lot of feeling. Shanghai was truly a city in which there were not laws. It was completely an open city. It was a place in which anything could be secured if you had the price for it, and a place in which the injustices of man toward fellow man were more graphically evident for all to see, than any other place that I've ever visited.

It was a place that was rampant with disease. Hundreds of people were dying every day and there was no money for the relatives to bury them. Infants were abandoned at birth. All manners of disease; cats, dogs; rabies; prostitution; drugs; gambling; you name it. I think you get the general picture. Being "shanghaied" really has some meaning. It was a refuge. It was the last refuge for adventurers, crooks, and all manner of odd types from all over the world. That's all gone.

If there are adventurers or crooks, they're not out in the open for anyone to see. There are not cats and dogs for anyone to see. There is not evidence of hunger. I did not see anywhere this time or in 1973 any evidence of any person who was not reasonable well fed. I did not literally see anyone in rags, in tattered clothes. This was wintertime when I was there; in 1973 it was summer. People had decent clothes to wear. They were much more colorful now than they were in 1973, but they were adequate and comfortable in both instances. I think the people living in the streets, the people living in shacks, are gone. The people live poorly by our standards. They live in very crowded circumstances and in what clearly would be sub-standard housing. The housing in our slums in the worst areas of our cities is pretty good housing by the standards of Shanghai and other cities in China.

But people have a roof over their heads. And although it's very inadequate for them, for many of them, it is an improvement. One great sense that I had, particularly this time, is of tremendous overpopulation -- a sense of people, people, people everywhere, and not a place to step. You literally can't walk on the sidewalks. You have to walk out in the middle of the streets. The sidewalks are so crowded.

Now, I'm told that some of that is due to people coming into the city to do their shopping. But whatever the reason is, you just can't get away from people. If you want to know what overcrowding is and what a population problem really is, or what it's going to be like, walk around the streets of Shanghai. So you have that sense of 400 million people having gone to a billion, and you feel it in China today. There's a sense of orderliness and civic obedience. People line up. People line up for buses. It's incredible for anyone who grew up in China to see that -- people getting into lines to climb onto buses, where before they'd kill each other to get on buses. So at that level, obviously, it's a place which for virtually all of the Chinese people is a much better place to live.

QUESTION: Mr. Secretary, this is due to the tremendous discipline that has been instilled through the past 30 years under the Mao regime. Do you see anything slipping there as we go along?

SECRETARY BLUMENTHAL: It's still there, and I can't really tell whether it will change. At the moment, it's there.

QUESTION: There are great number of students coming in huge numbers and will come to study here. What are the implications that that will have for controls?

SECRETARY BLUMENTHAL: My impression is that the number of students that will come here is not huge. I heard yesterday at the Chinese Embassy that the expected some 500. So it's going to be in the hundreds or maybe low thousands, but not a very large number. Obviously, one of the great problems is that there has been a tremendous gap in China with the universities and colleges not functioning for practical purposes for quite a while. And they have to catch up with that, and that's another great problem in pursuing their development program. These people will work hard, as Chinese students tend to do, and try to learn a lot. They'll be very busy. Obviously, it will impact, because they will come back with new ideas. But I don't think it will have a vast impact on China as a country. The numbers are much too few.

MS. SULLIVAN: I think we have time for one more question.

QUESTION: Mr. Secretary, there seems to be a growing interest in Congress about the creation of a Department of Trade. Do you foresee this as a possibility? And what do you think of that?

SECRETARY BLUMENTHAL: It's certainly a possibility, because there is considerable interest in it in Congress. It's not a new question. It's been considered over the years. There is no Administration position on this. So I am somewhat restricted in what I could say to you. I have wrestled with this problem on and off and on in a previous incarnation -- the last time I was in government. I think it's not easy in our system in the United States to set up a separate Department of Trade.

And one has to be clear as to what one is trying to establish. If you want a Department of Trade for the purpose of centralizing and promoting the development of exports, that's one thing. If you want to set up a Department of Trade, that is analogous to what the Japanese have under their MITI, Ministry of International Trade and Industries, you have a different kind of thing. And generally speaking, it has been felt that that kind of department would not fit into the American structure very well. So I see some problems.

I don't know what position we will take on it. It's still being discussed. And I think the question of goals and definition is a very important one.

MS. SULLIVAN: Thank you very much.

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

FOR RELEASE AT 4:00 P.M. March 20, 1979

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $6,000 million, to be issued March 29, 1979. This offering will result in a pay-down for the Treasury of about $200 million as the maturing bills are outstanding in the amount of $6,208 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $3,000 million, representing an additional amount of bills dated December 28, 1978, and to mature June 28, 1979 (CUSIP No. 912793 Z3 3), originally issued in the amount of $2,909 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,000 million to be dated March 29, 1979, and to mature September 27, 1979 (CUSIP No. 912793 2N 5).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing March 29, 1979. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,362 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. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, March 26, 1979. 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-1469

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. 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 $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.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on March 29, 1979, , in cash or other immediately available funds or in Treasury bills maturing March 29, 1979. 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 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, 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 RELEASE AT 1:30 P.M. MARCH 20, 1979

TREASURY POSTPONES AUCTION OF
TWO YEAR NOTES

The Treasury today announced it was postponing the auction of $2,880 million of 2-year notes originally scheduled for Wednesday, March 21, 1979. This postponement is necessary because Congressional action on legislation to raise the temporary debt limit to allow delivery of the new 2-year notes is not at this time assured.

Interested investors are advised to look for notice of any rescheduling of this auction in the financial press or to contact their local Federal Reserve Bank for such information.

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B-1470

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

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.
Thursday, March 22, 1979

STATEMENT OF EMIL M. SUNLEY,
DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY,
BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE
HOUSE WAYS AND MEANS COMMITTEE
ON THE INVESTMENT TAX CREDIT

Mr. Chairman and Members of this Distinguished Committee:

I am pleased to appear before you today to discuss the investment tax credit. This credit, which will reduce Federal receipts by over $15 billion in fiscal year 1980, is one of the largest tax expenditures of the Federal Government. It is, therefore, important that Congress periodically reexamine its impact on the economy and consider how its efficiency and fairness might be improved. I am not today going to recommend changes in the credit. A major thrust of my testimony is that the credit should not be turned on and off as a countercyclical policy but should be viewed as a stable feature of our tax law. I will, however, discuss some of the pros and cons of making several changes in the structure of the credit.

The investment credit is equal to 10 percent of qualified investment. Assets eligible for the investment credit include most machinery and equipment, but generally do not include structures. Eligible equipment is restricted to depreciable property with a useful life of 3 years or more.

The investment credit can be regarded as similar to a cash grant to purchasers of certain capital equipment, with certain peculiar rules related to the fact that it is cleared -- that is, paid and distributed -- through the tax system. The credit, however, differs in significant ways from an across-the-board 10 percent subsidy for new machinery and equipment.

- The credit is not refundable. If tax liability exceeds $25,000, the credit is limited to $25,000 plus 60 percent of tax liability in excess of $25,000. In 1982, after a transition period, the tax liability limitation will be increased to 90 percent. Prior to 1978, the credit beyond the first $25,000 was limited to 50 percent of tax liability. Unused credits may be carried back 3 years against prior tax liability and carried over for 7 years. Treasury estimates that credits claimed by corporations were about 68 percent of the tentative credits earned in any year when the 50 percent limit was in effect. The carryback and carry-over provisions enabled about 85 percent of these tentative credits ultimately to be used. The 90 percent limit will increase to about 78 percent the fraction of credits claimed by corporations in the year they are earned.

- The credit is reduced for short-lived assets. Investment qualified for the credit is two-thirds of the cost of the asset if the useful life is at least 5 but less than 7 years and is one-third of the cost of the asset if the useful life is at least 3 but less than 5 years. On the average, the short-lived property rules reduce the allowable amount of the investment credit by 10 to 15 percent.

- When an asset is purchased, its expected life is used in determining the fraction of the asset cost for the credit. Upon disposition of the asset, if actual life is less than the expected useful life any excess investment credits claimed in a prior year are recaptured.

- The investment credit claimed does not reduce the cost basis used for depreciation. Even though the Government has, in effect, paid for 10 percent of the investment, 100 percent of the purchase price may be depreciated. The tax savings from this additional depreciation to a corporation in the 46 percent bracket is equivalent, for an asset of average life (12 years) to a 29 percent increase in the investment credit from 10 percent to 12.9 percent.

In evaluating the investment credit, some fundamental questions should be asked:

- Should we subsidize the purchase of machinery and equipment?
- Does the investment credit substantially increase investment in machinery and equipment? Does it increase total investment?
- Are there more effective ways of providing the same subsidy?
- Does the investment credit create unintended or undesirable side effects? Some that have been mentioned are: 1) discrimination against small firms and rapidly growing firms because credit is limited to 90 percent of tax liability, 2) encouragement of leasing, 3) discrimination among investments with different useful lives, and 4) increased opportunities for tax shelters.

The main purpose of the investment credit is to increase permanently the fraction of GNP allocated to savings and investment. To the extent it accomplishes this, it increases the rate of growth immediately, and provides a permanent increase in the amount of capital per worker, productivity, and real wages.

A second objective of the investment credit is to increase the proportion of total private savings allocated to investment in machinery and equipment. The credit stimulates capital formation in major manufacturing industries and also furthers innovation by accelerating the installation of new capital embodying the most recent technological advances. The credit has not been extended to most real estate since this industry benefits from other significant tax preferences.

Impact on Investment

Any evaluation of the investment credit must consider how much it promotes these two objectives -- increasing the overall rate of capital formation and allocating a larger share of national savings to investment in machinery and equipment.

The investment credit operates by providing an incentive for firms to purchase new machinery and equipment. To finance these increased purchases, firms must acquire more funds, either through higher retained earnings, new equity issues, or increased borrowing. As firms bid for the scarce supply of savings generated in the economy, the return on savings is increased. This encourages an increased flow of savings at any level of income. In order for the rate of capital formation to increase, these increased savings must be forthcoming to match the increase in investment demand.

The net effect on total investment, therefore, depends not only on the stimulus to investment demand but also on the responsiveness of private savings to increased rates of return. It also matters how the revenue cost of the credit is financed, by the Federal Government. If it is financed by a larger deficit, the resulting increase in government borrowing will reduce savings elsewhere; if it is financed by increases in taxes on labor income or consumption or by a reduction in Government spending on current period goods and services, there will be an increase in savings at the expense of current consumption.

Economic theory strongly supports a conclusion that the investment credit increases the rate of capital formation. However, the size of its impact relative to the revenue loss is in dispute. A review of econometric studies reveals considerable uncertainty about the impact of the investment credit and of other capital formation incentives on total savings and investment.

A number of econometric studies have estimated the impact of the investment credit, and of other tax incentives to capital formation, on investment. The findings of this research are highly varied because investigators have used different methods and assumptions.

Early research by Professors Robert Hall and Dale Jorgenson found that enactment of the investment tax credit in 1962 had a powerful effect on investment demand in the 1960s. The Hall and Jorgenson study focused on the role of the credit in increasing the demand for capital by lowering the price of capital services. Their theoretical model used a formulation of the demand for capital that assumed that a 10 percent reduction in the price of capital services -- which could be achieved by a 10 percent refundable investment credit with a basis adjustment for depreciation -- would increase in the long run the stock of capital demanded by 10 percent. Subsequent investigators used more flexible assumptions that allowed them to estimate the impact of the investment credit on the long-run demand for capital and that, to varying degrees, stressed other factors as determinants of investment, such as corporate cash flow, expected future sales and financial market variables. The estimated long-run impact of the investment credit on the demand for capital in these studies is highly variable. Professor Charles Bischoff, for example, estimated that a 10 percent reduction in the cost of capital would also raise the demand for capital by 10 percent, while Professor Robert Coen estimated that such a reduction in the cost of capital would increase the demand for capital by only 3 percent. Professor Robert Eisner's estimates of the impact on capital formation of the investment credit are even smaller.

Studies that focus on investment demand alone ignore an important potential constraint on the effects of the investment credit -- the need for additional private savings to finance increased investment. If more private savings are forthcoming only if the after-tax yield from savings increases, then the resulting increase in interst rates will choke off some of the potential increase in investment demand. Professors Paul Taubman and Terence Wales have explored this issue, estimating that the need for higher interest rates to bring forth additional savings, reduces the impact of the investment credit to about one-fourth of the estimated increase in demand for capital. This issue -- the extent to which additional savings will be forthcoming to finance an increased demand for capital -- remains an important source of differences in estimating the impact of capital formation incentives such as the investment credit.

While the effect on total capital formation of the investment credit is uncertain, available evidence shows that the sectoral impact is strong. By changing the <u>relative rewards</u> to different uses of savings, the investment credit increases the share of total investment allocated to qualified machinery and equipment and reduces the share allocated to other sectors, especially real estate. The relatively strong impact of the credit on investment in machinery and equipment has been shown in many studies, beginning with the original paper by Professors Hall and Jorgenson. In a 1971 paper, Henry Aaron, Frank Russek and Neil Singer provided evidence from econometric simulations that removal of the investment credit in 1969 caused a significant shift of new investment from machinery and equipment to real estate, more than offsetting the effects of tightening real estate depreciation and recapture rules. Their findings are consistent with what we would expect in an economy where investors are seeking the highest after-tax return on their dollars and efficient financial markets facilitate movements of funds between different sectors.

Countercyclical Policy

One frequently used argument that is not an appropriate goal for the investment credit is short-run economic stimulation. It is true that an increase in the investment credit by itself increases the demand for investment and therefore could increase employment and promote recovery at a time when the economy is depressed. However, it should be recognized that any increase in the deficit can increase total demand in the economy and, if there is unemployment, create additional jobs. If fiscal stimulus is needed, individual tax cuts may well be superior to business tax cuts or changes in the investment credit or other expenditure programs because the individual tax cuts are probably translated into additional spending with shorter lags and less leakage into savings.

Moreover, changes in the investment credit are a very poor tool of countercyclical policy. Econometric studies have found a strong effect on aggregate demand from the investment credit. However, because capital spending plans are frequently made well in advance of actual expenditures and are difficult to change once set in motion, the investment credit impacts with a very long time lag. In the past, changes in the credit have often been poorly timed. The credit was temporarily suspended in 1966 -- just before the 1966-67 pause in economic growth. It was restored in 1967 -- just prior to the inflationary boom of the late 1960's. It was removed in 1969 -- just before the 1970 recession. It was restored again in 1971 -- shortly preceeding the overheating of the economy in 1972 and 1973. In all of these cases, the change in the investment credit had its strongest effect on aggregate demand at the wrong time; it was expansionary during an upswing and contractionary during a slump. Of course, this need not always result from a change in the credit, but the long-time lag between enactment of a change and its effect on investment demand make the investment tax credit an imprecise and uncertain tool of countercyclical policy.

Also, changes in the credit raise problems of determining appropriate transitional rules. For example, when the credit is suspended or reinstated, should the credit remain available for machinery and equipment placed in service before the effective date or to machinery and equipment ordered before the effective date? In the past, determination of how new rules should apply has been different for suspension of the credit than for reinstatement. When the credit was repealed in 1969, taxpayers could still receive credit for eligible property subject to a binding commitment before the change was first proposed by the Administration, as long as the actual delivery of the property occurred before the end of 1975. In contrast, the restoration of the credit in 1971 was made effective for property acquired or completed after the announcement date, August 15, 1971, or for property on which construction was begun or an order placed between March 31, 1971 and August 15, 1971. Further changes in the credit would require additional detailed rules relating timing of different stages of the acquisition process.

In summary, changes in the investment credit rate should not be considered in terms of short-run stabilization objectives, but for its long-run effect on capital formation and on promotion of the best use of available private savings. It is worthwhile for Congress to review periodically the effectiveness of the credit in achieving these long-run objectives; future changes in the investment credit should be based on these considerations and not, as has sometimes occurred in the past, on short-run economic forecasts.

Structural Issues

Introduction. Having reviewed the reasons for subsidizing the purchase of machinery and equipment by private firms, I now want to turn to the consequences of using the tax system as the mechanism for paying the subsidy, and what structural changes in the credit might be considered.

It is useful first to consider the simplest form of a subsidy to machinery and equipment: a direct grant program. Congress could encourage the purchase of machinery and equipment by allocating funds to the Department of Commerce, which would make payments to firms equal to 10 percent of the value of any qualified equipment purchased, or placed on order, after a specified effective date. Commerce would do this without regard to the tax posture of the recipient. If this type of subsidy were enacted, the normal method of tax treatment would be to regard the grant as a Government contribution to capital. The recipient's depreciable basis would not include the Government's contribution. The subsidy rate could be adjusted to make this type of cash grant program provide the same total subsidy to business firms as the investment credit. However, the distribution among firms of benefits received would be different than under current law. Firms that currently are not able to make full use of the credit or that invest heavily in short-lived property would be net gainers.

The investment tax credit could be altered to conform exactly to this direct subsidy program. This equivalence could be achieved by making the investment credit refundable, requiring a downward basis adjustment for the amount of credit received, and repealing the short-lived property rules. The only major difference between this type of investment credit and a direct expenditure program is that the tax credit would be under the jurisdiction of the congressional tax committees rather than appropriation and authorization committees and would not appear in the budget of any agency. Thus, with a tax credit, total Federal expenditures appear to be smaller. However, the effect on the deficit and on the amount of incentive provided for investment in machinery and equipment would be the same as an equivalent direct subsidy program.

This comparison illustrates that the present credit can be viewed as a direct expenditure program which is distributed through the income tax system, and which has some peculiar features because the income tax system is used. These special features create complexities in administration, anomalies for tax policy, and some unintended side effects. For this reason, their rationale and consequences deserve examination.

Nonrefundability

The most important of these provisions is the nonrefundability of the credit and its limit to 90 percent of all tax liability in excess of $25,000. This provision is important not only for its direct effects, but because it creates a need for other provisions -- the carryover and carryback rules and the inclusion of the credit in the depreciable basis -- that would not be likely features of an expenditure program to promote investment.

There are two rationales for nonrefundability of the investment credit -- one cosmetic and one substantive. The cosmetic reason is that, without the tax liability limit, it would appear that some large corporations are paying no tax or, in some cases, negative taxes. This issue of providing special tax relief for corporations would not arise if direct subsidies were used. Data on farm subsidy payments, for example, are not used to show that wealthy farmers pay no tax, and people do not consider linking eligibility to receive farm subsidies to a farmer's tax liability.

The substantive justification for the tax liability limitation relates to the numerous other subsidies being cleared through the tax system. These other tax subsidies should be taken into account. An example, as noted before, is offsetting the highly favorable tax treatment of real estate by restricting the investment credit to machinery and equipment. Restricting the credit by tax liability tends to limit its availability to other sectors receiving other tax subsidies -- for example, mining -- and thus tends to even out the total level of subsidies distributed in connection with any particular kind of activity. But the levelling out effect is haphazard because it depends in each case upon the mix of business in a particular company. As a result, it may encourage business combinations and mergers that are otherwise undesirable.

The denial of a portion of the investment tax credit to firms with low tax liability may have adverse consequences. Low tax liability is not necessarily the result of an abundance of tax subsidies. Companies experiencing temporary losses, companies making large expansions in capacity, and companies generally experiencing rapid growth frequently may not have sufficient tax liability to claim the full credit in the current period even though the income that will be earned from current period investment will generate high tax liability in the future. There is no reason to limit or deny the credit received by these companies.

The adverse consequences of nonrefundability are mitigated to some extent by provisions for the carryback and carryover of excess credits. In addition, firms with low current period tax liability can lease machinery and equipment from firms with sufficient tax liability to utilize fully the investment credit. By charging lower rental payments the benefits of the investment credit may be passed through by the lessor to the lessee. The lessor, however, usually has to be paid a "commission," and this commission represents an economic cost. There is no particular reason why the tax law should encourage leasing transactions where private parties, not influenced by tax considerations, would not consider leasing a convenient and low cost method of financing assets.

Carryback and Carryover Rules

Provisions allowing tentative investment credits to be carried back 3 years and carried forward 7 years to offset past and future taxes mitigate the most severe consequences of nonrefundability by permitting new and growing firms and firms with temporarily depressed earnings to use the credit. But they are not complete remedies for those consequences because a credit received today is worth substantially more than one which will not be received until 7 years from today. Equally seriously, these provisions, increase the complexity of the law. Their most serious consequence is to make it much more difficult to write a simple law -- however desirable -- which would exclude the credit from depreciable basis. Because of the tax liability limitations on the credit, even with carryovers we do not generally know if and when the credit will be used. Therefore, a basis adjustment for depreciation would necessitate recomputing the depreciable basis when credits expire at the end of the carryover period. This type of computation is possible, but would severely complicate depreciation accounting.

Basis Adjustment for Depreciation

Normally, firms would not be permitted to depreciate against taxable income the value of a cash subsidy received from the Government. However, under present law, the tax credit is included in the basis for tax depreciation even though it represents the portion of the asset's cost paid for by the Government, not the firm.

Including the credit in allowable depreciation raises the effective rate of investment credit by providing firms with extra tax deductions. In effect, the benefit of a $100 investment credit received by a taxpayer who purchases a $1,000 machine can be viewed as divided into two pieces. The first piece -- the credit itself -- reduces the cost of the asset by 10 percent for all taxpayers. The second piece is the $100 of additional tax depreciation in excess of the taxpayers' investment over the life of the asset. This piece is worth more to taxpayers in high tax brackets and is more valuable for short-lived assets because the benefits of tax depreciation for those assets are received sooner.

Because the extra depreciation is worth more to high bracket taxpayers, such taxpayers receive more encouragement to invest in qualified machinery and equipment than low bracket taxpayers. As in other situations where income is improperly measured, encouragement is provided for tax shelter formation. One way this has been manifested in the past is through leasing transactions that enable high bracket individual investors not actually using the qualified equipment to benefit from the credit. However, a 1971 provision limiting investment credits available to noncorporate lessors has substantially curbed this source of tax shelter abuse.

Reduction of Credit for Short-lived Assets

The extra benefit to short-lived assets provided by additional depreciation is offset by allowing only one-third of the credit for assets with a life of 3 to 5 years and two-thirds of the credit for assets with a life of 5 to 7 years. The combined effect of these two provisions -- the absence of a basis adjustment and the statutory limit on the credit for short-lived assets -- is that the investment credit provides the greatest subsidy for assets with lives of 7 years. Longer lived assets and shorter lived assets receive smaller effective subsidy rates. Requiring a basis adjustment for the investment credit would reduce the discrimination against long-lived assets and therefore reduce the necessity for statutory restrictions for short-lived assets. It would also permit repeal of the recapture rules and permit a uniform credit for both short and long-lived assets.

Recapture

The determination of asset life for the purpose of computing creditable investment is generally performed when the asset is placed in service. In the event of early disposition, the credit is recomputed if the limitations on short-lived assets apply to the actual asset life. Any difference between the investment credit claimed and the investment credit that would have been claimed if the actual life were used is recaptured.

Recapture provisions are an additional source of complexity in the investment credit. (Commissioner Kurtz will describe this complexity in his testimony.) Recapture would not be an issue if the investment credit were not limited for short-lived assets; but this requires a basis adjustment.

The 1974 Treasury Proposals

This discussion has illustrated some of the complexities and problems that have arisen from subsidizing the purchase of capital equipment through the tax system. I have mentioned how it is possible to design an investment tax credit exactly equivalent to a cash grant subsidy that would reduce these complexities and make the subsidy more neutral. The Treasury Department's 1974 proposal for restructuring the investment credit would have accomplished this objective. Along with increasing the rate of investment credit from its then 7 percent rate to the current 10 percent rate, the Treasury proposed to:

° Eliminate the limitations based on useful life, so that all property with useful life of more than 3 years would qualify for the credit.

° Provide for full refundability of the investment credit with a 3-year phase-in.

° Require the taxpayer to reduce the cost basis of qualifying property for depreciation by the amount of the investment tax credit.

Pros and Cons of Restructuring

Restructuring the credit, as proposed by the Treasury in 1974, would eliminate many of the problems of the current law. It would provide for an equal reduction in the cost to private firms of all assets with a life over 3 years. By not providing any tax-exempt income, it would be equally valuable to taxpayers in all income brackets. It would eliminate the need for complex carryover and carryback provisions and for recapture. Taxpayers would not engage in leasing transactions solely for tax purposes. In conjunction with the other changes, the credit rate could be altered to provide the same overall incentive to investment.

Although this type of restructuring has advantages and may indicate how the investment credit should have been designed originally, there are problems in changing current law. First, while the credit rate could be adjusted to maintain the same overall incentive, the benefits to some firms would increase and to others would decrease. Raising the credit rate to prevent major losses to any industry from the change would require a significant increase in the average investment incentive and would result in a large revenue loss to the Treasury. In addition, even if the average incentive to investment is unchanged, the restructuring proposed in 1974 would cause a significant immediate revenue loss to the Treasury. The revenue loss from increasing the rate of the credit would be incurred immediately while the revenue gains from requiring a basis adjustment would accrue over the life of the asset. Thus, even if the present value of revenue to Treasury is unchanged -- the higher future revenue offsetting the immediate lost revenue -- the deficit would be increased in the short run from the restructuring proposals.

Conclusion

The investment tax credit is a major tax expenditure program designed to increase investment, particularly in machinery and equipment. Available econometric research shows that it does promote increased investment, but its cost effectiveness at achieving this objective is still in dispute.

The investment credit is not a reliable tool of countercyclical policy. Changes in the investment credit should be considered only in the context of overall policies to stimulate long-run capital formation, and not to offset a temporarily overheated or depressed economy.

The investment credit could be made more similar to a direct expenditure program by allowing refundability, requiring a basis adjustment, and permitting the same credit rate for all asset lives. These changes if adopted as a package, would reduce the bias against short-lived and very long-lived assets in the present credit, reduce tax shelter problems, end the artificial encouragement to leasing, and eliminate the necessity for complex carryover rules. On the other hand, such a restructuring of the investment credit would be difficult to accomplish without large short run, or even permanent revenue losses.

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ederal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-566-2615

FOR IMMEDIATE RELEASE March 20, 1979

FEDERAL FINANCING BANK ACTIVITY

Roland H. Cook, Secretary, Federal Financing Bank (FFB), announced the following activity for February 1-28, 1979.

New Program

On February 7, the FFB entered into an agreement with the Secretary of Housing and Urban Development (HUD) whereby HUD agrees to guarantee and the FFB agrees to purchase obligations issued by local government units pursuant to Section 108 of the Housing and Community Development Act of 1974, as amended. Proceeds from the sale of these obligations are used to finance the purchase of real property by local governments, or the rehabilitation of real property already owned by local governments. The FFB commitment is in the amount of $500 million and expires September 30, 1979.

Guaranteed Lending

FFB provided Western Union Space Communications, Inc., with $18,675,000 on February 1, and $7,700,000 on February 20 at annual interest rates of 9.378% and 9.553%, respectively. These advances mature October 1, 1989, and are part of 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, which guarantees repayment of the advances.

Under notes guaranteed by the Rural Electrification Administration, FFB advanced a total of $55,211,000.00 to 19 rural electric and telephone systems.

FFB made 27 advances on existing loans to 15 foreign governments totalling $28,156,519.61. These advances are guaranteed by the Department of Defense under the Arms Export Control Act.

During February, FFB purchased the following General Services Administration participation certificates:

Series	Date	Amount	Maturity	Interest Rate
K-016	2/1	$1,565,679.00	7/15/04	9.057%
M-042	2/13	4,159,479.58	7/31/03	9.223%
L-051	2/16	750,521.25	11/15/04	9.226%

B-1472

On February 21, FFB purchased a total of $2,315,000 in debentures issued by 8 small business investment companies. These debentures are guaranteed by the Small Business Administration, mature in 3, 5, 7 and 10 years, and carry interest rates of 9.465%, 9.315%, 9.295% and 9.285%, respectively.

Department of Transportation Guarantees

On February 16, FFB entered into two agreements with the Secretary of the Department of Transportation (DOT) acting through the Administrator of the Federal Railroad Administration (FRA), whereby FFB agrees to advance funds to the Chicago and North Western Transportation Company (C&NW). The agreement committing $6,192,406 (511-78-2) will mature May 1, 1986, and the agreement committing $21,193,315 (511-78-3) will mature November 1, 1990. These are the second and third agreements under which FFB has committed to lend funds to C&NW. On March 8, 1978, FFB agreed to lend $17.6 million to C&NW. This agreement (511-78-1) will mature March 1, 1989. Funds advanced under these agreements are guaranteed by DOT under Section 511 of the Railroad Revitalization and Regulatory Reform Act of 1976.

Under these and other notes guaranteed by DOT pursuant to Section 511, FFB lent funds to the following railroads during February:

	Date	Amount	Maturity	Interest Rate
Trustee of Chicago, Rock Island	2/2	$2,112,393.00	12/10/93	9.345% an.
Chicago & North Western 511-78-1	2/13	499,727.00	3/1/89	9.539% an.
Trustee of The Milwaukee Road	2/14	3,756,422.00	11/15/91	9.508% an.
Chicago & North Western 511-78-2	2/23	876,118.00	5/1/86	9.668% an.
Chicago & North Western 511-78-3	2/27	534,935.00	11/1/90	9.403% s/a

On February 1, FFB lent $5.1 million to the Trustee of The Milwaukee Road. The advance matures April 20, 1988, and carries an interest rate of 9.115%. This sum represents the total amount committed by FFB to The Milwaukee Road under an April 20, 1978 Guarantee Agreement between FFB and DOT. The repayment of these funds is guaranteed by DOT pursuant to Section 3 of the Emergency Rail Services Act of 1970.

On February 23, FFB lent $468,400.00 to the United States Railway Association under their Note #8. This advance is guaranteed by the Department of Transportation, matures April 30, 1979, and carries an interest rate of 9.874%.

On February 16, the National Railroad Passenger Corp. (Amtrak) extended the maturity on the $66 million outstanding under their Note #17 until April 2, 1979. This maturity extension is provided for under the terms of the Note, and carries an interest rate of 9.725%. During February, Amtrak also borrowed the following amounts from FFB under Notes guaranteed by DOT:

Note #	Date	Amount	Maturity	Interest Rate
17	2/1	$ 8,000,000.00	2/16/79	9.749%
17	2/6	10,000,000.00	2/16/79	9.66%
17	2/14	7,500,000.00	2/16/79	9.76%
17	2/15	6,000,000.00	2/16/79	9.728%
17	2/16	5,000,000.00	4/2/79	9.725%
17	2/21	6,608,801.00	4/2/79	9.856%
18	2/21	3,391,199.00	3/30/79	9.856%
18	2/22	5,000,000.00	3/30/79	9.888%

Agency Issuers

The Tennessee Valley Authority (TVA) sold FFB a $15 million Note on February 14 and a $740 million Note on February 28. Both notes mature May 31, 1979, and carry interest rates of 9.811% and 9.957%, respectively. Of the total $755 million financed, $685 million refunded maturing securities, and $70 million raised new cash.

On February 2, FFB purchased a $715 million Certificate of Beneficial Ownership (CBO) from the Farmers Home Administration. This CBO will mature February 2, 1984, and carries an annual interest rate of 9.333%.

In its weekly short-term FFB borrowings, the Student Loan Marketing Association (SLMA), a federally-chartered private corporation which borrows under a Department of Health, Education and Welfare guarantee, refunded $300 million in maturing securities and raised $65 million in new cash. FFB holdings of SLMA notes total $980 million.

FFB Holdings

As of February 28, 1979, FFB holdings totalled $53.2 billion. FFB Holdings and Activity Tables are attached.

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FEDERAL FINANCING BANK HOLDINGS
(in millions of dollars)

February 1979

Program	February 28, 1979	January 31, 1979	Net Change (2/1/79-2/28/79)	Net Change-FY 1979 (10/1/78-2/28/79)
On-Budget Agency Debt				
Tennessee Valley Authority	$ 5,865.0	$ 5,795.0	$ 70.0	$ 645.0
Export-Import Bank	6,898.3	6,898.3	-0-	330.0
Off-Budget Agency Debt				
U.S. Postal Service	2,114.0	2,114.0	-0-	-0-
U.S. Railway Association	345.9	345.4	0.5	-10.9
Agency Assets				
Farmers Home Administration	25,160.0	24,445.0	715.0	2,885.0
DHEW-Health Maintenance Org. Loans	57.0	57.0	-0-	-0-
DHEW-Medical Facility Loans	163.7	163.7	-0-	-0-
Overseas Private Investment Corp.	38.0	38.0	-0-	-2.2
Rural Electrification Admin.-CBO	637.7	637.7	-0-	-0-
Small Business Administration	104.6	105.9	-1.3	-7.6
Government Guaranteed Loans				
DOT-Emergency Rail Services Act	22.4	17.3	5.1	4.9
DOT-Title V, RRRR Act	61.2	53.5	7.7	25.4
DOD-Foreign Military Sales	4,447.1	4,384.4	62.8	469.2
General Services Administration	312.3	305.8	6.5	42.2
Guam	36.0	36.0	-0-	-0-
DHUD-New Communities Admin.	38.5	38.5	-0-	-0-
Nat'l. Railroad Passenger Corp. (AMTRAK)	402.8	351.3	51.5	-131.6
NASA	321.3	294.9	26.4	84.7
Rural Electrification Administration	4,735.4	4,680.1	55.2	543.8
Small Business Investment Companies	281.3	279.0	2.3	30.7
Student Loan Marketing Association	980.0	915.0	65.0	235.0
Virgin Islands	21.6	21.6	-0-	-0.2
WMATA	177.0	177.0	-0-	-0-
TOTALS	$53,220.9*	$52,154.2*	$1,066.6*	$5,143.4*

Federal Financing Bank — March 13, 1979

*Totals do not add due to rounding.

FEDERAL FINANCING BANK
February 1979 Activity

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST PAYABLE (other than s/a)
Department of Defense					
Taiwan #8	2/1	$ 67,480.00	7/1/85	9.289%	
Jordan #3	2/1	6,090.50	12/31/86	9.234%	
Greece #9	2/1	1,109,807.22	5/3/88	9.193%	
Jordan #2	2/5	31,865.52	11/26/85	9.149%	
Greece #10	2/7	26,350,142.78	2/1/89	9.208%	
Korea #8	2/7	48,743.48	12/31/86	9.252%	
Spain #2	2/7	1,423,414.00	9/15/88	9.223%	
Honduras #2	2/8	66,500.00	10/7/82	9.645%	
Colombia #2	2/13	79,974.00	9/20/84	9.478%	
Ecuador #2	2/13	98,744.00	8/1/85	9.435%	
Israel #7	2/13	1,000,000.00	12/15/08	9.232%	
Jordan #3	2/13	419,340.00	12/31/86	9.387%	
Spain #1	2/13	1,636,314.95	6/10/87	9.377%	
Taiwan #3	2/13	79,890.46	12/31/82	9.641%	
Thailand #3	2/13	162,282.00	9/20/84	9.478%	
Tunisia #4	2/13	1,022.00	10/1/85	9.426%	
Colombia #2	2/14	463,829.25	9/20/84	9.47%	
Costa Rica #1	2/14	12,806.00	4/10/83	9.59%	
Costa Rica #1	2/15	5,621.43	4/10/83	9.585%	
Indonesia #3	2/22	31,607.30	9/20/86	9.465%	
Taiwan #9	2/22	1,100,000.00	7/1/86	9.472%	
Israel #7	2/27	21,597,674.07	12/15/08	9.297%	
Colombia #2	2/28	1,135,596.00	9/20/84	9.658%	
Jordan #2	2/28	6,785,851.77	11/26/85	9.591%	
Jordan #3	2/28	107,394.00	12/31/86	9.547%	
Malaysia #3	2/28	263,304.88	3/20/84	9.695%	
Tunisia #5	2/28	71,224.00	6/1/86	9.571%	
Farmers Home Administration					
	2/2	715,000,000.00	2/2/84	9.125%	9.333% annually
General Services Administration					
Series K-016	2/1	1,565,679.00	7/15/04	9.057%	
Series M-042	2/13	4,159,479.58	7/31/03	9.223%	
Series L-051	2/16	750,521.25	11/15/04	9.226%	
National Railroad Passenger Corporation (Amtrak)					
Note #17	2/1	8,000,000.00	2/16/79	9.749%	
Note #17	2/6	10,000,000.00	2/16/79	9.66%	
Note #17	2/14	7,500,000.00	2/16/79	9.76%	
Note #17	2/15	6,000,000.00	2/16/79	9.728%	
Note #17	2/16	71,000,000.00	4/2/79	9.725%	
Note #17	2/21	6,608,801.00	4/2/79	9.856%	
Note #18	2/21	3,391,199.00	3/30/79	9.856%	
Note #18	2/22	5,000,000.00	3/30/79	9.888%	
Rural Electrification Administration					
Corn Belt Power #94	2/1	2,123,000.00	2/15/81	9.785%	9.668% quarterly
United Power #6	2/1	3,000,000.00	12/31/13	9.044%	8.944% "
Arkansas Electric #97	2/1	3,337,000.00	12/31/13	9.044%	8.944% "
Sugar Land Telephone #69	2/2	1,500,000.00	12/31/13	9.043%	8.943% "
United Power #86	2/5	1,794,000.00	12/31/13	9.023%	8.923% "
United Power #122	2/5	205,000.00	12/31/13	9.023%	8.923% "
Wabash Valley Power #104	2/9	4,736,000.00	12/31/13	9.19%	9.087% "
Western Illinois Power #99	2/13	1,624,000.00	2/13/81	9.875%	9.756% "
Wolverine Electric #100	2/13	983,000.00	2/13/81	9.875%	9.756% "
Northern Michigan Electric #101	2/13	1,438,000.00	2/13/82	9.465%	9.356% "
Gulf Telephone #50	2/13	415,000.00	12/31/13	9.211%	9.107% "
Allegheny Electric #93	2/13	2,812,000.00	12/31/13	9.211%	9.107% "

FEDERAL FINANCING BANK

February 1979 Activity

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST PAYABLE (other than s/a)
Rural Electrification Administration (cont.)					
Tri-State Gen. & Trans. #79	2/14	$ 1,726,000.00	12/31/85	9.275%	9.17% quarterly
East Kentucky Power #73	2/16	8,134,000.00	2/16/81	9.855%	9.737% "
Northwest Iowa Power #95	2/21	7,442,000.00	2/21/82	9.475%	9.365% "
Big River Electric #58	2/22	2,224,000.00	2/22/81	9.885%	9.766% "
Big River Electric #91	2/22	3,071,000.00	2/22/81	9.885%	9.766% "
United Power #6	2/22	1,000,000.00	12/31/13	9.227%	9.123% "
Pacific Northwest Generating #118	2/22	1,807,000.00	12/31/13	9.227%	9.123% "
South Mississippi Electric #3	2/26	1,886,000.00	2/27/81	10.095%	9.971% "
South Mississippi Electric #90	2/26	514,000.00	2/27/81	10.095%	9.971% "
United Power #86	2/27	1,100,000.00	12/31/13	9.273%	9.168% "
Westco Telephone #112	2/28	1,000,000.00	2/28/81	10.065%	9.941% "
Southern Illinois Power #38	2/28	500,000.00	2/28/82	9.635%	9.522% "
Tri-State Gen. & Trans. #79	2/28	840,000.00	1/31/86	9.415%	9.307% "
Small Business Investment Companies					
Capital Resource Co. of Conn.	2/21	500,000.00	2/1/82	9.465%	
Central New York SBIC, Inc.	2/21	50,000.00	2/1/82	9.465%	
Central New York SBIC, Inc.	2/21	50,000.00	2/1/84	9.315%	
Funder Capital Corp.	2/21	500,000.00	2/1/84	9.315%	
Multi-Purpose Capital Corp.	2/21	165,000.00	2/1/84	9.315%	
Central New York SBIC, Inc.	2/21	50,000.00	2/1/86	9.295%	
Fourth St. Capital Corp.	2/21	300,000.00	2/1/89	9.285%	
Mid-Atlantic Fund, Inc.	2/21	700,000.00	2/1/89	9.285%	
Student Loan Marketing Association					
Note #182	2/6	85,000,000.00	5/8/79	9.66%	
Note #183	2/13	90,000,000.00	5/15/79	9.736%	
Note #184	2/20	105,000,000.00	5/22/79	9.773%	
Note #185	2/27	85,000,000.00	5/29/79	9.969%	
Tennessee Valley Authority					
Note #93	2/14	15,000,000.00	5/31/79	9.811%	
Note #94	2/28	740,000,000.00	5/31/79	9.957%	
Department of Transportation Emergency Rail Services Act					
Trustee of The Milwaukee Road	2/1	5,100,000.00	4/20/88	9.115%	
Department of Transportation Section 511					
Trustee of Chicago, Rock Island	2/2	2,112,393.00	12/10/93	9.136%	9.345% annually
Chicago & North Western 511-78-1	2/13	499,727.00	3/1/89	9.322%	9.539% annually
Trustee of The Milwaukee Road	2/14	3,756,422.00	11/15/91	9.292%	9.508% annually
Chicago & North Western 511-78-2	2/23	876,118.00	5/1/86	9.445%	9.668% annually
Chicago & North Western 511-78-3	2/27	534,935.00	11/1/90	9.403%	
United States Railway Association					
Note #8	2/23	468,400.00	4/30/79	9.874%	
Western Union Space Communications, Inc. (NASA)					
	2/1	18,675,000.00	10/1/89	9.168%	9.378% annually
	2/20	7,700,000.00	10/1/89	9.335%	9.553% "

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STATEMENT BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

Mr. Chairman. I am pleased to appear before you today to present the Administration's proposals for authorization of U.S. participation in replenishments of resources for the Inter-American Development Bank, the Asian Development Fund and the African Development Fund.

The authorization requests for these three institutions total $4,019 million, including $2,543 million for callable capital subscriptions which do not entail budgetary outlays and $1,476 million for paid-in capital subscriptions and concessional funding which will lead to budgetary outlays over an eight to ten year period. They cover the U.S. share of the financing necessary to sustain the lending operations of the institutions during the period 1979-1982. These requests require annual appropriations over a three to four year period beginning

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next year and provision has been made for the first of these appropriations in the FY 1980 Budget.

Prior to concluding the negotiations on these three replenishment agreements, we consulted actively with the Congress regarding U.S. objectives and positions on all the key issues. You will recall that I came before this Subcommittee in formal hearings last April prior to the final negotiating sessions for the replenishments of the Asian Development Fund and the African Development Fund and, in December, just before the final negotiations for the increase in resources of the Inter-American Development Bank. On both those occasions, I explained our aim in the negotiations and our view of their likely outcomes, and obtained your helpful guidance. These consultations were very helpful to us in carrying out and completing the negotiations. We hope they have laid the foundation for a common view between the Administration and Congress on these replenishments.

U.S. POLICY TOWARDS THE MULTILATERAL DEVELOPMENT BANKS

Before turning to the details of the individual replenishment proposals, I would like to set out the policy perspectives within which we view U.S. participation in the multilateral development banks, participation which we think is particularly important for the conduct of U.S. relations with both developed and developing countries. In discussing each of the replenishment proposals, I would like to relate our participation to spec)untries and to the achievement of specific foreign poliectives on a regional basis.

›lationships with the developing countries encompass majoŗical, security, economic and humanitarian concerns. U.S.:t for economic growth and development in poorer counis directly linked to meeting these fundamental conc‹Maintenance of the U.S. commitment to a constructive and ative program of international economic assistance is esseif we are to continue to provide that support effec- tive

:imary objective of U.S. foreign policy is to promote peac͡sperity, and cooperation among nations because the exisɔf these conditions in other countries contributes to tl-being of the United States itself. All of our forelicy programs, including those for the multilateral devet banks, have been designed to contribute to these obje.

ɔre than one hundred developing nations contain the grearity of the world's population. They differ greatly amonselves in terms of culture, history, political systd the level of economic development that they have atta Nevertheless, they all share one major aspiration: econrowth and development and material improvement in the liveheir people.

ess developed countries have moved to the forefront of wffairs. As increasingly active and effective participants in international political and economic organizations, they have assumed a much greater importance in U.S. foreign policy and national security considerations:

-- They occupy strategic geographical positions.

-- They are growing users of atomic energy for peaceful purposes and a number of them have the capability for developing nuclear weapons.

-- They have military capabilities which can be used to initiate conflicts affecting U.S. interests and having the potential of escalating into great-power confrontation.

-- They are an important source of critical raw materials for the United States and other industrial countries.

-- Their growing populations and aspirations place increasing demands on the earth's resources and environment.

Thus, in implementing U.S. non-proliferation policy, for example, we must recognize that less developed countries have a legitimate and expanding requirement for energy. In order to combat international terrorism effectively, we must be able to count on the support of less developed countries in multilateral organizations such as the United Nations and in dealing directly with individual situations as they may arise. The Law of the Sea Conference now going on under the auspices of the United Nations requires the cooperation of less developed countries on a number of issues if we are to reach agreement and still protect interests of the United

States relating to navigation, marine research, protection of the environment and exploration and exploitation of deep seabed mineral resources.

Negotiations toward the solutions to these global problems are complex and difficult, requiring a balancing of interests and a sensitivity to the requirements of developing countries. In the context of these competing and conflicting interests on major international issues, the multilateral development banks provide the United States with a practical and effective way to work cooperatively with developing countries to help them meet their most basic aspirations.

Another major objective of U.S. policy is to encourage the integration of the developing countries into the international economic system. The United States was instrumental in the establishment of this system shortly after the end of World War II, and we have worked hard to maintain its effectiveness. The system is based on the principles of free flows of trade and investment, and it has well served the United States and the world. Its continuation is necessary for our own progress and, we believe, for fulfilling the aspirations of the developing countries.

The multilateral development banks are an integral part of the international economic system. Through their assistance to the economic and social progress of the developing countries, the banks foster a structure of cooperation between developing and developed countries characterized by mutual responsibilities and joint contributions to the health of the international economic and political system.

Over the longer run, the health of the U.S. economy will depend to a considerable degree on the reliable growth in supply of the products we need from the LDCs and LDC markets for our exports, as well as the flow of investment between us.

In 1977, non-oil developing countries purchased 25 percent of our total exports. In the agriculture sector, these exports amounted to $6.7 billion and included large components of wheat, rice and cotton. In the same year, our imports from these countries totalled $36 billion, one fourth of total imports. Our reliance on the developing countries for supplies of necessary and, in some instances, vital raw materials is striking. It includes tin, natural rubber, bauxite, manganese and other raw materials.

DEVELOPMENT EFFECTIVENESS

One of the most effective means through which we can promote rapid and equitable growth and stability in the developing countries are the multilateral development banks.

The banks have become the leading institutions in the field of international economic development. They raise resources for both concessional and near market lending operations from many donor countries. As a consequence, they are able to operate on a significant scale and across the range of economic sectors. They are today the primary source of official development assistance. Their loan commitments in 1979 are expected to reach $12.5 billion, and their disbursements last year amounted to more than $5.5 billion.

The banks have also come to represent a significant share of U.S. foreign assistance in recent years, as a result of both Executive Branch and Congressional decisions. Including callable capital, appropriations for the banks have exceeded appropriations for AID bilateral development assistance since FY 1977. Excluding callable, the two have been roughly equal for the past year or so. As a share of all U.S. foreign assistance, including security supporting assistance and P.L. 480, our contributions to the banks still represent a distinct minority of the total. I have appended to my testimony several charts which illustrate this trend.

The high level of their lending gives the MDBs important influence in recipient countries. Because of their apolitical character, and the fact that they operate on the basis of economic and financial criteria, the banks are able to encourage, in their continuous policy dialogue with borrowers, the adoption of appropriate economic policies so as to ensure good use of our money.

They do this by analyzing individual projects in the context of both the recipient's development program and priorities and trends in the world economy, selecting for funding only the soundest projects which are proposed. They also assist in the diversification of developing countries' economies by providing additional capital to sectors requiring it. Their policy advice is generally consistent with U.S. views and stresses the importance of market forces and an open international economic system.

Their examination of projects within the context of the world economy is designed to assure that they do not finance projects which include production of any commodity in surplus on world markets. There have been complaints from domestic producers that the banks have been financing commodities in competition with U.S. products. The United States would vigorously oppose MDB financing of projects for the production and export of a commodity which could be deemed in surplus in the world market and could injure U.S. producers. All the banks have implicit or explicit policies against financing such projects. These loans would represent an inefficient use of the resources of the MDBs, in that they would be of questionable quality and unproductive nature.

Within the economic systems which developing countries have chosen for themselves, the banks stress the role of market forces in the effective allocation of resources, the development of outward looking trading economies and the spreading of development resources to poorer people. In conjunction with their financial assistance, the banks strengthen local institutions and provide training for local officials through extensive programs of technical assistance.

It is clearly in the interest of the United States that the MDBs should lend to countries with differing economic and even political systems, as long as there is assurance that the funds will be used effectively to advance the living standards of the people of such countries. Their relationship with the banks will result in their integration into the international economic system which we support and will contribute to the stability and growth of the international economy as their stake in it becomes more firmly rooted. The banks should not lend to countries with gross mismanagement or demonstrated unwillingness to benefit their populations, of course, whatever <u>their</u> economic or political systems.

The Administration is especially concerned, as the Congress is, that there should be costs to repressive governments for their human rights behavior. We have expressed this view to the managements of the banks and to the other member countries. We have demonstrated the seriousness of our concern by opposing through "no" votes or abstentions, in satisfaction of Section 701(f) of PL 95-118, and for policy reasons, 50 loans to fifteen countries. The Secretary of the Treasury and the Secretary of State submitted, in October 1978, a Report to the Congress on the implementation of the various provisions of PL 95-118, which reviews in detail our efforts in the banks to address human rights and basic human needs.

The competence and international character of the staff of the banks have established their reputation for rigorous and detailed appraisal of project proposals and programs. Therefore, their advice is often much more effective than that of individual bilateral donors, where political sensitivities may be involved.

The banks have also shown themselves able to respond to changing circumstances and new developmental initiatives. For example, they are now targeting a more substantial proportion of their assistance to projects which directly reach the poor -- responding to needs for broadening the growth process, helping to satisfy basic income, increase agricultural productivity and reduce rates of unemployment.

In response to our desire that they assist in increasing the productivity of the poor, the banks are placing increasing emphasis on employment creating projects, in connection with their efforts in both the agriculture and rural development sectors and in urban-oriented industrialization efforts.

One important means to help achieve the objective of effectively reaching the poor is to promote the utilization of capital saving technologies in order to increase the productivity and incomes of poor people. We have urged and supported the creation of units or groups within the MDBs to focus on the appropriateness of technologies incorporated into the banks' projects. Such groups have been established in the World Bank, the IDB and the ADB. We have sought, and obtained, policy decisions by the banks placing increased emphasis on the use of capital saving technologies in their projects. As a result of our initiatives, the banks are making increased efforts, at the preinvestment stage, to achieve a more effective application of appropriate technologies.

Efforts by the banks to reach the poor are essential. At the same time the multilateral development banks must also continue to pursue a multiplicity of goals if they are to be effective catalysts for development. The banks must preserve their recognized strengths in project design, sectoral and country analysis and programming, macro-policy leverage and infrastructure support. In many less developed countries, infrastructure projects are still key because they provide the necessary economic context for other assistance programs, including those developed to benefit the poor.

Hydroelectric projects provide an example of projects which are necessary if the developing countries are to meet their expanding energy requirements and reduce their reliance on expensive imported energy. Feeder roads serving small farmers in isolated areas of Africa for example, must lead to a main road eventually if production is to get out and inputs are to get in to assist in increasing production. Adequate port facilities are needed if fertilizers and other inputs from abroad are to reach the smallholders and if their coffee or cocoa or other production is to get out. Indeed, the success of products designed to meet basic human needs and to incorporate capital saving technologies is often dependent on these kinds of infrastructure projects.

Another high priority that we strongly support is the expansion of bank lending for energy development. In response to a request made at the Bonn Summit meeting, the World Bank has proposed a program which we have strongly endorsed to help solve the growing energy problems of developing countries. The Bank had already planned to start spending about $500 million per year on energy projects by 1979 -- that amount will now be tripled by 1983 to cover an expanded lending program to finance geological and geophysical surveys and exploratory drilling, and more lending for projects to develop and produce gas and oil. Over the next few years, the Inter-American Development Bank will be devoting a large proportion of its lending to developing hydroelectric and geothermal potential in Latin America. The Asian Development Bank has also embarked on a large lending program to finance the production of primary energy fuels. These MDB funds will facilitate additional private investment in the energy area, thus helping to meet urgent requirements in the developing countries and improving the world energy supply and demand balance.

The banks also contribute to the efficient use of scarce development assistance coming from many sources through their leadership and participation in the consultative groups and consortia which coordinate bilateral assistance efforts on behalf of numerous countries.

COST EFFECTIVENESS

The MDBs are a particularly cost-effective mechanism for providing economic assistance because they permit us to share the burden for providing this assistance with other countries, and because they mobilize private capital through bond offerings and cofinancing.

What was once a predominantly U.S. foreign economic assistance effort has been transformed today into a much more broadly shared one. The overall U.S. share of subscriptions and contributions to the MDBs has declined to 25 percent, as other countries have increased their capacity to provide more resources for development. These include industrialized countries such as Germany and Japan, OPEC nations, and some of the relatively more advanced developing countries such as Mexico and Brazil. For every dollar we contribute to the banks, they now contribute three dollars.

Participation in a multilateral framework means that the interests of donor countries are collectively represented. No one country can dictate the policies of the multilateral development banks. Because we share the same view of the objectives of the banks with most other member governments, however, and because we play a major role in each of the banks, their operations and policies have almost always responded to our policy priorities.

The banks rely on the callable capital subscriptions of their members as backing for their bond issues in private capital markets, and use these borrowed funds for their harder term operations. Because of their solid record of financing economically sound and feasible projects, the MDBs have been able to increase the leverage of their callable capital to the point where only one out of every ten dollars of capital subscriptions is in fact paid-in.

In the case of the World Bank, for example, each dollar the U.S. subscribed has generated some $50 in Bank lending. The Bank has made $45 billion of loans over its lifetime while the United States has paid in only $884 million. This tremendous leverage means that, particularly in a period of budget stringency, the banks are an extremely cost-effective channel for the U.S. foreign assistance dollar.

The banks also engage in co-financing operations with the private commercial banks. These have involved the purchase of shares in individual MDB loans as well as complementary financing arrangements for MDB financed projects. These operations are very desirable, not only because they mobilize additional resources but particularly because they provide a mechanism for the introduction of commercial bank lending in the developing countries for development projects. Some of these countries have not yet established a firm international credit standing, and the involvement of private commercial banks will permit these countries to enter the world financial system, paving the way for future decreases in their reliance on official assistance to meet external capital requirements.

BENEFITS TO THE UNITED STATES

The operations of the MDBs provide direct and indirect benefits to the U.S. economy substantially above our contributions. These benefits stem from project-related procurement of goods and services, bank administrative expenditures in the United States, net interest paid to U.S. holders of bank bonds, and faster LDC growth resulting in rapidly growing markets for U.S. exports. The total value of U.S. procurement alone since the inception of the banks has been over $8.3 billion, which exceeds U.S. subscriptions and contributions paid into the banks by $2.1 billion. As a result of their increased investment financed by the MDBs, the developing countries are able to improve their living standards more rapidly, providing a growing market for the United States and other exporters. This investment also helps developing countries produce raw materials the United States must import in order to prosper.

From the time of the banks' inception in 1946 to the middle of 1978, direct accumulated receipts by all segments of the U.S. economy have exceeded outflows to the MDBs by $2.4 billion. In addition, an econometric analysis which we have made shows that real GNP increased annually between $1.2 billion and $1.8 billion as a result of exports of U.S. goods and services to markets directly created by MDB financed projects in developing countries. This means that every U.S. dollar paid into the MDBs generated between $2.39 and $3.38 in real U.S. economic growth annually over the period. This also means that the banks' activities created between 50,000 and 100,000 jobs a year.

U.S. participation in the multilateral development banks is not motivated primarily by these kinds of benefits. However, it is clearly a mistake to view our contributions to the banks as giveaways or economic losses to the United States. To the contrary, they bring us net economic gains in both GNP and balance-of-payments terms.

ROLE IN THE INTERNATIONAL ECONOMIC SYSTEM

The multilateral development banks provide a practical and effective way for us to collaborate with the developing countries in helping them achieve their basic aspiration: economic growth and equity. Our participation in the MDBs and the overall levels of our foreign assistance are judged as a signal of the seriousness of our response to their problems.

The banks are also a forum for cooperation with industrialized countries. I mentioned earlier the increased role which these countries are playing in the banks, by shouldering large shares of the costs of their activities. We participate with these countries in discussions within the banks on all issues of development policy, and alternative approaches to the use of development assistance funds. We have recognized for many years that cooperation with other industrial countries is to the well-being of the United States. Our collaboration with them on these development questions positively affects our overall relationships with these countries and our dealings with them in other fora.

LATIN AMERICA

The bulk of the financing contained in the proposal before you today is to replenish the capital and concesssional windows of the IDB for the four-year period 1979-82. Our approach to this replenishment was based on the twin realities of Latin America's position in the world economy for the 1980s: impressive overall economic progress in most countries, but continued great needs in most of them.

During the past decade, Latin America's rate of economic progress has outstripped that of other developing regions:

-- Between 1965 and 1977, the gross domestic product of the region more than doubled in real terms to nearly $400 billion. This represents an annual growth rate of 6.1 percent -- compared with 5.1 percent for all developing countries, and about 3.9 percent for the developed countries. It maintained impressive growth even through the world recession, cushioning the impact of the recession on the industrialized countries-particularly the United States.

-- Real per capita GNP in the region has increased by more than half since 1965. It now stands at $1100, as compared with a per capita GNP of $450 for the rest of the developing countries.

As a result, Latin America has made the transition to a region with a global role of its own. Individual Latin American nations have become advanced developing countries (ADCs) with a vital stake in the future of the world economy, in the sucessful operation of the international trade and monetary systems, in ensuring adequate rates of production and demand, and in assisting the poorest countries of the world in eradicating extreme poverty.

Mexico is one example of how a country which is critically important to the United States benefits from MDB activities. Its importance to the United States stems primarily from geographical proximity to this country and the influence which this proximity can have on the political, economic, social, environmental and security aspects of American society. U.S. relations with Mexico are governed by two fundamental U.S. policy objectives:

-- Political stability and economic growth in a Mexico which is friendly to the United States.

-- Control of migration flows which could have potentially disruptive effects for the United States.

In addition, development of Mexico's hydrocarbon resources will increase the free world's supply of oil and provide Mexico with the revenue to increase domestic employment, thus reducing migration pressures on the United States. Finally, cooperation between our two countries is necessary for narcotics control and other border issues including sanitation, pollution control, and law enforcement.

Mexico does not receive concessional lending from the IDB. It has become, in fact, a donor to the FSO. It continues, however, to receive substantial amounts of market rate financing from the MDBs. In its most recent fiscal year, Inter-American Development Bank loans to Mexico totaled $238 million. Loans from the World Bank totalled $469 million.

The multilateral development banks play a financial intermediary role in Mexico. They are also able to provide advice on investment plans which may help Mexico to use its petroleum revenues most effectively to attack unemployment and under-employment and redress social and economic imbalances. And they advise the Mexican Government on how to approach the problems of equitable economic growth. During his recent trip to Mexico, President Carter visited an integrated rural development project which is being financed jointly by the World Bank and the IDB. The purpose of this project is to increase incomes and employment opportunities for poor people in rural areas of the country.

Brazil is another example. It is important to the United States simply by the weight of its size and strategic position. Brazil is the world's seventh most populous nation, the tenth largest economy, and has a resource endowment and agricultural capacity rivalling those of the United States.

The U.S. and Brazil share major global interests: the maintenance of Western security, a healthy world economy, the avoidance of North-South confrontation, and Brazil's successful completion of the transition to developed country status along with peaceful evolution toward a more equitable and politically open, pluralistic society, setting an example for other developing countries. Brazil's challenge for the future will be to maintain adequate growth to create the estimated 1.3 million jobs needed each year to keep pace with its rising population, while devoting more resources and attention to improving the productivity and well-being of its poor.

The multilateral development banks play the role of policy advisor as well as that of financial intermediary in Brazil as they do in Mexico. In calendar year 1978, the IDB made loans to Brazil totaling more than $282 million. In its most recent fiscal year, World Bank loans totaled $705 million Like Mexico, Brazil is a donor to the convertible currency resources of the concessional lending fund of the IDB and has agreed not to borrow from those funds.

However, Latin America is not a homogeneous region. Despite the progress of recent years, Latin America contains some of the poorest and least developed areas in the world. For example, the level of protein intake in Haiti is the lowest in the world, and its caloric intake is next to the lowest. Infant mortality rates throughout the region are three times as high as those in the United States. Forty percent of primary school-age children and sixty percent of secondary school age children do not attend classes. Population increases outpaced agricultural growth in 1975 and 1976 although a moderate improvement occurred in 1977. The labor force is increasing at a rate of 2.8 percent a year, exacerbating an already difficult unemployment problem. Although the growth in average per capita income in the region has been remarkable, there are now more people, perhaps as many as 150 million, living in absolute poverty than there were a decade ago.

And, notwithstanding the progress that has been made by the region as a whole, there are countries which have not shared in Latin America's overall progress and which continue to need concessional resources. These countries have little access to private capital markets and a limited ability to assume debt at market rates. Their per capita incomes remain low by Latin American and global standards as well.

Continuing self-help and structural change is crucial to development, but Latin America also requires a continuing flow of external financial resources to sustain the momentum of its economic and social development.

The United States has a keen interest in fostering the development and ensuring the stability of Latin America and the Caribbean. In economic terms, the importance of the region to the United States is obvious by the large flow of goods and services, technology and capital in both directions. In 1977, our exports to the Latin American region nearly reached the $20 billion mark, more than our exports to Japan and almost as much as those to the European Common Market. This export volume is projected to grow by 10 to 15 percent per year.

Since 1960 U.S. direct investment in Latin America and the Caribbean has doubled with a restructuring of that investment away from enclave investments in mining and petroleum toward manufacturing, trading and finance. These investments now exceed $20 billion, approximately two-thirds of all U.S. investment in the developing world. In 1977, Latin America and the Caribbean provided the following shares of U.S. mineral imports: petroleum, 26 percent; iron ore, 23 percent; bauxite, 88 percent; copper, 40 percent. In addition, we obtain about 50 percent of our sugar imports, 80 percent of our bananas, and 70 percent of our coffee from Latin America.

THE INTER-AMERICAN DEVELOPMENT BANK

With U.S. support, the IDB has contributed significantly to the economic development of the region. In its nineteen year history the IDB has proven itself an innovative leader, continually finding new ways to strengthen the development impact of its activities, through its project financing and through its technical assistance in developing planning and programming. By December of 1978, the IDB had provided $13.0 billion of assistance from its own resources of which $7.1 billion came from capital and $5.9 billion from the FSO. For the IDB to continue to play its important role in assisting

Latin America's development efforts, the resources of both the Bank's capital and the Bank's concessional window, the Fund for Special Operations (FSO) must be increased as their current convertible currency loan commitment authority will be depleted by mid-1979.

Economic development is the highest priority objective of almost every one of the countries of Latin America. Our participation in the IDB in support of the region's development efforts is a key element in our efforts to win their cooperation on matters of common concern such as narcotics, migration, and obtaining needed energy and raw materials. The IDB also provides an institutional setting where we can encourage the advanced developing countries to undertake a larger part of the responsibility for the functioning of the international economic system. The increased contributions of these countries in this replenishment demonstrate their recognition of their increased strength and responsibility as participants in the system.

Because of the joint gains to Latin America and to us of a free, liberal international economic system, we both stand to benefit from the process of shared participation and responsibility.

Over the long-term there has been a decline in the level of our bilateral grant and loan assistance to the region from the peak in the mid-60s, reflecting both Latin America's rapid economic growth and a deliberate shift in the emphasis of our bilateral concessional assistance program toward the poorer regions of Africa and South Asia. The proposed FY 80 AID budget for Latin America, however, actually represents a slightly higher level of bilateral assistance than the budget allocations in fiscal years 1977-79 -- $230 million versus $218 million.

We can demonstrate our continued strong interest in furthering the development of Latin America through our participation in this IDB replenishment. In line with our development finance policy, we have broadened our economic ties with Latin American countries through other avenues of bilateral economic cooperation which are more consistent with their individual levels of development. They have increasingly become larger recipients of Eximbank credits and guarantees as well as export credits for U.S. agricultural products through the Commodity Credit Corporation. The OPIC program of insurance and finance for private investors has also been active in the region.

The leveling off of U.S. bilateral assistance to Latin America at around $200 million a year does not, however, suggest a U.S. move away from the region. It is the result of our global policy in development finance. The application of this global policy to Latin America means that the region should, because of its development progress, be moving gradually but deliberately from concessional assistance as provided by AID and the soft windows of the multilateral development banks (MDBs) to the non-concessional windows of the banks and private capital markets. The replenishment before you conforms to this policy.

The U.S. approach to the IDB replenishment negotiations had the following objectives:

-- to focus lending on the poorer countries in the region and to the poor people in all recipient countries;

-- to increase burden-sharing by both developed and developing member countries;

-- to reduce the paid-in portion of the United States and other donors' subscriptions, consistent with maintaining the financial soundness of the bank.

With respect to the first objective, these replenishment negotiations significantly restructure the lending program of the IDB for the 1979-1982 period. In response to the economic realities of Latin America the number of countries which will tap the FSO for convertible currency loans will be reduced. Several borrowers have progressed sufficiently that they no longer need to turn to the FSO at all as a source of external capital. In addition to the five countries which had already volunteered not to borrow convertible currencies from the

FSO during the last replenishment period, 1976-1978 (Argentina, Brazil, Mexico, Trinidad and Tobago and Venezuela), Chile and Uruguay will now no longer do so. IDB lending for the Bahamas and perhaps one other Caribbean country might also now be wholly from capital resources.

As a result, the annual size of the FSO lending program can now be smaller than during the last replenishment. We believe this to be a most appropriate step in the evolution of development finance whereby, as countries make economic progress and no longer need concessional resources, they can graduate to harder lending terms and the level of concessional assistance they receive can fall. The FSO replenishment will allow for $468 million in convertible currency loans per year, down from an average level for the 1976-1978 replenishment of $540 million per year.

In addition, these concessional funds will be concentrated even more on the poorest and least developed countries in the hemisphere. During 1979-80, the initial years of this replenishment, at least 75 percent of convertible FSO resources would go to them. During the second half of the replenishment period, this minimum allocation would increase to 80 percent.

Because of their broad access to private capital markets, and their own recognition of the greater needs of their poorer neighbors, the largest and more prosperous Latin countries

-- Argentina, Brazil and Mexico -- will restrict their capital borrowing to present levels. They will thereby reduce sharply their percentage share of total IDB capital lending although retaining sizable amounts in absolute terms. The Bank will help them adjust to this change by assisting in arranging an increased amount of cofinancing for their IDB projects, improving still further their access to private capital. As has been the case since 1975, Venezuela and Trinidad and Tobago will not borrow at all from the Bank during this replenishment period.

These constructive steps by the more advanced developing countries of Latin America will permit the middle level and poorer countries to attain substantial annual increases in their real rate of total borrowing from the Bank. This will in turn help cushion their move from the concessional funds of the FSO to the harder lending terms of the capital window, and round out the three-step approach which recognizes the economic maturing of the region: (a) fewer borrowers from the concessional FSO's convertible currencies, (b) more capital lending for the countries shifting from the FSO to the capital window made possible by (c) increased reliance on private sector borrowing by the most advanced countries of the Hemisphere.

This replenishment also involves agreement to target IDB lending to poorer people in recipient countries. Those countries, outside the group of poorest and least developed, who retain some access to FSO resources have agreed to limit their FSO borrowing wholly to those projects which directly benefit their poor people. As far as the Bank's total resources are concerned, it has been agreed that 50 percent of 1979-1982 lending will benefit low-income groups, primarily through the creation of productive employment opportunities in the rural and urban areas.

The IDB replenishment proposal before you also contains major advances in terms of burden-sharing by non-regional countries and advanced developing member countries.

The non-regional members of the Bank will contribute a share of the capital increase (11 percent) which is two and one half times larger than their current share of 4.4 percent. In addition, the non-regional members will contribute 30 percent of the FSO replenishment, the high level which they had agreed to as part of their entry into the IDB.

The subscriptions of the Latin American members (except Venezuela) to paid-in capital will be two-thirds in convertible currency -- an increase from the 50 percent previously subscribed in convertible currency by these members.
As in the 1976-1978 replenishment, Venezuela will make its paid-in subscriptions entirely in convertible currency.

In continuation of the practice instituted during the 1976-78 replenishment, Venezuela and Trinidad and Tobago have again agreed to make all their contributions to the FSO in convertible currency. Moreover, as an indication of their growing financial and economic strength, Argentina, Brazil and Mexico have agreed to increase the freely usable portion of their FSO contributions from 25 percent to 75 percent -- raising the level of resources fully usable by the FSO by $191 million.

As a result of these contributions and those of the non-regional countries, the U.S. share of convertible FSO resources has dropped from 57 percent in the last replenishment to 45 percent in the proposed replenishment.

Because of these changes in the Bank's lending program and in the burden-sharing arrangements, this replenishment (in comparison to the previous replenishment) allows a reduction in the annual contribution to be paid in by the United States. To fulfill the proposed lending program of the IDB, the increase in capital resources for 1979-82 amounts to $7,969 million of which 7.5 percent or $598 million would be paid-in. The United States share of this increase would be $2,749 million -- 34.5 percent of the total -- comprising $2,543 million of callable capital and $206 million of paid-in capital. For the FSO, the increase proposed for 1979-82 would amount to $1,750 million of which the United States share would be 40 percent of the total or $700 million. The U.S. shares are those called for in the Sense of the Congress Resolution in the FY 1979 Foreign Assistance Appropriations Act, and they have been accepted by the Bank's other members as appropriate levels of U.S. participation.

Also, under this replenishment only seven and one half percent of the capital will be paid-in, down from the typical 10 percent paid in during previous replenishments. The annual U.S. capital subscription of $687.3 million thus involves $635.8 million of callable capital - which does not entail any budget outlay. The paid-in portion of the U.S. subscription would be $51.5 million annually.

The U.S. contribution to the FSO will decline absolutely from $200 million a year to $175 million a year. This is a twelve and one half percent reduction.

While the budget outlay commitments for the 1976-78 replenishment, as negotiated, were $240 million per year, the proposed 1979-82 replenishment would result in annual budget outlays of only $226.5 million -- an absolute reduction of $13.5 million. The reduction in real terms is, of course, much more substantial. For both capital and concessional funds, the budgetary outlays would as always be spread over a number of years because drawdowns are made only as needed to cover actual disbursements by the Bank or on the basis of an agreed schedule.

In the last two years, the Administration and the Congress have been carefully reviewing the appropriate budgetary and appropriations treatment of callable capital. In 1977, authorizing legislation was enacted for U.S. participation in a selective capital increase of the IBRD and a general capital increase of the ADB. That legislation -- Public Law 95-118 -- required that U.S. subscriptions to callable capital be made only after the amounts to fund the subscriptions had been appropriated. The Administration indicated its willingness to go along with this approach, immediately upon taking office.

The bill which we have submitted proposes language relating to the appropriation of callable capital for the new IDB replenishment different from that contained in Public Law 95-118 for the IBRD and ADB. The language provides that the commitment to subscribe to callable capital stock is to be effective "only to such extent or in such amounts as are provided in advance in appropriation Acts." The difference in language is for the purpose of allowing the Congress and the Administration maximum flexibility in determining the future treatment of callable capital in the context of the review of budgetary controls over all Federal credit and guarantee programs proposed for this year by the President in the budget documents for FY 1980. The Administration's proposals envisage the possibility of different forms of budget limitations in annual appropriations Acts, and -- while fully protecting the role of the Appropriations and Budget Committees -- we simply wish to avoid precluding, for application to the new IDB replenishment, any of the possible outcomes of that process.

The Administration strongly recommends this replenishment proposal. The increase in the Bank's resources will provide funds to support projects which build on the major economic successes of the past decade in Latin America, and continue the development momentum which will lead one day to the establishment of dynamic economies able to finance their own continued development.

United States participation in the proposed increase in resources would constitute a positive and concrete expression of United States interest in, and concern for, the development of Latin America and the Caribbean. A continuing flow of resources through the IDB will help the region to further improve its economic situation and that of the millions of Latin Americans who still live in poverty. It is a cooperative effort in which the more advanced Latin American countries are joining the industrial countries in providing a part of the convertible currency resources for IDB lending to the poorest countries in the region.

ASIA

As recent weeks have shown, conflict and instability remain problems in Asia, and are of continuing concern to the United States. From the standpoint of security, a strategic balance now exists in the region. It is clearly in our interest that this balance be maintained. Our policies are designed to preserve balance and stability in the region, prevent expansion of existing conflicts and maintain our commitments to our friends and allies. They obviously do not entail a return to our earlier deep involvement in the internal affairs of the region.

We have concentrated instead on the development of long term sustainable policies that emphasize national self-reliance, supplemented by continued U.S. support. In this regard, we have been especially encouraged by the emergence of the Association of Southeast Asian Nations (ASEAN) which is a successful example of the regional economic cooperation we believe will contribute to stability in the area. We continue to place high priority on the region. We cannot afford to do otherwise.

Viewed in this light, U.S. participation in the Asian Development Bank offers an effective way to demonstrate continued U.S. concern in the area and its stability and to show our willingness to provide financial support for the economic aspirations of its people. Indeed, Asia contains the overwhelming majority of the world's poorest people. On the basis of strategic considerations alone, it is in our interest to support effective actions to improve the conditions of their lives and to promote greater stability in the area.

Thailand is one example of how the work of the Asian Development Bank can advance U.S. foreign policy objectives in individual countries. Thailand has a central position in southeast Asia, and it has maintained a close relationship with the United States. It is in our national interest to support the stability and independence of Thailand because it is a key element of regional progress and balance in south-east Asia. We also have other important interests in Thailand. For example, Thailand's cooperation is essential if we are to have an effective narcotics suppression program. It has also provided a country of first refuge for Indo-Chinese refugees. Thailand is important as an expanding market for U.S. exports including cotton, tobacco, machinery, fertilizers, iron, and steel. It is also a reliable supplier of critical raw material imports such as tin, tungsten and rubber.

Economically, Thailand has grown at a rate matched by few developing countries. From 1960 to 1976, GNP growth averaged 7.6 percent a year. A high and rising level of investment has been maintained, exceeding 20 percent of GNP and largely financed by domestic savings. Per capita income doubled over the 1960-1976 period. Inflation has been kept under control by conservative fiscal policies, although price pressures have recently intensified.

In the past, economic policies have tended to favor Bangkok, other urban areas and the relatively better off farmers of the central plains. A large proportion of the rural population, particularly in the northeast, has not shared equitably in the benefits of economic growth.

The present government in Thailand is beginning to reorient economic policy in favor of these elements of the rural population. The Prime Minister has declared 1979 the "Year of the Farmer" and has stated his government's intention to direct far greater resources to rural areas. The revised Five-Year Development Plan for 1977-1981 calls for external borrowing of about $1 billion per year to finance rural and infrastructure development to bring services and improved agricultural technology to the rural poor.

For 1979, the proposed borrowing program includes $324 million from the ADB. Under the proposed ADF replenishment, Thailand will become eligible for concessional financing of projects addressing the needs of its poor citizens. It is in our interest that the flow of MDB financing continue to Thailand. Our participation in the Asian Development Bank and Fund will help assure that the country will be able to sustain its growth and carry out needed changes in its overall economic policies.

A second example is Pakistan. The turmoil in neighboring countries underscores U.S. interest in the security and stability of this Persian Gulf rim nation.

Pakistan suffers from political instability and a growing sense of isolation, and recently the economy has stagnated. The most important contribution the United States can make to Pakistan's stability and long-term development is to assist it in putting its economic house in order and, thereby, induce stability while political problems are resolved.

Pakistan is a poor agricultural country and its best prospects for growth lie in that sector of the economy. With one of the world's largest irrigation systems, Pakistan could become a major exporter of agricultural commodities while meeting the food requirements of its own population. It has a well-developed infrastructure in terms of railroads and roads, and there is a sound industrial base upon which to expand. The ADF can, and is, helping Pakistan to develop this potential. Its assistance, totalling $290 million at the end of 1978, has been focused on the improvement of agriculture through the support of irrigation projects, the production of fertilizer inputs, of power for rural electrification, and cement for use in civil works in agriculture.

THE ASIAN DEVELOPMENT FUND

Recently, there has been a significant increase in cooperation among the nations of Asia. This is exemplified by the efforts of the ASEAN to work together among themselves, and with the rest of Asia and the industrialized world, in an effort to increase regional stability and prosperity. The Asian Development Bank and Fund, as visible, technically qualified, moderate and respected regional institutions both aid and are aided by this move to increased regional self-reliance. Our participation in the Bank and Fund constitutes a clear, demonstrable statement of our interest in the region and associate the United States with the region's goals and aspirations.

The Asian Development Fund (ADF) was established in 1974 to mobilize concessional resources, on an organized and regular basis, to consolidate and standardize the Asian Development Bank's lending to the smaller and poorer developing member countries in Asia.

Six member countries account for the major share of these concessional loans: Pakistan, Burma, Nepal, Afghanistan, Bangladesh and Sri Lanka. These six are among the poorest countries in the world, and several of them are of central importance to U.S. foreign policy. Several Pacific islands which are of importance to U.S. policy toward the region (particularly the Solomons and Western Samoa) receive ADF funds -- our primary channel for providing assistance to them. In addition, under the proposed replenishment, the Fund will resume modest amounts of lending for basic human needs projects in Indonesia, the Philippines and Thailand. India has voluntarily refrained from receiving funds from the ADF, relying instead on IDA as its principal source of concessional aid.

Our goal in the replenishment negotiations was to ensure that substantial resources were provided for the ADF's activities, and that these resources should be more sharply focused on the poor. We were able to achieve an agreement that agricultural investment and rural development programs would continue to be the primary lending sectors of the ADF, and that these projects would increasingly focus on benefitting the poorer segments of the population. We also achieved a resumption of lending to the "marginally eligible" countries -- Thailand, the Philippines and Indonesia -- for projects which meet basic human needs.

The U.S. share of the total replenishment of $2.15 billion for the 1979-1982 period amounts to $445 million. This represents a substantial degree of burden-sharing. It is 20.69 percent of the total, below the level suggested by the Congress (22.24 percent) in the FY 79 Foreign Assistance Appropriations Act and consistent with the Sense of the Congress provision in Public Law 95-118. This share will require annual appropriations for the 1979-1982 period of $111 million. Authorization of the proposed U.S. contribution is required in 1979, and appropriation of the first tranche in FY 80 to prevent ADF commitments ceasing in December 1979.

I would like to briefly address the issue of Chinese membership in the Asian Development Bank. The situation in the ADB is different from that in the International Monetary Fund and the World Bank in that Taiwan was an original member of the ADB, joining in 1966. Taiwan is a full member of the Bank, although it ceased to rely on the ADB for external financing in 1971.

The People's Republic of China has not indicated an interest in membership in the ADB. Participation by the

People's Republic in the Bank raises a number of complex issues, such as the possible effects on the lending program, and legal mechanisms for their participation.

We believe the PRC is aware of the complexities involved in their joining the banks, and that their entry will take time. As Secretary Blumenthal said while testifying before the House Appropriations Subcommittee on Foreign Operations on March 14, it would be premature to state a U.S. Government position on the question of their participation.

AFRICA

We are proposing an increase in U. S. contributions to the African Development Fund. The African continent has assumed a much greater foreign policy importance for the United States which stems from the following factors:

- Africa is a growing locus of power both politically and economically.
- It commands vital economic resources which are essential to the United States and the industrialized nations of the West.
- It occupies a strategically important geographic position.
- It continues to experience instability and political and military weakness which could draw in larger, non-African powers for the resolution of local wars and pose risks for elevating and broadening regional conflicts.

-- Further, the persistence of racial injustice in southern Africa threatens the stability of the area.

-- It has acute problems of poverty and economic underdevelopment which have the potential to cause growing resentment against the United States and other developed countries.

In addition, African countries now play a prominent role in international politics and in the conduct of world diplomacy. By themselves, they comprise almost one-third of the membership of the United Nations. Together with other developing countries, they account for two-thirds of the membership of that organization. We need the cooperation of African countries to resolve the kinds of international problems which I have already mentioned.

In terms of the individual countries, Nigeria is the largest U.S. trading partner on the continent. Annual U.S. exports to that country currently exceed $1 billion, and Nigeria supplies us with almost 20 percent of our petroleum imports. After Saudi Arabia, it is our second largest source of foreign crude oil. Nigeria has taken a constructive leadership role and consistently opposed outside intervention in African conflicts.

In both economic and humanitarian terms, Africa represents the world's greatest development challenge. It is the least developed continent, containing two-thirds of the world's 30 poorest nations and some of the world's most deprived and disadvantaged people. In most countries of the region the numbers of individuals living in absolute poverty amount to more than one-third of the population. Seventy five percent of Africa's population is engaged in subsistence agriculture. Life expectancies in Africa average 43 years -- 10 years less than those in other developing countries and 30 years less than those in the United States. Less than 20 percent of the population of sub-Saharan Africa has access to safe drinking water.

Growth rates in Sub-Saharan Africa remain well below those in other developing regions. Per capita incomes expanded at a rate of less than 2 percent per annum in 1960-75. Although a large percentage of African labor works in the agriculture sector, agricultural production has also grown slowly, increasing at an annual rate of about 1.5 percent since 1960. This rate of growth has not been sufficient to keep up with the increase in population.

THE AFRICAN DEVELOPMENT FUND

The African Development Fund (AFDF) represents an important means to help these countries break out of the vicious cycle of poverty. It was created in 1973 as the concessional lending affiliate of the African Development Bank (AFDB). The Bank itself was established in 1964 to make loans to African nations on near-market terms; it has no non-African members.

The Fund makes concessional loans to the poorest countries in Africa. Except under the most unusual circumstances, loans are not granted to countries with 1976 per capita GNP above $550. Absolute priority is given to nations with per capita GNP below $280. The African Development Fund has concentrated its efforts on those most in need: in 1977, 64 percent of its lending went to countries with a per capita income of less than $280. In that same year, loans targeted to assisting the poor accounted for approximately 60 percent of total lending.

In the replenishment negotiations, it was agreed that the Fund's efforts to reach the poor should be continued and intensified. During 1979-1981, 80 percent of the Fund's resources will be lent to the poorest countries -- with a per capita GNP below $280. With respect to sectors, it was agreed the AFDF would focus particular attention on projects aimed at meeting basic food and health requirements and at increasing the effective utilization of human potential through training in such areas as agriculture. The AFDF is reaching those whom the United States believes should receive top priority for development assistance.

The AFDF donors agreed to a second replenishment which will permit the African Development Fund to expand its efforts to aid Africa's poor in the 1979-1981 period.

The U.S. contribution of $125 million to the second replenishment would be 17.5 percent of the total of $713.5 million of pledged resources. This U.S. share represents an increase in our position in the Fund. Recently, our share of Fund resources has been under 6 percent -- which was equal to Norway. We believe that a much more substantial U.S. share in this institution is consistent with both our objectives of increased burdensharing and the high priority we place on strengthening U.S. relations with the countries of Africa. The resulting 17.5 percent is still substantially less than our share in any of the other MDB windows. It is consistent with the Sense of the Congress Resolution, and we believe it is essential to demonstrate our interest in assisting growth and development in Africa.

We believe that the African Development Fund is an increasingly effective regional institution which can help address Africa's enormous prolbmes of proverty and underdevelopment. It is the kind of cooperative organization that we want to encourage because it provides us with a practical way to assist African development without unwarranted and direct involvement in the affairs of individual countries.

I would like to mention briefly the opening of membership in the African Development Bank (AFDB) to non-regional members. This Bank is unique among the MDBs in that its membership has been drawn entirely from regional developing nations since its establishment in 1964. As a result, its subscribed capital after 15-years is currently only $957 million and its cumulative loans total $620 million. In order to strengthen the Bank's resource base and lending program, negotiations have now been undertaken, pursuant to a 1978 authorization by the African Governors, to begin the participation of non-regional members in the Bank.

The Administration strongly supports the efforts of the African Development Bank to expand its base of resources. We have participated constructively in discussions with other non-African countries considering membership, and are now envisaging a U.S. capital subscription on the order of $360 to $400 million (to be contributed over a five year period FY 81-85) which would also represent a U.S. share of about 17-18 percent. This would provide us with our own Executive Director at the Bank, and make us the largest single shareholder. We will be consulting with you on details of U.S. participation in the Bank, looking toward the submission of legislation next year.

Africa's critical importance to the management of international political and economic affairs is now well-established. Our proposed support for this replenishment of the African Development Fund, as well as our prospective entry into the African Development Bank itself, reflect the strong commitment which the

Administration and the Congress share to support the aspirations of African peoples for a better life.

CONCLUSION

The Administration strongly supports the replenishments I have proposed today.

The multilateral development banks are a practical and effective way for the United States to cooperate with the developing countries in achieving their basic goal of equitable economic growth. Our participation in the banks and the overall levels of our foreign assistance are judged as an indication of the seriousness of the U.S. response to the problems of the developing countries.

As I have emphasized, the United States has important foreign policy interests in the developing countries. We will be more successful in obtaining the cooperation of these countries in our search for world economic and political stability if they see us to be willing to assist them in their development efforts. This basic reciprocity is at the heart of our relations with the developing countries.

For all the reasons I have given, we strongly support the recommended U.S. participation in the multilateral development banks. The proposals before you today deal only with the regional banks, which play a special role in the international economic system. Their operations reflect the assessments made by regional members of thier own needs, and they have an expertise and understanding of local conditions and problems. The regional development banks serve as useful complements to the global programs of the World Bank Group. Most importantly, U.S. support for these regional banks especially manifests our interest in the development and progress of the countries in each region and thus has particular political as well as economic significance.

U.S. Foreign Development Assistance
FY 1969-1979

($ Millions)

Fiscal Year	MDB Appropriations Total	MDB Appropriations Less Callable Capital 1/	AID Appropriations 2/	Foreign Assistance Appropriations Total	Foreign Assistance Appropriations Less Callable Capital	MDB Appropriations as Share of Foreign Assistance Appropriations Total	MDB Appropriations as Share of Foreign Assistance Appropriations Less Callable Capital
1969	686	480	1,207	1,893	1,687	36	28
1970	686	480	870	1,556	1,350	44	36
1971	455	255	989	1,444	1,244	32	20
1972	335	88	986	1,321	1,074	25	8
1973	738	570	910	1,648	1,480	45	39
1974	788	620	820	1,608	1,440	49	43
1975	619	522	691	1,310	1,213	47	43
1976	696	600	999	1,695	1,599	41	38
1977	1,141	404	1,121	2,262	1,525	50	26
1978	1,926	1,104	1,294	3,220	2,398	60	46
1979	2,515	1,632	1,544	4,059	3,176	62	51

1/ Indicating magnitude of budgetary expenditures that would eventually result in outlays.

2/ AID assistance, excluding Security Supporting Assistance and PL-480.

U.S. Foreign Development Assistance
FY 1969-1979

Constant 1978 Dollars
($ Millions)

Fiscal Year	MDB Appropriations Total	MDB Appropriations Less Callable Capital	AID Appropriations
1969	1,203	842	2,117
1970	1,142	799	1,448
1971	721	404	1,566
1972	510	134	1,500
1973	1,061	819	1,308
1974	1,033	813	1,075
1975	740	624	827
1976	791	682	1,136
1977	1,225	434	1,204
1978	1,926	1,104	1,294
1979	2,331	1,513	1,431

THE PRESIDENT'S 1980 BUDGET REQUEST

FOREIGN ECONOMIC AND FINANCIAL ASSISTANCE

BUDGET AUTHORITY

(in millions of dollars)

	FY 1978 Actual	FY 1979 Estimate	FY 1980 Proposed
FOREIGN ECONOMIC AND FINANCIAL ASSISTANCE:			
Multilateral development assistance:			
Multilateral development banks	1,926	2,515	3,625
International organizations	240	260	277
International Fund for Agri-Cultural Development	---	---	---
Agency for International Development	1,294	1,544	1,762
Proposed legislation	---	---	25
Food Aid	923	806	719
Security supporting assistance (AID)	2,219	1,921	1,995
Refugee assistance	79	164	152
Other foreign economic and financial assistance	127	149	162
SUBTOTAL, Foreign economic and financial assistance	6,808	7,359	8,718
Offsetting receipts	-336	-346	-370
TOTAL, net of receipts	6,472	7,013	8,348
MDBS AS PERCENT OF TOTAL	29.8	35.9	43.4

The President's FY 1980 Budget Request
Foreign Economic and Financial Assistance
Program Level
(in millions of dollars)

	FY 1978 Actual	FY 1979 Estimated	FY 1980 Proposed
FOREIGN ECONOMIC AND FINANCIAL ASSISTANCE:			
Multilateral development assistance:	1,104	1,630	1,842
Multilateral development banks	1,926	2,515	3,625
International organizations	241	260	277
International Fund for Agricultural Development	200	---	---
Agency for International Development	1,369	1,545	1,479
Proposed Legislation	---	---	25
Food Aid	1,192	1,438	1,399
Security Supporting Assistance (AID)	2,224	1,921	1,995
Refugee Assistance	79	164	152
Other Foreign Economic and Financial Assistance	138	155	171
SUBTOTAL	6,547	7,113	7,340
Offsetting Receipts	-336	-346	-370
TOTAL, Foreign Economic and Financial Assistance	6,211	6,767	6,970
MDBS AS PERCENT OF TOTAL	17.8	24.1	26.4

THE PRESIDENT'S FY 1980 BUDGET REQUEST

FOREIGN ECONOMIC AND FINANCIAL ASSISTANCE

OUTLAYS

(In millions of dollars)

	1978 Actual	1979 Estimate	1980 Proposed
FOREIGN ECONOMIC AND FINANCIAL ASSISTANCE:			
Multilateral development assistance:			
Multilateral development banks:	858	858	1,023
International organizations	210	251	272
International Fund for Agricultural Development	20	20	40
Agency for International Development	1,007	1,175	1,316
Proposed legislation			6
Food aid	808	1,055	993
Security Supporting Assistance (AID)	1,908	2,061	1,950
Refugee assistance	75	111	173
Other foreign economic and financial assistance	78	118	119
SUBTOTAL, Foreign Economic and Financial Assistance	4,965	5,649	5,893
Offsetting receipts	-336	-346	-370
TOTAL, Net of Receipts	4,629	5,303	5,523
MDBS AS PERCENT OF TOTAL	18.5	16.2	18.5

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TREASURY RELEASES REPORT ON THE
NATIONAL SECURITY EFFECTS OF OIL IMPORTS

The Treasury Department today released its report of an investigation under Section 232 of the Trade Expansion Act of 1962 into the national security effects of oil* imports.

The report consists of a memorandum from Secretary W. Michael Blumenthal to the President and the Treasury General Counsel's report of the investigation. The result of a year-long investigation initiated on March 15, 1978, the report concludes that oil imports are entering the United States in such quantities and under such circumstances as to threaten to impair the national security. Accordingly, the Secretary's memorandum to the President recommends that action be taken to reduce domestic oil consumption and increase domestic production of oil and other sources of energy by providing appropriate incentives and eliminating programs and regulations that inhibit the achievement of these goals.

The report notes that specific recommendations on achieving conservation and production objectives are being evaluated in an interagency group charged with presenting the President with policy options for his consideration.

The Secretary's report to the President is based on the investigation conducted by the General Counsel of the Treasury Department. The General Counsel's report of that investigation examines in considerable detail the causes and consequences of the nation's

* As used in the report, "oil" includes crude oil, crude oil derivatives and products, and related products derived from natural gas and coal tar.

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(MORE)

growing dependence on imported oil, particularly since 1975, when Secretary of the Treasury William E. Simon reported to President Ford that oil imports threatened to impair the national security.

The General Counsel's report concludes that the threat to the national security is greater now than before because:

- U.S. dependence on imported oil to satisfy domestic oil needs and overall energy demands has increased;

- The amount and cost of these oil imports have increased dramatically since 1975;

- Oil imports increasingly originate in a small number of distant foreign countries;

- The risk that oil imports will be interrupted by civil disturbances, terrorist acts, war and a variety of other causes has not diminished since 1975.

The report finds that, even apart from the possibility of supply interruptions, the monetary repercussions accompanying the growing dependency on imported oil constitute a threat to the national security.

The Secretary initiated the oil import investigation in March of 1978 to update the 1975 finding that oil imports threatened to impair the national security. The statute requires that the investigation be concluded within one year of the date it is initiated.

During his investigation, the General Counsel solicited and considered comments from the public as well as from a number of agencies. The agencies' comments, which were appended to the General Counsel's report transmitted to the President, and public comments received in the course of this investigation are available for public reading and copying at the Library of the Treasury Department, Room 5030, Main Treasury, 15th St. and Pennsylvania Ave. N.W., Washington, D.C.

o 0 o

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

MAR 14 1979

MEMORANDUM FOR THE PRESIDENT

Subject: Report of Section 232 Investigation on Oil Imports

I have completed the investigation I initiated last year pursuant to Section 232 of the Trade Expansion Act of 1962 to determine whether oil* imports are entering the United States in such quantities or under such circumstances as to threaten to impair the national security. I am transmitting herewith a detailed report of our investigation.

On January 14, 1975, acting pursuant to the same Section 232 authority, Treasury Secretary Simon found that the nation's dependence on imported oil was so great as to threaten to impair the national security and recommended to President Ford that action be taken to remove the threat. That conclusion is, unfortunately, even more valid today.

The nation's dependence on imported oil has increased dramatically since the 1975 finding. At the time of Secretary Simon's finding, 37 percent of United States demand for oil was supplied from foreign sources. In 1978, oil imports accounted for 45 percent of oil consumed in the United States. During that same period, the nation became more dependent on oil to meet overall energy demand, and oil imports increasingly originated in a small number of distant foreign countries. The increasing dependence on foreign sources of oil is a consequence of both rising levels of consumption and declining domestic production.

This growing reliance on oil imports has important consequences for the nation's defense and economic welfare. Because so much of the oil used in the United States originates thousands of miles away, supplies are vulnerable to interruption from a variety of causes. Recent developments in Iran have dramatized the consequences of this excessive dependence on foreign sources of petroleum. Furthermore, the rising level of oil imports adversely affects our balance of trade

* The term "oil", as used in this report, means crude oil, crude oil derivatives and products, and related products derived from natural gas and coal tar.

and our efforts to strengthen the dollar; in 1978, outflows of dollars for our oil imports amounted to $42 billion, $15 billion more than in 1975 and offsetting much of the rise in our exports of industrial and farm products.

The continuing threat to the national security which our investigation has identified requires that we take vigorous action at this time to reduce consumption and increase domestic production of oil and other sources of energy. To the extent feasible without impairing other national objectives, we must encourage additional domestic production of oil and other sources of energy, and the efficient use of our energy supplies, by providing appropriate incentives and eliminating programs and regulations which inhibit the achievement of these important goals.

Specific recommendations on achieving these conservation and production objectives are being evaluated by an interagency group in which Treasury is participating. The committee's work will be finished shortly and specific policy options will be formulated for your consideration.

WMBlumenthal

W. Michael Blumenthal

REPORT OF INVESTIGATION UNDER SECTION 232 OF THE TRADE EXPANSION ACT, 19 U.S.C. 1862, AS AMENDED

I. INTRODUCTION

1. Background.

Section 232(b) of the Trade Expansion Act of 1962 authorizes the President to take action to adjust imports of crude oil, crude oil derivatives and products and related similar products derived from natural gas and coal tar (hereinafter referred to collectively as "oil") if the Secretary of the Treasury finds that such commodities are being imported into the United States in such quantities or under such circumstances as to threaten to impair the national security.

Previous findings that oil imports threaten to impair the national security were made in 1959 and 1975.1/ Those findings have served as the basis for programs to control oil imports, first by means of quotas and later through use of license fees.2/ The use of license fees was upheld by the United States Supreme Court in an opinion which emphasized the breadth of the remedies permitted under Section 232(b).3/ On its face, Section 232(b) authorizes any remedy reasonably related to the adjustment in the importation of a particular article.

This investigation was initiated by the Secretary of the Treasury on March 15, 1978 (see Appendix A) to examine developments since 1975 and to determine:

1. whether increased reliance (since 1975) on oil imports from a small number of distant foreign suppliers continues to threaten to impair the national security;

2. whether the monetary repercussions accompanying continued large payments outflows for oil imports threaten to impair the national security.

At the time he initiated the investigation, the Secretary of the Treasury stated that the investigation was to be undertaken for contingency purposes only and that it should be conducted on a confidential basis. Initially, in the Secretary's judgment, national security interests required that public comments not be invited. Accordingly, the Secretary requested the General Counsel to proceed immediately with the investigation. Information and advice were solicited from the following agencies in the course of the investigation: Central Intelligence Agency, Department of Defense, Department of Energy, National Security Council, Federal Reserve Board, Department of State, Council of Economic Advisers, Department of Commerce, Department of Labor, Department of the Interior, and Department of Transportation. On February 2, 1979, the Secretary invited comments from the public, having reviewed his earlier determination and concluded that it was then appropriate to issue the invitation. None of the agency submissions or public comments challenged the proposition that oil imports threaten to impair the national security. The overwhelming conclusion of these submissions and comments is that such a threat continues to exist.

2. Conclusion

The conclusion of this report is that oil continues to be imported in such quantities and under such circumstances as to threaten to impair the national security. This threat arises both from increased reliance on a small number of foreign oil suppliers and the monetary repercussions accompanying continued large payments outflows for imported oil. Unlike temporary crises in the nation's ability to satisfy its oil import needs, the national security threat arising from growing reliance on imported oil has its gravest implications in the long-term.

II: INCREASED RELIANCE ON OIL IMPORTS FROM A RELATIVELY SMALL NUMBER OF FOREIGN SUPPLIERS THREATENS TO IMPAIR THE NATIONAL SECURITY

1. A threat to the national security has previously been established.

The 1959 finding.

In 1959, the President's Special Committee to Investigate Crude Oil Imports determined that oil imports constituted a threat to the national security.4/ The Committee concluded that, in order to have enough oil to meet the nation's security needs, "there must be a limitation on imports that will insure a proper balance between imports and domestic production.... [Absent that balance,] in an emergency the nation would be confronted with all of the liabililites inherent in a static, as contrasted with a dynamic, mobilization base, including the delays, waste and inefficiency that accompany efforts to strengthen any part of the mobilization base on a 'crash' basis."5/

The 1975 finding.

In 1975 the Secretary of the Treasury found that oil imports threatened to impair the national security. That investigation considered all factors relevant to a finding under Section 232(b), including the relationship of the nation's economic welfare to its national security. The Treasury report concluded that oil imports should be reduced in order to "wean ourselves away from a dependence upon imported oil, conserve our use of petroleum, promote the use of alternative sources of energy, and at least in part, stanch the outflow of payments resulting from our purchases of this commodity."6/

Congressional declarations.

In August 1977, Congress, in enacting Title I of the Department of Energy Organization Act, declared that the "energy shortage and our increasing dependence on foreign energy supplies present a serious threat to the national security of the United States."7/ This declaration echoed an earlier Congressional finding in section 2 of the Emergency Petroleum Allocation Act of 1973 that oil shortages will create severe economic dislocations and hardships which constitute a national energy crisis threatening the public health, safety and welfare. 8/ More recently, section 102 of the National Energy Conservation Policy Act of 1978 emphasized the need to stem the nation's increasing reliance on imported oil and the vulnerability which accompanies such reliance.9/

2. The nation has increased its dependency on a small number of distant foreign oil suppliers.

Since 1975, United States oil imports have increased as a share of oil consumed and of all energy consumed in the United States. In addition, because oil imports increasingly originate from a small number of foreign and mostly distant sources, they have become more vulnerable to interruption.

Level of oil imports.

Oil imports have risen steadily over the past 20 years.10/

1959	1.8 mmbpd (million barrels per day)
1975	6.5 mmbpd
1978	8.7 mmbpd (including the Strategic Petroleum Reserve)

Over the same period, oil imports have increased both as a share of domestic demand for oil 11/

1959	18%
1975	39%
1978	45%

and as a share of demand for energy of all types.12/

1959	9%
1975	19%
1978	23%

A growing share of our oil imports come from OPEC nations:13/

1959	70%
1975	78%
1978	83%

Oil imports averaged 8.7 mmbpd during 1978--down 6 percent from 1977.14/ However, this decline resulted from a rundown of domestic inventories and a one-time buildup of Alaskan production which more than offset the 1.6 percent rise in domestic oil demand and the 4 percent decline from 1977 in the crude oil production of the lower 48 states.15/ Alaskan oil, which began to flow in June 1977, approached the capacity pipeline flow of 1.2 mmbpd in the second quarter of 1978.16/

Sources of oil imports.

In the early 1960's, Venezuela was the largest external supplier of oil to the United States, providing about 46 percent of total oil imports.17/ Later Canada (non-OPEC) became a large supplier, accounting for about 22 percent of imports by 1970.18/ However, imports from Venezuela have declined sharply as a percentage of total imports, and Canada has adopted procedures which could virtually phase out all light crude oil exports to the United States by 1981.19/ As imports from these traditional Western Hemisphere suppliers have receded in significance, there has been a corresponding rise of the nation's reliance on Eastern Hemisphere sources, particularly those in the Middle East. The proportion of oil imports originating in Middle Eastern countries was:20/

1959	21%
1975	27%
1978	34%

For the next decade, the United States will probably continue to rely heavily on Middle Eastern supply sources. Although recent developments in Iran have diminished expectations for continuing the previous levels of production in that country, in all likelihood, U.S. dependence on other Middle Eastern producers will increase further.21/

As oil production in the United Kingdom and Norwegian sectors of the North Sea develops, some demand for Middle Eastern oil will shift to North Sea oil. However, the changeover is likely to have its greastest effect on the European markets, with substantial U.S. reliance on Middle Eastern oil remaining relatively undiminished. The expanding production in Mexico, for which the United States forms a natural market,22/ offers another alternative to imported Middle Eastern oil. Nevertheless, through 1985, U.S. dependence on Middle Eastern producers is not expected to be reduced significantly because of the development lead time required.

Value of oil imports.

Not only has the volume of U.S. oil imports expanded, but the landed price of foreign petroleum has jumped sharply as well. For example, the average unit value (f.a.s.) of U.S. petroleum imports has risen as follows:23/

1959	\$ 2.26 pb (per barrel)
1975	\$11.45 pb
1978	\$13.28 pb

As a consequence, the nation's annual oil import bill has grown dramatically over the past 20 years:24/

1959	\$ 1.5 billion
1975	\$27.0 billion
1978	\$42.3 billion

The cost of oil imports may be expected to increase further in 1979 as a result of the OPEC price increase of

14.5 percent--fourth quarter to fourth quarter--agreed upon at the meeting of OPEC ministers in December. Recent interruptions in Iranian production have put upward pressure on market prices and have prompted many oil producers to seek to obtain price increases beyond those scheduled in the December OPEC price decision.

3. The risk of detrimental interruption has not lessened.

Risk of interruption.

As noted above, the U.S. is heavily dependent for its imported oil on a small number of distant countries. These countries are a diverse group of nations with different resources and goals. While, in the main, the U.S. shares common interests with them, there are also some areas of political disagreement. In 1973, some of these countries demonstrated their willingness to use oil as a political weapon. For the first time in history, this country's access to major petroleum supplies was cut off by an embargo, as a result of dissatisfaction with our foreign policy. This action was prompted by a major military conflict in the Middle East. Although hostilities have generally subsided, the underlying political dispute has not yet been resolved. Despite the intervening years and strengthened relations with Middle Eastern nations, the United States cannot discount the possibility of another political disagreement with the nations on which it depends for its oil supplies.

In addition, recent developments in Iran have highlighted the potential for internal domestic upheavals to disrupt oil supplies. As a result of the events beginning with a strike in October 1978, Iranian exports until very recently have been limited to small amounts of heavy residual oil not usable within Iran. Although Iranian oil exports have been renewed, the Iranian government has stated its intention to limit oil exports to 3 mmbpd, well below the 5 mmbpd level that prevailed before the interruptions. Even though Iranian oil accounted for only 5 percent of U.S. oil consumption prior to December 1978, Secretary Schlesinger recently indicated that the continued interruption of even this relatively less important U.S. supply source could require the U.S. to consider mandatory conservation measures. This assertion serves to emphasize, as the Central Intelligence Agency has noted, the vulnerability of the U.S. economy to supply disruption. See Appendix B.

Furthermore, other types of supply interruption are possible. For example, six of the Middle Eastern nations which are major suppliers of oil to the U.S. ship their oil through the narrow Strait of Hormuz at the southern end of the Arabian Gulf.25/ This geographical situation alone renders this oil supply route vulnerable. Moreover, the producing nations themselves face a risk of terrorist action with attendant harm to oil production and shipment facilities. Indeed, the Central Intelligence Agency has stated:

> There is a high probability that acts of nature, human error, or deliberately targeted terrorist attack will interrupt the flow of oil in one or more of the oil exporting nations during the next several years.
>
> Interruptions of oil supply owing to guerrilla operations, acts of terrorism, or acts of nature are not likely, by themselves, to be of a magnitude and duration which would result in severe economic disruption of Free World economies, though they could exert strong upward pressure on prices in a tight world oil market. Extensive terrorist action against key oil storage and transportation facilities in the Persian Gulf could, in particular, significantly affect the market by substantially reducing oil supplies for the time required to put those facilities back into operation, which could be several months.

See Appendix B.

According to the Defense Department:

> The concentration of oil production facilities in the area presents the major physical risk. This creates a risk of interdiction, or even the risk of natural or accidental disturbances. The extensive damage in the Abqayq fires in May and June 1977, caused by accident, highlights the fragility of these facilities. Destruction of key facilities could cause major interruptions of oil deliveries to the U.S. and to our NATO and Japanese allies which would adversely affect U.S. and Western World political, economic and military security.

See Appendix B.

In short, the overall potential for an embargo or other interruption has not decreased since the embargo of 1973, nor since the 1975 finding by the Secretary of the Treasury that such a risk threatened to impair the national security. On the contrary, developments in Iran demonstrate that U.S. oil imports can be seriously affected by internal disruptions in a country even if it is not a primary supplier of the U.S. oil imports. Disruption in any source of supply serves to concentrate U.S. reliance on the other supply sources and, at a minimum, leads to unscheduled price increases, thereby increasing the nation's vulnerability.

Strategic petroleum reserve only recently initiated.

Congress has ordered the establishment of a Strategic Petroleum Reserve (SPR)26/ to reduce the impact of a potential interruption. However, the reserve currently contains only about 77 million barrels, or 7.7 percent of the one billion barrel goal proposed by the Department of Energy for 1985.27/

International Energy Agency Sharing Plan gives limited protection.

To minimize the effect on member countries of oil shortages created by an embargo or other circumstances, the United States and the 19 other International Energy Agency (IEA) member countries have agreed to an International Energy Program under which allocation of oil and mandatory demand and restraint measures can be triggered when the group as a whole sustains a 7 percent reduction in oil import supplies or when any one country (or group of countries) sustains a 7 percent reduction in its oil supplies.28/ Each country is required to have demand restraint mechanisms in place that are capable of reducing its oil consumption by 7 percent--about three and one half mmbpd for the IEA countries as a group based on IEA estimates of probable 1980 consumption. The supply sharing mechanism is coupled to the activation of the demand restraint program. In addition, countries have the obligation to build stocks equivalent to 60 days of imports.

The interruption of Iranian oil exports has not led to activation of the IEA oil-sharing agreement. Nevertheless, IEA member countries are greatly concerned regarding the current situation in the oil market, which has brought severe pressure on prices. Accordingly, the IEA Governing Board, meeting on March 1-2, 1979, agreed that IEA countries would promptly reduce their demand for oil on the world market by about 2 mmbpd. This amount corresponds to about 5 percent of IEA consumption. The share of the U.S. in this reduction would be just under one mmbpd.

The degree of protection afforded by the combined SPR and IEA sharing plans depends on a number of variables, including the amount of oil stored at the time of any interruption, as well as the magnitude and length of the interruption. The current level of protection afforded by the existing SPR and contingency conservation plans is limited. Because of the relatively small inventory in the SPR at the present time, conservation contingency plans take on added significance as a means of meeting our March 2 commitment to the IEA or, more generally, our potential commitment under the provisions of the IEA. Besides measures to reduce oil consumption by encouraging the use of natural gas, which is temporarily in surplus, and by shifting to non-oil generated electric power, the Administration has submitted to Congress for approval three contingency conservation plans. These three conservation plans, which were submitted on March 1, are estimated to save as much as 614,000 bpd. It is anticipated that these demand restraint plans will play a significant part in achieving the consumption reduction agreed upon on March 2 or in meeting our obligations in case of activation of the international sharing plans.

Impact of the National Energy Act on oil imports

It is estimated the National Energy Act will save between 2.4 and 3.0 mmbpd of oil imports by 1985. Sizeable savings will occur from the displacement of imported oil by additional supplies of domestically produced natural gas. This potential displacement is estimated to be in excess of one mmbpd. Increased gas supplies are anticipated to result primarily from provisions in the National Energy Act which raise the prices of natural gas and permit tapping supplies, formerly available only to the intrastate market, for the interstate market.

At the beginning of 1979 there were variously estimated to be between 1 and 1.4 trillion cubic feet of additional natural gas supplies immediately available as a result of the National Energy Act.29/ If these supplies were promptly put to use, they could displace over 500,000 bpd of imported oil for the next two or three years. However, there is uncertainty as to how much oil consuming equipment can be physically converted to use the additional gas and whether or not such conversion will be practical for the short term.

In summary, while the provisions of the National Energy Act are estimated to reduce oil imports by about 2.5 mmbpd by 1985, for the immediate future, reductions in oil use will be modest and will not significantly lessen U.S. vulnerability to disruptions in foreign supply.

Limited possibilities for the development of alternative energy sources.

Despite national programs to encourage use of alternative energy sources, immediate savings from conversion to other fuels are limited by the time required to change existing energy-using capital stock, i.e., industrial equipment, buildings, and transportation vehicles. For example, the conversion of industrial plants and electric utilities from oil and gas use to coal is slow, costly and constrained by environmental considerations. Thus, despite the recent emphasis on shifting the source of energy in major oilburning installations, the use of oil in utility plants increased from 396 mmb in 1971 to 624 mmb in 1977.30/

In the last decade, nuclear generating capability has grown, but nuclear power's share of domestic energy production remains small. The power generated from nuclear plants increased from 38.1 billion kilowatt hours in 1971 to 250.9 billion kilowatt hours in 1977.31/ Even so, nuclear sources provide only about 4 percent of total energy production.32/ As the United States' nuclear capability increases, demand for oil and gas by utilities may decline, but at a slow rate. In addition, the lead time currently required for placing a nuclear power plant in operation is 10-12 years.33/ Overall, the provisions of the National Energy Plan anticipated that nuclear power would reach an oil equivalent of 3.8 mmbpd by 1985, up from 1.0 mmbpd oil equivalent in 1976.34/ However, more recent projections of nuclear power generation provided by the Energy Information Administration to Congress are somewhat lower.35/

To date, renewable sources of energy, such as solar, wind, and geothermal, have not made significant contributions as substitutes for oil and gas. The 1977 National Energy Plan forecasts that these domestic energy supplies will increase from 1.5 mmbpd of oil equivalent in 1976 to 1.7 mmbpd oil equivalent in 1985.36/ This increase of only 200,000 bpd of oil equivalent indicates that any significant energy contribution from such new sources will not take place until after 1985.

Expanded domestic production hampered under current conditions.

Domestic production of crude oil has declined, from a peak of 9.6 mmbpd in 1970 to 8.7 mmbpd in 1978, despite the addition of production from the Alaskan North Slope.37/ Production from Alaska began in 1977 and by 1978 reached the current design capacity of the Alaskan pipeline of 1.2 mmbpd. Absent further incentives for the sale of Alaskan crude, production is estimated to remain at this level offering no further offset to the decline in production in the lower 48 states.

Of particular concern is the rapid decline of lower tier "old" oil production under the current pricing structure. The production of old oil is important because it constituted over 50 percent of domestic production at the beginning of 1977.38/

Production of old oil was projected to decline from 3.5 mmbpd in 1978 to 1.95 mmbpd by 1985, an annual decline rate of 8 percent over the seven year period.39/ However, Treasury studies have placed the actual annual decline rate for old oil at over 16 percent for the 12 month period beginning in December 1977. Decline rates are greatly influenced by the economics of production which may account for the abnormally high rates experienced in recent months.

Proven domestic reserves of crude oil have declined steadily from 39 billion barrels in 1970 (at the time of the Alaskan North Slope discovery) to an estimated 29.5 billion barrels at the end of 1977.40/ Moreover, subsequent to the discovery of oil at Prudhoe Bay, the new reserves added each year have not equaled annual production. The outlook for discovering significant quantities of new domestic petroleum reserves is uncertain from a geological standpoint.41/ Undiscovered oil resources in the U.S. are estimated to range from 46 to 143 billion barrels with a median amount of roughly three times the current proven reserves.42/ New reserves can only be proven by drillings. In addition, there is a significant potential for enhanced recovery from known deposits of oil.

Domestic production from existing wells has been hampered by price regulations that discourage some categories of marginal production. There are indications that at $15 per barrel (1976 $), enhanced production may amount to as much as 1.5 mmbpd by 1990.43/ In addition, the entitlements program, designed to equalize the price of imported and domestic crude oil to domestic refiners, has in fact encouraged oil consumption by indirectly subsidizing purchasers of foreign oil.44/

Under the current pricing structure, there appears little prospect for substantially increasing oil production or even stemming the natural decline of old oil. On the other side of the supply-demand system, conservation measures taken to date have not been sufficient to slow the rise in demand adequately. Thus, the nation's current prospects of reducing its vulnerability to interruptions in oil imports are not promising.

4. The impression of vulnerability created by the nation's seeming inability to control its increasing dependence on oil imports directly affects the nation's defense and foreign policy.

The United States' increasing reliance on foreign oil is perceived by its industrialized allies, the developing world, the Soviet bloc and the oil exporting countries themselves both as a sign of weakness and of a lack of internationally cooperative behavior. This perception works to the nation's disadvantage in terms of its national defense and its foreign policy.

National Defense.

The Department of Defense has described the national defense impact of the nation's dependence on imported oil:

> The threatened impairment of the national security must be assessed not only in terms of the domestic capability to support national defense needs ... but also in terms of international perceptions. Other countries make decisions on foreign relations and defense matters based upon their perception of our strengths. The impact of petroleum import ...[dependency] on the United States could alter these perceptions significantly causing them to misjudge U.S. intentions. Such decisions would affect directly the security of the United States.

See Appendix B.

The State Department concurred that dependence impairs the national defense:

> Our treaty obligations, particularly those that relate to mutual security, require the United States to be able to conduct an effective defense of its own interest and to make an effective contribution to the defense of its allies. Heavy dependence on imported oil can create doubts about our ability to sustain prolonged conflicts and assist our allies in an optimum way.

See Appendix B.

Foreign policy.

The dependence of the nation on imported oil also adversely affects its ability to achieve its foreign policy objectives and fulfill its international obligations. Other countries may doubt this country's resolve to fulfill political commitments or respond to challenges when the contingencies to which it may have to respond could affect the availability of oil. Respect for the United States' ability to take charge of its energy problem is critical to maintaining a position of world leadership. The State Department reported:

> It is our view that the current oil import situation impairs our ability to achieve our foreign policy objectives, both economic and political... Moreover, the way in which we deal with this situation is widely regarded by other countries as a test of United States leadership and determination to play a constructive role in international relations.

See Appendix B.

5. Conclusion

The nation's current and projected dependence on foreign oil is appreciably greater than when past findings determined that dependence on foreign oil threatened the national security. The risk of interruption has not significantly lessened, and measures to reduce substantially the impact of interruption are not yet in place. The threat to the national security is thus greater now than at any time in the past.

III. THE MONETARY REPERCUSSIONS OF EXCESSIVE DEPENDENCE ON IMPORTED OIL THREATEN TO IMPAIR THE NATIONAL SECURITY45/

1. The efforts of the U.S. to strengthen the dollar at home and abroad are being hampered by the excessive dependence on imported oil.

Efforts to strengthen the dollar.

Although the United States is pursuing a broad array of policies to establish the fundamental economic conditions for a strong dollar, these efforts are being hampered by excessive dependence on imported oil. A program of monetary and fiscal restraint, supplemented by voluntary wage-price programs, is being implemented to bring inflation down and achieve a more sustainable economic expansion. This will contribute to a substantial reduction in the U.S. trade and current account deficits, which is a prerequisite for the maintenance of a strong and stable dollar. A new export promotion program is expected to help increase exports further. However, curbing this country's reliance on imported oil is essential to any major and lasting improvement. As pointed out in a previous section, the actual cost of annual oil imports increased nearly thirty-fold from 1959 to 1978, from $1.5 billion to about $42 billion. In 1978, oil imports represented roughly 25 percent of the total imports of the United States and amounted to about one and a quarter times the total merchandise trade deficit.

In 1979, oil import costs are expected to rise substantially. The December 1978 OPEC price hike alone will add about $4 billion to the cost of U.S. oil imports during 1979 and even more in 1980. The disruption in world supply patterns due to political developments in Iran has already led to some further price rises and created the risk of substantial increases.

The continuing excessive dependence on imported oil is making it more difficult to achieve U.S. economic objectives. The rising price of imported oil increases inflationary pressures by directly raising costs and by heightening inflationary expectations. Uncertainties about supplies and costs hamper confidence and inhibit investment required for noninflationary growth. The growth of oil imports puts greater adjustment burdens on other elements of the U.S. balance of payments since it greatly increases the need for expansion of exports or decreases in other imports. With reduced dependence on oil imports, the U.S. economy could maintain appropriate levels of growth and grow faster with a lower inflation rate and a stronger dollar.

Exchange market perceptions.

Because of its impact on the U.S. trade and current account deficits, excessive and growing U.S. dependence on oil imports increases the danger of reduced confidence in the dollar and makes the dollar more vulnerable to downward pressures in the foreign exchange market.

If downward pressures on the dollar were to become so servere as to damage world confidence in the dollar, the national security of the United States would be impaired. The dollar serves as the principal international currency for the world economy. The dominant share of world trade is denominated in dollars. About three-fourths of all medium and long-term borrowing in international capital markets is in dollars. The IMF indicates that nearly 80 percent of official foreign currency reserves held by foreign central banks is in dollars. Thus, loss of confidence in the dollar if widespread, would be likely to precipitate sudden and large-scale international capital flows in ways which would be disruptive to the banking system and world financial markets. The danger of resort to restrictive measures which would jeopardize the open trade and payments system would be greatly increased.

As the Federal Reserve Board has indicated:

> Concern about the U.S. deficit and the international value of the dollar could lead holders of dollars to undertake reductions in their dollar assets. Exchange market uncertainties would thereby be heightened and instability increased. It is, therefore, necessary to demonstrate our resolve to contain our oil imports and to help avoid the economic disruption that could follow from such portfolio shifts.

See Appendix B.

Chairman Miller of the Federal Reserve Board has noted the relationship between the exchange value of the dollar and the health of the U.S. economy:

> At current quantity and price levels, imported petroleum is a major factor in the large U.S. trade and current account deficits. This has contributed to the substantial depreciation of the dollar in relation to other major currencies. Such depreciation adds to domestic inflation, fosters higher U.S. interest rates, creates instability in the international financial markets, and threatens further increases in international oil prices. These in turn foster conditions that could lead to lower domestic economic activity and higher unemployment.

See Appendix B.

Moreover, the world associates a strong currency with a strong country. The United States' relations with other nations and its ability to exercise leadership in political and military affairs are closely linked to confidence in the dollar.

According to the Department of State:

> Our high level of oil import dependence has contributed substantially to a current account deficit that has reduced international confidence in the dollar. This in turn has created difficulties in achieving the maximum degree of international cooperation to further our objective of promoting a stable, balanced recovery of the world economy...

See Appendix B.

2. Conclusion

A perception of continued inability of the nation to resolve its oil import problem could have significant consequences for the value of its currency and could thus seriously harm the nation's economic welfare. Such a perception, therefore, threatens to impair the national security.

IV. FINDINGS

This investigation has established that

- U.S. dependence on foreign oil has increased since 1975 and there has been no change in the risks of interruption, resulting in a greater threat to the national security than before;

- the monetary repercussions accompanying the growing dependency on imported oil constitute a threat to the national security, even apart from the possibility of supply interruptions.

Robert H. Mundheim
General Counsel
Department of Treasury

MAR 14 1979

FOOTNOTES

1/ The 1959 finding was announced in Presidential Proclamation 3279, on March 10, 1959, 24 Fed. Reg. 1781 (1959). The 1975 Treasury finding appeared as U.S. Dep't of Treasury, Report on Investigation of Effect of Petroleum Products on the National Security pursuant to Section 232 of the Trade Expansion Act, as amended, 40 Fed. Reg. 4457 (1975).

2/ See Presidential Proclamation 3279, 24 Fed. Reg. 1781 (1959) as amended (quotas), modified by Presidential Proclamation 4210, 38 Fed. Reg. 9645 (1973) (license fees). The supplemental license fees imposed by President Ford following the 1975 finding were subsequently revoked.

3/ FEA v. Algonquin SNG Inc., 426 U.S. 548 (1976).

4/ President's Special Committee to Investigate Crude Oil Imports, Report to the President, March 6, 1959.

5/ President's Special Committee to Investigate Crude Oil Imports, Report to the President, July 29, 1957.

6/ U.S. Dep't of Treasury, Report, supra note 1.

7/ Department of Energy Organization Act, Pub. L. No. 95-91, sec. 101, 91 Stat. 567 (to be codified at 42 U.S.C. sec. 7112 (1977)).

8/ Emergency Petroleum Allocation Act of 1973, sec. 2, 15 U.S.C. sec. 751 (1973).

9/ National Energy Conservation Policy Act of 1978, Pub. L. No. 95-619, sec. 102, 92 Stat. 3206, (to be codified at 42 U.S.C. 820 (1978)).

10/ 3 [1977] Energy Information Adm. Ann. Rep. to Cong. 23 [hereinafter cited as EIA Annual Report]. Imports for 1975 and 1978 are on balance of payments basis, derived from Bureau of Census statistics and covering imports from foreign countries into U.S. Customs territory plus the Virgin Islands and Guam; data obtained from Balance of Payments Division, Bureau of Economic Analysis, Department of Commerce.

11/ Data from Monthly Energy Review, Feb. 1979, at 30, adjusted to a balance of payments basis.

12/ For 1959, see 3 EIA Annual Report, supra note 10 at 5, 23. For 1978, see Monthly Energy Review, Feb. 1979, at 4, 30, adjusted to a balance of payments basis.

13/ Data by source are from Department of Energy and differ slightly from balance of payments data. For 1978 data, see

Letter from Deputy Secretary of Energy John O'Leary to Secretary of Treasury W. Michael Blumenthal (March 9, 1979). For 1975 data, see Monthly Energy Review, May 1978, at 12, 14. For 1959 data, see Independent Petroleum Association of America, United States Petroleum Statistics 1978 (preliminary). The 1959 data are for countries which are now OPEC members. Estimated indirect imports for all years have been included.

14/ Monthly Energy Review, Feb. 1979, at 30, adjusted to a balance of payments basis.

15/ Production data based on first 9 months of 1977 and 1978. See U.S. Dep't of Energy, Energy Data Reports, Petroleum Statement, Monthly, Sept. 1978, at 7.

16/ American Petroleum Institute, Estimated U.S. Supply/Demand Situation, June 1978, at 2.

17/ U.S. Dep't of the Interior, Energy Perspectives II, June 1976, at 191.

18/ Id. at 194.

19/ Canadian National Energy Board, Report, "In the Matter of Exportation of Oil," October 1974, 4-7.

20/ Data are Department of the Treasury estimates, based on information supplied by Department of Energy and the Central Intelligence Agency. Includes both direct and indirect imports.

21/ An indication of productive capacity can generally be estimated from the proven reserves. It should be noted that the Middle East contains approximately 385 billion barrels of proven crude oil reserves. This is almost 60% of the entire world's reserves. Within the Middle East, Saudi Arabia, Kuwait and Iran have 281 billion barrels. These three countries dwarf the rest of the world in their current reserves. By contrast, the reserves of Indonesia are only 14 billion barrels; Nigeria, 19 billion barrels; and Venezuela, 14 billion barrels. See "Estimated Proved and Provable Petroleum Reserves," in Central Intelligence Agency, International Energy Statistical Review, Feb. 7, 1979 at 4.

22/ Mexican exports to the U.S. constituted 0.3 percent of U.S. oil imports in 1973, about 2 percent in 1977, and are expected to continue to rise in the future. See Monthly Energy Review, May 1978, at 12, 14.

23/ Unit value for 1959 is for crude oil only; those for 1975 and 1978 cover crude and products. Data are based on Bureau of Census import statistics, and were obtained from Balance of Payments Division, Bureau of Economic Analysis, Department of Commerce.

24/ Balance of Payments basis. Represents Bureau of Census statistics covering imports from foreign countries into U.S. Customs territory plus the Virgin Islands and Guam.

25/ Iran, Iraq, Kuwait, Qatar, Saudi Arabia, and United Arab Emirates.

26/ Energy Policy and Conservation Act, secs. 151-166, 42 U.S.C. secs. 6231-46 (1976).

27/ The Department of Energy's Strategic Petroleum Reserve Plan, amendment no. 2 to increase the size to one billion barrels became effective June 13, 1978.

28/ Agreement on an International Energy Program, Brussels, September 27, 1974, ch. IV.

29/ *See, e.g.*, Section 232 Investigation Comment of American Gas Association dated February 21, 1979 (on file at U.S. Dep't of Treasury).

30/ Monthly Energy Review, May 1978, at 38.

31/ *See* 3 EIA Annual Report, *supra* note 10, at 5.

32/ Monthly Energy Review, Feb. 1979 at 6.

33/ The Administration supported a nuclear siting and licensing bill in Congress which would reduce lead time to 6 - 7 years. H.R. 11704, 124 Cong. Rec. H.2,298 (daily ed. March 21, 1978). The Administration anticipates introducing a similar bill in the near future.

34/ Executive Office of the President, National Energy Plan, April 29, 1977, at 95 [hereinafter cited as the NEP].

35/ According to the NEP, nuclear power will equal 24.5 percent of total electricity generated in 1985. NEP, *supra* note 32, at 95. The EIA forecasts 19 percent nuclear power for slightly less electricity generated in 1985. 2 EIA Annual Report, *supra* note 10, at 215.

36/ NEP, *supra* note 35, at 96.

37/ For 1970 data, *see* 3 EIA Annual Report, *supra* note 10, at 23; includes lease condensate. For 1978 data, *see* Monthly Energy Review, Feb. 1979, at 28.

38/ Monthly Energy Review, Feb. 1979, at 76.

39/ 2 EIA Annual Report, *supra* note 10, at 139 (table 6.9).

40/ American Petroleum Institute, Reserves of Crude Oil, Natural Gas Liquids and Natural Gas in the United States and Canada as of Dec. 31, 1977 24 (1978).

41/ 2 EIA Annual Report, supra note 10, at 149 (figure 6.3).

42/ 2 EIA Annual Report, supra note 10, at 149 (table 6.14).

43/ National Petroleum Council, Enhanced Oil Recovery, Dec. 1976, at 6 (figure 2).

44/ Entitlements essentially average the cost of crude oil to refiners. Higher priced imported oil is averaged in with lower priced, price-controlled domestic oil. The cost to refiners of a composite barrel is approximately $2/bbl. less than the cost of imported oil.

45/ The data in this section were developed by the Office of International Monetary Affairs, Department of Treasury.

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

FOR IMMEDIATE RELEASE
March 21, 1979

Contact: Robert E. Nipp
202/566-5328

TREASURY ANNOUNCES RESULTS OF GOLD SALE

The Department of the Treasury announced that 1,500,100 troy ounces of fine gold were sold yesterday to 20 firms and individuals who bid successfully at a sealed bid sale.

Awards of 1,000,000 troy ounces of gold in 400 ounce bars whose fine gold content is 99.5 to 99.94 percent were made to 16 successful bidders at prices from $240.00 to $244.00 per ounce, yielding an average price of $241.30 per ounce. Bids for this gold were submitted by 20 bidders for a total amount of 2.1 million ounces at prices ranging from $234.75 to $244.00 per ounce.

Awards of 500,100 troy ounces of gold in 300 ounce bars whose fine gold content is 89.9 to 90.1 percent were made to 12 successful bidders at prices from $238.74 to $242.03 per ounce, yielding an average price of $240.09 per ounce. Bids for this gold were submitted by 19 bidders for a total amount of 0.8 million ounces at prices ranging from $233.17 to $242.03 per ounce.

Gross proceeds from today's sale were $361.4 million. Of the proceeds, $63.3 million will be used to retire Gold Certificates held by Federal Reserve Banks. The remaining $298.0 million will be deposited into the Treasury as a miscellaneous receipt.

The list of the successful bidders and the amount of gold awarded to each is attached. The General Services Administration will release details on the individual awards later.

The current sale was the eleventh in a series of monthly auctions being conducted by the General Services Administration on behalf of the Department of the Treasury. The next sale, at which 1,500,100 ounces will be offered, will be held on April 17, 1979. At this sale, 1,000,000 fine troy ounces will be offered in bars whose fine gold content is 99.50 to 99.94 percent. The minimum bid for these bars will be for 400 fine troy ounces. A total of 500,100 ounces will be offered in bars whose fine gold content is 89.9 to 91.7 per cent. The minimum bid for these bars will be 300 fine troy ounces. Bids for bars in each fineness category will be evaluated separately.

B-1475

(over)

Firm	Fine Troy Ounces
Amax Copper Inc New York, N.Y.	50,700
Bank Leu New York, N.Y.	13,200
Credit Suisse Zurich, Switzerland	23,100
Derby & Co LTD London, England	10,000
Deutsche Bank Frankfurt, Germany	200,000
Dowdex Corporation Chicago, Ill.	1,600
Dresdner Bank New York, N.Y.	274,000
Englehard Minerals and Chem New York, N.Y.	72,000
Gerald Metals Inc New York, N.Y.	30,000
Gold Standard Corp Kansas City, Mo.	400
J. Aron & Company New York, N.Y.	76,400
Metals Quality Corp. New York, N.Y.	27,600
Mocatta Metals Corp. New York, N.Y.	80,000
Noranda Sales Corp. LTD. Toronto, Ontario, Canada	18,300
Republic National Bank of N.Y. New York, N.Y.	143,500
Samuel Montagu Inc. New York, N.Y.	28,000
Sharps, Pixley Inc. New York, N.Y.	66,200
Swiss Bank Corporation Zurich, Switzerland	107,100
Union Bank of Switzerland Zurich, Switzerland	256,000
Westway Metals Corp. Englewood Cl, N.J.	22,000

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

FOR IMMEDIATE RELEASE
March 21, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES FINAL DETERMINATION IN COUNTERVAILING DUTY INVESTIGATION OF AMPICILLIN TRIHYDRATE AND ITS SALTS

The Treasury Department today announced a final determination that exports to the United States of ampicillin trihydrate and its salts from Spain are being subsidized.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional duty equal to the subsidy paid on merchandise exported to the United States.

As a result of its investigation, Treasury found that Spanish manufacturers of this merchandise received subsidies.

Notice of this action will appear in the Federal Register of March 22, 1979.

Imports of this merchandise from Spain during 1978 were valued at about $5.4 million.

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B-1476

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

FOR IMMEDIATE RELEASE
March 21, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY REVOKES COUNTERVAILING DUTIES
ON CERTAIN PRODUCTS FROM URUGUAY

The Treasury Department today announced its decision to revoke countervailing duties on imports of Uruguayan leather handbags, non-rubber footwear, leather wearing apparel and a number of textile products. Countervailing duties will not be collected with respect to any of the products covered which were exported from Uruguay on or after February 16, 1979.

The decision was based on a finding that the export of these goods is no longer being subsidized. The Treasury Department found that the Government of Uruguay had totally eliminated the net subsidy each product was receiving when it was exported to the United States by the imposition of a tax on all exports of the affected products to the United States on or after February 16, 1979, in amounts equal to the subsidy applicable to that product. The Government of Uruguay will also inform the Treasury of any instances in which the tax was not properly imposed on any goods destined for the United States.

With respect to leather handbags, non-rubber footwear, and leather wearing apparel, the Treasury had determined in early 1978 that Uruguayan exports of these products to the United States were subsidized but that, based on actions undertaken by the Government of Uruguay to eliminate those subsidies, the imposition of countervailing duties was waived. In November 1978, however, it was determined that the conditions on which the waiver was based were no longer applicable and the waiver was revoked. The posting of estimated countervailing duties on all imports of those items from Uruguay has been required since that time.

In the case of certain textiles and textile products, the Treasury determined in November 1978 that exports of those products to the United States were being subsidized, and countervailing duties have been imposed since that time.

Notice of these actions will appear in the Federal Register of March 22, 1979.

Imports of leather handbags, leather wearing apparel and non-rubber footwear were valued at about the following amounts for 1978: leather handbags, \$6.3 million; leather wearing apparel, \$27.8 million; non-rubber footwear, \$18.7 million. No import statistics were available on Uruguayan textile products.

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

FOR RELEASE AT 4:00 P.M. March 22, 1979

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $3,340 million, of 364-day Treasury bills to be dated April 3, 1979, and to mature April 1, 1980, (CUSIP No. 912793 3F 1). This issue will not provide new cash for the Treasury as the maturing issue is outstanding in the amount of $3,346 million.

Without assurance, before the auction date of March 28, of Congressional action on legislation to raise the temporary debt ceiling, the Treasury will postpone this auction.

The bills will be issued for cash and in exchange for Treasury bills maturing April 3, 1979. The public holds $1,666 million of the maturing issue and $1,680 million is held by Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities. Tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities will be accepted at the weighted average price of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents of foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

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. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Wednesday, March 28, 1979. 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.

B-1478

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. 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 $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.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on April 3, 1979, in cash or other immediately available funds or in Treasury bills maturing April 3, 1979. 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 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, 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 RELEASE AT 4:00 P.M. March 22, 1979

TREASURY TO AUCTION $1,500 MILLION OF 14-YEAR 10-MONTH BONDS

The Department of the Treasury will auction $1,500 million of 14-year 10-month bonds to raise new cash. They will be an addition to bonds which are currently outstanding. Additional amounts of the bonds may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Without assurance, before the auction date of March 29, of Congressional action on legislation to raise the temporary debt ceiling, the Treasury will postpone this auction.

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-1479

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 14-YEAR 10-MONTH BONDS
TO BE ISSUED APRIL 5, 1979

March 22, 1979

Amount Offered:	
To the public........................	$1,500 million
Description of Security:	
Term and type of security...........	14-year 10-month bonds
Series and CUSIP designation........	9% Bonds of 1994 (CUSIP No. 912810 CF 3)
Maturity date.......................	February 15, 1994
Call date...........................	No provision
Interest coupon rate................	9%
Investment yield....................	To be determined at auction
Premium or discount.................	To be determined after auction
Interest payment dates..............	August 15 and February 15
Minimum denomination available......	$1,000
Terms of Sale:	
Method of sale......................	Price auction
Accrued interest payable by investor...........................	$20.74210 per $1,000
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.....	Thursday, March 29, 1979, by 1:30 p.m., EST
Settlement date (final payment due)	
a) cash or Federal funds.......	Thursday, April 5, 1979
b) check drawn on bank within FRB district where submitted..................	Tuesday, April 3, 1979
c) check drawn on bank outside FRB district where submitted..................	Monday, April 2, 1979
Delivery date for coupon securities.	Thursday, April 5, 1979

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

FOR RELEASE AT 4:00 P.M. March 23, 1979

TREASURY TO AUCTION TWO CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills, as follows:

24-day bills (to maturity date) to be issued April 2, 1979, representing an additional amount of bills dated October 26, 1978, and to mature April 26, 1979 (CUSIP No. 912793 Y2 6). The amount of the offering will be announced March 28.

78-day bills (to maturity date) for approximately $3,000 million, to be issued April 4, 1979, representing an additional amount of bills dated December 21, 1978, and to mature June 21, 1979 (CUSIP No. 912793 Z2 5).

Without assurance, before the auction dates for the bills, of Congressional action on legislation to raise the temporary debt ceiling, the Treasury will postpone the auctions.

Competitive tenders will be received at all Federal Reserve Banks and Branches, up to 12:30 p.m., Eastern Standard time, on the auction dates. The 24-day bills will be auctioned Thursday, March 29, 1979. The 78-day bills will be auctioned Friday, March 30, 1979.

Noncompetitive tenders will not be accepted. Tenders will not be received at the Department of the Treasury, Washington. Wire and telephone tenders may be received at the discretion of each Federal Reserve Bank or Branch. Each tender for each issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. The price on tenders offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

The bills will be issued on a discount basis under competitive 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 in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches.

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.

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. Those submitting tenders 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. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately available funds on Monday, April 2, 1979, for the 24-day bills, and on Wednesday, April 4, 1979, for the 78-day 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 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 may be obtained from any Federal Reserve Bank or Branch.

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

FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
March 27, 1979

TESTIMONY OF THE HONORABLE 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. 85 and S. 353. We support the efforts of the Congress to deal with the question of appropriate reserve requirements for depository institutions at this time. The Administration has endorsed several approaches to this question, including H.R. 7, which is presently under consideration in the House of Representatives. We hope the Congress will be able to act on this matter expeditiously.

Many plans have been put forward to deal with this problem. Rather than discussing them in detail, I would like to reiterate the principles that we believe should govern this undertaking.

They are:

-- improvement of the tools available to the Federal Reserve in the implementation of monetary policy.

B-1481

-- reducing competitive inequities among depository institutions engaged in the same or similar lines of business.

-- restraining the negative impact of any changes on the Federal Budget in this period when the Administration and the Congress are striving to squeeze down the deficit.

Universal and Uniform Required Reserves

These objectives are best served by imposing mandatory reserve requirements on all institutions holding similar deposit balances. Since reserve requirements are important to the effective formulation and implementation of monetary policy, their coverage should not be contingent upon voluntary or induced membership in the Federal Reserve System. They should be regarded as a price and a necessary component of participation in the monetary system rather than a result of decisions about the choice of a regulator, the value of access to the discount window or a nice balancing of the costs of maintaining reserves against the benefits of membership. Moreover, to the extent that all institutions maintaining transaction balances have the same level of reserves, the link between the aggregate amount of reserves and the money supply is made more firm.

For these reasons, S. 85 like H.R. 7 takes a constructive step in severing the connection between reserves and Federal Reserve membership, and by focusing instead on the type of balance involved. Extending reserve requirements to thrifts for transaction accounts is a timely shift toward competitive equality and a more equitable distribution of the reserve burden. The adverse impact on thrifts is relatively small because their transaction balances are small at this time.

Of course, it is not possible to achieve full equality of treatment with this step. There are many small depository institutions that with some justification will resist a reserve obligation on the ground that the adverse impact on earnings is too great, and their participation, while theoretically correct, may not in practice be necessary to the effective conduct of monetary policy. Reserves in excess of vault cash of the smaller banks would in any event constitute only a small proportion of total reserves.

Accordingly, some exemption from universal reserves for small institutions may therefore be appropriate, but we would hope that the exemption would be as small as possible. In this regard S. 85 goes a step beyond H.R. 7.

The reporting requirements contained in the bill provide important supplementary monetary coverage of all depository institutions not required to hold reserves. The report forms and statistics should be brief and rely as much as possible on existing information flows. The paperwork burden of all institutions, particularly the smaller, should be kept to a minimum.

Finally, we do not think that the concept of universal reserves is inconsistent with the principles of the dual banking system. That system recognizes that when there is an overriding Federal interest in an issue, the ground-rules should be established by the Federal government. That is the case, for example, with international banking. It is also the case with monetary policy. So long as reserves have a role to play in this process, all banks similarly situated should have the same burden to the extent practicable. Surely the Federal Government has no responsibility to insure the viability of state supervision by making it financially unattractive for a bank to be a member of the Federal Reserve. The strength of the system comes from the choice it offers on supervision and examination. That choice remains unchanged by this bill. Moreover, the availability of Federal Reserve services to all banks at nondiscriminatory rates will make it easier for a larger bank to be a nonmember.

<u>Interest on Reserves</u>

In the last Congress, the Administration indicated that if the Congress decided that the holding of reserves should continue to be voluntary, then the Administration would support legislation to reduce the financial burden of membership through the payment of interest on reserves. For all the reasons I have noted, we very much prefer the approach of required reserves embodied in this bill.

Revenue Loss Projections

In testimony before this Committee last June and August and in a letter to the House Banking Committee in September 1977, the Administration stated that it would accept a revenue loss of $200-300 million, after tax recoveries, to deal with this problem. Then, in an October letter to this Committee, with the budget outlook tightening, we indicated that a revenue loss at the lower end of that range was preferable. In the current budget environment, a solution to the membership problem involving a revenue loss under $200 million, net of tax recoveries, is essential. That figure is based on 1977 data and assumes full implementation. We understand that the Federal Reserve staff estimates that the pretax cost of fully implementing S. 85 on that basis would be approximately $133 million or $73 million after tax. The comparable cost figures for S. 353 would be $1,299 million and $714 million, respectively.

I have attached to my written statement a table showing the projected revenue impact of the changes contemplated by S. 85 over the next five years.

In any calculation of the total annual cost of a membership solution, the Congress should focus particular attention on the fiscal 1980 budget impact. There are several elements in the revenue and cost figures that make the near term financial results of the various membership solutions a special concern. In determining the after-tax revenue loss for most proposals, estimates of tax recaptures that may take several years are used. These deferred tax effects might leave a disproportionate after-tax shortfall in the first year of most annual loss projections.

Similarly, most proposals assume income of about $410 million from the explicit pricing of Federal Reserve services to reduce the annual net revenue loss the proposals will generate. Yet, not all the revenue will be available in fiscal 1980. It will take time to develop and institute prices on some services.

Accordingly, our support of S. 85 is premised on the assumption that the Federal Reserve will fully offset any revenue loss during the transition years. Chairman Miller has advised me that the Board of Governors has agreed to this approach.

Other Issues

Section 6 of S. 85 would require the Federal Reserve to price its services and make them available to all depository institutions, whether or not they are members or hold reserves. Once access to System services is no longer required as an inducement to membership, the more general availability of Federal Reserve services should benefit the banking system as a whole. Moreover, requiring that the Federal Reserve price services on a basis involving full allocation of cost, with appropriate allowances for costs unique to private organizations such as capital and taxes, should allow other vendors to compete with the System more effectively. Hopefully, market mechanisms will then become important in establishing the prices of these services and the relative roles of the competing vendors.

* * *

This concludes my formal testimony, Mr. Chairman. I would be pleased to answer any questions the Committee may have.

Estimated Revenue Effects of S. 85

Fiscal Years 1980-84

($ millions)

	Fiscal Years				
	1980	1981	1982	1983	1984
ɘduction in Federal Reserve earnings due to reduction in reserve requirements for member banks, at October 1979 projected membership levels, phased in over 2 years beginning October 1979	-373	-787	-831	-879	-929
ıcrease in Federal Reserve earnings from extension of reserve requirements to nonmembers, phased in over 4 years beginning October 1979	55	120	197	289	319
crease in Federal Reserve earnings from charges for Federal Reserve services, phased in over 2 years beginning October 1979	271	535	579	630	682
Net change in Federal Reserve earnings before tax recovery	-47	-132	-55	40	72
come tax offset	16	35	31	-3	-28
Net revenue effect before offset for membership attrition under present Federal Reserve requirements	-31	-97	-24	37	44
:set due to loss in Federal Reserve ːarnings caused by membership attrition ınder present Federal Reserve requirements adjusted for tax offset)	29	92	149	206	268
Net revenue effect	-2	-5	125	243	312

ice of the Secretary of the Treasury
Office of Tax Analysis

March 26, 1979

Assumptions Underlying Revenue Estimates of S. 85

1. Reduction in Federal Reserve earnings due to attrition in member bank reserves:

   (a) between December 1977 and September 1979 member bank deposit attrition continues at the average of the nation for the period 1974-77 (i.e., the member bank share of total commercial bank deposits declines 1.4 percentage points per year);

   (b) total commercial bank deposits increase at an average annual rate of 8.5 percent each year after 1977; and

   (c) the average return on the Federal Reserve portfolio is 6.5 percent per year from October 1979 through September 1984.

2. Increase in Federal Reserve earnings from charges for services:

   (a) full charging for Federal Reserve services, if fully implemented at the end of 1977, would have generated $410 million; and

   (b) Federal Reserve revenue from such charges grows proportionally to the growth in deposits.

3. Recovery of the loss of Treasury revenue from the decline in Federal Reserve earnings:

   (a) additional commercial bank earnings are taxed at an average marginal rate of 35 percent;

   (b) the lagged additional dividends paid to commercial bank stockholders from the higher commercial bank after-tax earnings increases total tax recovery 2-1/2 percentage points per year until the total tax recovery reaches 45 percent of the additional commercial bank earnings in four years.

4. Offset due to loss in Federal Reserve earnings caused by membership attrition under present Federal Reserve requirements:

   (a) if S. 85 is not enacted, the attrition of member bank deposits after 1979 would accelerate to a rate midway between that experienced in New England (4.6%) and that of the nation (1.4%);

(b) total commercial bank deposit growth and Federal Reserve portfolio return are as indicated in assumption 1; and

(c) the tax offset to higher earnings of member banks no longer subject to required reserves is as indicated in assumption 3.

Office of the Secretary of the Treasury
Office of Tax Analysis

March 27, 1979

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

FOR IMMEDIATE RELEASE
EXPECTED AT 2:00 P.M., EST
TUESDAY, MARCH 27, 1979

STATEMENT OF THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

Introduction

Treasury has reviewed the Report on the International Financial Institutions prepared for the House Appropriations Committee by the Committee's Surveys and Investigations Staff. We welcome this effort to add to the state of knowledge on the operation of the Multilateral Development Banks (MDBs). We also welcome the opportunity to assess fully and on the record the merits and shortcomings of these institutions.

We note at the outset that the Report records both a number of positive conclusions about the banks -- around fifty, by our count -- and a number of criticisms. Of these shortcomings, many have been identified by the banks themselves -- indeed, internal bank documents are the source of most of the criticisms noted by the investigators -- and corrective action is already underway. Some of the other criticisms are simply based on misconceptions, which we will try to clarify during these hearings. But some of the criticisms clearly call for additional responses; we will seek to implement remedial measures in the banks as rapidly as possible, and report back to the Congress on our progress within three months.

In general, we regard the Report as a useful aid in the consultation process between the Administration and the Congress on U.S. participation in the development banks. I should note for the record that the Survey and Investigations staff was granted complete access on an unrestricted, open-door basis to Treasury personnel and to the office of our Executive Directors at the Banks throughout the course of their work. Indeed, they were housed at Treasury for over a year to do the Report. We recognized the importance of the study from its initiation and were open, accessible and forthcoming in collaborating with the staff. Today I will respond to the recommendations contained in the Report and, with my colleagues, will be prepared to respond to specific criticisms cited in it.

An Overview of the Report

Let me summarize quickly our overview of the Report. Of its seven substantive chapters (II-VIII), the first ("Operational Mechanisms and Interrelationships of the International Finance Institutions") is a summary of how the banks function. In terms of attention and concern, the heart of the Report is contained in Chapters III-V: Oversight Procedures of the U.S. Executive Branch, Accountability of the International Financial Institutions, and Administrative Practices, Staffing and Remuneration. These three chapters account for over two-thirds of the analytical material in the Report. Chapters VI-VIII represent the other concerns spelled out in the Committee's directive to the investigators: Commodities, Human Rights and Reaching the Poor.

Virtually the entire Report is thus devoted to an examination of MDB processes rather than results. Process is important. But the Report does not address the question of whether the poorer countries have been successful in achieving development, whether the banks have been successful in promoting development, or whether supporting the banks represents an effective way to pursue the U.S. national interest in development. In assessing the Report, we should not lose sight of the fact that in no way does it question the fundamental contribution which the multilateral banks have made to development and improved living conditions in the poor countries of the world.

In addition, the Report does not question the cost-effectiveness of providing U.S. foreign assistance through the MDBs: that every dollar we put into the banks is matched by three dollars from other donor countries, and that the World Bank over its lifetime has made $50 of loans for every $1 we have paid into it. Nor does the Report question that the banks bring clear economic benefits to the United States: that every dollar we have paid into them has directly generaged $2.40-$3.40 of additional U.S. GNP and created 50-100,000 jobs annually, and that our balance of payments has gained about $2.5 billion from the operations of the banks throughout their histories. In short, the Report deals with an important but narrow set of issues -- but fails to addre some of the most central features of the banks and of U.S. policy toward them.

What is the record? What has been achieved? The excellent study prepared last year by the Congressional Research Service concluded that:

> ... there has been spectacular growth of GNP in the last 25 years... per capita income in the LDCs increased 3.4 percent [over this period]. This was faster than today's developed countries grew during the initial phases of their development, faster than the LDCs had ever grown before, and faster than anyone expected them to grow. (p. 37)

This economic growth has been accompanied by dramatic advances in literacy, education, nutrition, health, family planning and life expectancy -- in sum, in the central indicators of the quality of life.

The matter can be brought closer to home. Many countries that were heavily dependent on U.S. bilateral economic aid or grants in the early 1960's no longer need such aid. They now rely entirely on MDB loans at market rates and on loans from private commercial banks.

This outstanding performance was achieved during the period in which the World Bank and its sister institutions, the regional development banks, were being formed and reaching maturity. The banks have increasingly become the base of external support for the development process, and have contributed importantly to the development results just cited. We believe that they have become the most efficient and cost-effective international agents for economic and social progress in the developing world. Nothing in the Report suggests otherwise.

Why is this so?

The answer cannot be found solely in the size of the lending programs of these banks -- important as they are. They now supply about 10-15 percent of the total external capital moving to the developing world. The proportion is much higher for the poorest countries who do not have the credit standing to borrow on international capital markets. Nonetheless, the main contribution of the banks lies in the catalytic effect of their operations on the flow of capital from other sources, and in the manifold ways in which they encourage efficient economic policies in the borrowing countries and thus increase domestic savings and investment.

Their catalytic role is widely demonstrated. The MDBs have guided the development of new international assistance efforts such as the Caribbean Development Group, the Islamic Development Bank, the OPEC Special Fund and the International Fund for Agricultural Development. They help to coordinate the bilateral assistance programs of the OECD countries. Key development strategies used in the poorer countries have been formulated with the help of the MDBs: growth with equity, project design to reach the poor, appropriate technology, integrated rural development, and energy development.

Furthermore, the major commercial banks in the United States and other industrial countries depend heavily on the World Bank's assessment of conditions in developing countries to determine their own country risk profiles. The existence of lending programs by the Multilateral Development Banks is an important element in determining the availability and size of loans from the commercial banks. The MDBs have done much to open the door of international capital markets to creditworthy developing countries.

The contribution of these banks to promoting economic efficiency is also a matter of record. This is accomplished by assisting the developing countries in:

-- the preparation of national development plans;

-- the formulation of economic policies;

-- the identification and design of individual projects;

-- the supervision and control of project costs and execution;

-- the development of human capital; and,

-- the strengthening of local administration and institutions.

What do these general statements mean? Some specific examples may help to bring them to life.

In 1971, the World Bank ceased lending to Argentina until that country took steps to implement needed economic policy changes. In 1972 Pakistan responded to the World Bank-chaired donor consortium by liberalizing its imports and rationalizing its foreign exchange system. The World Bank's basic economic report on the Philippines in 1976 advanced an overall policy framework which served as a basis for the country's current five-year development plan.

Examples of constructive influence on Tanzania include improving electrical and water supply tariff structures, improved budgetary control and import liberalization. The Inter-American Development Bank required the Government of Brazil to prepare and present a five-year sector program prior to its approval of a specific loan. Also in Brazil, the World Bank has built up through technical assistance the institution in charge of many of the rural development programs in the impoverished northeastern part of the country -- POLONORDESTE, some of whose projects I have visited personally and found to be of exceptionally high quality. The World Bank has improved the operating efficiency of rural credit institutions in India by insisting on tough organizational changes to promote greater loan recovery. In Bangladesh, World Bank recommendations led to reduced governmental subsidies for wheat and rice and increasing the price paid to the farmer. The Asian Development Bank has insisted on revised water-user charges prior to approving a number of urban water supply projects.

In Kenya, World Bank recommendations which were incorporated in the national development plan included higher producer prices for farmers, exchange rate changes and wage restraint in the high wage urban areas -- all of which served to channel a greater share of total income to rural areas. In Indonesia, technical assistance from the World Bank increased the management capabilities of the irrigation authority of western Java, now considered to be among the most capable public works agencies in Indonesia. In Bolivia, the IDB recognized the need to expand the agricultural frontier into virgin territories and underdeveloped areas; its projects in the transportation, communication and agricultural sectors were designed with the goal of national economic integration in mind.

In the Dominican Republic, the IDB has decided on a plan of action which will focus on the key sectors of agriculture and energy. With respect to the energy sector there, the plan calls for developing the nation's hydroelectric potential. In Morocco the World Bank has, through its policy discussions and project preparation activities, had a major influence on urban development policy -- a policy that is now much more responsive to the needs of the poorest population at a cost which is widely replicable.

In almost every single project financed by the banks, there are specific requirements which must be met in terms of pricing policy, cost recovery, project implementation monitoring, institution building, and evaluation. In a very real sense, each project thus becomes a vehicle for improving the economic policies of the borrowing country. This is the influence exercised by the banks. It is what lies behind the statement which appears on page 45 of the Investigators Report:

> Multilateral lending embraces a subtle influence throughout the Third World of encouragement of beneficial adherence to economic patterns of the Free World rather than embracing the communist patterns of development with the assistance offered by the IFIs being insulated from policy variations of any one member country.

This, however, is only one of many positive statements about the banks in the report under review today. From press coverage to date, and indeed from a cursory reading of the Summary and Observation section of the Report, one might be led to conclude that the Report had nothing positive to say about the banks. This is far from true, and it might help right the balance to cite some of the more important of these comments:

> 1. ...at the World Bank and the ADB operational efficiency is clearly recognizable in the quality of professional staff and the procedural controls and systems. (p. 10)
>
> 2. The IFIs are interested in aspects of a country's economy wherein the most influence might be expressed in altering or emphasizing broad economic policies and in building institutions within the country... (p. 26)

3. In its field visits, the Investigative Staff observed a number of uses of light capital technology in agricultural, rural development, urban development irrigation, and road projects in Latin America, Asia, and Africa. All were being effectively used and local project managers and government officials were highly pleased with the inclusion of such approach in the design of the projects. (p. 42)

4. Multilateral institutions enjoy a political assistance (sic) frequently more effective, staffs trained in a variety of disciplines to provide technical assistance, leverage of capital with borrowing in private markets, equitable burden-sharing among donors, and freedom to employ infrastructure and industrial development which generate employment that are outside the scope of USAID. (p. 45)

5. The United States has considerably greater day-to-day review of matters coming before the Executive Directors than does any member country ... (p. 62)

6. Generally effective systems of management control are operative in all of the IFIs, with the World Bank's being perhaps the most sophisticated. (p. 71)

7. From a management viewpoint, the World Bank is tightly controlled in the areas of program planning, budget, finances and operations. (p. 77)

8. The internal audit reports issued in FY 1978 appear to be meaningful, necessary and consistent with IBRD Internal Audit Department functional responsibilities. The Investigative Staff examined a representative sample of audit reports of its own selection and found them to be of good quality. (p. 80)

9. The United States was instrumental in obtaining a study of compensation principles and structure of the IMF and World Bank by private consultants which resulted in a January 1978 report to the Governments of France, Germany, Japan, the United Kingdom and the United States. (p. 113)

10. The Investigative Staff reviewed an abundance of evidence reflecting a clear awareness within the IFIs of the plight of the poor as well as efforts to shift their lending not only toward the poorer developing countries but also toward reaching the poor elements in all the LDCs. (p. 165)

11. In general, the 36 projects which were designed mainly to assist the poor or had substantial segments so designed were being diligently pursued by local project managers and staff toward objectives set, and the failures encountered in meeting objectives...were outweighed by the accomplishments being achieved. (p. 167)

However, many criticisms of the banks are also presented in the Report. We do believe that a number of its findings are simply wrong, that others reflect a misunderstanding of the ways in which the institutions operate, and that still others represent problems which the banks or the U.S. Government are already addressing. Nevertheless, we have examined all these criticisms with an open mind and, as you will see, are prepared to adopt new policy measures to respond to a number of them.

A great many specific criticisms are made, and we are prepared to respond to all of them during the course of these hearings. It seems to us, however, that there are three areas in which the Report is most critical:

-- The auditing and evaluation efforts of the banks;

-- The flow of information to member countries;

-- The ability of the United States to effectively influence the management of the institutions.

Audits and Evaluations

A major theme of the Report is that the MDBs should do a much better job in auditing and evaluating their own activities. The Report (p. 70) addresses the confusing and interchangeable use of the words "audit" and "evaluation" and comes to essentially the right conclusion: "In this Report, traditional definitions are adhered to in that audit refers to the methodical review and verification of records of account, and evaluation refers to the study and appraisal of the worth of a function or of its product." I would add to the latter"... and the achievement of the aims originally intended within cost and time factors originally set forth."

In these terms, the audit requirements of the banks are well established. There are many internal checks. One principal check is the requirement for tendering foreign procurement through international competitive bidding. This is the basic procedure used internationally and, of course, by the U.S. Government, to ensure that the best quality goods and services are procured at the best price. Winning suppliers and contractors are held to account for their performance and the proper use of funds. Where there are lapses, the MDBs take corrective action.

Each MDB's charter contains provisions requiring the institutions to ensure that the funds made available to borrowers are used only for the purpose for which the loan was made. In pursuance thereof, borrowers are required to substantiate their expenditures of MDB funds by submitting contracts or confirmed purchase orders, evidence of payment, suppliers' invoices and bills of lading, contractors' and consultants' invoices and certificates of work progress, letters of credit, commercial banks' reports of payment and whatever other documentation is appropriate in a given circumstance.

Evaluation is carried out by normal implementation, supervisory, and financial procedures. In addition, I would like to call attention to a relatively new system instituted by the World Bank. It is called "built-in project monitoring evaluation." This procedure builds into project implementation a continued surveillance by special units. Their goal is to evaluate project performance to assess its economic impact, measure project management efficiency, and get a better understanding of the motivations and constraints of the project beneficiaries.

This system also can, and does, bring to light instances of financial or other irregularities. In FY 1976 and

FY 1977 about 60 percent of the agricultural projects had built-in M&E units, costing an average of 2 percent of total project costs. This is a relatively new mechanism, and the Bank is still actively engaged in improving its effectiveness and utility.

We also believe that the report fails to credit the banks for the extensive efforts they already make in this area. Last year's study by the Congressional Research Service, conducted for this committee, referred as follows to the World Bank:

> In reading the reports of the Operations Evaluation staff, one is struck by the extremely critical analyses of Bank projects contained therein. The harshest analyses we have read of the Bank's operations come from its own Operations Evaluation unit. The criticism was more well informed than that found in the popular press and academic journals.

and:

> Among the bilateral and multilateral development agencies the World Bank is probably the most self-critical. The Bank staff appears to be making a genuine effort to learn from experience and to alter future policies in light of what can be learned from past successes and failures.

In connection with the auditing and evaluation procedures employed by the banks, I would like to bring to the attention of the Committee a number of studies conducted by the General Accounting Office. The GAO has been monitoring the banks' review and evaluation procedures since 1973. This was in response to the will of the Congress as expressed in PL93-189, which amended the Foreign Assistance Act of 1961 and provided that the U.S. Executive Director to the IBRD shall "actively seek the establishment by the governing authorities" of an independent program of "review and evaluation of the programs and activities" of the Bank. The law further provided that the reports prepared under such an independent program shall be transmitted to Congress and to the Comptroller General. Furthermore, the Comptroller General is charged with reviewing these reports and reporting to the Congress "any suggestions the Comptroller General may deem appropriate concerning auditing and reporting standards..., the recommendations made and actions taken as a result of such recommendations." All of the foregoing is being complied with fully.

In 1974, in response to U.S. urging, the World Bank created a new post of Director General, Operations Evaluation. The incumbent is appointed by the Board, holds office for renewable terms of five years, is removable only by the Board and reporting directly to the Board. The Director General's operating arm is the Operations Evaluations Department. OED's independence has been advocated by the GAO, and applauded by the GAO. The Department is charged with preparing the project performance audits on each completed project, and other evaluation studies and operational policy reviews. All OED reports go to the Board and to the Congress.

The GAO reviewed the IBRD's evaluation system in June of 1978 and issued a report entitled, Effectiveness of the World Bank's Independent Review and Evaluation System. Its principal conclusion was: "The World Bank Group...has made considerable progress toward developing an independent and continuous selective examination, review, and evaluation of the Bank's programs and activities."

Regarding the ADB, the U.S. Director, in response to the 1973 legislation, recommended that the Bank establish an independent evaluation system. The ADB system was established in 1973 and a special post-evaluation unit was created in 1974. In response to GAO suggestions, and the recommendations of the U.S. Director, the recent ADB reorganization (July 1978) upgraded this unit to an office, added staff, altered reporting responsibility to the President, and broadened its mandate. The GAO held discussions with ADB management and expressed the hope this office would eventually report directly to the Board.

In June 1977 the ADB Board established a three-member Audit Committee, again largely in response to concerns expressed by the U.S. Executive Director. The Audit Committee is charged with reviewing the adequacy and efficiency of the bank's internal audit and post-evaluation activities. Quoting from the Investigators' Report:

> The Audit Committee has been active and successful in the recent strengthening of both the internal audit function and the post evaluation function.

Moreover, in assessing the committee, the Report concludes:

> Accountability of management to the Board within ADB is enhanced subtly by ...the informal and free interchange of activity and bank documents between the Board and Management....

In the case of the IDB, Congressional interest in the evaluation function pre-dated the 1973 legislation. In 1967 (PL 90-88), Congress advocated that a review unit be established. At U.S. urging, a three-member Group of Controllers was established in 1968. Appointed from outside the Bank, they report directly to the Board. An American has always been one of the three members of this Group. The Group has concentrated primarily on internal administrative and policy making procedures.

The GAO in a June 1978 study concluded:

> The effectiveness of the Group has improved steadily since its creation.

It went on to state:

> "...of 150 recommendations the Board has approved, 122 had been fully or substantially implemented...the fact that Management has implemented so many of the Group's recommendations indicates that the Group is contributing to improving the Bank operations."

The IDB Board, after some months of consideration, has acted to reorganize the Group of Controllers. As of July 1, 1979 the present Group of (three) Controllers will be replaced by a single Director of External Review nd Evaluation. The broad authority to look into any and all activities of Bank activity will be continued, as will previous policy of selecting the Director from outside Bank staff and proscribing service on Bank staff after expiration of his term. The reorganization also establishes a standing Committee of the Board to guide and supervise the work of the Director and staff. This reorganization was strongly supported by the U.S. Executive Director and follows GAO suggestions.

This brief summary of the comments of the GAO regarding its review of the MDB auditing and evaluation systems indicates that, over the years, substantial improvements have been made in these systems -- largely in response to U.S. recommendations. Indeed, the Report itself points to one or two instances where these systems have achieved their purposes quite effectively by detecting and correcting behavior inconsistent with their rules. Contrary to what is stated in the Report, deviation from prescribed practices leads to effective counteraction, including requiring the borrower to issue a new tender for bids or, in extreme cases, cancellation of a portion of the loan contract or the entire contract.

Let me cite some recent examples for the Committee's benefit:

1. In an education project in Africa, the Ministry of Education purchased building materials in excess of the agreed quantities and by negotiations instead of international competitive bidding as required by the Bank. The Bank refused to finance the additional quantities and

cancelled $130,000 from the credit -- the amount of those building materials.

2. On a railway loan in a Mid-Eastern country, bidding was undertaken for carrier telephone equipment and the borrower awarded the contract to a local supplier, who was the second-lowest bidder, instead of to the lowest responsive bidder, who was foreign. As a result the Bank cancelled the amount in question -- $300,000 -- from the loan.

3. In a Middle Eastern country a road construction contract was awarded to a state controlled construction company rather than to the lowest evaluated bidder. As a result, a supplemental loan for the highway program amounting to some $15 million for this country was dropped by the World Bank.

However, further improvements can be made. In this regard, a number of suggestions made in the Investigators' Report will be quite useful, and we will pursue them.

Specifically, we share the Investigators' opinion that, to the maximum feasible extent, the banks' auditing systems must be independent and detached from the operational side of the institution. There we support, and will promote, suggestions that:

1. The World Bank's Internal Audit Department should report directly to the President (p.79)

2. In the IDB, the Auditor General should not report to an official with operating responsibilities (p.89).

We also agree with the Investigators' recommendation that regular monitoring of all internal bank functions should be instituted by the auditing arms of the respective banks. No internal management system is fault-free; all can be improved.

We therefore also support the following recommendations and will press for their adoption within the MDBs:

3. The ADB's evaluation unit should not limit itself to project evaluations; it should also evaluate Bank operations (p.98).

4. The World Bank's OED should devote more time and resources to broad review of how well management performs its responsibilities (p.83).

5. The IDB should establish an Audit Committee composed of Executive Directors similar to the ones in the World Bank and the ADB (p.89).

6. The IDB Group of Controllers should evaluate the work of the Auditor General's office (p.89).

7. The IDB Operations Evaluations Office reports should be made available to the EDs (p.90).

We will report back to Congress on our progress in promoting these changes in the MDBs in three months' time.

The Flow of Information

The flow of information is obviously critical to the effective functioning of any institution, public or private. We thus take extremely seriously the concerns expressed in the Report that there is excessive classification of MDB documents, that some documents are not available to the Executive Directors and that some which are available are not, but should be, circulated routinely.

We agree that more bank documents should be available to the public and that the number of bank documents with a limited distribution can be further reduced. The United States has already made a great deal of progress in achieving such a reduction. We will persevere, in the interest of maximum openness of the operations of the banks.

However, as noted by Secretary Blumenthal in his testimony before this Committee last year:

> "Complete disclosure of all documents is neither desirable nor feasible. Each IFI's policy on disclosure must balance the oversight responsibilities of its member governments with the confidential nature of normal bank/client relationships. This last consideration deserves additional explanation. In the course of their economic policy advisory role, the IFIs often recommend politically unpopular measures. If these recommendations become public information through extremely liberal public disclosure policies, domestic political opposition would impede the effectiveness of the IFIs' role. So we cannot achieve, nor do we want, complete disclosure."

Despite this important caveat, let me state clearly that Executive Directors in the MDBs have access, on request, to all bank documents necessary to carry out their responsibilities. We are exploring whether more documents should be routinely available to the Executive Directors.

We also believe that documents distributed to the Executive Directors and available to concerned government departments should be available to appropriate Congressional Committees under suitable arrangements to protect, where necessary, their confidentiality. We understand that such arrangements have been worked out in other policy areas and look forward to working out satisfactory understandings in this area as well.

I must also take this occasion, Mr. Chairman, to remind the Committee that -- while we can, and will, seek changes in the classification system of the banks -- the United States, like all member countries, is required to observe the rules governing disclosure of bank documents. The Surveys and Investigation Staff acknowledged this requirement, and clearly indicated in its Memorandum for the Chairman (of the Committee) which transmitted the Report that it had obtained internal bank documents with a limited distribution with the understanding they would be afforded the same protection as required by the institutions. We regard it as extremely unfortunate that, despite repeated discussions and my letter of March 20, the Committee publicly released the Report without deleting specific references drawn from internal bank documents with a limited distribution. I request that my letter of March 20 be inserted in the record to make clear the views of the Administration on this issue.

The Report points out that U.S. influence in the banks is reduced when we fail to fulfill our financial pledges, or inject extraneous political issues into bank policy discussions. A failure to observe the normal standards of conduct pertaining to the treatment of bank documents can only risk a similar result. Treasury neither had, nor has, any desire to suppress one iota of substance in the Report, but we cannot lightly disregard a clear obligation of membership in the banks.

U.S. Influence on the Banks

This reference to U.S. influence in the banks reminds us that, in numerous places, the Report suggests that the United States lacks influence on bank policy. On this one, the Report is simply wrong. In fact, this criticism is somewhat ironic because a frequent charge levied at the United States by other donor and borrower countries -- and often by the banks' managements and staffs themselves -- is that the banks, far from independently dominating the member nations, are completely under the thumb of the United States.

To be sure, the United States cannot dictate its every wish to the banks on every issue. These are multilateral institutions where others contribute 75 percent of the funds. If we (or any other country) stray far from the charters, or the purpose of the banks, our views will be poorly received. But whenever our own efforts are seen as promoting internationally acceptable goals or the objectives of the institutions themselves, we can generally gain the support of other members required to assure success.

To a large extent, the charge of "no U.S. influence" is contradicted by the Report itself. It remarks favorably on the influence of the U.S. Executive Directors in advancing appropriate technology as a consideration in bank lending. It cites the success of the United States in initiating a review of World Bank salaries; indeed, it rightly says that the force of the United States in advocating the salary review has created strong pro and anti-United States factions within the banks. It comments on how United States views are taken into account in general development issues. It describes the major shift in the banks' lending priorities to better reach the poor, a major development assistance objective of the United States. It points out the success the United States has had in reducing the paid-in component in the periodic capital increases of all the MDBs. These are hardly the signs of "no influence."

But there are many other examples of effective U.S. influence on the banks, usually taken in cooperation with other member countries in reflection of the realities of multilateralism:

<u>The World Bank</u>

- -- The United States has advocated increased MDB lending for energy development; the World Bank has recently announced a major program of energy lending.
- -- The United States has recommended shifts in the Bank's sectoral lending composition; the World Bank is lending much more in the agricultural and rural development sectors.

-- The United States has urged the World Bank to adopt an interest formula which relates interest charges to costs of borrowing; the Bank has adopted such a formula.

-- The United States along with other members recommended that IDA lending for basic needs projects be resumed to certain eligible countries; IDA resumed such lending.

-- The United States supported the creation of an independent Operations Evaluation Department; the OED is now an important arm of the World Bank.

-- The United States has encouraged the World Bank to act as an international financial catalyst; the Bank has increased considerably its cofinancing of projects.

-- The United States has suggested that the Bank's graduation policy be reviewed; the Bank is undertaking a major review of its graduation policy.

Inter-American Development Bank

-- The United States has urged the IDB's Group of Controllers be strengthened; such changes have been implemented.

-- The United States has sought the declassification of the Bank's reports on loans in process and bid awards; such reports are now routinely available.

-- The United States has urged improved IDB budget control and limits on staffing; the IDB has adopted a functional budget system and a lid has been placed on staffing, in spite of an 83 percent increase in lending volume.

-- The United States has continuously stressed the importance of appropriate technology; the IDB formed an internal management committee on appropriate technology.

But it has been the recently concluded replenishment of IDB resources which gives us the best examples of U.S. influence in the IDB. The objectives we sought and achieved in the replenishment negotiations include:

-- Increased concentration of FSO resources on the poorest countries; more countries have agreed not to borrow FSO convertible resources.

-- All FSO loans not destined for the poorest countries will directly benefit low income groups.

-- 50 percent of total Bank lending will benefit low-income groups.

-- The less developed countries will be able to borrow moderately increasing amounts because the advanced countries agreed to a stable rate of borrowing.

-- The regional borrowing countries will make a larger portion of their paid-in subscriptions convertible.

-- The more advanced borrowing countries agree to make more of their FSO contributions convertible to assist their less fortunate neighbors.

-- The non-regional members will increase their share of capital and maintain their already high contributions to the FSO.

-- The U.S. share of capital and FSO is within the guidelines established in the Sense of the Congress resolution.

Asian Development Bank

The Asian Development Bank is an interesting case to study regarding U.S. influence because, unlike the World Bank and the IDB, we are not the largest contributor. Japan is. Yet even here the record of positive U.S. influence on the Bank is clear.

The United States took the lead in advocating the creation of a post-evaluation unit in 1973. As a recent GAO report attests, at U.S. urging the unit was expanded into a full office, its mandate was widened to include elements of project auditing in addition to project evaluation, and it was made responsible directly to the President to increase its independence. It is expected that within a few years the office will report directly to the Board, as the GAO has suggested. At U.S. urging, the ADB Board of Directors committee reviews the internal auditing and project evaluation functions of the ADB and makes recommendations for expanding those functions.

The ADB, with consistent U.S. support, has kept tight control over its administrative costs. In fact, it is described in the Report as the most cost-conscious of all the banks. The ADB has, at U.S. urging, declassified its project pipeline document and has undertaken distribution on a modest subscription cost basis. This is to improve the information flow to potential suppliers under bank-financed projects.

Last year, as part of the reorganization of the ADB, the United States supported creation of a second vice president's position in order to rationalize internal management along more modern lines. The person selected for this position is a U.S. national. The ADB has, at the suggestion of the

the United States, agreed to send its senior procurement officer on a tour of the United States to speak to business groups about ADB procurement requirements and opportunities.

The ADB has been responsive to U.S. concerns in financial policy matters as well. The ADB lending rate is regularly reviewed to insure that it fully reflects and covers the Bank's borrowing and administrative costs. Also, the United States sought and obtained an increase in the commitment fee charged by the Bank. Partly as a consequence of these changes, the bond market stature of ADB has been further enhanced.

In the most recent ADB replenishment of its concessional loan window, the Asian Development Fund (ADF), the United States advocated, and it was ultimately agreed, that three important Southeast Asian countries would gain become eligible for some ADF loans to help meet basic human needs. The United States also urged greater burden-sharing, and as part of that exercise succeeded in reducing the U.S. share on the ADF replenishment to a figure below that contained in the Sense of the Congress resolution. In addition, the ADB has been responsive to U.S. initiatives regarding capital saving technology, agricultural and rural development lending, graduation and maturation and local cost financing.

The problem in the Report is that it fails to understand the decision-making process in the banks. It seems to look solely to the formal meetings of the Executive Boards to see whether the U.S. Executive Director prevailed on a given vote, or was overriden. It seems to be based on the assumption that the Directors rather than management should be responsible for many of the details of preparing, administering and auditing or evaluating individual loans.

The actual situation is, and should be, quite different. The member governments provide the policy framework for the banks -- and, as I have indicated, the United States has done quite well in achieving its goals in so doing. It is the job of the banks' managements to execute that policy, under the daily guidance of the Executive Board. We, and other member countries, exercise our policy function through formal and informal meetings of the Governors of the institutions, through numerous bilateral and multilateral meetings at every level and, importantly, through the periodic replenishment negotiations as outlined above.

The record is clear over 35 years: these institutions have successfully advanced U.S. policy objectives in the developing nations while the burden of financing has been met increasingly by other donors. It is a record which bears the mark of effective U.S. influence in the MDBs.

Conclusion

In conclusion, I would note again that the Report does not challenge the funadmental premises of U.S. participation in the development banks: that the development of the poorer countries is a U.S. national objective of high priority, that the banks are an extremely cost-effective way through which we can pursue that objective and that United States policy goals are effectively advanced.

As I also noted at the outset, the Report--unlike the summary--also notes the steps which are being taken by the Bank and the United States to address some of the problems identified in the report. I have highlighted in my statement information on additional measures which have been taken or planned by the MDBs. Many of the findings in this Report are based upon assessments and evaluations made by Bank managements precisely for the purpose of improving the effectiveness of their loans and operations.

In addition, the Report points the way toward further strengthening of the banks in several areas, most notably the audit and evaluation functions, and the flow of information. We have profited from the work of the Surveys and Investigation staff in these areas, and we are initiating additional steps to implement several of their recommendations in the near future.

Finally, let me reiterate that we view the Report as representing one more step in the close collaboration and consultation -- if not always uniformity of views--which have marked relations between the Administration and the Congress on these issues for the past two years. We are pleased to have the opportunity to appear before you so promptly after the filing of the Report, and stand ready to try to answer any questions you may have.

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Statement of The Honorable Donald C. Lubick,
Assistant Secretary of the Treasury for Tax Policy,
before the Committee on Ways and Means,
Subcommittee on Select Revenue Measures

Mr. Chairman and Members of this Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on H.R. 2797, the "Technical Corrections Act of 1979." The Technical Corrections Act is the first of many important bills the Subcommittee will consider this year, and I look forward to working with you on a wide range of tax issues.

H.R. 2797 would effect technical changes in four tax acts adopted in the 95th Congress: the Revenue Act of 1978, the Foreign Earned Income Act of 1978, the Energy Tax Act of 1978, and the Black Lung Benefits Revenue Act of 1977. The staff of the Joint Committee on Taxation has drafted H.R. 2797 in an effort to reflect more accurately and clearly the Congressional intent underlying these four tax measures. Treasury staff has had substantial involvement in the drafting process, and we agree with nearly all the proposed amendments. In the appendix to this statement, I discuss the few revisions Treasury recommends. My testimony will focus on the importance of the technical corrections process itself and on some of the most significant provisions in the bill.

Most of us remember vividly the hectic tax legislative activity in the final days of the 95th Congress. The conference reports on three major tax bills -- the Revenue Act, the Energy Tax Act, and the Foreign Earned Income Act -- were adopted on October 15, 1978. The Revenue Act alone comprises about 200 pages of statutory language and over 100 provisions, with many significant issues being resolved by the House-Senate conferees during the waning hours of the session. The draftsmen performed remarkably well under the severe time pressures; but as expected, there are some technical problems that need to be corrected this Congress.

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Although the time constraints last fall made the drafting task especially difficult, the need for technical corrections is not an isolated phenomenon. Regardless of the time devoted to consideration and drafting of statutory language, technical errors are inevitably discovered in major tax legislation. Problems range from clerical oversights, to ambiguous wording, to unforeseen and unintended implications of an amendment. These problems become apparent as Treasury and IRS begin to prepare regulations interpreting the Code and as taxpayers and practitioners seek to apply the new provisions to specific fact situations.

Prior to 1977, there was no established mechanism to correct the errors in tax legislation. Taxpayers and tax administrators simply had to deal with the statutes as originally drafted, and to accept many tax results that Congress did not intend. However, with the introduction of the Technical Corrections Act of 1977, a formal procedure was implemented to make technical modifications to the Tax Reform Act of 1976. The 1977 Corrections Act, like the bill you are now considering, was drafted initially by the Joint Committee staff with the aid of comments from Treasury, IRS and private tax practitioners.

Our experience with the 1977 Corrections Act is instructive. Once Congress has made a substantive decision on tax policy, both taxpayers and the Government have a strong interest in assuring that the policy is implemented by proper statutory language; the 1977 Act advanced this objective, and I believe the effort was well received by all individuals concerned with the tax system. At the same time, the process suffered last Congress from undue delay; technical corrections for the Tax Reform Act of 1976 were not adopted until passage of the Revenue Act of 1978.

The protracted legislative course of the 1977 Corrections Act created a number of problems. For example, the delay affected IRS efforts to make timely and accurate changes in tax forms. A number of changes were made in the 1977 tax forms on the assumption that the pending 1977 Corrections Act would be enacted in 1977. When enactment was postponed until late 1978, the effective date of one of the corrections relating to community property laws and to the credit for the elderly was changed from January 1, 1977 to January 1, 1978 -- a change that required corrective action by the IRS to assure that affected taxpayers did not overpay their 1977 taxes.

The 1977 Corrections Act was stalled in Congress because it became encumbered with major substantive amendments. We hope that this problem can be avoided in connection with the consideration of H.R. 2797. Mr. Chairman, your announcement of March 14, 1979 states that, "Issues that involve modification of the policy decisions underlying these acts are beyond the scope of this particular hearing." Treasury has carefully adhered to this standard, and we urge other witnesses to do likewise.

Discussion of Specific Provisions

H.R. 2797 contains 66 amendments, not including changes that are purely clerical in nature. To keep my testimony brief, I will not discuss all of the proposed amendments; detailed descriptions are contained in the pamphlet prepared by the Joint Committee staff. However, I would like to mention some of the most important provisions in H.R. 2797.

Three amendments are necessary to coordinate properly the investment credit provisions contained in the Revenue Act and the Energy Act.

° The Revenue Act was designed to make the investment credit permanent at a 10-percent rate, rather than reverting after 1980 to a 7-percent rate as scheduled under prior law. However, the Energy Act restated the investment credit provisions of old law and was formally enacted after the Revenue Act. As a result, the Code may still technically retain a December 31, 1980 expiration date for the 10-percent credit. The Technical Corrections bill would clarify Congressional intent to make the 10-percent rate permanent.

° Certain equipment may qualify for both the regular 10-percent investment credit and an additional 10-percent credit for energy property acquired after September 30, 1978 and before January 1, 1983. Under the Revenue Act, only one-half of the otherwise qualified investment is eligible for the regular investment credit where the taxpayer uses the special 5-year amortization provision for pollution control facilities and also finances the facilities with tax-exempt bonds. Congress intended also to reduce the special energy investment credit to 5-percent in the case of energy property, including certain pollution control equipment, financed by tax-exempt bonds. But through interaction of the two provisions, the energy credit is effectively only 2.5 percent with respect to pollution control equipment subject to the limitations on the regular investment credit. This result was not intended, and the bill would amend the Code to provide a 5 percent energy investment credit to this property.

- The Revenue Act extends the regular investment credit to certain rehabilitation expenditures attributable to buildings that are at least 20 years old. To preclude the claiming of a double regular investment credit, the credit for rehabilitation expenditures is denied for property qualifying under other investment credit rules. As now drafted, the Code also prohibits a taxpayer from claiming both the energy investment credit and the regular investment credit for rehabilitation expenditures that qualify as expenditures for energy property. The bill would correct this unintended result.

Under the Revenue Act, no deduction is generally allowed for expenses incurred with respect to entertainment facilities. The Act specifically excepts "country club dues" from the new deduction disallowance rule. Congress did not intend the exception to be so restricted, and the bill would reflect the Congressional intent by deleting the word "country" from the exception for club dues.

The Revenue Act increased the capital gains deduction from 50 percent to 60 percent for individuals (so that 40 percent of individual capital gains would be subject to tax) and also reduced the alternative capital gains tax rate for corporations from 30 percent to 28 percent. H.R. 2797 contains several technical amendments to correct drafting errors and to clarify the application of these capital gains changes. Among the technical corrections are the following:

- Prior to the Revenue Act, an individual in a high rate bracket could elect to have the first $50,000 of capital gains taxed at a 25 percent rate in lieu of deducting one-half of capital gains from gross income. This special "alternative tax" for individuals was repealed for taxable years beginning after December 31, 1978. Through inadvertence, the rules for calculating the alternative tax for taxable years prior to repeal were not altered to reflect the increase in the capital gains deduction from 50 percent to 60 percent. After consulting with Treasury staff and the Joint Committee staff, the Internal Revenue Service prepared its 1978 tax forms and instructions as though the conforming change were properly made, and the Technical Corrections bill would now formally correct this oversight in the Revenue Act.

° The increase in the capital gains deduction for individuals was made effective for sales or exchanges after October 31, 1978. The reduced alternative capital gains rate for corporations was made effective for sales or exchanges after December 31, 1978. Left unclear was the treatment of payments received after the respective effective dates for sales or exchanges occurring before the effective dates. Under the Technical Corrections bill, the capital gains tax reductions would apply in instances where the income is properly taken into account by the seller during a period after October 31, 1978 (in the case of individuals) or after December 31, 1978 (in the case of corporations).

Another important change relates to the effective date of the targeted jobs credit. The Revenue Act was drafted to make the targeted jobs credit effective for wages paid or incurred through December 31, 1980. The statement of conference managers indicates that the expiration date is to be December 31, 1981. The statement of managers reflects the correct Congressional intent, and the Technical Corrections bill would rectify the clerical error in the Act.

In the appendix to this statement, I list several suggested amendments to the Technical Corrections bill. Most of these amendments are minor. But there is one item that deserves special mention; we believe that the Subcommittee should delete section 103 (a)(3)(A) of the bill, which would permit passive net lessors to claim the investment credit for building rehabilitation.

Since the reinstitution of the investment tax credit in 1971, section 46(e)(3) of the Code has denied the credit to an individual owner who is merely a passive lessor of the property. The purpose of this rule is to discourage tax shelter activities. It has been applied to all property eligible for the investment credit. Some persons may advance policy considerations for creating a special exception in the case of building rehabilitation; however, this issue is clearly one of substance. Regardless of the relative merits of the arguments for or against a special exception, this substantive provision should not be included as part of a Technical Corrections bill.

Mr. Chairman, with the exception of the "net lease" provision, H.R. 2797 is limited to technical revisions in the tax legislation passed last Congress. The bill is an important effort to relieve confusion and unintended hardship for taxpayers, but it is not designed to reopen substantive policy debate on the scores of tax issues considered in 1977 and 1978. To fulfill its purpose, prompt passage is critical. We join with you in urging that the bill not become a vehicle for the presentation of controversial, substantive changes in tax policy.

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APPENDIX

TREASURY COMMENTS REGARDING CURRENT PROVISIONS OF THE TECHNICAL CORRECTIONS BILL

(1) Election for Application of New ESOP "Put" Option (Section 101(a)(5)(B) of the bill and section 141(g)(5) of the Revenue Act of 1978).

Employees who receive a distribution of employee stock from an ESOP must under certain circumstances be given a put option to dispose of the stock. The Revenue Act of 1978 established new put option conditions with respect to stock acquired by an ESOP after December 31, 1978. H.R. 2797 would allow an employer to elect to have the new put option provisions apply to securities acquired by a tax credit ESOP before January 1, 1979. In effect, this election would allow an employer to avoid tracing with respect to which securities were subject to the old or new put option rules. The bill would also allow an employer to revoke the election with the consent of the Treasury.

Treasury is opposed to the provision which allows revocation of an election. The statute provides no guidance with respect to the standards to be applied in the revocation process. In the absence of guidance, it is likely that whatever standards are adopted would be challenged as being arbitrary. Further, it is likely that there would be significant administrative problems in dealing with the revocation process, both in the determination of whether consent should be granted and in the number of requests for consent in the absence of statutory guidelines.

If it is intended that revocation is to be allowed only in very narrowly defined circumstances such as where the employer was precluded by law from making the election, there would appear to be ample regulatory authority to provide relief; if an employer's election were ineffective, it could be treated by regulations as not having been made.

(2) Antidiscrimination Requirement for Certain Employee Contributions to an ESOP (Section 101(a)(5)(G)(ii) of the bill and section 141 of the Revenue Act of 1978).

Prior law relating to ESOPs allowed employers up to an additional 1/2 percent investment credit for employer contributions which matched employee contributions to the

ESOP. One of the requirements for eligibility to claim the additional credit was that the employee contributions must satisfy the antidiscrimination requirements of the Code applied to qualified plans. This would require actual contributions from a cross-section of employees and not merely an opportunity to contribute. Section 101(a)(5)(G)(ii) of H.R. 2797 would delete the specific reference to the antidiscrimination requirement with respect to employee contributions. We understand that the requirement is believed to be redundant because, under the 1978 Act, ESOPs must meet all the requirements applied to qualified plans.

If in fact the revision made by this section of the Technical Corrections bill does not change prior law relating to employee contributions to a tax credit ESOP, we have no objection to the change. However, if our understanding is not correct and if the Technical Corrections bill is intended to exempt employee contributions to a tax credit ESOP from the antidiscrimination rules, then we object to the provision both on the grounds that it is not a technical correction and on the grounds that such a change would not be sound tax policy.

(3) Deduction for Estate Tax Attributable to the Non-Capital Gain Portion of a Lump Sum Distribution (Section 101(a)(6) of the bill and section 142 of the Revenue Act of 1978).

This provision would reduce the amount of a lump sum plan distribution, subject to 10-year averaging, by the amount of estate tax attributable to the lump sum distribution. The revision would be applicable to estates of decedents dying after the date the bill is enacted.

We agree with the need for a technical amendment, but we recommend a language change to clarify the intent that the estate tax deduction in question refers to the estate tax attributable to the portion of the distribution currently included in gross income. Under our proposed modification, paragraph (6) of section 101(a) of the bill would be amended by striking out "lump sum distribution" at the end of that paragraph and inserting in lieu thereof "total taxable amount."

(4) Period of Excess Contributions to an Individual Retirement Account (Section 101(a)(12)(E)(iii) of the bill and section 157 of the Revenue Act of 1978).

The Revenue Act of 1978 added provisions which allow an excess contribution to an IRA to be withdrawn without income or penalty tax consequences under certain circumstances. As included in the Revenue Act, the withdrawal is allowed for "any contribution paid during a taxable year" if the conditions are met (Code section 408(d)(4)). The Technical Corrections bill would revise this provision to apply to "any contribution paid for a taxable year" (emphasis added).

The proposed technical amendment creates a problem because the excise tax applied to excess contributions is based on excess contributions made during a year. The difficulty is illustrated in the following example:

> Assume Employee X is an active participant in a qualified plan for 1979 and 1980 and that X makes a contribution to an IRA on January 15, 1980. It is clear that a contribution made in either year will be an excess contribution. However, has X made his excess contribution for 1979 or for 1980? The determination is significant since the deadline for taking advantage of the Code section 408(d)(4) withdrawal provision is determined by reference to the deadline for filing X's tax return "for such taxable year." If X made the contribution for 1979, the withdrawal under section 408(d)(4) must take place before he files his 1979 income tax return on April 15, 1980; if the contribution was for 1980, he has until April 15, 1981 to made the withdrawal.

To avoid confusion, we recommend that section 101(a)(12)(E)(iii) be deleted from H.R. 2797.

(5) Availability of the Rehabilitation Investment Credit to Net Lessors (Section 103(a)(3)(A) of the bill and section 315 of the Revenue Act of 1978).

Section 103(a)(3)(A) of the bill would permit passive net lessors to claim the investment credit for expenditures incurred to rehabilitate certain buildings. Since the reinstitution of the investment tax credit in 1971, section 46(e)(3) of the Code has denied the credit to an individual owner who is merely a passive lessor of the property. The purpose of this rule is to discourage tax shelter activities. It has been applied to all property eligible for the investment credit. Some persons may advance policy considerations for creating a special exception in the case of building rehabilitation; however, this issue is clearly one of substance. Regardless of the relative merits of the arguments for or against a special exception, this substantive provision should not be included as part of a Technical Corrections bill.

(6) Tires Used in the Manufacture of Buses (Section 108(c)(3) of the bill relating to the Energy Tax Act of 1978).

This section of the bill was intended to provide a credit or refund of the excise tax on tires and tubes purchased by a manufacturer and placed on a new bus chassis in view of the fact that the law exempts new buses completely from tax. However, as now drafted, the amendment applies only to tires and tubes placed on a "qualified bus." Thus, there is no credit or refund for a few buses sold for use by churches, by manufacturers to pick up employees, and by some charter operations. To extend "exemption" coverage to these buses, sections 6416(b)(3)(C) and 6416(b)(4)(B) of the Code should be amended as follows:

> Paragraph (3)(C) is amended by inserting "is an automobile bus chassis or automobile bus body, or" after "and such other article". Paragraph (4)(B) is amended by inserting "is an automobile bus chassis or automobile bus body, or" after "such other article".

New buses are exempted from the excise tax, whether the buses are domestically manufactured or imported. Therefore, the bill should also contain an amendment to Code section 4071 (e) to exempt tires and tubes placed on the chassis of a new imported bus. The exemption could be achieved by inserting ", or such article is an automobile bus chassis or automobile bus body" after "4061" in the last sentence of Code section 4071 (e).

SUGGESTED ADDITIONS TO THE TECHNICAL CORRECTIONS BILL

(1) Simplified Employee Pensions (Section 152(g)(2) of the Revenue Act of 1978).

Section 152(g)(2) of the Revenue Act of 1978 requires insertion of a cross reference "in the material immediately following subparagraph (G) of section 415(b)(2)." However, there is no subparagraph (G) in section 415(b)(2). The reference should be to "the material immediately following subparagraph (G) in section 415(a)(2)."

(2) Certain Powers of an Independent Trustee Not Treated as a Power for Purposes of the Tax on Generation-Skipping Transfers (Section 702(n)(2) of the Revenue Act of 1978 and section 2613(e) of the Internal Revenue Code).

The Tax Reform Act of 1976 imposed a tax on certain generation-skipping transfers. Under the generation-skipping provisions, an individual is a beneficiary of a trust if he has a present or future power or interest in it. "Power" means "any power to establish or alter beneficial enjoyment of the corpus or income of the trust." A person has an "interest" if the person has either "a right to receive income or corpus from the trust" or "is a permissible recipient of such income or corpus." Thus, one can be a beneficiary by satisfying either or both of the tests.

In the 1976 Act, Congress sought to exclude certain independent trustees from being treated as beneficiaries solely because of powers which they held to distribute trust corpus and income. The original language in section 2613(e) of the Code was found too restrictive and section 702(n)(2) of the Revenue Act of 1978 expanded the categories of individuals to whom independent trustees could make distributions without being treated as beneficiaries. However, since the time of enactment of the original generation-skipping provisions, there has been a question whether an individual trustee who was the permissible appointee of trust assets under an unexercised power of appointment held by another would be deemed to have an interest in the trust and therefore be treated as a beneficiary under that test.

Congress clearly intended to carve out an exception for independent trustees. The draftsmen did not focus on the question of whether a contingent future interest, such as that of a permissible appointee, should be treated as an interest for purposes of beneficiary determination. We recommend that, solely for purposes of the independent trustee exemption, a trustee will not be treated as having an interest in the trust if his only interest is as a permissible appointee under a power of appointment held by another.

The General Explanation of the Revenue Act of 1978 states that an individual trustee will not be treated as a beneficiary if "he has no interest in the trust other than as a potential appointee under a power of appointment held by another." The purpose of this amendment is simply to codify the intent of Congress, as expressed in the General Explanation.

(3) Meals or Lodging Furnished for the Convenience of the Employer (Section 205 of the Foreign Earned Income Act of 1978 and section 119 of the Internal Revenue Code).

Section 4 of P.L. 95-427, which was enacted October 7, 1978, effective for tax years after 1953, redesignated most of the existing Code section 119 as subsection (a) and added a new subsection (b). The new subsection (a) began as follows: "(a) GENERAL RULE.--There shall be excluded. . . ." Section 205 of P.L. 95-615, the Foreign Earned Income Act of 1978, then amended Code section 119 as follows:

> Section 119 . . . is amended . . . by striking out "There shall" and inserting in lieu thereof "(a) MEALS AND LODGING FURNISHED TO EMPLOYEE, HIS SPOUSE, AND HIS DEPENDENTS, PURSUANT TO EMPLOYMENT. -- There shall".

Section 205 of P.L. 95-615 should also have struck out "(a) GENERAL RULE.--". This clerical change should be included in the bill.

(4) Gasoline Used in Commercial Fishing (Section 222 of the Energy Tax Act of 1978 and section 6421(d)(2) of the Internal Revenue Code).

Section 6421(d)(2)(C) of the Code contains three cross references relating to refund of fuel and oil taxes for commercial fishermen. The cross references are not complete. Two additions are suggested to read as follows:

"(iv) section 6424 (relating to payments for qualified business use of lubricating oil), and

(v) section 6427 (relating to payments for special fuels used other than for the use for which sold)."

(5) Chassis or Bodies Converted to Buses (Section 231 of the Energy Tax Act of 1978 and section 6416(b)(3)(A) of the Internal Revenue Code).

While section 231 of the Energy Act exempts from excise tax sales by manufacturers or importers of bus chassis and bus bodies, there is no explicit credit or refund provision if a truck chassis or truck body is sold tax-paid and then modified to form a bus. This could be rectified with an amendment to Code section 6416(b)(3)(A) by inserting after "him" the phrase ", or such other article is an automobile bus chassis or an automobile bus body". This amendment would permit the person who modifies the truck into a bus to apply for credit or refund of the tax on the truck chassis or body.

(6) Lubricating Oil (Section 404 of the Energy Tax Act of 1978 and section 6416 of the Internal Revenue Code).

Section 404 of the Energy Act provides an exemption from the tax on lubricating oil with respect to lubricating oil sold for use in mixing with rerefined used oil; the exemption is available to the extent that the new oil does not exceed 55 percent of the mixture and the rerefined oil constitutes at least 25 percent of the mixture. No provision was made for credit or refund of tax if tax-paid lubricating oil is mixed with rerefined oil. To provide for a credit or refund, a new Code section 6416(b)(2)(N) should be added by deleting "or" after subparagraph "(L)", by changing the period at the end of subparagraph "(M)" to a semicolon, and by adding the following new subparagraph:

"(N) in the case of lubricating oil taxable under section 4091, mixed with rerefined oil (as defined in section 4093(b)(3) and the lubricating oil does not exceed 55 percent of such rerefined oil."

Department of the TREASURY NEWS

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STATEMENT OF
THE HONORABLE DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
March 28, 1979

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the Treasury's views on H.R. 2550, a bill dealing with the deductibility of travel expenses by Federal and State legislators.

H.R. 2550 would extend for one year, through tax year 1978, the temporary rules on State legislators' travel expenses which were enacted by section 604 of the Tax Reform Act of 1976. The Ways and Means Committee approved such an extension on March 21, 1979. Treasury supports this one-year extension.

In addition, H.R. 2550 would enact permanent rules on travel deductions for both State and Federal legislators. Treasury supports these rules with certain modifications.

B-1484

Present Law and H.R. 2550

Section 162 of the Internal Revenue Code allows a deduction for ordinary and necessary business expenses, including meal and lodging expenses incurred while travelling away from home in the pursuit of a trade or business.

For purposes of determining whether travel expenses are incurred away from home, Code section 162 provides that the "home" of a Member of Congress will be his place of residence within the State, Congressional district, or possession which he represents in Congress. Section 162 also imposes a $3,000 annual limitation on the amounts which a Member of Congress may deduct for living expenses incurred away from home. Transportation fares are deductible without regard to the $3,000 limit.

Under the temporary rules for State legislators which were enacted in 1976, a State legislator may elect as his tax home his place of residence within the legislative district which he represents. He may deduct for living expenses away from home, without substantiating those expenses, the amount computed by multiplying the legislator's total number of "legislative days" for the year by the per diem amount generally allowable to Federal employees for travel away from home. For this purpose, "legislative days" include (1) days in which the legislature was in session (including any day in which the legislature was not in session for 4 consecutive days or less, i.e., weekends) and (2) days in which the legislature was not in session but the legislator attended a meeting of a legislative committee.

Revenue Ruling 79-16, 1979-3 I.R.B. 6, holds that for purposes of these rules the "generally allowable" Federal per diem is the maximum Federal per diem authorized for the seat of the legislature. The Federal per diem travel allowance is $35 for most areas of the United States but is higher for certain high cost areas, including a number of State capitals. For example, the Federal per diem for Juneau is $60; for Honolulu, $58; for Boston, $49; and for Albany, $39.

H.R. 2550 would make permanent these temporary rules for State legislators. In addition, H.R. 2550 would repeal the $3,000 limitation on amounts deductible as living expenses by Members of Congress. The bill would allow Federal legislators (like State legislators) to deduct, without substantiating the expenditure, an amount equal to the number of "legislative days" for the year times the Federal per diem for Washington, D.C. (which is currently $50).

Comments on Permanent Rules Proposed in H.R. 2550

To understand the impact of H.R. 2550, it is necessary first to understand the travel expense deduction rules which would apply to legislators in the absence of special statutory rules. Under the rules applicable to taxpayers generally, a taxpayer's "home" for purposes of section 162 is his principal place of business. A legislator's principal place of business would be determined annually on the basis of factors involving the total time ordinarily spent by the legislator at each of his business posts, the degree of business activity at each location, the amount of income derived from each location, and other significant contacts. Thus, under the generally applicable rules, the Washington metropolitan area would be the tax home for Members of Congress, regardless of the fact that they maintain their legal residence elsewhere. With the increasing lengths of State legislative sessions, the tax home for some State legislators might well be the State capital.

Thus, under the generally applicable rules for determining tax home, Members of Congress and some State legislators would be restricted to deductions for business travel away from the seat of the legislature (essentially, deductions for travel to their legislative district). However, because of the nature of the legislator's job, it might not be fair to restrict legislators to a deduction for some expenses of living in their legislative district. Legislators, unlike most other taxpayers, often have business reasons to maintain two residences, one near the seat of the legislature and one in their legislative district. Moreover, in many cases it is reasonable for the legislator's family to continue to reside in the legislative district.

Deductions for lodging expenses incurred away from home are appropriate to reflect a duplication or increased level of expense which the taxpayer would not incur in the absence of business necessity. Similarly, deductions for meal expenses incurred away from home are appropriate to reflect an additional expense (of eating outside the home) which the taxpayer incurs for business reasons.

For these reasons, it is appropriate to have a special statutory rule allowing legislators to deduct a portion of their living expenses incurred at the seat of the legislature. Such a rule cannot provide perfect results in all circumstances, but it can be fair and neither overly harsh nor overly generous.

One approach to providing such a rule is to allow legislators to elect their residence in their legislative district as their tax home. (H.R. 2550 takes this approach for State legislators but not Federal.) In cases where the legislature is in session for a substantial portion of the year, providing such an election without limitation could have the effect of permitting legislators to choose as their tax home the location at which the lesser portion of living expenses was incurred and hence to deduct the full amount of expenses incurred at the location where the greater portion was incurred. Thus, the election could provide overly generous results in many cases.

Another approach to providing a statutory rule for legislators is to designate the legislative district as the legislator's tax home and allow substantiated living expenses incurred at the seat of the legislature to be deducted without limit. However, in cases where the legislator maintains only minimal permanent quarters in his legislative district, this rule would place legislators in a uniquely favorable tax position.

We believe therefore that the type of rule currently provided by Code section 162 for Members of Congress (designating the legislative district as the Member's tax home and imposing a ceiling on the deductible amount of living expenses) is a reasonable approach toward providing a statutory rule. This type of rule has been in effect since 1952, and there appears to be no reason to change, except of course to increase by some means the $3,000 ceiling to reflect the substantial price changes of the past 27 years.

To achieve this result, we suggest that H.R. 2550 be modified in two ways. <u>First, limit to 180 days a year the number of "legislative days" allowable in computing deductible amount for both State and Federal legislators</u>. Allowing deductions for living expenses incurred at one business location during more than half the year may contradict the idea of being "away from home." Limiting the deduction to an amount based on a maximum of 180 legislative days per year would allow a deduction of $9,000 a year for living expenses incurred by Members of Congress ($50 a day for 180 days) and would allow comparable amounts for State legislators. If the $3,000 limitation were increased simply to reflect rises in the consumer price index which have occurred since the limitation was enacted in 1952, the limitation would be increased to about $8,000.

Second, designate the residence in the legislative district as the tax home for both State and Federal legislators. H.R. 2550 would permit State legislators to elect the residence in the legislative district as their tax home; the tax home of those who did not so elect would be determined on the basis of the circumstances in the individual case. Allowing an election could foster uncertainty and lead to annual shifts in a legislator's tax home. Designating the legislative district as the tax home for both State and Federal legislators would provide certainty.

It should also be understood that under H.R. 2550, as under existing law for taxpayers generally and for legislators, deductions would be allowable only for legislative days on which the legislator is "away from home" in the traditional sense (i.e., overnight). Legislators who are not away from home overnight do not incur lodging expenses other than in their principal residence. Nor do they incur any meal expenses which other taxpayers are allowed to deduct.

In summary, we believe that it is reasonable to provide a special statutory rule for away-from-home living expense deductions of State and Federal legislators. We also believe that, if modified in the two ways we have suggested, H.R. 2550 provides an appropriate rule.

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STATEMENT OF
EMIL M. SUNLEY
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
BEFORE THE
OVERSIGHT SUBCOMMITTEE OF THE
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and members of the Subcommittee:

I welcome this opportunity to appear before you to discuss several important issues involving the distribution of subsidies through the tax system to regulated utilities. This subject is not only of great interest to the Congress and the Administration, but also to regulators, ratepayers and utilities throughout the country.

Let me begin by recalling for the Subcommittee why it is that a tax policy official is testifying before a tax committee on a subject of fundamental importance to regulated utilities, ratepayers and regulators. The issues before the Subcommittee involve two general subsidies to capital formation provided through the Internal Revenue Code: accelerated tax depreciation and the investment tax credit.

When tax depreciation rules permit write-offs at a faster rate than the actual physical deterioration of capital assets, the economic effect is the deferral of tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans to the taxpayer during the early years of the asset's life, which are repayable in the later years.

The other subsidy -- the investment credit -- was the subject of extensive testimony before the Subcommittee this past week. This credit is roughly equivalent to a direct cash grant paid by the Treasury to purchasers of certain capital assets. The grant is paid by allowing taxpayers to reduce their tax liabilities otherwise payable.

Thus, we are talking about two forms of Federal subsidies -- interest-free loans and cash grants -- which are "cleared" -- that is, paid and distributed -- through the Federal income tax system.

If these subsidies had been enacted as direct grant and loan programs administered by the Commerce Department, then not only would we be before a different committee, but most of the issues before us would never have arisen. This is because under a direct loan or grant program, the real character of the payments to assist private capital formation would be obvious to all concerned. The accounting treatment for government grant and loan assistance is simply not controversial in the private sector. Consequently, there would be no need to prescribe accounting rules by Federal law and, therefore, no need to exercise oversight review of such rules.

That we are here at all may be the most persuasive reason for exercising greater restraint in the future when we are tempted to use the tax system as a mechanism to finance Federal subsidy programs. Programs whose objectives and costs are obscured by the method chosen to finance them and whose administration becomes intertwined with administration of the income tax laws impose unnecessary social and political costs we can ill-afford to bear.

Why Provide These Subsidies to Regulated Utilities?

The investment credit, as originally proposed by the Treasury Department in 1962, would have completely excluded public utilities from the credit. The Treasury argued that, "Investments by these regulated monopoly industries are largely governed by determined public requirements and are subject to regulated consumer service charges designed to provide a prescribed after-tax rate of return on investment" The House Ways and Means Committee compromised by giving the public utilities one-half the credit allowed other industries. The Committee justified the decision as follows:

> The smaller credit [for public utilities] is provided ... because much of its benefit in these regulated industries is likely to be passed on in lower rates to consumers, thereby negating much of the stimulative effect on investments. Moreover, the size of the investment in regulated public utilities ... will in large part be determined by the growth of other industries, rather than their own.

The reasoning reflected in the Treasury and Ways and Means statements prevailed until 1975 when Congress placed regulated companies on the same footing as all other companies for investment credit purposes. It is clear today that the earlier reasoning is essentially wrong. In both the regulated and unregulated sectors of the economy, technology and consumer preferences operate to determine which particular forms of capital will be employed and which kinds of output will be increased. If the full beneficial effect of an investment tax credit for machinery and equipment is to be achieved, it should be made generally available, on the same terms, to all sectors of the private economy -- to the regulated as well as to the unregulated. Only in this way can the structure of product prices and the output mix of the private sector fully reflect technological possibilities and consumer preferences. The capital cost of goods produced by the regulated sector should not be made arbitrarily higher or lower than the capital cost of goods produced by the unregulated sector.

A second argument often made for denying the full investment credit to regulated utilities is that the regulatory process inherently biases public utilities to excessive use of capital. As a purely abstract principle, a case can be made that as long as the average "fair rate of return" allowed by the regulators exceeds the marginal cost of funds, the management of regulated utilities will have an incentive to utilize more capital intensive production methods. However, there are several factors in the real world which tend to reduce this effect.

First, the familiar regulatory lag in adjusting the prices of utility services to rising costs will operate to prevent the realization of higher returns from marginal investments. Related to this, is the fact that the regulatory authorities themselves may adjust downward the fair rate of return thus offsetting the tendency toward excessive capital intensity.

Similar checks are provided by competition among utilities (e.g., gas or electric power) and between utilities and large companies able to produce their own utility services. Finally, to the extent that utilities are interested in maximizing sales rather than profits there would be no pressure for excessive capital intensity.

Attempts at empirically estimating the degree of excessive use of capital in the utility sector have not adequately come to grips with the difficulties in measuring the marginal cost of funds relative to the average "fair" rate of return or with the ability of regulators to adjust the fair rate of return as conditions warrant. Indeed, throughout the history of regulation, we have seen large variations in the profits of utilities and in their ability to attract funds in capital markets, all while a "fair" return was presumably being earned.

Thus, we would conclude that it would be unwise policy to offset a theoretically possible excessive use of capital by utilities by denying to them an instrument designed generally to stimulate capital formation.

Phantom Taxes

Let us now turn to the question of "phantom taxes". This is an issue of perception, not of economics, financial accounting, or fairness. The phantom tax problem evolves from the natural response of a utility ratepayer who is told that he is being charged a greater amount for utility income tax liability -- a part of his cost of service -- than the utility actually pays as taxes. Of course, what the ratepayer does not see and is not told is that part of the utility's tax liability is offset by Federal subsidy payments to the utility, and that there subsidies will lower his cost of service. This portion of the utility's taxes are by no means phantom or fictitious. They are simply being offset by Federal subsidies.

The phantom tax problem would not arise if the Federal subsidies in question -- the investment credit and accelerated depreciation -- were paid directly in cash grants or as interest-free loans, rather than cleared through the tax system. If the Commerce Department, instead of the Treasury Department, were in the business of providing these subsidies, ratepayers would see that they were being charged the same amount for utility taxes as the utility actually paid in discharging its liability. Ratepayers would also see a series of checks being written by the Commerce Department to the utilities. Since utility taxes paid to the Treasury would then equal utility taxes paid by ratepayers, the phantom tax issue would have disappeared. And yet, this hypothetical arrangement involving the Commerce Department is the economic equivalent of the system we have today. No one -- not the ratepayers, not the utilities -- is any better or worse off in the hypothetical. Thus, as I said before, the phantom tax problem is one of perception, and not of economics or fairness.

Since this point is essential to understanding the issues before the Subcommittee, let me provide a simple illustration. Suppose a company owes the Treasury $1 million in income taxes, and Congress has decided to pay that company a subsidy of $100,000. Congress could pay the subsidy by having Treasury write a check for $100,000. Alternatively, instead of having the company write a check to Treasury and Treasury write a check to the company, the two payments can be folded together. In effect, this is what happens when subsidies are paid through the tax system. In our example, the company has indeed paid $1 million in tax, and the Treasury has paid $100,000 in subsidies. Of course, an outsider will observe only that a net payment of $900,000 is remitted to the Treasury.

By using the tax system to clear Federal subsidies, we naturally end up with some tax liabilities being less than they otherwise would be. The reduction in tax does not mean that the taxes were never paid. It simply means that two offsetting payments -- a tax payment to the Treasury, and a subsidy payment to the taxpayer -- have cancelled out. The appropriate accounting for subsidies cleared through the tax system is discussed below.

Let me emphasize the important policy lesson contained in the phantom tax issue. We must realize that when the Federal tax system is used for a purpose other than simply raising revenues -- such as for paying capital subsidies -- unexpected and undesirable consequences may follow. In the case before the Subcommittee, the fact that the Federal tax system -- rather than a direct aid system -- is being used to pay capital subsidies to regulated companies is responsible for some ratepayers believing that they are being charged for taxes that the utilities never pay. While there is no economic or financial substance to the ratepayers' view, their annoyance is quite understandable. Moreover, their respect for the basic fairness of the Federal tax system may well be diminished.

The lesson is an important one. When we run subsidies through the Federal tax system, we risk creating significant problems of misperception. These problems may well impinge on the ability of the Federal tax system to function properly, and create problems elsewhere.

How Should Tax Subsidies to Capital be Accounted For?

The next issue is how regulated utilities should account for tax subsidies to capital, such as accelerated depreciation and the investment credit. I would like to offer for the record an analysis of the accounting rules prepared by Treasury, which is attached to my testimony.

Utility regulators have two basic goals: (1) to establish prices that cover the cost of providing utility services, and (2) to minimize the costs of providing those services.

The amount utilities charge for services must be sufficient to cover current expenses such as labor, fuel, and taxes, and the costs of capital used to provide those services. The total costs attributable to the use of capital include depreciation, interest, and a sufficient after-tax return to shareholders to maintain and attract equity capital. The amount charged for utility services must, therefore, be set so that after current expenses, including income taxes, as well as interest and depreciation, shareholders receive an adequate after-tax rate of return.

Consequently, the size of the rate base -- that is, the total capital contributed by lenders and shareholders -- determines all components of the cost of using capital. The rate of return to lenders and shareholders is some "fair return" as a percentage of the rate base. Depreciation represents the fraction of the rate base used up in each year's production.

If part of the rate base is financed by a source other than shareholders and lenders, such as a government subsidy, the charge for utility services should reflect this fact. If the Federal Government provides a 10 percent purchase subsidy with respect to plant and equipment, the rate base should be reduced accordingly, thereby properly recognizing the Federal contributions. By reducing rate base, cost of service elements that are determined by rate base -- both depreciation and fair rate of return -- are also reduced in proportion to the Federal subsidy. If the government furnishes $10 and private lenders and equity owners provide $90, only $90 has to be regarded as the base for depreciation and a fair rate of return.

The term "normalization" refers to the modifications of utility rate base which reflect the investment credit in the manner I have just described. What this means is that the rate base is reduced by the amount of the subsidy to reflect the fact that private financing is not required for a portion of the assets acquired by the firm. If this is done, the cost of service charged to ratepayers will be precisely the same as if the subsidy had been paid by the Commerce Department in cash. At the same time, the utility's tax expense is the tax liability for the year <u>without reduction</u> for the subsidy. The smaller cash payment to the Treasury is the method by which the government's contribution to the purchase of machinery and equipment has been provided. Section 46(f) of the Code is intended to incorporate this result. For reasons I will explain later, section 46(f) is somewhat deficient.

The analysis for accelerated depreciation is similar to that for the investment credit, except that we are now dealing with interest-free loans rather than cash grants. By providing accelerated tax depreciation to regulated companies, part of the rate base is being financed by interest-free loans from the Treasury. Proceeds of the Treasury loans cannot directly reduce rate base since the loans must be repaid. However, the cost of service is reduced since no rate of return need be paid with respect to the portion of the rate base financed by Treasury's interest-free loans.

Some have suggested that Treasury's interest-free loan is never repaid, that is, the deferred taxes are forever deferred. This is not the case. For any given asset, the loan is repaid as the tax depreciation allowances are reduced in later years of the asset's life. It is true that as new assets are acquired to maintain productive capacity, new loans are extended which, in effect, repay the expiring ones. Thus, a permanent supply of borrowing from the Treasury may be maintained. The "permanency" of the Treasury loan supply is, however, no differnet from the supply of long-term debt provided by private lenders, which is also being replenished on a continuing basis.

The proper accounting treatment for these interest-free loans is also referred to as "normalization". This treatment, which again is consistent with the Congressional intent and with cost of service ratemaking objectives, is the treatment generally required by section 167(l) of the Code.

If a procedure other than normalization is applied to the investment credit or accelerated depreciation, the result will be inconsistent with both the Congressional intent and the objectives of cost of service regulation. If the income tax expense for which ratepayers are charged is reduced by the capital subsidy -- a procedure commonly called "flow-through" -- current ratepayers are being undercharged for their cost of service while future ratepayers will more than make up the difference. Under flow-through, only the current tax expense is reduced. On the other hand, under normalization, all capital costs associated with rate base -- depreciation, interest, taxes, and after-tax returns to stockholders -- may be reduced since the rate base is reduced. These reductions are realized over the life of the asset.

Thus, under flow-through, only the tax expense is reduced. Under flow-through, regulated companies are in effect told that there has been no cost reduction in the qualified property. This plainly defeats the purpose of providing the subsidy in the first place. Likewise, the objective of cost of service ratemaking is defeated since current year customers have cost of service reduced by the full amount of a reduction in capital cost when that reduction should have been spread over the life of the asset for the benefit of future ratepayers.

Let me illustrate these principles with a simple example. A utility buys some machinery with a 30-year life for $30 million. No one would suggest that in the year of acquisition, ratepayers be required to furnish the full $30 million. Instead, assuming straight-line depreciation of the machinery for cost-of-service rate regulation, ratepayers will be charged $1 million per year for depreciation over the life of the machinery, and they will pay a fair rate of return on the undepreciated remainder, financed by lenders and stockholders. Suppose the manufacturer has a "10-percent-off" special. The utility rushes to the store, and the $30 million item instead has a cost of $27 million. No one would suggest that the full amount of the savings be passed on immediately by reducing current rates by $3 million. What happens instead is that annual depreciation charges are reduced from $1 million to $0.9 million. This has the effect of spreading the benefits of the 10-percent discount to ratepayers over the life of the machinery. Additionally, the fair rate of return charges will be reduced by 10 percent over each year of the asset's life.

The investment credit is no different. The "10-percent discount" provided by the credit should not be flowed-through immediately. Instead, as in the example, the rate base must be adjusted to reflect the fact that assets in the rate base cost 10-percent less. A similar analysis follows for accelerated depreciation except that the tax deferrals -- interest-free loans -- reduce the "finance charge" to lenders and stockholders whose financing is no longer needed.

To summarize then, we must evaluate accounting rules here on the bases of how Congress intended these subsidies to be treated and the objectives of cost-of-service rate-making. Flow-through of the tax subsidies defeats the Congressional objectives by greatly reducing the capital subsidy nature of the provisions.

Should Normalization be Enforced Through the Internal Revenue Code?

At this point, we have told you that the two subsidies in question, accelerated depreciation and the investment credit, should be made available to regulated companies on the same basis as unregulated companies. We have also described how regulators should account for these subsidies. We must next turn to what is the most difficult issue before the Subcommittee -- whether the proper accounting treatment of the subsidies should be enforced through the Internal Revenue Code.

Sections 46(f) and 167(l) do two things. They describe how the subsidies should be accounted for in utility rate-making, and they prescribe penalties for failure to do so. The penalties are quite severe. If the wrong accounting method is chosen, the subsidies are completely disallowed. No middle position is available. It is worthwhile to explore the reasons for imposing such severe penalties.

Initially, the issue involved only accelerated depreciation. Congress first provided accelerated depreciation in the Code in 1954. By the mid- to late 1960's, certain problems had developed with regulated utilities. Some regulators were immediately flowing through the benefits of accelerated depreciation, thereby reducing greatly its capital-subsidy effects. In certain cases, where utilities resisted flow-through, regulators set rates as if flow-through had been elected. At this point, Congress intervened. The Tax Reform Act of 1969 enacted section 167(l) of the Code. These rules provide generally that accelerated depreciation is available to regulated utilities only if normalization is followed for ratemaking purposes. In 1971, when the investment credit was restored, Congress provided the credit to regulated utilities only if a set of rules based upon normalization was followed. These rules are now found in section 46(f) of the Code. The Congressional concern was that absent such rules, regulators would flow-through the credit, thereby defeating its capital subsidy impact.

In the unregulated sector there need be no such concern that company managements may willfully misconstrue a capital purchase subsidy by the accounting procedures they adopt. The management that behaves as if the capital purchase subsidy is a mere reduction in its tax bill will be disciplined by competitors who adopt production and marketing strategies based on the lower cost of production made possible by the subsidy. Regardless of how the subsidy is presented in an unregulated company's financial books of accounts, market prices and output will respond to the real underlying changes in private costs. Prices and costs are equilibrated in unregulated markets independently of accounting formalities. In the regulated sector, on the other hand, the regulatory authorities influence prices and outputs by their interpretation of the rules for cost measurement. By misconstruing the real nature of subsidies cleared through tax accounts, they may misdirect public subsidies.

Further, although flow-through accounting is clearly contrary to the Congressional intent in enacting capital subsidies, it can be extremely attractive. First, it corresponds to the popular misperception that receipts of these subsidies are "phantom taxes". Second, by converting a potential stream of lowered capital charges into a misconstrued reduction in current cost of service, flow-through provides current ratepayers rate reductions that can be quite substantial. In periods of high inflation, there is great impetus to keep rates low currently.

Thus, regulators are subject to intense pressure, both economic and political, to keep rates as low as possible. Under such circumstances, flow-through may be irresistible. In order to offset this pressure, it is suggested, stringent rules such as those found in sections 46(f) and 167(l) are required. Regulators are thereby furnished with the means to counteract pressure to reduce rates currently.

On the other hand, these provisions of the Code no doubt preempt some element of discretion that would otherwise be left to ratemaking authorities. However correct the normalization rules may be, it is argued, they constitute Federal intervention in ratemaking policies. Moreover, since utilities receive enormous quantities of these tax subsidies, ratepayers perceive that they are paying far more for utility taxes than the utilities ever pay. Although, as we have said before, phantom taxes are a problem of perception and not of substance, the perception creates real political problems. Regulators are hard pressed to explain satisfactorily why more taxes are charged for than are actually paid. Furthermore, as some have pointed out, while the tax rules prescribe accounting rules, they do not authorize an inquiry into the motivation for regulators choosing a particular rate of return. This means there are limits as to how far the tax rules can be enforced in the regulatory process.

We cannot be oblivious to the significant problems arising from enforcement of normalization through the Code and from clearing the subsidies through the tax system. If the identical subsidies were provided directly by the Commerce Department in the form of grants and interest-free loans, phantom tax and similar issues would disappear, and the question of whether or not to normalize the subsidies would never arise. Since we believe that (1) normalization is the appropriate accounting technique, (2) the Congressional intent is well served by normalization, and (3) enforcement through the Code has generally been effective, we are constrained to conclude that sections 46(f) and 167(l) are useful and that the policies underlying their enactment continue to have validity.

<u>Administration of Sections 46(f) and 167(l)</u>

The penalties for failure to comply with sections 46(f) and 167(l) are severe. In addition, affected taxpayers are regulated and for the most part, publicly owned. In view of these constraints, we believe that there has been general compliance with these requirements. In some cases, where utilities have doubts about whether a proposed rate order will comply with the requirements of the Code, they have requested a ruling from the Internal Revenue Service. Due to the severe penalties imposed in the event of noncompliance, we assume that in most cases, these provisions are reasonably self-enforcing.

It is, therefore, not surprising that there have been very few administrative problems involving the IRS. Few ruling requests or requests for technical advice have been received. We understand there are presently two or three normalization issues being considered on audit. No tax liability litigation has as yet involved a normalization issue.

On the other hand, as recent events in California have shown, the current tax rules are not very well equipped to handle controversy. The basic problem is that two different parties, the utility and the regulator, have a say in determining the facts on which the tax subsidies are based. One process -- ratemaking -- exists to handle the relationship between the regulator and the utility. A second process -- tax administration -- exists to handle the relationship between the utility and the IRS. The two processes are independent, and as a result, a problem in one cannot as yet be handled easily in the other.

In view of recent events, we are currently exploring both with regulators and utilities whether a separate tax proceeding can be devised to resolve quickly any questions involving sections 46(f) and 167(l). We hope to know soon whether a satisfactory procedure can be developed.

A Technical Problem With Section 46(f)

The accounting rules prescribed for the investment credit in section 46(f) do not adequately reflect the principles of normalization and cost of service ratemaking. Since we believe that if any rules are to be enforced, they should be normalization rules, we would like to discuss with you the problems with section 46(f) and how these problems should be remedied.

1. Section 46(f)(1). This section provides that the credit shall not be allowed if

> "... the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable ... or

"... the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable ... [unless] the reduction in rate base is restored not less rapidly than ratably."

Current investment credit rules permit taxpayers to claim depreciation for the portion of the asset financed by the credit. Section 46(f)(1) is ambiguous because it does not provide guidance as to how to account for depreciation attributable to the portion of the asset financed by the investment credit.

The correct set of rules should provide that (1) tax expense in any year may not be reduced by the allowable investment credit or by the tax savings from depreciation attributable to the portion of the asset financed by the investment credit, and (2) the rate base used for both depreciation charge computation and to which the fair rate of return is applied must be reduced by the allowable investment credit and by the tax savings from depreciation attributable to the portion of the asset financed by the investment credit.

2. Section 46(f)(2). Here, an alternative procedure is prescribed. The cost of service may be reduced by no more than a ratable portion of the allowable credit over the life of the asset. But the rate base may not be reduced "by reason of any portion" of the credit. In effect, the depreciation charge is reduced in recognition of the government capital purchase subsidy, but ratepayers are expected to pay stockholders the entire fair rate of return on the government's contribution to the rate base assets.

Not surprisingly, utilities elect section 46(f)(2), for it seems to ensure them of a greater than fair rate of return on their own funds.

We believe that section 46(f)(1) should be rewritten to reflect more accurately the correct accounting procedure for normalization of the investment credit. In addition, we believe that section 46(f)(2) should be deleted, since it does not accurately reflect normalization accounting procedures.

Should an Excise Tax be Substituted for the Income Tax on Utilities?

In response to controversies involving phantom taxes and flow-through, it has occasionally been suggested that these issues be resolved by substituting an excise tax on utility services for the corporate income tax now levied on utilities. We believe that any such change in the law would be a serious mistake.

We believe that the motivation for such proposals is misplaced. As we discussed before, the only reason utility taxes actually paid vary so much from utility taxes that ratepayers are charged for is that capital subsidies are being cleared through the Federal tax system, and utilities use enormous amounts of capital. Once this is recognized, there is no further reason for suggesting that an excise tax be substituted for the income tax on utilities.

In addition, we would note the following:

° Sound principles of public finance policy disfavor specific excise taxes except for (1) control purposes, and (2) overcoming "market failure", as in the case of an excise tax serving as a substitute for price controls, and pollution taxes, which internalize externalities.

° The proposal implies that an excise tax may, in fact, be substituted for an income tax. This is not true. An excise tax is, in effect, imposed on all inputs: labor, materials, and services provided by other firms, as well as capital. An income tax falls on earnings only.

° Either an ad valorem or a specific excise tax would impose widely varying tax burdens on consumers. An ad valorem tax would penalize consumers of high cost companies dependent on expensive fuel or burdened by high local taxes. A specific excise tax would penalize consumers served by low-cost companies, largely comprised of publicly-owned entities.

° Most public utilities do more than sell electric energy. Construction and supply of gas services are common. As a result, segregation of exempt income from taxable income will be an administrative nightmare.

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Accounting for Tax Subsidies with Special Reference to Cost of Service, or "Fair Rate of Return", Utility Regulation

An Annex to the Statement of
Emil M. Sunley
Deputy Assistant Secretary (Tax Analysis)
Department of the Treasury
Before the
Oversight Committee of
The Committee on Ways and Means
March 28, 1979

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<u>Introduction</u>

The prices of goods and services exchanged voluntarily in markets, when there are no barriers to entry, tend to approximate "cost of production." Conventionally, cost of production comprises two elements, payments for labor services and materials embodied in the goods and services produced for sale and payments for the services of capital--plant, equipment, inventories, etc.--similarly embodied in the output. In the unregulated sector, where freedom of entry and exit by individual enterprises is presumed to exist, prices "automatically" equilibrate with costs: if a seller receives prices in excess of labor, material and normal capital costs, his abnormal return, conventionally expressed as a return to his equity capital, attracts competition; if the prices he receives fall short of his total costs, he exits. In the regulated sector, where it is presumed that technological conditions preclude freedom of entry and exit, regulatory commissions function to equilibrate prices and costs.1/

1/ Another function performed in unregulated markets is the assurance that the costs of production to which prices are equilibrated are minima. Since markets for labor and capital both function to allocate these resources to employments in which the value product is a maximum, it follows that least-cost technologies will tend to be employed. Neither workers nor capital owners will accept returns for productive services that are lower than might be earned elsewhere <u>either</u> because the products they produce fail to fetch sufficiently high prices <u>or</u> because the technology being employed is obsolete. In the case of regulated industries, it is presumed the regulators will exercise vigilance to ensure that prices received are no higher than costs, <u>and</u> that the costs are as low as technology permits.

Because regulatory agencies must replace impersonal market forces in establishing both quality of service and schedules of allowable maximum rates to be charged for services, their responsibilities are varied and complex. Given a specification of "quality of service", the "cost of service" must be measured so that revenues generated by the schedule of allowable rates will not be "excessive." To carry out this responsibility, regulatory commissions establish procedures by which the varied transactions of regulated companies are recorded so that the outcome of the operations of the companies may be reviewed and made subject to control by the commissions.

An understanding of these standard procedures, commonly known as standard accounts, is critical to an understanding of the logically consistent way in which tax subsidies should be accounted for, in both the regulated and unregulated sector of the economy. Therefore, the first section of this annex sets out the elements of an accounting system, and defines the terms relevant to an accounting for "cost of service" and for the subsidies which affect this cost. The next section introduces a capital grant subsidy, the class to which the investment tax credit belongs, and demonstrates how this public support of capital formation operates to reduce the "cost of service." The following section introduces a capital subsidy in the form of an "interest-free loan," the class to which "artificially accelerated tax depreciation" allowances belong, and contrasts this with a capital grant form of subsidy. The subsidy accounting procedure commonly called "normalization" is shown to be the only technique that correctly portrays the intended effect of both capital subsidies on the cost of service. The fourth section demonstrates that "normalization" accounting also effectively portrays the results of capital subsidies under dynamic conditions; the last section comments on the extension of these subsidy accounting techniques to the unregulated sector.

I. Accounting for the "cost of service."

Three classes of transactions

Any enterprise, whether regulated or unregulated, engages in a myriad of transactions involving the employment of labor, procurement of materials, the acquisition and maintenance of plant and equipment, and the payment of taxes in the course of producing and selling goods. Organizing these transactions in a structure that is both comprehensive and analytically useful is the subject matter of accounting, both for financial reporting and income tax compliance. Three sets of transactions must be dealt with: First those involving the purchases of goods and services which are directly embodied in the goods and services sold within an accounting period, usually a year. In principle, purchase transactions are cumulated, or "inventoried" over the course of the year and subtracted from the sales transactions as "cost of goods sold"; the excess of sales proceeds over cost of goods sold is "operating income" of the enterprise.

The second set of transactions to be dealt with are those pertaining to the acquisition and use of plant and equipment items, the services of which are embodied in the enterprise output over a long span of accounting periods. For this class of transactions, in addition to accounting for acquisition of the assets encompassed in market exchanges, it is also necessary to account for the using-up of these assets; and since this cost of output is normally not observable in a set of market transactions, a procedure for imputing the value of the capital consumed during a period is required.

Finally, there is the class of transactions concerned with financing operations, particularly the acquisition of plant and equipment items. These include the extension of trade credit to finance sales, the receipt of trade credit to finance purchases, and the issuance of long-term debt instruments or issuance of stock to obtain additional equity. Unlike the other two sets of transactions which are concerned with measuring the cost of producing goods and services for sale, and the net outcome of an enterprise' economic activity, these transactions involve only the recording and assignment of claims against the assets of the enterprise.

Assumptions underlying the base case.

We will not concern outselves here with the problems of maintaining surveillance over the classifications of transactions in order to derive reliable measures of income, whether for financial or tax purposes. This is a tremendous burden of auditing borne by regulatory, financial, and income tax personnel which we will assume is satisfactorily accomplished in the real world. Instead, we will concentrate our attention on the statements which summarize the outcome of accounting for the economic performance of an enterprise.

To do this most expeditiously, and to facilitate the later discussion of accounting for the introduction of tax subsidies, we will make the following simplifying assumptions:

(1) The enterprise, a regulated utility, has financed its operations in such a way that its "current assets" equal its "current liabilities." That is, the amount of its cash on hand, accounts receivable, and inventories of materials and supplies is exactly equal to its accounts payable (including accrued

taxes). This means that the net value of its plant and equipment is eactly equal to outstanding interest-bearing debt and the claims of its equity, or share, owners. Plant and equipment is therefore the "rate base."

(2) All plant and equipment is depreciable.

(3) The acquisition cost of plant and equipment is the same for both regulatory (financial) and tax accounting purposes.

(4) The regulatory life of plant and equipment is 30 years; and the total plant and equipment account is comprised of 30 equal units, one of which must be replaced each year.

(5) There is no growth and no inflation; the state of technology does not change.

(6) Sixty percent of the rate base is financed by debt, 40 percent by equity; the interest payable to bondholders is 10 percent, the after-corporate-tax return to equity is 15 percent.

(7) All interest is paid at the end of the year; corporate income after taxes is also distributed at that time.

(8) Plant and equipment acquisitions are made at the beginning of each year.

These assumptions generally define the case of a "going concern" in what is technically described as "stationary equilibrium." However, as will be noted below, this model of an enterprise may also be used to describe dynamic adjustment to changes in the size of the enterprise or in the terms on which its assets are acquired or financed.

Description of the "base case."

In the base case, we assume that income tax accounting perfectly matches regulatory accounting, and there are no subsidies. Then, for the year 1979, Table A-1 shows the income statement summarizing the first two classes of transactions noted above. Sales of utility services aggregated \$274.6 million, of which \$165 million (60 percent of sales) consisted in cost of goods sold, leaving an operating income of \$109.6 million. This operating income is allocable into \$30 million for depreciation, \$27.9 million paid in interest, \$23.8 million in corporation income tax, and an after-corporate-tax return to shareholders of \$27.9 million. Operating income is therefore no more, or less, than the capital cost portion (40 percent in this example) of total cost and sales: it includes provision for recovery of capital consumed during the year, a return to bondholders, corporation income tax--a tax on the income attributable to equity capital, the incomes attributable to labor, suppliers, and creditors having been allocated to them--and a return to shareholders. The 40 percent of total cost (sales) allocable to capital is approximately typical of electric utilities.

Since we are assuming that interest and shareholder earnings are paid out at year end, the beginning and ending balance sheet, summarizing the third class of transactions dealing with claims against the assets, also in Table A-1, shows that, net, no change in total assets or claims against them have occurred.

On the asset side, cash and other current accounts are up by $30 million, representing the cash-flow resulting from the allowance for 1979 depreciation included in cost of service (sales); but net plant and equipment has been reduced by that same $30 million. As claims against the total of $565 million of assets, current liabilities remain at $100, and the $465 million of plant and equipment continues to be financed by $279 million in long-term debt, the basis for an interest charge of $27.9 million, at 10 percent, and by $186 million of shareholder equity, the basis for an after--corporate-tax return of $27.9 million.

If we assume there are 10 million shares outstanding, they will sell at $18.60 a share, for they will receive $2.79 a year in dividends, a 15 percent return, which is sufficient to warrant their being held, under the assumption we are operating with. So long as the prices of utility services yield $274.6 million in total revenue, and costs, including market rates of return to capital, remain unchanged, the combined return to capital of $55.8 million, representing a 12 percent return to the $465 million of privately furnished funds to operate the utility, is a "fair return" and the 12 percent a "fair rate of return."

In fair rate of return regulation, then, a regulatory commission forecasts the net plant and equipment (rate base) that will be required to furnish a postulated quantity of service, multiplies this by the "fair rate of return", adds to this an income tax quantity which is functionally determined by the equity return, and finally adds to this estimate of the cost of capital services a forecast of labor, fuel, and materials costs of production. This forecast total cost of service becomes the required sales revenue, and given a forecast of the service produced and distributed, rates per unit of services fall-out. This is "cost of service" utility regulation, including a "fair rate of return", on rate base.

A note on the base case replacement of plant and equipment.

By our assumptions of no growth, inflation, or change in state of technology, it follows that each year our illustrative company will have to acquire $30 million of plant and equipment items in order to maintain its service capacity at unchanged prices (and cost of service). Thus at the beginning of 1980 (end of 1979), the illustrative utility will have to buy $30 million of replacement capital goods. Therefore, at the beginning of 1980, the $30 million increment of cash and other current assets accumulated during 1979 is exchanged for the plant and equipment, and the balance sheet reverts to its beginning-of-1979 appearance. Under plant and equipment, $30 million of assets that had been acquired in 1950 are removed from the account and are replaced by $30 million of new items. Similarly, the $30 million of accrued depreciation with respect to the 1950-vintage assets is removed from the accrued depreciation account; this restores the net plant and equipment account to $465 million, the rate base required to produce the utility company services for 1980.

Table A-2 may be helpful in comprehending the process of maintaining a capital stock. There a partial array of each vintage of assets in service at the beginning of 1979 is shown. Under the regulatory rules for measuring cost of service, each vintage is "depreciated" 1/30th each year; an imputation method called "straight-line." Thus, at the beginning of 1979, the 1950 vintage, the oldest in use during 1979, has a net book-value of $1 million, $29 million having been recovered in costs of service over the prior 29 years of its use, whereas the 1979 vintage, being just acquired has a net book-value of $30 million. Altogether, of the original acquisition cost of $900 million, $435 million has been recovered by the private suppliers of financial capital, leaving a net rate base of $465 million.

At the beginning of 1980, the 1950 vintage drops out, its position at a $1 million net book value being assumed by the 1951 vintage; likewise, the 1979 vintage eases down a notch to a net book-value of $29 million, being replaced by the new 1980 vintage with a net book-value of $30 million. Thus, at the beginning of 1980, the original cost of all 30 vintages in use is still $900 million, of which $435 million has been recovered in depreciation charges embedded in the cost of service for years prior to 1980.

A note on the meaning of net book-value.

Clearly, the allowance for depreciation is an imputation of the decline in value of depreciable assets. In the regulated company case, since regulatory commissions establish rates based on their rule for imputing depreciation, so long as the fair rate of return applied to the rate base (original cost less previously imputed depreciation) matches the opportunity cost of financial capital for the utility, the market value of stock will equal the book-value of that stock. That is, the regulatory commission's valuation of plant and equipment, $465 million, less the claims of bondholders, $279 million, equals the book-value of equity. Then book-value _is_ the market value of plant and equipment as well; by its ratemaking power the commission establishes a market value of regulated company plant.

For what follows, this is a critical point. Regardless of the "quality" of regulatory ratemaking rules, commission rules for imputing depreciation as a cost of service must be taken as the "norm" against which tax depreciation rules will be compared. For example, it might be demonstrated that, if utiliity commissions tried harder to account for obsolescence due to technical change in production and distribution facilities used by the utility and/or to changes in the relative costs of fuels or other inputs used, they would find a set of depreciation imputation rules other than straight-line more realistic. Applying these more realistic rules would permit more timely introduction of improved plant and equipment, and these "better" depreciation imputation rules would ultimately result in a lower total cost of service as more efficient combinations of labor and materials were thereby put into use.2/ But, since the logic of fair rate of return price setting validates whatever depreciation imputation rule that is used by a regulatory commission, whether the rule is optimal or not it is the norm to measure income of the regulated company, both for financial and tax accounting purposes.

II. Accounting for a subsidy for the acquisition of capital

So long as a replacement module costs $30 million and the entire $30 million must be financed with funds obtained in private capital markets, the capital portion of cost of service will be $109.6 million in the example we have postulated as the base case. During 1979, 1980, and every succeeding year, this cost of service will recur and have to be recovered in the charges permitted the regulated company.

2/ The FCC staff has recently suggested that depreciation imputation rules used by that agency may have retarded technical progress and cost reduction in the telecommunications industry. Virtually every investigation of depreciation patterns for machinery and equipment has concluded that "straight-line" patterns are poor approximations for asset value decline, the phenomenon depreciation is supposed to describe.

Let us now examine the consequence of a 10 percent subsidy for the purchase of depreciable property, <u>when tax accounting rules match</u> regulatory accounting rules.3/ Since the

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3/ Those familiar with the analysis of excise taxes and subsidies will be aware that whether the subsidy is conferred on the purchaser, or the seller of a commodity, the net effect will be the same. If the subsidy is given to the seller, and if entry into the production of the subsidized article is free, selling prices will be competed <u>down</u> by the amount of the subsidy. If the subsidy is given to the buyer, offer prices will be bid <u>up</u> by the amount of the subsidy. But, if the article in question can be produced at constant prices, then the selling price (net to the producer) cannot be more than the cost of production, and the whole amount of the subsidy will be "passed through" to buyers in the form of lower net purchase prices. The government will be paying that fraction of the cost represented by the subsidy; buyers will be paying for the remainder with their own disposable resources.

In the present case, a subsidy for the purchase or sale of capital goods, a subsidy paid to the buyer rather than the seller is preferable on administrative grounds. Whether a "qualified" article is a capital good or not depends on the use to which a buyer will put it. A vehicle used by the purchaser in a productive enterprise ("trade or business") is obviously a capital good; the same vehicle used for recreation or personal transportation is not. Since qualification of an article for a capital subsidy can be more easily determined after its purchase by whether the purchaser must "capitalize" the acquisition cost and recover his capital through depreciation imputations as he uses it to produce salable output, it is more convenient to pay a capital subsidy to the purchaser.

"proper" regulatory accounting rules for a form of this subsidy conveyed as a credit against income tax otherwise due is the subject of controversy, we shall here simply develop the "regulatory rule" that reflects the logic of cost of service, or fair rate of return, utility rate regulation. As will become apparent, this rule for accounting for a subsidy is generally that called "normalization."

A cash subsidy for the purchase of qualified property.

Suppose that, effective January 1, 1979, Congress authorizes the Secretary of Commerce to pay each purchaser of depreciable property with an expected life of 7 or more years, on the submission of evidence that such property has been acquired, an amount equal to 10 percent of the purchase price of the property. Since the regulated company buys and uses depreciable property with an expected life of more than 7 years, its 1979 purchase of $30 million will be eligible for the subsidy when company officials duly present invoices or contracts and similar documentation of the purchase. As was shown in Table A-1, in any year, the result of the regulated company's operations was to increase its cash and other current assets by $30 million which was then available to acquire that amount of replacement items for its plant and equipment account. Thus, at the end of 1978, the company had $30 million, amassed as a recovery of capital consumed during 1978 from its sales revenue, with which to buy property that would now only cost it $27 million, net of the cash contribution of the Commerce Department.

The remaining $3 million of cash and other current assets at the beginning of 1979 is now redundant for maintaining the constant stock of company plant and equipment. The $3 million excess therefore should be used to reduce debt and outstanding equity so that utility customers will not be burdened with providing a return to the now displaced private financing; customers should pay only for returns to privately financed capital used to produce the output they buy. Since there is no reason to alter the debt-equity ratio of the company, \$1.8 million of outstanding bonds will be retired along with \$1.2 million of shareholder equity. The bonds may be retired either by not "rolling over" that amount of debt maturing on January 1, 1979, or by buying back that amount of outstanding bonds. Similarly, the \$1.2 million of redundant equity might be paid back as a "return of capital" to all existing share-holders, or \$1.2 million of outstanding stock might be purchased in the market and cancelled.

The effect on net rate base of the utility therefore has been a reduction of \$3 million at the beginning of 1979 as compared with the pre-subsidy case discussed above: total net acquisition cost of the property is now \$897 million because the 1979 vintage cost only \$27 million rather than \$30 million, while accumulated depreciation is still \$435 million, leaving a net rate base of \$462 million rather than \$465 million; and this reduced rate base is financed with \$277.2 million of debt, and \$184.8 million of shareholder equity.

The subsidy also has two effects on the cost of service for 1979. First, only \$0.9 million of depreciation, recovery of private capital, need be provided for the 1979 vintage addition to the capital stock. Thus, since the other 29 vintages in use during the year each require \$1 million, the total depreciation charge entered into cost of service for 1979 need only be \$29.9 million instead of \$30 million. Second, interest paid bond holders is reduced to \$27.72 million and the after-corporate-tax return to equity is also reduced to \$27.72 million. The reduction in required return to equity has a related effect on the Federal income tax.

Altogether, the cost of service will have been reduced by virtue of the subsidy in 1979, assuming the regulatory authority acts promptly to reflect the subsidy in the rate charges it approves.

But before tracing the net effect of the subsidy in 1979 and future years as each additional replacement vintage benefits from the 10 percent subsidy, an accounting convention needs to be introduced and explained. Because the market price of the equipment items acquired in 1979 is still $30 million, accountants feel constrained to show $30 million as the acquisition cost in balance sheets. But, since $3 million was contributed by government subsidy, they initially offset the $30 million by a $3 million account labelled "unamortized subsidy". Thus, at the beginning of 1979, the balance sheet entry for the 1979 vintage, in isolation, would be:

Plant and equipment (beginning of 1979):

Acquisition cost......................		$30
less: Unamortized subsidy....	$3	
Accrued depreciation...	0	3
Net rate base..................		$27

For the 1979 vintage, still in isolation, the end of 1979 balance sheet entry would be:

Plant and equipment (end of 1979):

Acquisition cost......................		$30
less: Unamortized subsidy....	$2.9	
Accrued depreciation...	1.0	3.9
Net rate base..................		$26.1

In effect, this esoteric accounting treatment, in which the subsidy is amortized over the life of the property, shows the net book-value of the subsidized asset at private cost. Also under this accounting treatment, while the $30 million is apparently "depreciated" over 30 years, this is offset by annual amortization of the subsidy so that the net reduction in book-value, at private cost is, in fact, $0.9 million, 1/30th of the $27 million. "Net depreciation" of subsidized assets entering cost of service is of private cost only.

With this in mind, we may now assemble the 1979 financial statements incorporating the cost of service impact of the $3 million capital subsidy received with respect to the 1979 vintage of capital; these are shown in Table A-3. Instead of the base case required total revenue of $274.57 million, after one vintage of capital has been subsidized, the required revenue shrinks to $273.95 million. This saving to utility customers of $0.62 million in 1979 results from the following reductions:

Private capital recovery......	$0.10 million
Interest payment..............	$0.18 million
Federal tax...................	$0.16 million
Return to equity..............	$0.18 million
Total.....................	$0.62 million

We have already noted the reduction in rate base, from $465 to $462 million, at the beginning of 1979, also shown in the beginning and end of year balance sheets in Table A-3. It will be observed that, at the end of 1979, the book-value of plant and equipment has diminished by only $29.9 million, for the "depreciation" of the $30 million market price of the 1979 vintage is offset by a $0.1 million reduction in unamortized subsidy. By the same token, cash and other current assets have increased by only $29.9 million, instead of

$30 million as in the base case because only this amount of cash-flow has been provided in the reduced cost of service charges.

Thus, at the beginning of 1980, after one year of operation under the subsidy, the regulated company has $29.9 million to finance the acquisition of a new vintage of equipment items. Again, with a 10 percent cash subsidy, the market price of $30 million will require only a $27 million drain on the company's cash resources. Thus, at the beginning of 1980, $2.9 million of excess private debt and equity develops, resulting in a retirement of $1.74 million of debt and $1.16 million of shareholder equity. For the year 1980, cost of service will be further reduced, and the process of reducing annual net (of subsidy amortization) charges for depreciation and returns to creditors and equity holders will continue until all 30 vintages have been replaced by property subsidized by the Commerce Department. The annual net rate base, total revenue required, and cost of service elements comprising the revenue requirement 1979 to 2009, are arrayed in Table A-4. Each year, a little more of the privately financed net rate base is displaced by public subsidy so that, by 2008, the net rate base has shrunk by $46.5 million from its unsubsidized level of $465 million; since the capital subsidy is 10 percent, so long as the subsidy remains in effect for at least thirty years, 10 percent of privately financed capital in a regulated company will be replaced by publicly financed capital.

Taxpayers generally will assume the cost of maintaining 10 percent of the qualified capital stock, and since they do not require a return for supplying this capital used in the private sector, for both these reasons the capital cost portion of total cost of service shrinks by 10 percent. In the year 2008, gross revenues need cover only $27 million of the cost of $30 million of equipment items required to maintain the company's capital stock; the other $3 million is supplied by Federal taxpayers through the Department of Commerce. Interest coverage in sales revenue becomes $25.11 million, as does the after-corporate-tax return to shareholders, 10 percent less than the unsubsidized levels of $27.9 million. Finally, the Federal income tax coverage in revenues becomes $21.39 million, also 10 percent less than the base case level of $23.77 million. Because capital costs comprise 40 percent of the base case total cost of service, the subsidy induced 10 percent reduction of capital cost of service becomes a 4 percent reduction in total cost of service; in 2008, customers would need to pay only $263.61 million for the capital-subsidy-assisted output of a plant costing $30 million in resources annually to maintain instead of $274.57 million.

The importance of correctly accounting for a capital subsidy.

The foregoing step-by-step analysis of a procedure for accounting for a capital subsidy has an inherent economic logic worth exploring. As noted earlier, the function of an accounting system is to portray the outcome of transactions, economic decisions, involved in the production and sale of goods and services. The names one attaches to the procedures, or to the transactions, are unimportant; rather, the test of validity of the accounting procedures is whether they produce accurate measures of underlying phenomena.

To demonstrate that the foregoing procedure, popularly called "normalization," is the only acceptable way to account for a capital subsidy, because it alone provides an accurate measure of the underlying phenomena, let us substitute a real 10 percent reduction in the cost of acquiring the regulated company's plant and equipment items. That is, suppose that, at the beginning of 1979, some unspecified change in the cost of producing this plant and equipment occurs so that what had formerly cost $30 million now costs $27 million to purchase. Referring to Table A-3, we would observe that the only changes in the income statement and the beginning and ending 1979 balance sheets would be elimination of references to "unamortized subsidy" and "subsidy amortization." The rate base would have shrunk by $3 million, assuming the regulatory authority is vigilant; the excess $3 million would have been returned to creditors and shareholders to dispose of however they chose; and the cost of service would have been shrunk accordingly. Similarly, at the end of 1979, $29.9 million of cash-flow would have been generated, $2.9 million in excess of the $27 million capital expenditure requirement at the beginning of 1980. Then Table A-4 might simply be recaptioned to refer to the effect on rate base, income from sales, and cost of service in the event capital goods prices are reduced by 10 percent. Since the economics of a 10 percent capital subsidy are exactly the same as the economics of a 10 percent goods price reduction, the proper way to account for the latter is also the proper way to account for the former.

The mischief caused by accounting for a capital subsidy as "income" in the year received.

Note has been taken earlier of the self-fulfilling character of rate regulation. Because entry into regulated markets is restricted, and regulatory commissions prescribe accounting procedures on which they base maximum rates, the depreciation and other income accounting rules they prescribe produce the rates which, in the end, will validate the rules. If, in a particular year the rules produce too low revenues, market prices of regulated company shares will tend to fall, destroying the relationship to book-value. Such an occurrence indicates the commitment to creditors and shareholders is being abrogated. This condition will induce some change in regulatory commission rules, such as formulation of the "fair rate of return", which will restore the relationship between book and market value, and this will "validate" the commissions's ratemaking rules. Thus, one further test of the rationality of the "normalization" rule is to examine what happens when a capital subsidy, or real reduction in the price of plant and equipment is arbitrarily accounted for by a regulatory commission as an increase, or source of, after-corporate-tax income of regulated company shareholders. This is popularly called "flow-through" accounting for a subsidy.

In terms of our illustrative example, Table A-5 presents the 1979 "flow-through" outcome as it would appear in the financial statements of the regulated company. "Flowing-through" the $3 million capital subsidy permits a $5.56 million reduction in required 1979 revenues, as compared with the base case. This "amplification" of the $3 million flow-through to equity income, after-tax, results from the fact that tax-exempt compensation, to equity holders in this case, obviously substitutes for a much larger pre-tax payment, as would be included in the required sales revenue to cover cost of service, and the higher the tax rate, the larger is the pre-tax payment eliminated by each dollar of after-tax payment.4/ As compared with the 1979 results under proper accounting for the subsidy, or normalization, shown in

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4/ The reader should note that, for expositional simplicity, we have extended equality of tax and regulatory accounting to treatment of the subsidy, presumed to be in cash, as a tax-exempt income payment to shareholders. In fact, the tax accounting for a cash capital subsidy would be to exclude the subsidy from the depreciable basis of the property and this would increase the tax due as well as increase the required revenues.

Tables A-3 and A-4, 1979 rates are lowered by $4.94 million through this incorrect accounting for the capital subsidy. But, since "flow-through" procedures maintain the $465 million rate base, and hence the equivalent amount of private financing, as the balance sheets in Table A-5 show, the lowered "flow-through" rates, which are permanently sustained so long as the subsidy remains in effect, merely borrow from the future. As may be seen in Table A-4, in 1989 and every year thereafter, a proper accounting for the capital cost of service will yield a <u>lower</u> required revenue than "flow-through" procedures. In 1989, the properly measured cost of service is $268.76 million and declining while the "flow-through" cost of service is still $269.01 million, its permanent level.

"Flow-through" procedures never approach the cost of service reduction measured by the appropriate accounting for a capital subsidy because they, in effect, finance a larger first-year reduction in required revenues (and reductions for 9 more years, in our example) with the proceeds of additional borrowing and equity financing, for which rates of return will have to be paid. Since the rate base to finance this erroneous treatment of a capital subsidy is permanent, its recovery through depreciation and its interest and after-tax return to equity (plus income tax) will be permanently paid by the regulated utility's customers. There is no way to interpret <u>cost of service</u> rate regulation theory in a way which authorizes a regulatory authority to permanently impose a burden in excess of their real cost of service on future users of utility services in order to provide current users rates below their real cost of service.

This characteristic of "flow-through" accounting of a capital subsidy appears clearly when that procedure is applied to a real reduction in the price of plant and equipment items. Suppose again that on January 1, 1979, the $30 million vintage of equipment drops in price to $27 million. As we have noted before, this event should result in a $0.62

million reduction in the real cost of service, with the $3 million saving in equipment cost utilized to reduce the rate base. However, if a regulatory commission designates the $3 million saving in equipment cost an addition to "net income" attributable to shareholders' equity, while treating the $27 million of equipment purchased as if it cost $30 million, the current year cost of service could be reduced by $5.56 million; the $3 million saving is "flowed-through".5/ Thus, the rate base remains at $465 million, supported by that amount of debt and equity, rather than falling to $462 million, reducing the required amount of debt and equity. Clearly, to manipulate a lower current charge for service, $3 million of additional private funds are utilized in the regulated company, the unnecessary cost of which will ultimately have to be paid by utility customers.

Happily, this "flow-through" of savings in the cost of acquiring capital would never be tolerated by regulatory commissions: They would note that, for the same reason they did not "flow-through" to current cost of service the $30 million of equipment cost, nor the reduced $27 million cost (since neither expenditure was embodied fully in the service sold in the year of acquisition), it would be improper to consider the $3 million difference an addition to net income of the regulated company. Transactions involving the purchase of assets to be used for a period of years affect current year cost of service only to the extent the assets are used-up that year, as estimated by the depreciation imputation rule, and as the net investment of creditors and shareholders is changed by virtue of those transactions.

5/ Again, for simplicity, we assume that $30 million will be permitted as the tax basis for depreciation purposes. If only $27 million is paid, under the tax laws and all the normal rules of financial accounting, only $27 million of the taxpayer's (enterprise's) capital is recoverable through imputed depreciation allowances.

In view of the conclusion reached by this discussion of procedures for accounting for capital subsidies, the 17 years of controversy over the accounting treatment of the investment tax credit, the most general capital subsidy paid by the Federal government, is indeed perplexing. That there is any lingering question about the merits of "normalization" versus "flow-through" of the investment credit is probably attributable to the (originally) unconventional way in which the subsidy is conveyed. We now turn to the issues peculiar to the tax credit.

A capital subsidy paid as a credit against income tax.

To this point we have dealt with a 10 percent subsidy payable by the Commerce Department on the submission of evidence that a depreciable asset with an expected life of more than 7 years has been acquired for productive use. In the examples we have detailed above, the regulated company annually acquires $30 million of assets eligible for the subsidy, hence receives a cash payment on this account of $3 million so that the net cost to it is $27 million. Also, each year, the company pays income taxes, in amounts depending on the rate base and, consequently, on the amount of private equity invested, given the after-corporate-tax return required to maintain the value of the company's shares and the corporation income tax rate. The $27 million expenditure enters cost of service as depreciation allowances, returns to financiers of the (reduced) rate base and as taxes attributable to the equity share of those returns. The $3 million subsidized reduction in acquisition cost is reflected in reductions in each of these elements of cost of service.

Suppose that Congress, in order to reduce the volume of checks being written by the government decides to make capital subsidy payments in the following way: Companies qualifying for the subsidy will be permitted to simply subtract from the taxes otherwise payable by them the amount of the subsidy owed them; eligibility for the subsidy would still be documented by invoices, contracts and other evidences of purchase, as in the case of the subsidy payable by the Commerce Department. This mode of payment will save check-writing expense for the government; it will also save administrative expenses because the capital goods qualifying for the credit are already accounted for in the tax books-of-account reviewed by the IRS.

Under this mode of payment, i.e., as a credit against tax otherwise due, the illustrative regulated company, at the beginning of 1979 still has $30 million in additional cash and other current assets with which to purchase a replacement vintage of plant and equipment items. But now, when it buys the items, it will automatically reduce the cash requirement for paying taxes (included among the current liabilities in its end of 1979 balance sheet) by $3 million. Thus, the financial statements shown in Table A-3 still correctly portray the results of its subsidized acquisition of plant: The $3 million of redundant cash would be used to reduce outstanding debt and equity to correspond with the $3 million reduction in rate base; the 1979 income statement would show exactly the same entries, including $23.61 million as provision for Federal income taxes, an amount that must be included in cost of service.

This latter figure, the $23.61 million provision for Federal income tax when $3 million less will actually be paid, is the source of continuing confusion as to the proper way to account for the capital subsidy. Many argue that the $3 million is not "paid" and, hence ought not to be included in the 1979 cost of service, i.e., that the "reduction in tax" be "flowed-through" and accounted for as in Table A-5.

These persons regard the $3 million of investment credit not subtracted from the $23.61 million of 1979 tax expense and therefore included in cost of service as a "phantom tax" that inflates the cost of service and thereby enriches regulated company stockholders.

The confusion results from a common tendency of laymen to regard the clearance of payments through a single account as destroying the basic transactions which gave rise to the net payment. That is, while these same persons would agree that a Federal subsidy of $3 million paid in cash to a regulated company on the purchase of plant and equipment is perfectly consistent with a tax expense of $23.61 million that year; nonpayment of $3 million in tax liability in o... to get the same subsidy as additional cash is inconsistent with the same tax expense of $23.61.

Since these persons are not persuaded of the analytical error they are committing by a demonstration that the dollar magnitudes resulting from a transaction in which $30 million of assets are purchased at a net private cost of $27 million are the same whether the subsidy is paid in cash, accompanied by a full payment of tax liability, or not paid in cash but cleared as a credit against tax liability, the following example may be helpful. Suppose that, included in the cost of goods sold for 1979, is $5 million of fuel purchased from company A and that included in the regulated company's 1979 sales is $1 million of services sold to A. Suppose further, that A and the regulated company have agreed that, in view of their reciprocal seller-customer relations, the regulated company will remit to A only the net amount owed it. The regulated company will therefore use its account payable to A to clear amounts owed it by A. Thus, in the year in question, the $5 million of fuel purchases are recorded as an expense (debit) and as an equivalent account payable (credit); and the $1 million sales to A as gross income (credit) and an equivalent account receivable (debit). At the end of the year, the regulated company clears its account receivable from A of $1 million against the $5 million account payable, and closes its account payable by remitting a check for $4 million.6/ Clearly, the fact that the regulated company paid only $4 million in cash in settlement of the reciprocal obligations of it to A and from A to it does not mean that the $1 million in sales to A have been obliterated or that its cost of goods sold has been reduced from $5 million to $4 million, because this is the net cash remittance to the fuel supplier.

Similarly, when a capital subsidy, such as the investment credit, is cleared against the tax account of the regulated company, the clearing operation does not obliterate the tax liability generated by the company's operation, nor does it obscure the conveyance of a subsidy to the company in respect of its acquisition of property qualified for the subsidy. Thus, the accounting procedure that properly analyzes a cash subsidy for the acquisition of capital is also appropriate for a capital subsidy paid by permitting a credit

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6/ The accounting entries to reflect this clearing transaction are:

Debit: Accounts payable........$1 million
Credit: Accounts receivable............$1 million

Debit: Accounts receivable.....$4 million
Credit: Cash............................$4 million

Note that none of these entries affect entries for sales of $1 million to A or of cost of goods sold of $5 million (purchases of fuel from A).

against income tax. The "phantom tax" issue raised in connection with capital subsidies cleared through the tax system is a false issue: It arises from incomplete analysis of the transactions involved. Moreover, any careless consideration of "tax paid" net of subsidies, or other payments, cleared through the tax accounts of a given year as a measure of tax liability generated by a taxpayer's economic performance during a year will lead to a grossly misleading indication of the taxability of that taxpayer's income, or what is popularly called his "effective tax rate."7/

Differences between capital subsidies paid in cash and as credits against income tax.

Although the accounting for capital subsidies, when paid, is independent of the form in which they are paid--whether as cash or as credits against income tax otherwise due--there are three notable differences between cash capital subsidies and the present investment credit. First, because capital subsidies cleared through tax accounts are regarded as "reductions in tax," the amount of the subsidy payable during a year is limited to the first $25,000 of tax liability plus (ultimately) 90 percent of the tax liability in excess of $25,000.8/ Although attachment of conditions

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7/ See U.S. Treasury Department, Effective Tax Rates Paid by Corporations, 1972, May, 1978.

8/ Prior to 1979, the annual limitation on the amount of investment credit that might be taken by a single taxpayer was the first $25,000 of tax liability that year plus 50 percent of the tax liability in excess of $25,000. In 1979, the annual maximum is the first $25,000 plus 60 percent of any additional tax liability, the percentage increasing by 10 points in 1980 and each succeeding year until it becomes 90 percent in 1982. Amounts of credit earned in any year but not taken by reason of this limitation may be carried back 3 years and forward 7.

to the granting of cash capital subsidies is not unusual, imposition of a requirement that the private investor have current tax liability is not a normal condition. The effect of this limitation on effective receipt of the capital subsidy is frequently a delay in its conveyance to the investor, and in some cases, partial denial of the subsidy.

The second difference between a normal cash subsidy for the purchase of qualified capital goods and the present investment credit is that the credit is payable in advance of the legal acquisition of the asset, under certain circumstances. If the asset in question takes more than two years to construct, then if the purchase contract calls for advance payments, popularly called "progress payments", then the investment credit may be taken as these payments are made.9/ This is a curious, and asymmetrical, intrusion of "cash accounting" procedures in a tax accounting system that, except for its general reliance on the occurrence of an exchange event to trigger "recognition" (measurement) of gross and net taxable income, applies accrual procedures.

The event that signifies entitlement to a purchase subsidy is the legal acquisition of the qualified property; the basis for the subsidy is the value of the property at the time acquisition occurs. If the terms are C.O.D., the exchange price covers all costs--including capital costs--incurred prior to the exchange; if the terms call for pre-delivery, "progress," payments, then part of the capital costs--interest on working capital--are assumed by the buyer; if the terms call for deferred payment, then two transactions are involved, an exchange of property, and a loan. In

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9/ Internal Revenue Code, section 46(d).

principle, the subsidizable basis of the property should be the same in all these cases, because the value of the property is the same when the property exchanges. _If_, in the progress payment case, an explicit imputation of the contribution by the purchaser to the value of the property in the form of interest on loans he has made were recognized, and that interest income attributed (and taxed) to him as lender, it would be clear that the "progress" payment should not trigger a "purchase" subsidy. The implicit amount of interest paid, like that paid to any creditor, would be incorporated in the selling price of the property, and that selling price, when paid on delivery, would constitute the basis for the purchase subsidy.

Under present tax law conventions, no interest is imputed with respect to progress payments; it neither appears in the taxable income of the implicit lender, nor is it accumulated as part of the cost of the property. It therefore follows that, when delivery has occurred and the property financed by progress payments has been placed in service, the amount of subsidy payable is less than it would be under a C.O.D. contract. But, this is as it should be, for part of the acquisition price has been paid with untaxed funds--the implicit interest on the advance of funds. To allow an acceleration of subsidy payments therefore provides an unwarranted enhancement of the subsidy that encourages this form of project financing.10/

10/To appreciate the illogic of allowing purchase subsidies when _prepayments_ of the purchase price are made, consider whether purchase subsidies should be delayed as repayments of principal are made over the life of a _deferred payment_ plan to finance the same purchase. This would clearly devalue the purchase subsidy. There is no reason to structure a purchase (or sale) subsidy in a manner to favor particular payment schedules.

As it happens, "progress" payments are common among regulated companies so that this unusual characteristic of the investment tax credit is particularly valuable to this sector of the economy. We shall not attempt to demonstrate here how this further reduces the cost of service for, to do so, we would have to introduce an additional set of accounts relating to "construction work in progress", an activity of regulated companies that is separate from its normal activities of producing and distributing services, which is of major concern here. Rather we will simply observe that, in terms of real resource costs, the $30 million expenditure for rate base assets we have been recording are already subsidized by some amount, the amount depending on the length of time the utility has taken to construct the $30 million unit it places in service each year.

The third difference between a cash capital subsidy and the investment tax credit derives from the tax treatment of the subsidy itself. Whereas a government grant (or other nonshareholder "contribution to capital") for the purpose of acquiring an asset is treated under the tax laws as not recoverable by the beneficiary of the grant, the subsidy conveyed as an investment tax credit is. That is, if the Commerce Department had paid $3 million toward the purchase of $30 million of equipment, the purchaser of the equipment would be treated under the tax laws, as under the normal rules of financial accounting followed in the balance sheet presentation above, as having only $27 million in private resources recoverable as depreciation.11/ However, when that same subsidy is conveyed as a credit against income tax, the investor is permitted to take tax depreciation deductions with respect to the $3 million of subsidy as well as the $27 million paid with his own (or borrowed) funds. Clearly, a 10 percent investment tax credit so structured is worth more, *i.e.*, displaces more privately financed rate base, than a 10 percent cash subsidy.

11/Section 362(c).

Accounting for the "extra" subsidy inherent in the investment tax credit.12/

Just as it was convenient to develop rules for accounting for a subsidy by first examining it when paid in cash, so it will be illuminating to translate the additional subsidy element conveyed by tax depreciation of a capital subsidy into cash grant equivalents. To do this, we modify the original 10 percent subsidy paid by the Commerce Department in the following way: To enhance the capital subsidy while not initially paying the full amount, the Secretary of Commerce offers to add to the 10 percent subsidy, which is payable on submission of evidence that qualified property has been acquired, an additional subsidy in subsequent years, provided the purchaser retains and uses the property. Thus, the additional subsidy is formulated as an amount, payable at the end of each period of use, equal to the reduction in income tax payable had the government's grant been included in the investor's tax depreciation basis. The rationale for such a subsidy might be that the government believes that, first, by delaying the payment of the additional subsidy to the purchaser he will be disciplined into making fewer frivolous investments since he initially will have to pay the 90 percent unsubsidized portion of the asset's cost and wait for the remainder for the full life of the asset. Secondly, it might be thought that stringing out part of the subsidy

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12/ We do not here account for the enhancement of the investment credit resulting from its availability as "progress payments" are made. To do so would require complicating the presentation to separately account for the regulated company's construction activity. Since this is not related to current cost of service, it is better ignored in the exposition.

over the life of the investment will serve to induce the investor to squeeze out the full productivity of the asset. Gearing the amount of additional subsidy to the tax rate of the subsidized investor is questionable. There would appear to be no economic policy objective served by making the additional subsidy worth more to high-income investors. The basic 10 percent subsidy, of course, is equal-valued to all investors.

Under this revised formulation of the 10 percent capital subsidy, still assuming that tax depreciation imputation rules match those used by the regulatory authority, at the end of 1979, the first year of the subsidy program, the Commerce Department will pay an additional subsidy of $46,000 to the utility company. This is equal to 46 percent (the income tax rate) of $100,000, the annual depreciation of the subsidy ($3 million/30 years) for the 1979 vintage. At the end of 1980, both the 1979 and 1980 $3 million subsidies will qualify for an additional $46,000 payment from Commerce. Ultimately, after all 30 vintages have been brought within the scope of this modified subsidy, each year the regulated company will realize a cash subsidy of $4.38 million for each $30 million of plant and equipment it purchases: $3 million representing 10 percent of the purchase price of the qualified property, $1.38 million as supplementary subsidy for 30 vintages in use, at $46,000 per vintage. The annual subsidy per $30 million investment in qualified property is, therefore, effectively 14.6 percent ($4.38 million divided by $30 million).

Altogether, the revised "10 percent" cash subsidy will ultimately reduce the unsubsidized rate base of our regulated company from $465 million to $397.11 million, the remaining $67.89 million of capital having been furnished by the Federal government. Thus, the enhanced "10 percent" subsidy brings about the following cost of service:

Cost of goods sold..........	$165.00 million
Net depreciation............	25.62
Interest paid...............	23.83
Income taxes................	20.30
After-corporate-tax return to equity.................	23.83
Total cost of service....	$258.58 million

By reducing the capital cost elements by 14.6 percent, the "10 percent" subsidy supplemented by future subsidies equal to the value of private tax depreciation of the initial subsidy succeeds in reducing total cost of service by 5.8 percent.

The present investment tax credit possesses exactly the characteristics just described for an enhanced "10 percent" capital subsidy. It therefore follows that the proper procedure for accounting for the investment credit is that also just described: While the tax expense entering cost of service is $20.30 million each year after full adjustment to the enhanced subsidy, a total capital subsidy of $4.38 million is cleared against this accrued liability, resulting in a payment of $15.92 million in cash to the Treasury and leaving $4.38 million as an addition to "unamortized subsidy" which will exactly offset the amortization of the balance in that account and sustain a net rate base of $397.11 million financed by $238.27 million of bonds and $158.84 million of equity.

III. Accounting for a subsidy for the financing of capital.

Subsidies to private capital formation may either be in the form of grants, or the investment tax credit, discussed above, or in the form of financing. In the case of grants, the government assumes some part of the cost of acquiring the eligible property, thereby relieving the customers who purchase the product of this capital of a part of the costs of replacing the capital as well as the return thereon (and the income tax attributable to that income). In the case of financing subsidies, loans to displace private financing are either made directly by the government, or the terms of private loans are subsidized, i.e., by government guarantees to lenders which reduce loan rates of interest, or by governmental assumption of all or part of the interest payments to lenders. Thus, in the case of subsidies pertaining to the financing of private capital, customers are relieved only of the subsidized capital return costs; they must still pay prices which will permit recovery of the capital used-up in production.

Normally, the accounting for interest subsidies raises no issues. However, the formulation of Federal financing subsidies commonly described as "tax deferral" contains elements that confuse analysts and laymen alike, making the accounting for these subsidies a continuing source of controversy, again centered on debate over the merits of "normalization" or "flow-through". To clarify analysis of a proper accounting for such subsidies, we shall again first specify the present "tax deferral" subsidy as a program administered by the Commerce Department to derive from its structure and functions a set of accounting procedures capable of measuring the impact of the subsidies. These will again be found transferable exactly to an accounting for the same subsidies cleared through the tax system. And once more, these procedures will be found to be those called "normalization."

<u>A "zero interest" Federal loan for financing the purchase of qualified property</u>.

Suppose that, beginning on January 1, 1979, Congress authorizes the Secretary of Commerce to make loans, at zero rates of interest, to any purchasers of depreciable property in order to assist them with the financing of this form of capital formation. The Secretary, after seeking a formula which would be easy to administer, avoid 100 percent financing, and could be flexibly adapted to the varying life characteristics of depreciable property, devises this formulation: At the end of each year after the purchase of depreciable property, the Commerce Department will lend a sum to the owner, at zero interest, equal to the product of his tax rate times the difference between a proclaimed depreciation imputation schedule for that property and one which describes the real economic decay of that property. The proclaimed schedule will simply be that produced by the sum-of-years' digits formula computed for a life equal to 80 percent of the real life. The "real" life and depreciation imputation schedule will be that used for financial reporting.

This is an extremely clever formulation of the terms of a loan to achieve the objectives of Congress in authorizing the program to encourage private capital formation:

1. The timing of loans and their repayment are automatically determined. Since the total basis of the asset to be recovered under either the proclaimed schedule or the real underlying schedule is the same, loans automatically will be extended in the early years of the ownership of the property, repaid in the later years.

2. The amount of the loans will be greater the more durable the asset, i.e., the longer lived and/or decelerated the pattern of real underlying depreciation. This is desirable because the private financing needed to "carry" assets is roughly correlated with durability.13/

On the other hand, because the amount of the financing subsidy thus provided is directly proportional to the investor's tax rate, the program formula lends more to high income investors than others. Again, this seems to serve no useful economic policy objectives.

Accounting for the specified "zero interest" loan subsidy.

In tracing out the effects of this Federal lending program, it is helpful to ignore any subsidies for purchasing the assets. Considering only the loan, since the regulated company's 1979 investment qualifies for the zero interest, or interest-free, Federal lending program, we may easily determine the schedule of such loans and repayments this vintage of investment will generate. This is shown in Table A-6. The proclaimed schedule of "depreciation" amounts in this

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13/ In the limit of non-durability, an asset which is used-up and requires replacement each year will require a cost of service charge for depreciation equal to replacement cost and no private financing of its acquisition is required; the beginning balance sheet will show $X for such an asset, the ending balance sheet zero, with cash and other current assets increased by $X, available for purchasing a replacement. Virtually no capital is required to carry such an asset. At the opposite extreme, an infinitely durable asset costing X will require permanent financing of X.

case will distribute the $30 million cost of the qualified property over 24 years (80 percent of 30) by the sum-of--years' digits formula. Thus, in the first year, the proclaimed schedular amount for the regulated company is $2.4 million. Since its norm for depreciation that year is $1 million, it can borrow from the Commerce Department $644,000 at the end of 1979 ($2.4 million, less $1 million, times the 46 percent tax rate equal $644,000). At the end of 1980, the 1979 vintage will qualify the regulated company for an additional $598,000 of interest-free borrowing, and so on, through 1992 for, in 1993, the proclaimed schedular amount is equal to the depreciation norm of $1 million. Through 1992, $4.8 million of interest-free borrowings will have been generated by the 1979 vintage. Then, beginning in 1994, under this lending program, repayments begin so that, when the 1979 vintage is retired at the end of 2008, all $4.8 million of outstanding loans generated by the 1979 vintage will have been repaid.

However, at the beginning of 1980, the regulated company will acquire another $30 million of qualified property, and this, too, will generate qualification for interest free loans. Indeed, at the end of 1980, the $598,000 of loan eligibility of the 1979 vintage just noted will be added to by the $644,000 first-year contribution of the 1980 vintage, providing a total of $1.242 million in new interest-free loans.

Continuing with the assumption of no growth or inflation, Table A-7 arrays the annual results of this lending program over the next 30 years. In columns (2) and (3) are shown the annual loan proceeds to which qualified property in service entitles the regulated company. For 1979, the $644,000 generated by that vintage is shown in column (2), as is the combined $1,242 million the 1979 and 1980 vintages generated at the end of 1980. Returning our attention to the end of 1979, it is obvious that the $644,000 of interest-free loans may be used to eliminate that amount of private financing of the $465 million of rate base; thus, at the beginning of 1980, $644,000 of debt and equity has been retired, leaving only $464.356 million of private financing for the $465 million of rate base. Then the additional loan eligibility of $1.242 million generated during 1980 enables the retirement of that additional amount of private financing so that, at the beginning of 1981, private debt and equity to support the $465 million rate base has been reduced to $463.114 million.

Until 1992, the addition of each vintage of assets increases the regulated company's loan eligibility each year by an amount greater than the preceding year. The reason why increases in the annual increment to loan eligibility peaks in 1992 is that, after that year, as we saw in Table A-6, loans with respect to the 1979 vintage have to be repaid. Thus, in 1993, the combined increment to loan eligibility provided that year by the 1993 vintage and others is offset in part by repayment of $46,000 with respect to the 1979 vintage assets. Beginning in 1994, the annual increment to loan eligibility declines, reaching zero in 2008, after all vintages in use have become eligible for interest-free loans to the regulated company.

By the beginning of 2008, outstanding interest-free loans to the regulated company have increased to $94.3 million, a total which will remain constant so long as the regulated company maintains its stock of subsidy-financed plant and equipment (rate base). Should it fail to spend $30 million some year, it will have to reduce its interest-free loans outstanding, pay-off $644,000 that year, the amount of expiring loans with respect to all its vintages not offset by "new" lending for the vintage not acquired. But, since we have no reason to suppose that the regulated company will not continue to maintain its rate base, the \$94.3 million of interest-free loans will be sustained by the equivalent of "rolling-over" outstanding private bonds: Loan repayments will be covered by new borrowing.

The ultimate effect of the Commerce Department lending program has been to reduce the unsubsidized financing of \$465 million required to sustain a \$465 million rate base to only \$370.7 million, with consequent reductions in the cost of service. The effects on cost of service resulting from the subsidized financing program are tabulated in columns (5)-(9) of Table A-7. Since the subsidy does not reduce the private cost of purchasing plant and equipment, the \$30 million annual depreciation cost of service remains unaffected. However, the interest paid, income tax, and after-corporate-tax return to equity steadily declines as Federal interest-free financing grows. Ultimately, since the private financing required is reduced by 20.3 percent, the portions of cost of service relating to returns to private capital similarly decline, and this brings about a 5.9 percent reduction in total cost of service, from \$274.57 million to \$258.43 million.

Clearing the interest-free loan program through the income tax.

The lending program just described required the Commerce Department to write checks in exchange for private firms' notes agreeing to the terms of the loan, including repayments. Once again, the necessity for writing checks to implement the financing subsidy program can be avoided by clearing the government lending through the income tax accounts of investors. Indeed, this has been done. In 1954, all taxpayers were allowed to use formulas for determining annual depreciation allowances that include the sum-of-years' digits method and others consistent with it, whether or not this matched the real depreciation pattern of assets. Beginning in 1971, taxpayers have been allowed to use 80 percent of the guideline life for such assets published by the Treasury Department, regardless of the economic lives of their assets. In certain other cases, Congress has explicitly introduced 5-year write-offs and immediate expensing privileges that are the functional equivalents of interest-free lending programs described above.

It will be recalled that the magnitude of the interest-free loans is dependent on the difference between the "proclaimed" schedule of depreciation allowances and that which would be used for actual income measurement. This characteristic of the lending program raises certain issues concerning the "norm" of depreciation imputation that should be used for "actual" income measurement, a matter to which we will turn below. However, in the regulated company case, as has been noted above, the depreciation imputation norm is specified and validated by regulatory commission rate making rules.

Thus, to the extent that taxable income of utilities is measured with the use of depreciation imputation rules that depart from those used by regulatory commissions, the Federal government is implementing an interest-free lending program of the type just described. Prior to the modifications of the tax laws beginning in 1954, there was reasonably close correspondence between the regulatory and tax rules governing depreciation imputation. In regulated industries, therefore, the post-1954 deviations of tax rules for income measurement from regulatory norms marked the introduction of a subsidy program that may only be correctly accounted for as a source of interest-free loans.

We may translate the discussion above of an accounting for the effect of interest free Federal financing into the terminology of regulatory accounting for tax expense as follows: Attendant on investment in depreciable assets is the need to measure pre-tax income flowing from their use, after making allowance for the ultimate worthlessness of those assets due to wear-and-tear and to obsolescence. Whatever formula is used for imputing the occurrence of this decline in value over the life of the assets in order to measure taxable income, the same total imputation will be made for regulatory purposes. If the tax rules result in larger depreciation imputations early in the lives of assets than is imputed under regulatory rules, then tax depreciation imputations for the same assets will be smaller later in the assets' lives. In effect, the entries in Table A-6 measure the time-displacement of tax payments--"tax deferral"--not a "forgiveness" of tax. Since income tax is a statutory percentage of income, and income is a function of the privately financed capital used to produce service by the regulated company, then if, and only if, the regulatory commission computes tax expense--an element of cost of service--by using its own depreciation imputation rules will it measure and fairly distribute the cost of capital services over time. "Tax deferral" represents interest free borrowing, the benefits of which will be distributable to customers as the loans, generally called "deferred taxes", displace private financing.

This accounting procedure is called "normalization" of the difference between income tax liability, the current year tax expense, using the company's depreciation imputation rules (the regulatory commission's rules in the case of a regulated company) and that using the tax depreciation imputation rules. The tax liability computed using the regulated company's own rules, since it is purely a function of the tax rate applied to an income measure based on the value of assets employed, and which are privately financed, is the correct measure of income tax expense for the period; the difference, "deferred taxes" is a source of financial funds available (and used) to displace private financing.

The financial statements for 1979 that reflect this procedure are shown in Table A-8. The only difference between these statements and those of the base case for the same year (Table A-1) is the $0.64 million ($644,000, rounded) of deferred tax: In the income statement reflecting the first-year lending program, tax expense of $23.77 million is presented in two parts, the net $23.13 million payable after netting the $0.64 million of interest free loan plus the loan proceeds for the year itself, labelled "deferred tax"; in the end of 1979 balance sheet, deferred tax appears on the liability side, offset on the asset side by an equivalent $0.64 million of cash and other current assets. This raises total assets and liabilities to $565.64 million at the end of 1979. When the $0.64 million is used to reduce debt and equity, at the beginning of 1980, the asset and liability totals will revert to $565 million. This process of displacing private financing of the rate base shown in Table A-7 to reflect the accumulation of interest- free loans can occur, of course, only if the regulatory commission properly regards the total tax expense, computed on the basis of its own depreciation imputation rules and also shown in Table A-7, as a cost of service. Assuming prompt regulatory response, this normalization procedure to account for the effects of an interest-free lending program charges each year's customers their true (private) cost of service, as this has been reduced by the volume of interest-free lending by Federal taxpayers.

<u>Mischief caused by regarding the proceeds of interest free loans as additions to equity "income" for the year.</u>

The fundamental accuracy with which "normalization" of subsidies cleared through the tax system accounts for the underlying phenomena can be demonstrated again by considering the outcome of "flow-through" procedures applied to proceeds of interest-free loans cleared through income tax accounts. In Table A-7, column (2) arrays the annual amount of interest-free loans, or "deferred taxes", generated by the volume of subsidy-qualified property then in service. If these loan proceeds, payable to the regulated company in exchange for notes labelled "deferred taxes", are simply regarded as "reductions in tax" for the years in question, then they make possible a reduction in required revenues that is a multiple of the deferred taxes. As noted in connection with "flow-through" of the investment credit, since these payments are tax-exempt, at a tax rate of 46 percent each dollar of loan proceeds can displace $1.851 of pre-tax--customer-paid--income from sales. For example, in 1980, as shown in column (2) of Table A-7, the 1979 and 1980 vintages generate $1.242 million of interest-free loan proceeds that year. This makes possible a reduction in required revenues of $2.3 million ($1.242 times $1.851) as compared with the base case level of $274.57 million, or a required 1980 revenue of $272.27 million. If that is the 1980 revenue, after deducting $165 million (cost of goods sold), $27.9 million (interest paid), and a <u>tax</u> depreciation deduction of $32.7 million (28 vintages @ $1 million each plus $2.3 million for the 1979 vintage and $2.4 million for the 1980 vintage), <u>taxable</u> income is $46.67 million, and the tax liability payable is $21.47 million. This amount is treated as tax expense for the year, "deferred tax" not being recorded; the interest-free loan is therefore not accounted for by the regulatory authority. The required 1980 revenue of $272.27 is decomposed in that year's income statement as follows:

Cost of goods sold....	$165.00	million
Depreciation..........	30.00	
Interest paid.........	27.90	
Federal income tax paid.................	21.47	
Net return to equity..	27.90	
Total..........	$272.27	million

Table A-9 shows this annual required revenue from sales, along with those for 1979 and other years through 2009, under a regulatory procedure which "flows-through" to net income of equity the proceeds of interest-free loans made available for depreciable assets acquired after January 1, 1979. To compare this result with a proper accounting of the effects of interest free loans, the required revenues from sales under "normalization" accounting for each year, transcribed from Table A-7, are also shown. Under the "flow-through" procedure costs of service assessed steadily drop until 1992, and after 1993 steadily rise. This pattern mirrors the pattern of interest-free loans generated, shown in column (2) of Table A-7. Thus, by 2008, when no additional interest-free loans are generated to clear through the tax accounts, the "flow-through" required revenue from sales that year has returned to the base case level, where it will remain so long as there is no change in the rate base.

Given the nature of the underlying phenomena, a shifting in time of tax liabilities, and hence the generation of interest-free loans, the "flow-through" pattern is indeed curious: until 1992, "flow-through" procedures afford customers lower rates than if the loan proceeds were properly accounted for, as interest-free loans; thereafter, they are assessed higher charges, and by 2008, they are paying rates as if the Federal loan program had never existed or continued in effect! Any technique for accounting for the effects of tax deferral which produces such results must be defective: so long as tax deferral is in effect, and the calculations here assume the subsidy program is permanent, it should be reflected in lower costs of service. Though the conditions in 2009 include the interest-free loan program while the base case does not, revenues required in the two instances are the same. If this is the result of "flow-through" accounting for the loan program, it must be an improper regulatory accounting technique.

The inherent error of "flow-through" techniques is their failure to account for the cumulative effect (a growing stock) of interest-free loans provided by artificially accelerated tax depreciation imputation methods. It therefore misallocates the proceeds of interest-free loans to current year consumers as a cost of service reduction; this deprives future years' consumers of the benefit of interest-free financing of plant and equipment. As noted in the previous section dealing with the accounting for a capital purchase subsidy, forcing future generations to pay the price of unnecessary private financing of rate base is a policy inconsistent with the objective of cost of service rate regulation. Under that regulatory procedure, each year's customers ought to pay the cost of <u>their</u> service; they should neither be forced to bear a burden to benefit future generations of customers, nor be given price breaks that will be a burden to other generations.

Moreover, in the (improbable) event that replacement does not continue so that loans will have to be repaid, the generation of customers in that year will experience an increase in cost of service. For example, if in 2009 the $30 million is not spent on replacement, $644,000 of the deferred tax will have to be repaid. But, in order to "repay" this, income from sales will have to be increased by $1.193 million above the base case, which has no subsidy! Had the subsidy been accounted for properly, the increase in tax payable due to a net repayment of deferred taxes would have been so accounted for: as a reduction in deferred taxes, a repayment of outstanding loans, not an increase in current cost of service.

The combined effect of the two tax subsidies.

The previous section showed how the investment tax credit, if properly accounted for in the cost of service, would ultimately reduce the rate base of $465 million required, absent a subsidy, to $397.11 million requiring private financing. In this section we have shown how a properly accounted for interest-free lending program financed through the income tax accounts would reduce the required private financing of rate base assets by 20.3 percent. Table A-10 summarizes the combined effect of these two subsidies on the cost of service, when the assumed static stock of assets required to produce the established level and quality of service have all come under the cover of the subsidies.

As noted, the investment credit, by providing complete Federal financing and replacement of 14.6 percent of the $465 million worth of plant and equipment, reduces the financing requirement to $397.11 million. Then, the interest-free loan program provides $80.53 million of financing, leaving only $316.58 million to be financed with long-term debt and shareholder equity. The net effect of these two subsidies is, then, a reduction in all the capital cost elements: the net depreciation charge is reduced by the investment tax credit, and the interest, income tax and return to equity are reduced by both the investment credit and the loan program. Altogether, the capital cost elements have been reduced by 30.6 percent, from $109.57 to $76.06 million, and this translates into a total reduction in cost of service of 12.2

percent, from $274.57 to $241.06 million. Depending on the responsiveness of service demand to this reduction in cost of service, expansion of service capacity, and hence plant, will ensue.

It is worth noting in conclusion that the indicated reduction in tax liability shown in Table A-10 does not imply some net reduction in Treasury revenues. We are here examining only the outcome of Federal subsidies for a unit of capital employed by a regulated company to provide utility services. The reduction in income tax revenues generated by these subsidies to private capital formation, which are translated into reductions in prices paid by customers, are regenerated when the purchasing power released in lowered prices is spent for other goods and services. Whether these tax subsidies to private capital formation result in net changes in Treasury revenue flows depends largely on whether the response to the subsidy programs in the <u>aggregate</u> stimulates a net change in the tax base, <u>i.e.</u>, GNP originating in the private sector. This is an empirical question for which there is as yet no definitive answer.

IV. <u>Consistency of Tax Subsidy Normalization Rules with Dynamic Change</u>

<u>Relaxing the no-growth assumption: the investment tax credit</u>

The foregoing accounting of the way in which subsidies to private capital operate to reduce the private cost of, charges for, service in the context of fair rate of return utility regulation was intentionally presented with the aid of a model of a regulated company in "stationary equilibrium." Assuming the regulated company merely operates a fixed stock of plant and equipment items incorporating an unchanging state of technology and using labor and materials with similarly unchanging costs makes it possible to clearly trace out the effects of a subsidy. The accounting of these effects, however, is not dependent on the model's assumptions.

For example, suppose that, as a result of the subsidy-induced decline in service charges, or for any other reason, the amount of service demanded in the regulated company's market increases. Then, in addition to the $30 million annual investment in plant, some additional investment will be made to expand capacity. Suppose that a one percent increase in capacity is called for in 1979, and approved by the regulatory commission. If the book-value of the existing plant is $465 million, a one percent expansion would require an additional expenditure of $4.65 million, if the entire expansion is made at the beginning of 1979. Absent a purchase subsidy, $4.65 million of additional financing, $2.79 million of new issues of bonds, $1.86 million of stock (or retention of that amount from 1978 after-corporate-tax income of the company), would be required. In 1979, this addition would add $0.155 million of depreciation to cost of service, $0.279 million for interest, a like amount for return to equity, and $.238 million to income tax expense.

If, in 1979, a 10 percent investment credit is introduced, the combined purchase of $34.65 million that year would generate a subsidy of $3.465 million (plus $1.594 million later). Then, just as we saw above, the subsidy would ultimately decrease capital costs of service of both the initial rate base <u>and</u> the 1979 increment by the relative size of the subsidy, 14.6 percent in the case of the present investment credit. Moreover, the availability of $3.465 million in cash due to the subsidy means that only $1.185 million of new financing will be required at the beginning of 1979 to finance the additional $4.65 million acquisition.

Thus, introducing growth changes nothing in the accounting for the investment subsidy. However, it is worth noting that because the dollar magnitude of the investment subsidy each year is determined by the sum of "replacement" plus "new investment", the net new financing required for the addition to capacity (rate base) is greatly reduced; the redundant private financing with respect to "replacement" rate base is available to help finance the increment to rate base. In inflationary times, when mere "replacement" prices rise, the additional current dollar investment called for which would also have to be financed with additions to debt and equity, equally benefits from the subsidy as if it represented real growth. Thus it can be seen that in any period in which regulated companies are both growing in a real sense and plant and equipment costs are inflating, the existence of a subsidy program greatly reduces the search for additional private financing. This is probably why regulated company managements have come to regard the investment credit as essential "means" of financing their annual outlays for plant and equipment. Again, the use of cash or other accounts through which to clear a multitude of transactions may cause careless observers to accept this fallacious interpretation of the function of a capital subsidy.

Deferred taxes

In a similar fashion, interest-free loans generated by additions to capacity provide the same pattern of future reductions in cost of service associated with additions as was observed above in connection with the gradual qualification of all the vintages of plant for deferred taxes. Continued growth, or inflation, by generating larger combined loan eligibility for each vintage of "replacement" and the "new" investment, provides a larger fraction of each year's new financing requirements and again creates the illusion that the current year's subsidy is mainly an expansion financing device. Of course, in terms of the underlying economics of the transactions, while the aggregate displacement of private financing of the rate base may be large relative to any current year's purchases of plant and equipment, the distinction between the two elements of the displacement--that pertaining to additional loans for which previously acquired property become eligible and the other pertaining to the first-year eligiblity of the increment--should not be obscured simply because both elements are cleared through the current year's tax account.

It is worth noting in passing that, if the rate of growth of annual outlays for rate base assets rises at a high enough rate, the point at which annual required revenues determined by "flow-through" of interest-free loan proceeds exceeds the revenue required under a proper accounting of these loans is delayed, as compared with the no growth case we have examined in detail above. So long as growth and/or inflation cause the rate base to increase, the cumulation of deferred taxes increases. Thus as compared with the U-shaped cost of service decline from 1979 to 1992 and rise from 1993 to 2008 shown in column (2) of Table A-9, which may be regarded as a cost per unit of output because it is assumed capacity remains constant, had annual outlays grown at some constant rate, the cost curve would have been stretched over time, the minimum cost of service would have occurred after 1992, and so long as the annual rate of growth had persisted, the annual cost per unit of service would never quite return to the unsubsidized level. However, even under these circumstances, the cost of service established under "flow-through" accounting procedures would never reach the levels of correct cost of service calculation. If properly accounted for, the continued increase in interest-free financing of the growing rate base would bring about steadily declining costs of service.

In sum, the appropriate accounting for subsidies cleared through tax accounts in no-growth situations is also appropriate for a growth situation. In either case the technique called "normalization" distributes the benefit of the subsidies to customers over time in accordance with the terms of the subsidies: the investment credit as an initial reduction in the acquisition cost of the qualified property, plus subsequent supplements earned as the asset is held in use; the interest-free loan program, with the proceeds in the form of deferred taxes determined by the loan and repayment schedule implied by the divergence between tax and regulatory rules for imputing the occurrence of depreciation, as a displacement of private financing.

Effects of unforeseen changes.

Suppose that an investment error has been made: The "wrong" facilities were acquired at the "wrong" time. That is, facilities were built to embody a technology that later proves to be inefficient, or the plant is located on a site that later appears to have been badly selected, or anticipated demand for utility services has failed to materialize. These investments that subsequent events prove to have been made in error are incorporated in the rate base. Under the logic of fair rate of return regulation, since the regulatory commission has tacitly approved inclusion of the "excess" investment in the rate base, the costs of these "mistakes" are distributed to customers over time in the form of charges for depreciation, rate of return, and income taxes.14/

14/ Footnote 1 indicated that surveillance over the quality of regulated company decision making is one of the responsibilities of regulation. In unregulated markets, commission of investment errors results in losses to equity owners. As a consequence, rates of return to equity in the unregulated sector tend to be higher than rates of return in the regulated sector.

The accounting for subsidies cleared through the tax system is, of course not affected by this; the subsidies generated by the mistaken investment should be distributed in the same way as the mistaken costs themselves. It is also probably the case that, if there are subsidies which have the effect of reducing private costs of acquiring and using capital, more "mistakes" will be made pari passu with the increase in investment that may be induced by the lower cost of service made possible by the subsidies. However, given a quality of regulatory vigilance over the investment planning of regulated companies, there is no reason to suspect they will relax their vigilance because subsidies are available. The relative cost of "mistakes" is not altered by the subsidies, which apply equally to "good" and "bad" decisions.

V. Extension of the regulated company analysis to unregulated companies.

The phenomena associated with the provision of subsidiees for the acquisition, or financing, of private capital are the same in both the regulated and unregulated sectors. It therefore follows that the proper accounting of tax subsidies described above for regulated companies applies equally to unregulated companies. In the unregulated sector, however, the economic import of the company's own accounting system is much less. Because entry into markets in the unregulated sector is more or less free, and because there is also inter-product competition in the unregulated sector, selling prices, and hence revenue from sales, does not annually track changes in cost of goods sold and the several elements of capital cost. "Required revenues" to cover all costs, including a "fair rate of return", cannot simply be obtained in unregulated markets by the mere posting of such prices.

In the regulated case described above, capital cost changes were "rolled-in" over 30 years, the average life of the plant. This is one example of average cost pricing: The annual charge for depreciation, interest, and return to equity is derived from the costs of the 30 prior years. Thus, when a subsidy, or any other cause for a reduction in private cost of acquiring capital, reduced the purchase price of capital by 10 percent, 30 years had to elapse before the full change in cost, the lower marginal cost, was finally realized by customers. And with perfect cost of service regulation over this period, the regulated company's book-value of rate base was kept equilibrated to the market value of the company's bonds and shares.

In the unregulated company case, however, where market prices are freer to vary as cost conditions change, revenues more quickly adjust to cost changes. For example, after a 10 percent capital purchase subsidy has been introduced, in an industry which replaces its capital in, say, 15 years, it will not take 15 years for the effect of the subsidy to work its way through to prices and revenue. New firms, for example, or divisions of firms in other industries, that equip themselves after the introduction of the subsidy will be able to install a plant at 90 percent of the cost of plants built before the subsidy. These firms will be able to price their output lower to capture larger shares of the market, and this will force older firms to more rapidly adjust prices downward to reflect the lower costs or be forced out of business. For an unregulated company, therefore, the historic book-value of assets acquired before the subsidy, and the corresponding book-value of equity, may be overstated as compared with the valuation placed on these assets in the market, after a subsidy has been introduced. For example, if market prices of products adjusted instantaneously to the change in marginal capital costs, then the earnings of pre-subsidy assets, and the corresponding equity, would immediately shrink. These lower "earnings per share" of "old" firms would cause market prices of these shares to decline, which is to say the market value of pre-subsidy assets carried in balance sheets would be lower than book-value.

In the unregulated sector, then, the response to a capital subsidy is much more rapid than in the regulated sector. A 10 percent purchase subsidy will more quickly lead to a higher rate of investment to expand capacity. Of course, after adjustment to the reduction in capital costs has been made, the only effect of the subsidy will be to sustain the higher replacement investment required to sustain the larger capital stock it has induced.

Deferred taxes in the unregulated sector.

The foregoing remarks on the looser ties between book-value and market value of unregulated company assets and equity than is found in the regulated sector apply also to the substantive content of unregulated companies' imputations of depreciation for financial reporting purposes. For an unregulated company, its depreciation imputation rules do not determine a "cost of service (production)" element it can "claim" in prices it charges. Rather, it is an accounting convention employed to derive a financial measure of pre-tax income, and to correspondingly revalue depreciable assets in its balance sheet. If the company's depreciation imputation rule produces too low an annual depreciation "expense", as compared with real depreciation, this simply means that pre-tax income for the period is overstated, and "net income" (after-tax) likewise. But, since dividend payouts need not correspond to this measure of book-income, there is no financial or other penalty to overstatement of book-income.

On the other hand, if the depreciation imputation rule used by an unregulated company aims to rapidly write-off assets, regardless of the real rate of depreciation, its book-pre-tax income will be understated, and its "net income" correspondingly. Again there is no penalty for not measuring income in a manner such that the amount so measured could actually be paid out and permit the company to carry on its operations, as in the regulated company case.

Of course, "quality" of reported earnings is an important dimension of a company's performance that is carefully assessed by investment analysts. Shares of companies that employ depreciation imputation methods calculated to overstate "net income" will naturally sell for prices that are smaller "multiples" of reported earnings per share in recognition of this source of "low quality" earnings; companies that use more accelerated depreciation imputation methods will sell for a higher multiple, all other things being equal. Since too slow a method of imputing depreciation also results in a higher book-value of depreciable assets, book-value per share of companies employing such depreciation methods will tend to exceed market value on this account, as well. Conversely, the consistent use of too rapid depreciation imputation rules for financial reporting will be associated with a market value in excess of book-value.15/

15/ Cf., Solomon, Ezra, "Alternative Rate of Return Concepts and Their Implications for Utility Regulation," Bell Journal of Economics and Management Science, Vol. 1, No. 1, (Spring, 1970), pp. 65-81.

Since the depreciation imputation method employed by an unregulated company has no normative value, the divergence between it and tax depreciation imputation methods also has no normative implications. However, the logic of accounting in the unregulated company case nevertheless requires recognition of "deferred taxes" for, whether the book imputation really measures depreciation, timing differences between it and tax depreciation must be accounted for if only to provide a record of the degree to which assets employed in the business have less "tax basis" to be recovered than the assets' reported book-value and, therefore, how much extra income tax liability might be owed in the event assets are not replaced. Thus in the case of unregulated companies, due to the uncertain content of the company's reported (book) depreciation, reported accrual of "deferred taxes" during a year is not normally a satisfactory measure of interest-free loans extended. To obtain a measure of interest-free loans extended to unregulated companies requires that a real measure of depreciation for the year be computed and this compared to the tax depreciation imputation allowed for the same year. The corrected figure, less the tax depreciation amount times the corporate tax rate yields the measure of interest-free loans qualified for during the year, the proper "deferred tax amount" to add to the net income tax payment to derive tax expense for the year.

Table A-1
Base Case Financial Statements

Income Statement
for year, 1979
(millions)

Income from sales		$274.57
less: Cost of goods sold		165.0
equals: Operating income		$109.57
less: Depreciation	$30.00	
Interest paid	27.90	57.90
equals: Pre-tax income		$ 51.67
less: Provision for Federal income tax @46 percent		23.77
equals: After-tax ("net") corporate income		$ 27.90
less: Distribution to stockholders		27.90
equals: Addition to retained earnings		0.00

Balance Sheets
1979
(millions)

Assets		Beginning		End	Liabilities	Beginning	End
Cash and other current assets		$100		$130	Accounts payable (including taxes)	$100	$100
Plant and equipment original cost	$900		$900		Long-term debt	279	279
less: accrued depreciation	435	$465	465	$435	Net worth: Capital stock	186	186
Total assets		$565		$565	Total liabilities	$565	$565

Table A-2

Illustrating Maintenance of A Constant Capital Stock, When The Regulatory Depreciation Imputation Rule is Straight-Line

Year asset vintage was acquired (Jan. 1)	Assets in use, at beginning of 1979: Original cost	1979: Accumulated depreciation	1979: Net book-value	1980: Original cost	1980: Accumulated depreciation	1980: Net book value
1950	$ 30	$ 29	$ 1	-	-	-
1951	30	28	2	$ 30	$ 29	$ 1
1952	30	27	3	30	28	2
.	.	.	.	.	.	.
1959	30	20	10	30	21	9
1960	30	19	11	30	20	10
.	.	.	.	.	.	.
1978	30	1	29	30	2	28
1979	30	0	30	30	1	29
1980	-	-	-	30	0	30
Total	$900	$435	$465	$900	$435	$465

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Office of Tax Analysis

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Table A-3
Financial Statements, With 10 Percent Capital Subsidy

Income Statement
for year, 1979
(millions)

Income from sales		$273.95
less: Cost of goods sold		165.00
equals: Operating income		$108.95
less: Depreciation	$30	
Subsidy amortization	(0.1)	
Interest paid	27.72	57.62
Pre-tax corporate income		$51.33
less: Provision for Federal income tax		23.61
equals: after-tax ("net") corporate income		$27.72
less: Distributions to stockholders		27.72
equals: To retained earnings		0.0

Balance Sheets
1979
(millions)

Assets		Beginning		End	Liabilities	Beginning	End
Cash and other current assets		$100		$129.9	Accounts payable	$100	$100
					Long-term debt	277.2	277.
Plant and equipment original cost	$900		$900		Net worth:		
less: unamortized subsidy	3			2.9	Capital stock	184.8	184
accrued depreciation	435	$462	465	$432.1			
Total assets		$562		$562.0	Total liabilities	$562.0	$562.

Table A-4
Net Rate Base, Income from Sales, and Cost of Service Elements, with 10 Percent Capital Subsidy; when Tax and Regulatory Income Measurement Rules are Identical

Year	Net rate base (beginning of year) (1)	Income from sales (2)	Cost of service				
			Cost of goods sold (3)	Net depreciation (4)	Interest paid (5)	Federal income tax (6)	Return to equity (7)
			(millions)				
Base case	$465.00	$274.57	$165.00	$30.00	$27.90	$23.77	$27.90
with subsidy:							
1979	$462.00	$273.95	$165.00	$29.90	$27.72	$23.61	$27.72
1980	459.10	273.36	165.00	29.80	27.55	23.47	27.55
1981	456.30	272.78	165.00	29.70	27.38	23.32	27.38
1982	453.60	272.22	165.00	29.60	27.22	23.18	27.22
1983	451.00	271.67	165.00	29.50	27.06	23.05	27.06
1984	448.50	271.14	165.00	29.40	26.91	22.92	26.91
1985	446.10	270.63	165.00	29.30	26.77	22.80	26.77
1986	443.80	270.14	165.00	29.20	26.63	22.68	26.63
1987	441.60	269.66	165.00	29.10	26.50	22.57	26.50
1988	439.50	269.20	165.00	29.10	26.37	22.46	26.37
1989	437.50	268.76	165.00	28.90	26.25	22.36	26.25
1990	435.60	268.34	165.00	28.80	26.14	22.26	26.14
1991	433.80	267.93	165.00	28.70	26.03	22.17	26.03
1992	432.10	267.54	165.00	28.60	25.93	22.09	25.93
1993	430.50	267.16	165.00	28.50	25.83	22.00	25.83
1994	429.00	266.81	165.00	28.40	25.74	21.93	25.74
1995	427.60	266.47	165.00	28.30	25.66	21.86	25.66
1996	426.30	266.14	165.00	28.20	25.58	21.79	25.58
1997	425.10	265.84	165.00	28.10	25.51	21.73	25.51
1998	424.00	265.55	165.00	28.00	25.44	21.67	25.44
1999	423.00	265.28	165.00	27.90	25.38	21.62	25.38
2000	422.10	265.03	165.00	27.80	25.33	21.57	25.33
2001	421.30	264.79	165.00	27.70	25.28	21.53	25.28
2002	420.60	264.57	165.00	27.60	25.24	21.50	25.24
2003	420.00	264.37	165.00	27.50	25.20	21.47	25.20
2004	419.50	264.18	165.00	27.40	25.17	21.44	25.17
2005	419.10	264.01	165.00	27.30	25.15	21.42	25.15
2006	418.80	263.86	165.00	27.20	25.13	21.41	25.13
2007	418.60	263.73	165.00	27.10	25.12	21.40	25.12
2008	418.50	263.61	165.00	27.00	25.11	21.39	25.11
2009	418.50	263.61	165.00	27.00	25.11	21.39	25.11
2010							

Table A-5
Financial Statements, When a Capital Subsidy
Is "Flowed-Through" to Equity

Income Statement
for year, 1979
(millions)

Income from sales		$269.01
less: Cost of goods sold		165.00
equals: Operating income		104.01
less: Depreciation	$30.0	
Interest paid	27.9	57.90
equals: Pre-tax income		$ 46.11
less: Provision for Federal income tax		21.21*
equals: After-tax corporate income		$ 24.90
plus: Capital subsidy		3.00
"Net" income		$ 27.90
less: Distribution to stockholders		27.90
equals: Addition to retained earnings		0.00

*Assumes tax accounting will ignore nonshareholder contribution to capital.

Balance Sheets
1979
(millions)

Assets					Liabilities		
	Beginning		End			Beginning	End
Cash and other current assets		$100		$130	Current liabilities (including taxes payable)	$100	$100
Plant and equipment original cost	$900		$900		Long-term debt	279	279
less: accrued depreciation	435	$465	465	$435	Net worth: Capital stock	186	186
Total assets		$565		$565	Total liabilities	$565	$565

Table A-6
Schedule of Interest-free Loans Extended and Repaid:
1979 Vintage of Plant and Equipment

End of year	Depreciation Schedule Proclaimed 1/ (1)	Norm 2/ (2)	Loan extended /(1)-(2)/x.46 (3)	End of year (4)	Proclaimed 1/ (5)	Norm 2/ (6)	Loan repaid /(6)-(5)/x.46 (7)
				(millions)			
1979	$ 2.4	$ 1.0	$0.644	1994	$0.9	$ 1.0	$0.046
1980	2.3	1.0	0.598	1995	0.8	1.0	0.092
1981	2.2	1.0	0.552	1996	0.7	1.0	0.138
1982	2.1	1.0	0.506	1997	0.6	1.0	0.184
1983	2.0	1.0	0.460	1998	0.5	1.0	0.230
1984	1.9	1.0	0.414	1999	0.4	1.0	0.276
1985	1.8	1.0	0.368	2000	0.3	1.0	0.322
1986	1.7	1.0	0.322	2001	0.2	1.0	0.368
1987	1.6	1.0	0.276	2002	0.1	1.0	0.414
1988	1.5	1.0	0.230	2003	0.0	1.0	0.460
1989	1.4	1.0	0.184	2004	0.0	1.0	0.460
1990	1.3	1.0	0.138	2005	0.0	1.0	0.460
1991	1.2	1.0	0.092	2006	0.0	1.0	0.460
1992	1.1	1.0	0.046	2007	0.0	1.0	0.460
1993	1.0	1.0	0.0	2008	0.0	1.0	0.460
Totals	$25.5	$15	$4.830		$4.5	$15	$4.830

Office of the Secretary of the Treasury
Office of Tax Analysis

March 5, 1979

1/ The proclaimed schedule is based on sum-of-years' digits, for 24 years. Thus, the denominator for each year's fractional depreciation is 300. Then for 1979, the fraction for determining the schedular amount is 24/300, and this multiplied by $30 million yields $2.4 million. The amount for 1980 is 23/300 times $30 million, and so on through 24 years.

2/ The depreciation norm is based on 1/30 of $30 million each year.

Table A-7
Privately Financed Rate Base, Income from Sales, and Cost of Service Elements, With Federal Interest-Free Loan Program

Year	Financing of rate base: Beginning of year private funds (1)	Financing of rate base: Zero interest loans at end of year: For given year (2)	Financing of rate base: Zero interest loans at end of year: Cumulative (3)	Income from sales (4)	Cost of service: Cost of goods sold (5)	Cost of service: Depreciation (6)	Cost of service: Interest (7)	Cost of service: Income taxes (8)	Cost of service: After-tax return to equity (9)
Base case	$465.000	-	-	$274.57	$165.00	$30.00	$27.90	$23.77	$27.90
With lending subsidy:									
1979	$465.000	$0.644	$0.644	$274.57	$165.00	$30.00	$27.90	$23.77	$27.90
1980	464,356	1.242	1.886	274.46			27.86	23.73	27.86
1981	463.114	1.794	3.680	274.24			27.79	23.67	27.79
1982	461.320	2.300	5.980	273.94			27.68	23.58	27.68
1983	459.020	2.760	8.740	273.54			27.54	23.46	27.54
1984	456.260	3.174	11.914	273.07			27.38	23.32	27.38
1985	453.086	3.542	15.456	272.53			27.19	23.16	27.19
1986	449.544	3.864	19.320	271.92			26.97	22.98	26.97
1987	445.680	4.140	23.460	271.26			26.74	22.78	26.74
1988	441.540	4.370	27.830	270.55			26.49	22.57	26.49
1989	437.170	4.554	32.384	269.80			26.23	22.34	26.23
1990	432.616	4.692	37.076	269.03			25.96	22.11	25.96
1991	427.924	4.784	41.860	268.22			25.68	21.87	25.68
1992	423.140	4.830	46.690	267.40			25.39	21.63	25.39
1993	418.310	4.830	51.520	266.58			25.10	21.38	25.10
1994	413.480	4.784	56.304	265.75			24.81	21.13	24.81
1995	408.696	4.692	60.996	264.93			24.52	20.89	24.52
1996	404.004	4.554	65.550	264.13			24.24	20.65	24.24
1997	399.450	4.370	69.920	263.35			23.97	20.42	23.97
1998	395.080	4.140	74.060	262.60			23.70	20.19	23.70
1999	390.940	3.864	77.924	261.89			23.46	19.98	23.46
2000	387.076	3.542	81.466	261.23			23.22	19.78	23.22
2001	383.534	3.174	84.640	260.63			23.01	19.60	23.01
2002	380.360	2.760	87.400	260.08			22.82	19.44	22.82
2003	377.600	2.300	89.700	259.61			22.66	19.30	22.66
2004	375.300	1.840	91.540	259.22			22.52	19.18	22.52
2005	373.460	1.380	92.920	258.90			22.41	19.09	22.41
2006	372.080	0.920	93.840	258.67			22.32	19.02	22.32
2007	371.160	0.460	94.300	258.51			22.27	18.97	22.27
2008	370.700	0.000	94.300	258.43			22.24	18.95	22.24
2009	370.700	0.000	94.300	258.43	$165.00	$30.00	22.24	18.95	22.24

Office of the Secretary of the Treasury
Office of Tax Analysis

March 6, 1979

Table A-8
Financial Statements, First Year of a
Federal Interest-free Loan Program Financed
Through the Tax System

Income Statement
for year 1979
(millions)

Income from sales		$274.57
less: Cost of goods sold		165.00
equals: Operating income		$109.57
less: Depreciation	$30	
Interest paid	27.90	57.90
equals: Pre-tax income		$ 51.67
less: Provision for Federal income tax:		
Accrued taxes payable	$23.13	
Deferred tax	0.64	23.77
equals: After-tax ("net") corporate income		$ 27.90
less: Distribution to stockholders		27.90
equals: Addition to retained earnings		$ 0.00

Balance Sheets
1979
(millions)

Assets					Liabilities		
	Beginning:		End			Beginning:	End
Cash and other current assets		$100		$130.64	Current liabilities	$100	$100.00
					Long-term debt	279	279.00
Plant and equipment acquisition cost	$900		$900		Deferred taxes	0	0.64
less: accrued depreciation	435	$465	465	$435	Net worth: Capital stock	186	186.00
Total assets		$565		$565.64		$565	$565.64

Table A-9
Comparison of Income from Sales, When Proceeds of Interest-Free Loans Are So Accounted For and When They Are "Flowed-Through" to Equity Income in the Year Received

Year	Income from sales: loan benefits distributed as earned: "normalize" (1)	Interest-free loans "flowed-through" to income: Income from sales (2)	Costs of service: Cost of goods sold (3)	Costs of service: Depreciation (4)	Costs of service: Interest (5)	Costs of service: Income taxes "paid" (6)	Net return to equity (7)
			(millions)				
Base case	$274.57	$274.57	$165.00	$30.00	$27.90	$23.77	$27.90
With loan subsidies:							
1979	$274.57	$273.37	$165.00	$30.00	$27.90	$22.57	$27.90
1980	274.46	272.27				21.47	
1981	274.24	271.24				20.44	
1982	273.94	270.31				19.51	
1983	273.54	269.46				18.66	
1984	273.07	268.69				17.89	
1985	272.53	268.01				17.21	
1986	271.92	267.41				16.61	
1987	271.26	266.90				16.10	
1988	270.55	266.47				15.67	
1989	269.80	266.13				15.33	
1990	269.03	265.88				15.08	
1991	268.22	265.71				14.91	
1992	267.40	265.62				14.82	
1993	266.58	265.62				14.82	
1994	265.75	265.71				14.91	
1995	264.93	265.88				15.08	
1996	264.13	266.13				15.33	
1997	263.35	266.47				15.67	
1998	262.60	266.90				16.10	
1999	261.89	267.41				16.61	
2000	261.23	268.01				17.21	
2001	260.63	268.69				17.89	
2002	260.08	269.46				18.66	
2003	259.61	270.31				19.51	
2004	259.22	271.16				20.36	
2005	258.90	272.01				21.21	
2006	258.67	272.86				22.06	
2007	258.51	273.71				22.91	
2008	258.43	274.57				23.77	
2009	258.43	274.57	$165.00	$30.00	$27.90	23.77	$27.90

Office of the Secretary of the Treasury
Office of Tax Analysis

March 6, 1979

Table A-10

Combined Effect of Investment Tax Credit
and Interest-Free Loan Program on Cost of Service
(millions)

Plant and equipment required to produce specified quantity and quality of service; "rate base," at market prices			$465.00
Rate base assets to be financed:			
Base case (without subsidies)		$465.00	
After 10 percent investment credit fully effective		$397.11	
Financing of rate base assets:			
Base case: Interest-bearing debt	$279.00		
Capital stock	186.00	$465.00	
After investment credit and interest-free loan program effective:			
Interest-bearing debt $189.95			
Capital stock $126.63	316.58		
Interest-free loans, "deferred taxes"	80.53	397.11	

Cost of Service

	Base case	Subsidies fully effective
Total cost of service	$274.57	$241.06
Cost of goods sold	165.00	165.00
Capital costs: Depreciation	30.00	25.62
Interest paid	27.90	18.99
Provision for Federal income tax	23.77	12.45*
After-corporate tax return to equity	27.90	18.99

*Includes coverage of $4.38 million in initial and supplementary investment credit, but no addition to "deferred taxes."

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

FOR IMMEDIATE RELEASE March 26, 1979

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $3,000 million of 13-week Treasury bills and for $3,001 million of 26-week Treasury bills, both series to be issued on March 29, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing June 28, 1979			26-week bills maturing September 27, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	97.608	9.463%	9.86%	95.250	9.396%	10.03%
Low	97.593	9.522%	9.92%	95.221	9.453%	10.09%
Average	97.599	9.498%	9.89%	95.229	9.437%	10.08%

Tenders at the low price for the 13-week bills were allotted 97%.
Tenders at the low price for the 26-week bills were allotted 13%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 44,680,000	$ 39,665,000	$ 37,890,000	$ 22,890,000
New York	4,307,190,000	2,301,405,000	4,491,860,000	2,680,460,000
Philadelphia	34,900,000	34,900,000	37,360,000	37,360,000
Cleveland	28,510,000	28,510,000	38,755,000	38,755,000
Richmond	19,815,000	19,815,000	12,580,000	12,580,000
Atlanta	40,840,000	40,840,000	23,485,000	23,485,000
Chicago	390,660,000	305,660,000	161,370,000	86,370,000
St. Louis	34,775,000	12,775,000	32,260,000	13,260,000
Minneapolis	27,175,000	7,175,000	23,085,000	3,085,000
Kansas City	23,480,000	23,480,000	20,790,000	20,790,000
Dallas	9,575,000	9,575,000	7,815,000	7,815,000
San Francisco	391,370,000	166,280,000	212,430,000	37,430,000
Treasury	10,170,000	10,170,000	16,270,000	16,270,000
TOTALS	$5,363,140,000	$3,000,250,000a/	$5,115,950,000	$3,000,550,000b/

a/Includes $370,870,000 noncompetitive tenders from the public.
b/Includes $223,795,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

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

FOR RELEASE AT 4:00 P.M. March 27, 1979

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $6,000 million, to be issued April 5, 1979. This offering will result in a pay-down for the Treasury of about $200 million as the maturing bills are outstanding in the amount of $6,214 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $3,000 million, representing an additional amount of bills dated January 4, 1979, and to mature July 5, 1979 (CUSIP No. 912793 2A 3), originally issued in the amount of $2,910 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,000 million to be dated April 5, 1979, and to mature October 4, 1979 (CUSIP No. 912793 2P 0).

Without assurance, before the auction date of April 2, of Congressional action on legislation to raise the temporary debt ceiling, the Treasury will postpone this auction.

Both series of bills will be issued for cash and in exchange for Treasury bills maturing April 5, 1979. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,321 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. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, April 2, 1979. 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.

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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. 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 must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on April 5, 1979, in cash or other immediately available funds or in Treasury bills maturing April 5, 1979. 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, 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 RELEASE AT 4:00 P.M. March 27, 1979

TREASURY POSTPONES AUCTION OF
52-Week BILLS

The Treasury today announced it was postponing the auction of $3,340 million of 52-week bills originally scheduled for Wednesday, March 28, 1979. This postponement is necessary because Congressional action on legislation to raise the temporary debt limit to allow delivery of the 52-week bills is not at this time assured.

Interested investors are advised to look for notice of any rescheduling of this auction in the financial press or to contact their local Federal Reserve Bank for such information.

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

FOR IMMEDIATE RELEASE
March 28, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES COUNTERVAILING
DUTY INVESTIGATION ON CERTAIN SCALE
AND WEIGHING MACHINES FROM JAPAN

The Treasury Department has started an investigation into whether imports of certain scale and weighing machines from Japan are being subsidized.

A preliminary determination in this case must be made by August 15, 1979, and a final determination by February 15, 1980.

Imports of this merchandise during 1978 were valued at about $4 million.

The investigation follows receipt of a petition alleging that manufacturers and/or exporters of this merchandise receive benefits from the Government of Japan.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional customs duty equal to the subsidy paid on merchandise exported to the United States.

Notice of this investigation will be published in the Federal Register of March 29, 1979.

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

FOR IMMEDIATE RELEASE
March 28, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY TO START ANTIDUMPING
INVESTIGATION ON SODIUM ACETATE
FROM CANADA

The Treasury Department today said it will start an antidumping investigation of imports of sodium acetate from Canada.

Treasury's announcement followed summary investigations conducted by the U. S. Customs Service after receipt of a petition filed by the Niacet Corp., Niagara Falls, N.Y., alleging that firms in Canada are dumping sodium acetate in the United States.

The petition alleges that imports of this merchandise are 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.) The Customs Service will investigate the matter and make a tentative determination by September 29, 1979.

If sales at less than fair value are determined by Treasury, the U. S. International Trade Commission will subsequently decide whether they are injuring or likely to injure 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 March 29, 1979.

Imports of this merchandise in 1978 were valued at $381,000.

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B-1490

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

FOR IMMEDIATE RELEASE
March 28, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES COUNTERVAILING
DUTY INVESTIGATION ON CERTAIN VALVES
AND PARTS THEREOF FROM JAPAN

The Treasury Department has started an investigation into whether imports of certain valves and parts thereof from Japan are being subsidized.

A preliminary determination in this case must be made by August 16, 1979, and a final determination by February 16, 1980.

Imports of this merchandise during 1978 were valued at about $43.9 million.

The investigation follows receipt of a petition alleging that manufacturers and/or exporters of this merchandise receive benefits from the Government of Japan.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional customs duty equal to the subsidy paid on merchandise exported to the United States.

Notice of this investigation will be published in the Federal Register of March 29, 1979.

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

FOR IMMEDIATE RELEASE
EXPECTED AT 9:00 A.M. EST
WEDNESDAY, MARCH 28, 1979

John Ray, Director of International Trade, delivered the speech for Assistant Secretary Bergsten.

REMARKS BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
AMERICAN FOOTWEAR INDUSTRIES ASSOCIATION
KEY BISCAYNE, FLORIDA

Trade and the U.S. Economy

International trade is more important to the U.S. economy than most Americans realize. And it is becoming increasingly more important.

In 1970 our combined exports and imports accounted for 8-1/2 percent of our Gross National Product (GNP). By 1978 the share of total trade in our GNP had nearly doubled to 15 percent -- with a bit more than a 6-1/2 percent share for exports and slightly-less than an 8-1/2 percent share for imports. This difference of almost 2 percent in our import and export shares -- and the rapid growth of U.S. imports of both oil and non-oil products in recent years, as compared to a much slower growth in total U.S. exports -- is at the root of our present trade deficit problem.

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In 1977 and 1978 we ran record trade deficits of $31 billion and $34 billion, respectively. We expect to see some improvement in these figures in 1979, as our trade deficit moves closer to $27 billion. But the basic problem remains. We cannot continue to run deficits of these magnitudes and expect to maintain confidence in the dollar, or combat inflation, or enjoy continued solid growth of our own economy.

An increasing number of Americans unfortunately would have us close our doors to imports in response to our deficit problem, especially in areas where domestic industries are finding it increasingly difficult to compete with foreign production.

We do not rule out the selective use of import restraints in certain cases. It is important, for example, to protect our manufacturers against unfair dumping or subsidy practices of other nations which cause or threaten injury. And it may be necessary in critical or emergency situations to temper dramatic surges in imports which can radically disrupt domestic markets.

For example, in June 1977 as you are well aware, we entered into Orderly Marketing Arrangements (OMA's) with Korea and Taiwan to restrict their exports of nonrubber footwear to the U.S. market. We did so with great reluctance, as contrary to our general philosophy of open markets, but as a necessary step to deal with the rapid surge of footwear imports which came almost entirely from these two nations. The OMA's were part of an overall package of assistance to the domestic footwear industry which was designed to help provide a breathing space for U.S. shoe producers to adjust to increasing import competition.

Such restraints should not be the norm. They are not intended to be permanent. And they must take into consideration the impact of restraints on the domestic economy as a whole.

I would like to focus my comments today on the following issues:

-- first, the general importance of open markets to the U.S. economy;

-- second, the importance of adjusting to increased import competition from the developing nations;

-- third, the problem of unfair trade competition (especially as regards government subsidies); and

-- fourth, the problems of the footwear industry in particular, and what we have done to help ease the adverse impact of import competition in this area.

The Importance of Open Markets

Imports are a vital component of U.S. production and consumption. We depend on imports for essential raw materials; for a wide range of choice in consumer goods; for needed domestic competition and a spur to more efficient production;

as an important rein on domestic inflation; as necessary inputs for domestic production; and as a source of jobs in import-dependent industries.

Some, I know, will argue that we don't _need_ import competition in order to produce for the American market. Given our high standard of living, they contend, we can afford slightly higher prices - and obtain better quality products, to boot. Imports don't provide jobs they say, but rather cause us to lose jobs in import-competing industries. And they would equally contend that imports have no direct effect on prices charged by domestic industries -- import competition doesn't cause U.S. producers to _reduce_ the prices they would otherwise charge, and import restraints don't cause them to charge _more_.

I can't agree with any of these arguments. Inflation is the most important problem facing the United States today. Imports are an essential part of our fight against inflation.

There are basically three categories of U.S. imports: non-competitive, competitive, and supplementary goods:

-- Nearly half of all U.S. merchandise imports consists of _noncompetitive_, and in many cases essential supplies and materials, including oil. These products are either not available in the domestic market, or not available in sufficient amounts to meet domestic demand. Tin, chromium, iron ore, and natural rubber are good examples, as are more than 50 percent of our agricultural imports.

-- Many other imports are <u>supplementary</u> to domestic production. They fill gaps in domestic supplies, or offer alternatives in terms of style, quality, and technological advancement. Italian shoes and small, fuel-efficient cars are examples, although the U.S. auto industry is learning to produce smaller and more efficient cars as well.

-- The remainder of our imports compete directly with U.S. production, and affect prices to the same extent that domestic competition does: that is, the larger the number of competing firms and the lower the concentration ratios, the more direct impact on price competition. Shoe imports from the developing nations of Asia and Latin America are an example of directly competitive imports.

The fundamental point is that import competition stimulates innovation and efficiency. The competitive environment nourished by the relatively open trade posture of the United States over the past forty years has spurred American industries to make steady improvements in the range and quality of available goods. Import barriers, by contrast, permit protected industries to raise prices and reduce incentives to improve the quality of their output.

They promote an inefficient allocation of resources and detract from our ability to produce the things we make best.

Imports hold down prices and stimulate the discovery of cost-saving technology and other innovations. Trade barriers, by contrast, raise prices to consumers and push up the cost of living. When import penetration raises serious problems for a domestic industry, it is always sensible for the Government to consider helping that industry to improve its competitive ability directly as an alternative to providing insulation from the forces of the marketplace.

The burden of import restrictions falls particularly heavily on low-income consumers, who tend to spend a greater share of their budgets on protected items such as low-cost shoes and meat. In some cases, foreign suppliers respond to trade barriers by discontinuing lower-priced items in favor of those with higher unit prices. This tendency also hurts poorer Americans more than others.

U.S. industries which compete most directly with imports have voiced considerable concern in recent years about two major problem areas: (1) imports of low-cost goods from the developing countries and (2) unfair trade practices of other nations, including both price-cutting and government subsidies which serve to distort trade flows. I would like to discuss U.S. policy toward each of these problems in the context of the growing importance of U.S. exports to the developing nations, our global efforts to work more closely with them to resolve trade problems, and the new rules of fair trade which we have agreed upon as part of the recently concluded Multilateral Trade Negotiations.

Trade With the Developing Nations

The developing countries are becoming increasingly important markets for U.S. exports. They accounted for more U.S. export sales in 1978 than Western Europe and Japan combined, representing 37 percent of all our exports -- or $53 billion. Furthermore, they are the fastest-growing markets for our goods. Between 1970 and 1978, our exports to the developing countries grew by 340 percent, compared with a growth of 180 percent in our exports to developed countries. Even excluding the OPEC countries, U.S. exports to the developing countries grew by 270 percent -- still far faster than those to the developed countries.

We expect these trends to continue into the future. The World Bank's World Development Report projects LDC imports of goods and services of $900 billion in 1985, compared with their actual 1975 imports of $270 billion. The reasons for this are not hard to find.

First, the developing countries are growing more rapidly than the rest of the world. Between 1960 and 1975, total production in these countries grew at an average annual rate of 5.6 percent compared with 4.2 percent for the developed countries.

Second, these countries have an enormous need for the goods and services that will allow them to provide an acceptable standard of living for their populations. Particularly for machinery and other capital goods -- the kinds of manufactured goods in which the United States has its clearest international advantage -- the appetite of the developing countries over the longer term is potentially insatiable.

Nevertheless, the future of the developing countries and the extent of our exports to them depend crucially on their ability to export to us those products where they have a comparative cost advantage. Trade must be a two-way street.

As you are well aware, exports from the developing countries have become quantitatively important in some sectors, such as shoes and textiles. Some have implied that, because of our high-wage economy, U.S. industry cannot compete with producers in these countries. This is not the case, for high-wage workers in the United States are also high-productivity workers. For manufactured goods as a whole, the LDCs import much more than they export. In 1976, we and the other industrial countries imported $36 billion in manufactured goods from the developing countries, but we exported $124 billion worth of manufactures. Thus, the industrial countries had a trade surplus for manufactures of nearly $90 billion with developing nations.

In the case of the United States individually, we exported $2 worth of American manufactures to developing countries for every dollar we imported.

Unquestionably, the capacity of the developing countries to export manufactures will continue to grow. The World Bank projects an annual growth rate for export volume of 12 percent through 1985. Even at that time, however, developing countries will still be a relatively small force in comparison to imports from all sources -- accounting for less than 14 percent of industrial country imports of manufactures and less than 3 percent of total domestic sales.

Those who call for generalized protection from imports must not ignore these realities. Efforts to artificially reduce imports from such countries will have two effects. First, it will invite retaliation against U.S. exports, putting at risk the millions of jobs now producing for the LDC market. Second, it would reduce the capacity of these countries to import, thereby slowing the growth of potential markets for American goods and costing American jobs. Both would adversely impact on our prosperity and standard of living.

Thus, continued access to our markets by the developing countries is essential both to our own interests and those of the world economy. Nevertheless, I want to assure you of our unyielding belief that such international trade needs to be conducted on a basis of fairness to all participants.

Fairness requires two main elements:

-- First, all countries must accept responsibilities consistent with the benefits they receive from a liberal international trading system. A few developing countries, notably including Hong Kong, South Korea, Taiwan and Brazil, have emerged very rapidly as serious competitors to the industrial countries for a wide range of products. We have taken a strong stand in urging these Advanced Developing Countries (ADCs) to liberalize their import systems and to assure that they accept the responsibilities consistent with their increasing role in world trade. We believe we have had a large measure of success, both in the Multilateral Trade Negotiations (MTN) and in bilateral discussions.

-- Second, the use of subsidies to promote export-led growth must be controlled. Clear limits on subsidies that influence international trade are essential particularly to assure that countries do not use them in a way that harms other countries. Again, we have made a major effort in the MTN to assure consistent principles that would assure producers in all countries that they will not be hurt by unfair competition.

The New Subsidy/CVD Code

The new subsidy/countervailing duty code which we have negotiated as our top priority item in the MTN includes important provisions for the assumption of obligations by the developing countries. Developing countries which join the code can fulfill the general obligation to refrain from the use of industrial and mineral export subsidies by assuming obligations regarding the use of these subsidies commensurate with their competitive needs. This provision specifically recognizes that export subsidies are an integral part of many development programs, but that they become less necessary as nations develop. The requirement is designed to encourage the phase-out of export subsidies as nations become more advanced, and hence have less need for such practices. Nations which accept these reponsibilities under the code receive an assurance that, as their subsidies are phased out, their exports will not be countervailed unless injury is shown.

Brazil, for example, has already announced the phase-out of its major export subsidies over a period of approximately four and a half years within the context of the code. Reductions in its export incentives began in January, and will continue at quarterly intervals. This is a significant contribution to improved discipline in the subsidies area, since Brazil has for some years maintained perhaps the largest subsidy program of any major trading country. It is particularly significant for the United States, since Brazil is our eighth largest trading partner. We regard the Brazilian action as a statesmanlike assumption of the increased responsibilities attaching to its sharply increased role in the world economy, and enormously important in assuring cordial U.S.-Brazilian economic and overall relations in the years ahead.

Brazil's adherence to the code offers real benefits to U.S. industry, which has long been concerned about the very high level of subsidization offered by Brazil to competing industries exporting to our market. Brazilian non-rubber footwear exports have benefitted from federal and state export subsidies ranging from 5 to 12 percent of the value of the product in recent years. U.S. industries should experience more equitable competition from Brazil in these and other industrial products in the years ahead.

Beyond Brazil, we expect other advanced developing nations to undertake similar phase-out commitments, tailored to their own situation, and negotiations are actively underway with a number of them.

As a result of implementing the subsidy/countervail code domestically, we will adopt the first genuine overhaul of the U.S. countervailing duty law in 80 years. Consistent with our international commitments, we should now have a law that provides, first, for prompt consideration of the twin tests of subsidy and injury; second, for provisional measures within four months of the filing of a petition -- cutting by two-thirds the time now usually taken before the law "bites"; third, an expanded and much more transparent procedure allowing all interested parties to participate and review information collected; fourth, assured periodic review to update the basis on which CVDs are collected; and, fifth, a system under which we can quickly accept undertakings from foreign governments or exporters to end the injurious effects of subsidies to achieve the aims of the law without going through all of its elaborate procedures. Retroactive countermeasures will be available to ensure that such undertakings are not violated. All in all, the new procedures will provide for the open and expeditious resolution of subsidy complaints, which should be welcome news for the U.S. footwear industry, and other industries, as well.

Trade and the U.S. Footwear Industry

The U.S. footwear industry is an excellent example of a competitive domestic industry in which imports have a clear impact on domestic shoe prices, with substantial benefits for U.S consumers. Indeed, a recent Brookings study has shown that imports of nonrubber footwear from

Latin America and Asia (which account for 72 percent of all U.S. imports of these shoes) are, on average, 24 percent less expensive than comparable domestic products. Nonrubber shoe imports from Europe, Japan, and Canada - in contrast - are 20 percent more expensive on average than domestic shoes -- a strong indication of the influence of fashion and brand attraction for these shoes.

The footwear industry has indeed been faced with severe import competition. Between 1975 and 1976, for example, imports of nonrubber footwear from Taiwan and Korea increased by a dramatic 80 million pairs, as compared to total U.S. production of 422.5 million pairs of nonrubber shoes. Any restraint on imports, however, must clearly take into account both the industry's need for government intervention and the potential cost of restraints to U.S. consumers.

Although the President recognized that the cost could be significant, he also believed that temporary relief was necessary to permit the domestic shoe industry to adjust to the sudden increase in imports which had occurred during this period.

As a result of the OMAs which we negotiated and which became effective in July 1977, a recent Brimmer study has shown that by June 1978:

-- U.S. production of nonrubber footwear actually increased by 2 percent, a sharp reversal of the previous downward trend; and

-- the rise in imports of nonrubber footwear was clearly halted.

These are major improvements for the U.S. shoe industry. There have also been costs, however, especially for low-income consumers.

Our OMA's have concentrated on the low-cost producers -- Korea and Taiwan -- which supplied 75 to 100 percent of total U.S. imports of the kinds of nonrubber footwear bought by low-income groups in 1976-77: women's plastic dress and casual shoes under $5.00, men's plastic work shoes under $12.00, leather work shoes, and athletic shoes. The quotas have therefore fallen most heavily on low-income Americans, while permitting higher prices to be charged by European and Japanese suppliers.

Trade restrictions clearly are not the long-run solution to the industry's problems. If the industry is to survive and prosper, it is essential that this period of restraint be used to enhance competitiveness, to become more innovative, and to adjust to the realities of international competition. By directing that a major new trade adjustment effort be undertaken in conjunction with a program of limited import restraints, the President has underlined the need for adjustment. These two programs are complementary: one providing breathing space during which the other can begin to yield positive results.

The Footwear Industry Revitalization Program is a comprehensive $56 million, 3-year effort to meet the needs of both individual firms and the footwear industry as a whole, emphasizing technical and financial assistance to firms as well as broader programs to confront industry-wide structural problems. Since the program's inception, the Commerce Department has certified 77 footwear manufacturers for trade adjustment assistance; in the previous 15 years only 31 manufacturers had been certified.

Because many of the certified firms are small to medium-sized firms lacking the resources to identify weaknesses and implement the innovative marketing, manufacturing and management techniques necessary to revitalize the industry, special assistance from teams of private consultants with industry expertise has been a key element of the program.

Recent reports from the Footwear Specialist Teams indicate that the footwear industry has both inherent strengths and potential advantages upon which to capitalize, as well as serious weaknesses which will require considerable effort to overcome. With new marketing strategies, more efficient methods of production, and greater fashion awareness, there is no inherent reason that the U.S. footwear industry cannot be a pacesetter both here and abroad.

In fact, one of the more successful aspects of the footwear program has been the export promotion program. In the last quarter of 1978 exports totalled 2.7 percent of U.S. production. If exports continue at this pace they will exceed our goals of 3 percent of annual production in 1981 and 5 percent of production in 1983.

Current export promotion efforts include participation by 24 U.S. firms in the Dusseldorf Trade Show, a U.S. Trade Mission to Holland and Denmark, and a comprehensive "in store" promotion effort in major retail stores in nine principle European cities.

The footwear industry is not unique in its failure to exploit potential export markets. However the industry's response to export promotion efforts has been gratifying. There appear to be excellent opportunities for profitable ventures. Data drawn from the returns of Domestic International Sales Corporations indicate that the profit per unit on export sales has been twice the level of profit per unit on domestic sales for a number of years across a range of products.

The Interagency Footwear Group has also been in contact with the AFIA and has demonstrated the Administration's commitment to ensure that the effectiveness of the OMA's is not being undermined. At the most recent meeting on March 7 the Interagency Group outlined our present concerns about the effectiveness of the OMA's as well as actions we have already taken.

For example, when imports from Hong Kong increased sharply in 1978, threatening the effectiveness of the OMA's, we consulted with the Government of Hong Kong and determined that a large portion of the surge in trade resulted from imports into Hong Kong of components and subsequent shipment of finished footwear to the United States.

Hong Kong agreed to institute a licensing system whereby only footwear made from components manufactured in Hong Kong would be issued a Hong Kong certificate of origin. The United States will deny entry to nonrubber footwear from Hong Kong which does not have a valid certificate of origin.

This system went into effect in the United States on November 28, 1978. Although we should expect some temporary lag before the impact of the new arrangements shows up in actual trade figures, if it becomes evident that the arrangements are not working effectively, we will again meet with the Government of Hong Kong in order to negotiate a more effective agreement. We have been working with the Government of the Philippines to resolve a similar problem.

We have also consulted with the Koreans, in response to a recent surge in their exports of leather work shoes to our market. They have agreed to limit exports of leather work shoes to the United States to a maximum of 3.7 million pairs yearly for the duration of the restraint period. We have raised this issue with Czechoslovakia and Romania, as well. We have received a favorable initial response from Czechoslovakia that they do not plan to exceed their 1978 level of 800,000 pairs in 1979 and 1980. We are continuing to discuss this problem with Romania and are hopeful of a satisfactory resolution of the problem.

Other areas of mutual concern are:

(1) Increasing imports from a few other countries.

(2) The surge in rubber fabric imports from Taiwan and Korea which competes directly with nonrubber.

(3) Upgrading by Taiwan and Korea and the resultant disappearance of the most inexpensive shoes.

(4) Imports of lasted shoe uppers as a means of circumventing the OMA's.

The Administration is committed to do all that we can within the framework of the existing agreements to ensure that Taiwan and Korea live up to their commitments and that other suppliers do not increase their exports to the extent that they undermine the effectiveness of the restraint on the part of Taiwan and Korea.

However, there are realistic limits on what we can do. For example, rubber footwear was not included in the original injury determination and therefore we cannot impose unilateral restraints on rubber footwear imports without a separate 201 investigation.

In spite of these factors, however, I am gratified to note that the U.S. shoe industry has in fact done quite well during 1978, in comparison with the persistent decline in the previous decade:

(1) Production was off by less than 0.5 percent last year.

(2) Imports rose by only 1 percent, the smallest rise in 10 years.

(3) Exports, although still a modest 6.8 million pairs, rose by 28 percent to the highest level in ten years.

(4) Employment in the footwear industry remained exceptionally stable, with a decline of less than 0.5 percent (about 600 employees) during 1978.

These figures speak well for our overall efforts to assist the domestic footwear industry. The agreements have worked. They have clearly turned the import situation in non-rubber footwear around. There are a few new problems which we can handle within the framework of the present agreements. But the basic challenge now is for our own industry to devote its efforts to using its resources in the most efficient manner and to stay one step ahead of our foreign competitors in meeting the demand and taste preferences in our own market.

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

FOR RELEASE AT 4:00 P.M. EST March 28, 1979

TREASURY POSTPONES AUCTIONS OF 14-YEAR 10-MONTH BONDS AND 24-DAY BILLS

The Treasury today announced it was postponing the auctions of $1,500 million of 14-year 10-month bonds and the 24-day bills originally scheduled for Thursday, March 29, 1979. This postponement is necessary because Congressional action on legislation to raise the temporary debt limit to allow delivery of the securities is not at this time assured.

Interested investors are advised to look for notice of any rescheduling of these auctions in the financial press or to contact their local Federal Reserve Bank for such information.

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

FOR RELEASE ON DELIVERY
March 30, 1979 -- 9:30 a.m. EST

STATEMENT OF THE HONORABLE RICHARD J. DAVIS
ASSISTANT SECRETARY OF THE TREASURY
(ENFORCEMENT & OPERATIONS)
BEFORE THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
ON
S. 333
"THE OMNIBUS ANTITERRORISM ACT OF 1979"

I very much appreciate the opportunity to appear before this Committee in order to discuss the explosives tagging provisions of S. 333, the "Omnibus Antiterrorism Act of 1979." As you know, Mr. Chairman, in the Ninety-Fifth Congress we testified before other committees of both the House and the Senate concerning the Treasury Department's reasons for supporting the adoption of explosives tagging legislation; and recently we have again testified in the House in support of tagging legislation.

Today, I will present an overview of what the explosives tagging program is intended to accomplish, why Federal legislation is needed, what kind of legislation is most desirable and what our answers are to criticisms of this program raised in other hearings. In addition to my remarks, Mr. G. Robert Dickerson, the Director of the Bureau of Alcohol, Tobacco & Firearms, will submit a detailed statement and supporting materials for the record.

As an attorney and former Federal prosecutor, my primary experience has involved dealing with how to investigate and prosecute crimes after they have been committed. But my responsibilities for the protective as well as the investigative enforcement activities of the Treasury Department demand a perspective which gives at least equal weight to the ability of government to prevent criminal activities, especially those employing violence.

Consequently, I have followed closely the development, under BATF and Aerospace auspices, of capabilities for introducing into non-military explosives those unique elements -- taggants -- which would permit identification and detection of explosives. Very simply, the explosives tagging system would work as follows. Identification tagging involves the insertion of a number of tiny particles -- the taggants -- in an explosive material which would survive intact after an explosion and be recovered by bomb scene investigators. The identification taggant which is presently ready for commercial use involves several color-coded layers identifiable under a microscope. At the bomb scene, it would first be found in the debris through use of a long-wave ultra-violet light which causes the taggants to fluoresce. Since one side of most taggants will be magnetic, a magnet will be used to extract the taggants from the debris. The taggant itself would reveal the type of explosive involved, its manufacturer, and the date and shift when it was made. From this, the explosive could be traced through the distribution chain from manufacturers, to retailers and, in many instances, to the last, or a group of possible last, legal owners of the explosive.

Detection taggants -- which are microscopic capsules containing an inert material -- would emit a vapor which could be detected by specially developed equipment and animals before the explosive containing them was detonated. The presence of bombs could, thus be detected and lives and property saved.

These techniques, some of which could be implemented nationally in 1979 if we had the authority, offer law enforcement and security authorities an opportunity to use science and technology not only to solve more bombing crimes but also to prevent their occurrence. In this manner, a comprehensive explosive tagging program can significantly enhance the public safety.

The extent to which tagging will help counter bombing crimes will be largely influenced by how quickly and how many forms of explosives are tagged. It is very important therefore, that as soon as technology allows, the requirement that a particular class of explosives be tagged should go into effect. One class of explosives -- dynamites, water gels and slurries -- is ready for identification tagging now; black powder will be shortly. Tagging for the other types is expected to be ready at different times throughout the next three years. Following is a chart reflecting the status of development for tagging the various categories of explosives. It describes the dates we expect tagging could begin to be implemented if legislation is passed in this session and if sufficient taggants are then available. These estimates are those of BATF technical experts and the Aerospace Corporation, the technical managers of this program.

IDENTIFICATION TAGGING

-- Black Powder, June 1979
-- Smokeless Powder, July 1981
-- Dynamites, water gels & Slurries, June 1979
-- Fuse and Detonating Cord, November 1979
-- Boosters, March 1980
-- Detonators, June 1981 (label method)
October 1981 (double plug method)

DETECTION TAGGING

-- Black Powder, October 1980
-- Smokeless Powder, October 1980
-- Dynamites, water gels & slurries, October 1980
-- Fuse and Detonating Cord, October 1980
-- Boosters, January 1981
-- Detonators, January 1981 (both single plug methods)
June 1981 (label method)
October 1981 (double plug method)
-- Detection Taggant Sensors, April 1981 through
March 1982 (implementation of different devices)

Changes, both positive and negative, from the schedule projected last summer are due to various factors, including scientific developments, the lack of legislation, and delays in securing testing agreements with some manufacturers.

We urge that legislation be passed during this session which provides the Secretary with the necessary authority to require tagging of all types of non-military explosives in order that we can minimize the delay in getting tagged explosives into the marketplace and maximize our ability to apprehend those who use bombs and to save the lives of their intended victims at the earliest possible time. Elimination of particular classes of explosives from this legislation will, we fear, provide a disincentive for the producers of those explosives to cooperate with the development and testing of tagging. The passage of comprehensive legislation, on the other hand, will provide a stimulus which would accelerate the process by which tagging of all explosives used in crimes could be accomplished.

The enactment of tagging legislation in a piecemeal fashion also will minimize and, likely, defeat the timely impact on bombing crimes which tagging might have. For example, if we were to achieve legislative authority that permits us to institute identification tagging for the dynamites, water gels and slurries (which are ready for national identification tagging) but not for other explosives, we would not be able to respond rapidly to the expected shift from dynamites to other forms of explosives; and that shift will receive impetus because of these exclusions. Instead, we will have to: (1) continue to perfect tagging of those categories of explosives not ready today, (2) submit additional legislation to authorize the tagging requirement for those types, (3) go through additional sets of hearings to cover again the testimony already given on this, and (4) if the additional legislation then passes, wait for the taggant manufacturers and explosive manufacturers to gear up for production and use of the taggants in these other types of explosives. This will be a very lengthy process giving bombers years of immunity from the tagging of what are already commonly used explosives in bombs, such as black and smokeless powders.

On the other hand, if we have a single, comprehensive bill -- with the requirements that all taggants be safe, suitable, non-damaging, and available, and with the discretionary authority to make exemptions or delays when needed -- the only step remaining once taggants for these other types of explosives are ready will be to institute the tagging requirement. This approach will not authorize the inclusion of taggants before it is safe to do so; tagging will happen only after tests, participated in by the manufacturers, have been completed successfully.

Passage of a comprehensive bill is also necessary so that the manufacturers of taggants and explosives will be prepared to invest willingly the resources needed to have production and distribution facilities ready. They will do so only if they know that there is a legal requirement for compliance and that the tagging requirement will be implemented on a certain date. This certainly can only be achieved through a comprehensive tagging bill.

The Department recognizes that some have urged that black and smokeless powders be excluded from this program because they are used lawfully by sportsmen. We cannot endorse such an exclusion. All explosives have both lawful and unlawful uses. Black and smokeless powders are not only used by the law-abiding; they are also used by the bombers. For example, among all bombings in 1978 recorded by ATF -- including unidentifiables and incendiaries -- black and smokeless powders were used in 18.5 percent of the total bombings. FBI figures for this period attribute 22.1 percent to the powders. A chart presenting a statistical analysis of the various explosives used in crime is attached to my testimony. Together, those powders comprise a tiny portion of the commercially available cap-sensitive explosives, yet their frequency of occurrence in bombings is <u>several magnitudes greater</u> than their proportional availability.

Given this situation, a program that excludes these powders will clearly have serious deficiencies. Initially, such an exclusion would encourage the increased use of powders in bombs. We are especially concerned about excluding powders from the detection tagging program. Given the relative frequency of their use in bombings, the use of taggant detectors would be of questionable value if they could not detect black and smokeless powder bombs. This exclusion would also reduce the cost benefits of identification tagging.

We have recently heard charges that the safety testing for identification-tagged dynamites, water gels, and slurries is not sufficient. That is not true. In our charge to Aerospace we have placed, and continue to place, the highest priority on the safety of taggants. Dynamites, water gels, and slurries tagged with the finally selected identification taggants have met every safety test. These tests were established and conducted by the explosives manufacturers themselves. Based on these tests, the manufacturers were confident enough to market their own tagged explosives. The explosives manufacturers have produced and sold seven million pounds of tagged explosives. These are undisputed facts attesting to the safety of identification taggants in this class of explosives. Further information supporting the safety testing is submitted as an exhibit to Mr. Dickerson's prepared statement. Safety tests are now being pursued on all other classes of explosives with participating manufacturers, and under our approach no tagging would be required until these tests have been passed.

From Treasury's perspective another vital issue for tagging has been whether the crimes solved and the deterrence established are worth the effort and costs of requiring the taggants. In order to assess this as objectively as possible, Management Science Associates was asked to study this question. While acknowledging the difficulty in assessing the impact of any program before it begins, the study concluded, and we believe, that the value and cost effectiveness of identification tagging is clear.

Identification tagging will not, of course, serve as an instantaneous means of finding bombers. We do not expect to solve crimes and obtain convictions on the basis of tagging evidence alone. Identification taggants will instead provide initial leads and supply an additional specific connection between the manufacturer of an explosive, the category of last legal purchasers of a particular lot, and other evidence found at a bomb scene such as package fragments, wires, clockworks. In addition, evidence extrinsic to the bomb scene, such as employees with grievances against a bombed business, can be compared with the list of purchasers of an identified lot of tagged explosives in order to reduce further the list of suspects. The additional speed with which taggants will help investigators make these initial links will provide an increased possibility of focusing on a class of suspects while the criminal among them is still likely to have some incriminating evidence in his possession.

The identification taggant is analogous to the date/shift code already required to be printed on high explosives. We know that date/shift data permits speedier traces and that ATF has analyzed those cases where date/shift code information has been retrieved from dynamite wrappers that survive explosions or were found before detonation. Their study shows that cases forwarded for prosecution where a date/shift code was found were nearly twice the number of cases without date/shift information. We expect at least a comparable result from the use of indentification taggants.

Furthermore, this analogy should apply equally in terrorist bombings or bombings by professional criminals, where link analysis will be greatly enhanced through the taggants providing a clear means of showing connections and patterns common to several bombings even if perpetrated in several different parts of the country. Focus on the individual or group of extremists connected to multiple bombings will not only increase the likelihood of solution of several bombings through one overall investigation but will also save immense expenditures of manpower on bombings which might otherwise appear as unconnected events.

Detection tagging is, in a way, the part of the tagging program from which the greatest direct benefits to the public safety can be expected. With detection devices placed at high target value locations, we can go beyond solving bombing crimes only after the destruction has happened and begin, through pre-detonation discovery, to prevent bombings from occurring. The MSA study suggests that the cost-benefit of this form of tagging is less certain than that for identification tagging. Its analysis makes clear, however, that if one considers just the high risk, potential targets of catastrophic bombings -- airports, planes, public buildings -- then the benefits are clear. In addition, when one considers what detection tagging can do -- save life and limb -- the essentiality of going forward with this program becomes clearer.

While additional information on costs is contained in Mr. Dickerson's statement, I would like to note that the costs of tagged high explosives have been calculated at two cents per pound of tagged explosives. We do not believe this to be an unreasonable burden on either manufacturers or purchasers of explosives.

We have also heard claims that complex and costly regulatory schemes will be initiated as part of the tagging program. Treasury and ATF have asked for no new recordkeeping legislation. Records are now required under existing laws, including those applicable to black and smokeless powders. The only additional requirement would be to show the taggant's code in existing records. This small additional bit of information could not possibly be a serious burden.

We also do not seek to tag those types of explosives seldom found in any bombings. We have no desire to impose burdens on commercial enterprises or private pursuits that do not have a clear public benefit. For example, we are <u>not</u> seeking to require the tagging of those smokeless powders inserted in commercially manufactured, fixed ammunition. Only powders for sale in bulk quantities should be tagged. We take this position because there is no measurable public benefit to achieve by tagging individual rounds of ammunition.

Furthermore, we will not require the tagging of blasting agents which are very rarely used in crimes. The greatest portion (80 percent) of the materials produced for use in commercial blasting is made up of blasting agents, the most common of which is a mixture of ammonium nitrate and fuel oil known as ANFO. The components of ANFO are not explosives until compounded at the blasting site. Then they nearly always require a booster and detonator in order to be exploded successfully. Both boosters and detonators are going to be tagged under this program since they nearly always occur in criminal use of high explosives. Thus, in the event that blasting agents are used in a particular crime, booster and detonation tagging will provide the tracing mechanism, and we will not have to undertake the massive and costly job of requiring that blasting agents themselves be tagged. Tagging of the boosters and detonators is cheaper, more readily applicable, and will have a much greater impact on bombings than tagging of the blasting agents.

The explosives tagging program is designed to help significantly in defeating the bomber, whether he is a terrorist or any other form of criminal. And because we believe in the overall value of tagging, we think that it would be appropriate, in addition to the specific safety and other protections which

Mr. Dickerson and I describe in our statements, to have an obligation placed on Treasury and the Bureau of Alcohol, Tobacco and Firearms to report to Congress at least annually on the results of the tagging program. Such a report will enable Congress to continue to evaluate this program and, we believe, recognize its worth. We will be happy to work with the Committee in developing this and other proposals designed to assure the proper implementation of this program.

We recognize that many Americans have been touched by acts of terrorism and other bombing crimes. The victims -- or their survivors -- know that bombing is a particularly vicious and indiscriminate crime. It is a clearly deliberate act of violence in which the bomber has to acquire the knowledge of how to make a bomb; he has to fabricate the explosive device; and he has to plant it. This is a calculated, planned and indisputably intentional process with severe consequences: death, injury and the destruction of property. For these reasons we believe that we should do all that we legitimately can to meet this problem.

Mr. Chairman, we have never offered tagging as a panacea to bombing crimes. It will not be. All bombings will not be stopped or prevented. In addition, we know that it will take time for the effectiveness of tagging to have an impact that gives a clear measure of its worth. We are confident, however, that identification tagging will help solve more bombings and that detection tagging will cause the discovery of more bombs before they detonate. Together, these two forms of tagging will meaningfully advance our ability to deal with the bombing problem and deter some criminals from using this deadly instrument. We believe that this is a contribution to the general welfare to which the American public is entitled.

Department of the Treasury Statement
March 30, 1979, Committee on
Governmental Affairs,
United States Senate

February 26, 1979

Attachment

1978

Distribution of Explosives in Crime

	FBI			ATF		
	Number	Percent Known	Percent w/Unknown	Number	Percent Known	Percent w/Unknown
Incendiary	636	39.30	34.60	468	36.10	26.50
Black Powder	196	12.10	10.70	171	13.20	9.70
Smokeless Powder	209	13.00	11.40	157	12.10	8.80
Military	133	8.20	7.20	55	4.20	3.10
Dynamite	173	10.70	9.40	251	19.40	14.20
Other	271	16.70	14.70	194	15.00	11.00
Subtotals	1618	100.00		1296	100.00	
Unknown	219		12.00	471		26.70
Totals	1837		100.00	1767		100.00
Black & Smokeless (Shown as percentage of known)		25.10			25.30	
Black & Smokeless (Percentage including unknowns)			22.10			18.50
Black & Smokeless (Percentage excluding		40.8			39.6	

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

FOR IMMEDIATE RELEASE
March 29, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT FINDS METHYL
ALCOHOL FROM CANADA IS SOLD HERE
AT LESS THAN FAIR VALUE

The Treasury Department today said it has determined that methyl alcohol imported from Canada is being sold in the United States at "less than fair value."

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 decision of the Commission is affirmative, dumping duties will be collected on sales found to be at less than fair value.

Appraisement has been withheld since the tentative decision issued on December 19, 1978. The weighted average margin of sales at less than fair value in this case was 59.2 percent, computed on all sales.

Interested persons were offered the opportunity to present oral and written views before this determination.

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

Imports of this merchandise during 1978 were valued at about $18,000.

Notice of this determination will appear in the Federal Register of March 30, 1979.

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Department of the TREASURY NEWS

WASHINGTON, D.C. 20220 TELEPHONE 566-2041

For Release on Delivery
March 29, 1979

Remarks by the Honorable Anthony M. Solomon
Under Secretary of the Treasury
Before the Foreign Exchange Association of North America
Thursday, March 29, 1979 7:00 P.M.

I am pleased to have the opportunity -- and the challenge -- of reviewing recent developments in the foreign exchange markets with the men and women who represent the professional trading community in the United States. The exchange markets have enormous importance for the international financial system and for the world economy at large. From a practical perspective, they serve as a catalyst for the expansion of international trade and investment, which is essential for raising living standards here and abroad. But in addition, the exchange markets play a special economic role. They form the arena in which exchange rates are determined. Out of that process flow critical price signals influencing what is produced, where it is produced, and where it is sold. It is for these reasons that exchange market stability is of such utmost importance. Only when conditions are orderly can the markets effectively perform their basic function, that of generating a pattern of exchange rates which is consistent with fundamental economic trends and at the same time helps shape international adjustment.

As professionals, however, you know full well that on a daily basis there are many more influences on the exchange markets than just the fundamentals. Rightly or wrongly, any piece of news -- economic, political, social -- can affect people's expectations about where an exchange rate may go next. That means virtually anything can set off buying or selling of a currency, and on occasion in very large amounts. But traders don't have the luxury of disengaging from the market simply because they personally feel that the trading factor of the moment is unimportant or transitory. They must serve their customers and make markets. And they must perform their responsibilities without exposing their banks to undue risks. So while we all might hope otherwise, the internal dynamics of the exchange markets cannot always be relied upon to produce stability. In times of great uncertainty, the markets may need firm support from the authorities.

Last fall was a time when uncertainties ran unusually deep. The dollar had moved a long way against most other major currencies. Yet selling persisted and in fact broadened, despite frequent official intervention by the U.S. and other authorities. To many thoughtful market participants, there was a sense of unreality to it all. But there was little confidence that the sequence of sharp declines in the dollar almost every day would be halted or reversed by the market itself. And few were bold enough to be the first to try.

To those of us responsible for the international financial policy of the United States, the situation became intolerable. In our view, exchange rate movements for the dollar had clearly gone beyond what could be justified by fundamental economic trends. The consequences were serious. Excessive exchange rate movements threatened to make it more difficult to bring inflation under control by subjecting our economy to new upward pressures on prices.

Faced with that grim scenario, we sought to design a response to accomplish two objectives. The basic aim was to lay the foundation for a gradual improvement in confidence that could take hold more firmly as fundamental adjustments in the world and our national economy proceeded. But the immediate objective was to jolt market psychology out of the extreme bearishness that seemed to have taken over. That meant dealing with the market's concerns explicitly and convincingly.

The market's concerns had coalesced around three central themes. First was the problem of the United States inflation rate, which had increased during 1978, while inflation in other major countries had declined. What were the prospects for slowing and then reversing our performance, which was a source of dismay to all? Second was the problem of large current account imbalances -- here and abroad. Would those imbalances narrow enough and would improvement be sustained? Third was perhaps a more intangible but nevertheless deep-seated concern about the coherence of U.S. economic policy. Would there be a determined, comprehensive, and effective approach to the difficult choices we faced, choices imposed by domestic inflation, external imbalances, energy needs, and foreign exchange market disorder?

We recognized the validity of these concerns and appreciated their importance. Even so, the intensity of the pessimism manifested in the exchange markets seemed to us exaggerated.

First on the inflation problem: The President had stated unequivocally that arresting inflation in the United States was our major economic objective. A series of steps covering a wide range of policies to achieve that goal had been initiated. A gradual move to monetary restraint was under way. Fiscal policy actions were being planned to reinforce this restraint. Governmental sources of inflation were being attacked. Stricter wage-price standards were set down. In short, we had committed ourselves to deal with inflation and that commitment was being systematically implemented -- not in one grand, comprehensive package, but by individual actions taken as rapidly as possible. We recognized that results would not come overnight, and there would be setbacks along the way. There was full recognition that a moderation of economic growth, which was clearly advisable, and public support for the anti-inflation initiative together would strengthen the chances for success.

Second, on the balance of payments problem: Our current account deficit had peaked by early 1978. In subsequent months, the wide divergences between U.S. and foreign economic growth had started to narrow, and previous exchange rate movements were reinforcing the balance-of-payments impact of that narrowing. As a result, the U.S. current account deficit was declining significantly and there was progress toward reducing some of the major surpluses abroad. As it turned out, by the second half of 1978 the U.S. deficit was less than half what it had been the year before, and every indication was pointing toward further improvement.

To be sure, increases in oil prices will offset a part of the full improvement that would otherwise have occurred. How much, we don't know, because OPEC has essentially given producing countries a license to charge what the traffic will bear. Some will probably do just that. Others may take a longer view of the impact of oil prices on the world. But as you know, the United States is committed, along with other countries participating in the International Energy Agency, to a 5 percent reduction in oil consumption this year. Conservation efforts are essential, and as they take hold, petroleum imports should slacken. If we and other major consumers succeed in these conservation efforts, the surcharges which some OPEC countries hope to collect may not hold.

In any case, the oil situation is one factor that complicates the balance-of-payments outlook. Decisions of the new Iranian government to curtail military purchases are another. But U.S. exports of goods and services continue to grow strongly, and there are signs that the public is grasping the pressing need to save energy. Going through the exercise of estimating the net effect of these various influences is more difficult than usual, and I think it is premature to cite any particular forecast today. But based on preliminary findings, we still anticipate a substantial reduction in our current account deficit this year. At the same time, we expect further adjustment abroad by countries in surplus as economic growth there is maintained and in some cases expanded.

Third, on the problem of policy coherence. It is imperative for government to pursue appropriate policies. But sometimes that is not enough. There must also be an unmistakable signal of commitment. In the circumstances confronting us last October -- extreme disorder in the exchange markets and worsening inflation in domestic markets -- decisive action on many fronts was needed to dramatize a new thrust to policy. On the monetary side, the Federal Reserve acted forcefully to stiffen the degree of restraint. The discount rate was increased by a full percent and reserve requirements were raised. Those actions were important. They helped lay a firm domestic basis from which to launch a major attack against foreign exchange market disorder. To implement it, we mobilized a very large amount of resources, using a variety of financing techniques, new and old, and working in close cooperation with the Germans, Japanese, and Swiss authorities. We wanted to leave no doubt that we were fully prepared to back up our commitment to restore stability to the markets. You know the details of the November 1 financing package and how we proceeded to use it -- whenever and on whatever scale necessary to dispel any residue of skepticism about our intentions.

The results so far have been gratifying. By any standard, market conditions have been better since November 1 than before. That is not primarily because of a stream of what might be called "good news". I'd say the recent news has been mixed. Some of the numbers have been disturbing -- such as the latest wholesale and consumer price statistics. I draw little comfort from the fact that faster price rises have been recorded abroad as well as in the United States. However, other numbers have been reassuring -- for instance, the continued deceleration in the growth of the money supply in reaction to the Fed's policy of restraint. Moreover, while I avoid placing too much emphasis on one month's figures, the trade statistics for February announced yesterday do tend to reconfirm the improving trend that began last year. Still other events, inherently complex and with implications not only for the United States but for all countries, have had diverse effects on the exchange markets. The Iranian situation is a good illustration of that kind of complex development, and so is the oil supply and price situation more generally. All countries are affected, but in different ways, and the differential impact is hard to determine with any degree of certainty. I think most participants in the exchange markets appreciate that point, and have responded accordingly.

What I conclude, and take some satisfaction from, is that the underlying tone in the exchange markets has vastly improved. By itself, this has promoted a more judicious assessment by market participants of new trading factors as they come along. No longer is there a knee-jerk reaction to sell the dollar on most every item carried over the wire services. Certainly, dollar exchange rates have showed some daily variation. That is to be expected in a normal, orderly market. But rate movements are not cumulating. There is a counterweight, stemming from the market itself but occasionally reinforced by operations of the authorities, tending to restore balance. As a result, the average daily movement in most major currencies is just a fraction of what it was last October. In recent weeks, the only currency that has fluctuated fairly sharply has been the Japanese yen. In large part, that reflects shifting market perceptions of Japan's relative vulnerability to the oil situation. But I think that a firm official response is helping to reduce the erratic movements in the yen market.

There are other concrete signs of an improvement in exchange market conditions. Some of last year's leads and lags in commercial payments have been unwound. The pace of diversification has slowed noticeably and may even have been reversed in some cases. Borrowing of dollars to finance exchange positions has diminished. Investors are responding to relative interest rate incentives and are acquiring dollar assets. And perhaps most concretely, we have substantially improved our own net position in foreign currencies. Factoring in the proceeds of our foreign currency note issues and other acquisitions of currency, the United States now has more resources immediately available for current operations than we did just after November 1.

Looking to the future, I don't pretend to know with any precision how the markets will develop. From what I hear in the Street, opinions naturally differ about the possible course of rate movements over the rest of the year. But I am intrigued as much by the flavor of the comments as by the predictions themselves. Expectations do not seem to be held with any great conviction, perhaps because the past few months have been a chastening experience for a number of people. I'm encouraged by this greater sense of two-way risk in the market. It helps keep market conditions more orderly. Consequently, unless there is some major shock to the world economy, I would foresee a continuation of the generally balanced trading conditions we have now.

Whatever your own personal views on the outlook, I want you to bear in mind these final thoughts. We remain committed to the underlying principles embodied in the measures taken last fall. We will not hesitate to use our ample resources to meet our objectives. And above all, we will continue to pursue a coordinated policy of restraint to ensure that progress is made in curbing inflation, lowering payments imbalances, and achieving more moderate but sustainable growth in our economy. Surely, those are the essential ingredients for a strong and stable dollar over the long haul.

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

For Release on Delivery
Expected at 2:00 p.m.
March 29, 1979

DEPARTMENT OF THE TREASURY
OFFICE OF THE SECRETARY
NATIONAL CONSUMER COOPERATIVE BANK

STATEMENT OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE)
BEFORE THE H.U.D.-INDEPENDENT AGENCIES SUBCOMMITTEE
OF THE HOUSE COMMITTEE ON APPROPRIATIONS

Mr. Chairman and Members of this Distinguished Subcommittee:

I am pleased to present the Administration's initial budget request for the National Consumer Cooperative Bank.

The National Consumer Cooperative Bank Act was signed into law by the President on August 20, 1978. The Act establishes a bank to make sound loans at market rates of interest to cooperatives in a variety of fields. It also creates an Office of Self-Help Development and Technical Assistance within the Bank to extend capital advances and to make management and technical assistance available to cooperatives with special needs.

Last September the Administration established an Inter-agency Task Force, which I chair, to expedite implementation of the Act. The Task Force held 19 public meetings on the Bank in Washington and around the nation. At these meetings, people who are members of cooperatives or who are interested in forming cooperatives voiced deep interest in the Bank.

The Bank

The Bank is modeled on the highly successful Banks for Cooperatives, which make credit available to agricultural cooperatives. It was established to satisfy the unmet credit needs of other cooperatives, particularly consumer cooperatives. The Bank represents an effort by Congress and the Administration to achieve increased growth and stability for cooperatives in order to secure lower consumer prices, enhanced power for consumers in the market place, and a fair share in the benefits of cooperatives for low income people. The request that I present today will allow the Bank to begin moving toward these goals.

Like the Banks for Cooperatives, the Bank will initially be financed with a government investment that will be redeemed over time. And like them, it is intended to operate on a sound and self-sustaining financial basis.

The Bank's Self-Help Development Office will be separate from its lending operation. It's Self-Help Development Fund will make capital advances, or soft loans, to cooperatives which cannot secure adequate financing from hard loan sources. These capital advances will help satisfy cooperatives' need for equity and junior debt. The advances will increase

cooperatives' financial soundness and will help them qualify for conventional loans from the Bank and other sources. This is particularly important for new cooperatives and for cooperatives serving low income people. The Office's technical assistance program will offer management and technical assistance to cooperatives, including low-income credit unions that are not eligible to become borrowers.

Budget Summary

Our budget request can be summarized as follows: For FY 1979, we seek a $40 million appropriation for capitalizing the Bank (purchasing its Class A stock); $10 million for capitalizing the Self-Help Development Fund; and $2 million each for the Bank's administrative expenses and of the Self-Help Office, which include the expenses of its technical assistance program. For FY 1980, we seek an additional $60 million for Class A stock, $20 million for the Self-Help Fund, $2.459 million for the Bank's expenses, and $6.441 million for the expenses of the Self-Help Office.

Capitalizing the Bank

The moderate capital investment that we have requested is necessary to establish the Bank as a sound, independent entity capable of generating sufficient earnings from its nation-wide business to repay the government's investment over a reasonable length of time. Our FY 1979 request for funds for purchasing Class A stock is significantly below the $100 million authorized by Congress for that year. However, our fiscal year 1979 and 1980 requests together should satisfy the Bank's capital needs in those years and firmly establish it as a self-sufficient, independent entity.

The Bank's Class A stock is preferred stock yielding cumulative dividends. The dividend rate will be determined by the Secretary of the Treasury, who will take into consideration the market rate for Treasury securities of comparable maturity. Until October 1, 1990, however, dividends are limited to 25% of the Bank's net income.

The government's investment will be repaid out of the Bank's retained earnings and the proceeds of required purchases of stock by cooperative borrowers. As I noted before, the model for this procedure is the highly successful Banks for Cooperatives in the Farm Credit System. The statute requires that the Bank retire the Class A stock as soon as possible consistent with the Act's purposes. It also requires that the proceeds of all sales of Class B and C stock after October 1, 1990 be used for this purpose.

Until all the Class A stock is redeemed, the President of the United States will appoint at least six members of the Bank's thirteen member board of directors. Thereafter, he will appoint only one. I expect that after its initial organizational phase, the Bank will place a high priority on retiring the Class A stock. In this way the Bank will be independent and wholly controlled by cooperatives as soon as possible.

<u>Lending Policies</u>

The Bank's objective is to make sound loans at market rates of interest. The statute requires that every loan be fully repayable in accordance with its terms and conditions. It also requires that as long as the Bank is making loans from government capital, it must charge interest rates that are at least equal to rates prevailing in the local area for loans from other sources for similar purposes and maturities. The loan program will thus be a hard loan program.

By the end of FY 1980, the Bank should have nearly $100 million in loans outstanding if the requested appropriations are granted. This would constitute a significant step toward meeting the needs of cooperatives for conventional credit. Among the types of cooperatives assisted would be food coops, housing coops, low-income agricultural coops, energy coops, health care coops and handicraft coops. By statutory mandate, the Bank must use its best efforts to see that 35% of the total goes to cooperatives serving low-income people. Low-income people will thus share substantially in the benefits from increased growth in cooperatives. In order to assure that existing small businesses are not unfairly harmed, the Bank will assess the impact of its loans on small business.

The Bank is authorized to leverage its resources by borrowing in the credit markets. However, we assume that the Bank will do no borrowing in fiscal years 1979 or 1980. We also assume that the Bank will implement its guarantee program on no more than a demonstration basis in those years. We feel that the lack of a substantial track record would make it difficult for the Bank to sell debt on advantageous terms in these years. Sound business practice would thus lead it to look solely to its equity capital as a source of funds. We therefore ask that the Bank's authority to make or guarantee loans be limited to $40 million in FY 1979 and $100 million in FY 1980. The requested ceiling will allow the Bank to lend its capital while keeping a reasonable reserve for losses and for continuity of operations into FY 1981.

Salaries and Expenses of the Bank

The statute authorizes funds for the Bank's administrative expenses. Our request would chiefly cover the costs of establishing and operating the Bank's direct loan program. Such costs include hiring and training personnel, designing and implementing loan procedures, acquiring and remodeling office space, and the like.

Let me stress here that our request for administrative expenses reflects assumptions about the Bank's structure upon which its Board of Directors will ultimately decide. We have assumed, for example, that the Bank and its Self-Help Office will share many overhead services in order to secure cost efficiencies and that the bulk of these shared services (performed by roughly fifty full-time employees) would best be located in the Bank proper. We have also assumed that the Bank and the Self-Help Office will each maintain a separate field staff of credit analysts.

The bank will have no funds at all until it receives a FY 1979 appropriation. I therefore urge that you expedite treatment of the FY 1979 request.

Capitalizing the Self-Help Development Fund

The Self-Help Development Fund is designed to promote the growth and development of cooperatives that cannot obtain sufficient funds from other sources, particularly cooperatives that serve low-income people. The Fund's capital advances are well suited for achieving this objective. They will satisfy the need of many cooperatives for capital infusions that are subordinated to ordinary debt.

The statute requires that applicants present an acceptable plan for replacing capital advances with equity within thirty years. It also requires that advances bear interest at a rate determined by the Bank's Board of Directors. All interest income and repayments of principal will be redeposited in the Fund's capital account. The requested capital appropriations will enable the Fund to assist cooperatives on a significant scale in fiscal years 1979 and 1980.

Salaries and Expenses of the Self-Help Office and the Technical Assistance Program

Our request for the expenses of this Office is separate from our request for the expenses of the rest of the Bank. It covers the cost of setting up and operating both the Office's capital advance program and its technical assistance program. It also covers the Office's share of the cost of services provided to it by the Bank.

The Office's technical assistance program will aid cooperatives with special needs, particularly those serving low-income people. For many cooperatives, technical assistance is the most important type of aid. Such assistance could include training in management, bookkeeping, financial planning, contracting, serving on a board of directors, and membership education. It could also include training in skills relevant to a cooperative's particular line of business, such as produce buying for food cooperatives, retail marketing for retail cooperatives, or health care management for health care cooperatives. In many cases the Office may recover all or part of the cost of assistance by charging fees.

Personnel

Let us turn briefly to the question of personnel. We believe that the Bank will be able to operate effectively and economically in fiscal years 1979 and 1980 with the authority to hire 166 full-time employees. We have assumed that roughly 101 of these employees will work under the direction of the Bank's president and that roughly 65 will work under the direction of the Self-Help Office's Director. Bank on a shared-cost basis.

We have further assumed that roughly fifty of the employees working for the President and roughly eight of the employees working for the Director will perform services for the entire Bank on a shared-cost basis.

This arrangement would help secure the cost savings sought by Congress in consolidating the Office within the Bank. I suggest, however, that the Bank should have discretion to modify this structure within the overall personnel limit of 166 full-time employees.

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Thank you, Mr. Chairman and members of the Subcommittee for your attention. I will be happy to answer any questions you may have.

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

FOR IMMEDIATE RELEASE
March 30, 1979

Contact: George G. Ross
202/566-2356

TREASURY RELEASES FIRST REPORT ON
THE INTERNATIONAL BOYCOTT PROVISIONS OF
THE INTERNAL REVENUE CODE

The Treasury Department today released its first annual report on the international boycott provisions, titled, "The Operation and Effect of the International Boycott Provisions of the Internal Revenue Code."

The international boycott provisions, added to the Code by the Tax Reform Act of 1976, deny certain tax benefits to persons who participate in or cooperate with an international boycott. The tax benefits affected by the international boycott provisions are the foreign tax credit, the deferral of tax on the earnings of controlled foreign corporations, and the deferral of tax on the earnings of Domestic International Sales Corporations (DISCs).

The international boycott provisions are generally effective for operations after November 3, 1976.

The Report covers the period November 4, 1976, through December 31, 1976. It provides an estimate of the tax benefits lost and information on the number and type of boycott requests received and agreements entered into.

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B-1498

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

FOR RELEASE AT 4:00 P.M. EST March 29, 1979

TREASURY POSTPONES AUCTION OF
78-DAY BILLS

The Treasury today announced it was postponing the auction of $3,000 million of 78-day cash management bills originally scheduled for Friday, March 30, 1979. This postponement is necessary because Congressional action on legislation to raise the temporary debt limit to allow delivery of the 78-day bills is not at this time assured.

Interested investors are advised to look for notice of any rescheduling of this auction in the financial press or to contact their local Federal Reserve Bank for such information.

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WASHINGTON, D.C. 20220 TELEPHONE 566-2041

File Copy

FOR IMMEDIATE RELEASE
EXPECTED AT 10:30 A.M. EST
MARCH 30, 1979

REMARKS BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE CANADIAN-AMERICAN COMMITTEE
NEW YORK, NEW YORK

U.S.-Canadian Economic Cooperation: Harbinger of Global Accords

The United States and Canada share a special relationship across a broad spectrum of mutual interests and concerns. As neighboring nations, we share the world's longest open border, a common heritage, similar endowments of natural resources, and a history of strong independence. Canada and the United States have joined hands in addressing problems in a number of crucial areas in our bilateral relations, ranging from trade in automobiles and agricultural products to environmental issues and national security. As industrialized nations with a strong stake in the global economy, the United States and Canada have worked closely together

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in multilateral forums, as well, to address mutual problems and to create and maintain a framework for beneficial economic exchange with all nations.

The need for continued cooperation is especially critical in the area of international trade and investment. The magnitude of trade and investment flows between the United States and Canada gives each country a distinct and almost unsurpassed importance in the other's economy:

-- We are each other's largest trading partner, and indeed we carry out by far the largest bilateral trading relationship in the world. U.S.-Canadian trade accounted for one-fifth of total U.S. trade in 1977, and 70 percent of total Canadian trade.

-- The total value of U.S. trade with Canada ($62 billion in 1978) is slightly more than U.S. trade with all nine members of the European Community and exceeds U.S. trade with the OPEC nations as a group.

-- The United States is the largest foreign investor in Canada, and Canada is the third largest foreign investor in the United States. Canada's private direct investment in the United States now totals $6 billion. U.S. investment in Canada is more than $35 billion.

-- New flows of capital for direct investment from Canada to the United States have exceeded U.S. flows to Canada for the past few years.

The size of these flows, and the relative ease with which goods and capital cross our shared border, make it inevitable that problems and tensions will arise. Indeed, problems in U.S.-Canadian economic relations have often served as harbingers of later, global issues of a similar nature. This was true for a number of international monetary issues during the 1960s. Today the use of domestic and export subsidies which affect trade flows, export controls, conditional duty remissions, responses to the operations of multinational corporations, investment incentives, and procurement or offset requirements are clear cases in point.

The ability of the United States and Canada to deal with such problems, and our efforts to assure that new problems will not arise, is critical for maintaining effective bilateral relations between our two countries. Beyond this, however, U.S.-Canadian ingenuity in dealing with bilateral economic issues can help provide a framework for shaping international solutions to global concerns of a similar nature. Indeed, there would seem to be little hope of reaching successful global accomodations on such difficult matters if the United States and Canada, with their long history of cooperation and strong mutual interest in peaceful settlement of economic disputes, cannot do so. I would therefore like to take this opportunity to discuss a few of the areas where cooperation between the United States and Canada is critical, both to our bilateral relations and to the future of global economic cooperation.

Investment Incentives

The proliferation of investment incentives, frequently coupled with such measures as domestic or export performance requirements and offsets, is becoming a potential irritant in U.S. relations with Canada and other countries. These measures are becoming more widespread throughout the world. However, cases involving the use of incentives in North America are more likely to cause tensions, primarily because of the geographical proximity of our two countries.

We in the United States are fully cognizant of the economic problems facing Canada at this point in time, and thus sympathize with the desires of Canadian authorities to adopt policies to deal with them. However, we too have serious economic problems. And, as a longer run proposition, we cannot condone efforts by one country to shift its economic burdens to another. These issues are of concern not only to the Administration but to the Congress, as indicated most recently by Senator Javits on the floor of the Senate on March 22.

Several recent cases illustrate the practices I am referring to and the problems they can cause from the U.S. point of view. I am sure that Canadians could cite cases of their own. Indeed, Canadians have commented widely on their own practices in this area; today I would like to add our viewpoint on them.

(1) Six years ago the U.S. Treasury Department determined that the assistance grants and loans extended by the Governments of Canada and Nova Scotia to the Michelin Tire Corporation constituted a bounty or grant under the U.S. countervailing duty law. The determination was based on a decision that the investment incentives, while designed to promote the development of an economically depressed area, actually had the effect of assisting tire exports to the United States. The case is still in litigation in the U.S. Customs court.

(2) Last year the Canadian Government, in conjunction with the Province of Ontario, offered the Ford Motor Company an inducement of $68 million to build a new plant in Ontario rather than Ohio. In August, Ford announced its decision to build its plant in Ontario. The U.S. Government has strongly objected to the use of such incentives, which distort the economically efficient allocation of resources and can result in the loss of U.S. export opportunities and U.S. jobs.

(3) The use of offset requirements in connection with procurement of goods from foreign firms is also increasing in Canada. The purchase of goods from a firm is conditioned on agreement by that firm to enter into licensing or co-production arrangements in Canada. This practice was concentrated at first in the area of defense procurement, but its use by the Canadian and other governments is becoming a common practice in large commercial transactions as well.

(4) The Canadian Government has also recently announced new government investment incentives for the forest products industry, which could serve to stimulate exports in this area. Roughly half of Canadian production of forestry products is now exported, principally to the United States. Further stimulation of exports could be a sensitive issue, and might run afoul of the U.S. countervailing duty statute or the proposed international Subsidy/Countervailing Duty Code. I understand that the Canadian Government has similar reviews of some 20 other industrial sectors underway, as potential beneficiaries of government assistance.

(5) In January of this year Treasury determined that Canadian Government grants to Honeywell in 1975 for optic liquid level sensing systems also involved

a countervailable subsidy. This conclusion was reached after Treasury concluded a detailed examination of the uses to which the funds were put and, consistent with the Michelin decision, determined that the *ad valorem* subsidy was significant and a preponderance of the production was exported. Treasury did not, by extension, decide that research and development grants *per se* are a bounty or grant under the U.S. countervailing duty law. Rather, the decision rests on the particular use of the funds in the specific cases and its potential impact on trade.

Policy Responses

A number of U.S.-Canada trade and investment problems are therefore on the table. Fortunately, steps are being taken on both sides of the border to help deal with them.

For one thing, some of the new international arrangements worked out in the Multilateral Trade Negotiations will limit the use of such incentives as export and other subsidy practices. The major provisions of the new Subsidy/Countervailing Duty Code, which I will discuss later, are particularly relevant.

In addition, the development of disciplines over government policies toward investment flows is an important element of the U.S. Government's approach to international economic policy. My colleagues in other agencies and I have recently discussed these problems bilaterally with Canada, with other key industrialized countries, and multilaterally in the OECD.

Our talks with Canada focused initially on the Canadian incentives offered to Ford, but have broadened to cover the use of investment incentives in general. There is general agreement that the use of public funds for these purposes on both sides of the border is, as our Canadian colleagues put it, "a mug's game". We are continuing to meet bilaterally to discuss the issues in this area in greater depth.

The United States is encouraged by a statement made earlier this month by the Canadian Government that Canada is anxious to pursue an agreement with the United States on the use of incentives in the automobile sector. In announcing new measures to promote the Canadian auto industry, Jack H. Horner, the Canadian Industry, Trade and Commerce Minister, said: "The Government's position is that its involvement in competitive subsidization with U.S. federal, state or municipal governments is a costly, no-win proposition for the governments. Such intervention in the investment decision-making process will lead to uneconomic decisions."

He went on to add that "The Government will pursue, on an urgent basis, discussions with U.S. authorities on the question. The objective of the discussions will be to reach agreement to contain such investment incentives."

The United States welcomes this initiative by the Canadian Government and hopes that our continued discussions will help improve cooperation in this area. Any bilateral resolution will give us a head start in moving toward multilateral arrangements as well.

Mr. Horner indicated, however, that pending negotiation of such an agreement his government "will not stand by while investment is lost as a result of incentives available in other countries." To this end, it will offer special assistance to the provinces when they lack the resources to compete.

A key aspect of U.S. discussions with the Canadians will thus be participation by the U.S. states. Canadians obviously regard them as competitors for investments and will be anxious to have at least some of them involved in any understandings we might reach on the incentives question. One idea is for the leaders of selected states and provinces to begin a dialogue in this area among themselves. Our governments will be considering this and other approaches in the months to come, while continuing to discuss the substantive issues involved in the incentives problem.

The United States is also raising the problem with other countries on a multilateral basis, primarily in the Organization for Economic Cooperation and Development (OECD). Progress on this front has been slower, but is now proceeding.

We face some formidable difficulties in trying to promote agreement on the need to curb governments' use of investment incentives. One stems from the fact that investment is relatively new as a major vehicle for international economic exchange. As a result, most governments have not yet recognized the need for international cooperation on investment, even though they long ago recognized the need for rules in the other major spheres of international economic activity -- trade and international monetary relations.

Some governments recognize the dangers inherent in competition with others for investments and are uncomfortable about it. However, they find it politically impossible to de-escalate unilaterally and are pessimistic about the chances of persuading others to join in a general reduction in the use of incentives.

Yet, situations are developing abroad which have the potential for generating the same sort of international tensions that have occurred in U.S.-Canadian bilateral relations. Many governments are striving vigorously to attract foreign investments as a solution to their economic and social ills. The firms being courted are in a position of being able to benefit handsomely at the taxpayer's expense by pitting one country -- or political subdivision -- against others. A case in point is the incentives competition that is developing among a number of European countries seeking to win a prospective investment by the Ford Motor Company.

To the U.S. Government, the need for international cooperation to head off the further development and sharpening of this competition is obvious. It will not be achieved overnight at a simple stroke; rather it will emerge from a long process of discussion and negotiation. We hope that our discussions with Canada will prove to be a significant step in that direction.

U.S.-Canadian Trade

Bilateral trade between the United States and Canada almost doubled between 1973 and 1978, from a level of approximately $32 billion to nearly $62 billion. In 1978 the United States exported $28 billion in merchandise trade to Canada, and imported

$34 billion in goods from Canada. Canada is our single largest partner for both imports and exports.

About two-thirds of total U.S.-Canadian bilateral trade is in manufactured goods. The United States exports more engineering products and machinery for specialized industries to Canada than we import from Canada, while importing more motor vehicles, raw materials, and fuels. Total primary products account for nearly one-third of U.S. imports from Canada. Aside from these areas, however, U.S.-Canadian import and export trade is evenly dispersed across a broad spectrum of products.

This complementarity of U.S.-Canadian trade, and our strong dependence upon one another for primary goods, semi-manufactures and manufactured products alike, emphasizes the importance of cooperation in the trade area -- and the need to avoid artificial incentives or restraints which distort normal trading patterns. It is inevitable that the proximity of our markets and the competitive nature of U.S. and Canadian production of a number of goods can at times cause problems, if sharp rises in exports threaten employment and production in the importing nation. But Government intervention has also been the source of a number of trade problems in recent years. We have worked together in helping to resolve such problems in the past, and must continue to do so in the future.

The U.S.-Canadian Automotive Agreement represents the most comprehensive effort to deal with bilateral trade problems in a constructive and mutually beneficial manner. Negotiated in 1964 and implemented in 1965, the Agreement set forth these objectives:

1. Creation of a broader market for automotive products within which the full benefits of specialization and large-scale production can be achieved;
2. Liberalization of U.S. and Canadian automotive trade in respect to tariff barriers and other factors tending to impede it, with a view to enabling the industries of both countries to participate on a fair and equitable basis in the expanding total market of the two countries; and
3. Development of conditions in which market forces may operate effectively to attain the most economic patterns of investment, production, and trade.

The Auto Pact was also designed to head off potential conflicts over Canada's efforts to improve the performance of its automotive industry. The catalyst for negotiation of the Agreement was the possible imposition of countervailing duties by the United States against a Canadian scheme for subsidizing exports of automotive products by means of conditional duty remissions on imports. Canada had a deficit of $560 million in automotive products trade with the United States in 1964 and expected the deficit to grow over the next few years.

As a result of the Agreement, Canada did not introduce export subsidies and did not impose additional restrictions on imports of U.S. automobiles. In effect, the Agreement permitted Canada to develop a more efficient automotive industry without damaging the long-term interests of the auto industry, workers, and consumers on the U.S. side of the border. Free trade in specified new motor vehicles and original equipment automotive parts helped to create an integrated North American industry and market with the benefits of specialization and large-scale production for both nations. As a result of the Agreement, total bilateral automotive trade grew from $720 million in 1964 to over $20 billion in 1977.

Canada in particular has gained an efficient automobile industry, lower prices to consumers and improved wages and employment. The United States has maintained a substantial market for automobiles in Canada and has experienced increasing export opportunities in automotive products.

The Auto Agreement offers a clear example of the mutual benefits which can be gained from duty-free trade in a given sector. Even so, there are lingering problems. Canada remains concerned about its deficit in automotive products, particularly automotive parts trade with the United States. However, the overall Canadian deficit on automotive products declined from $1 billion in 1977 to $473 million in 1978, and recent exchange rate changes should help reduce the deficit further in the future.

In an effort to help Canadian parts manufacturers, the Canadian Government announced a duty remission agreement with Volkswagen Canada, Ltd., in June of last year. The purpose of the plan is to increase sourcing of Canadian parts through duty reduction on VW auto imports from Pennsylvania and other locations. The duty reduction is determined by the value of Canadian automotive components exports purchased by Volkswagen. Additional schemes are now planned with Nissan and other firms. We have expressed our deep concern to the Canadian Government about them.

Multilateral Trade Negotiations

While individual instances of measures taken in possible violation of the GATT can be dealt with on a case-by-case basis, as in U.S. dealings with Canada on the Michelin case and the auto duty remission plans, a broader approach is required.

The MTN affords a major opportunity for broader cooperation. One of the U.S. Government's most important objectives in the MTN was the negotiation of a code regulating the use of subsidies and countervailing measures. Canada is one of the most important participants in that process. Negotiation of a code is essentially completed. We believe that the code will promote the smooth unfolding of future U.S. trade relations with Canada and other code signatories in this critical area.

In particular, the code provides new guidelines regarding the use of subsidies in the following areas:

(1) There is a <u>much stronger prohibition of industrial export subsidies</u>, complemented by an updated list of prohibited export subsidy practices. This new list includes practices such as export inflation insurance, exchange risk guarantees, and duty drawbacks in addition to items carried over from the previous GATT list.

(2) There is an explicit recognition that <u>countries must accept responsibility for the trade effects of their domestic subsidy programs</u>, and commit themselves to <u>avoid granting such subsidies that adversely affect the trade interest of other countries</u>.

(3) Domestic subsidies which impair GATT tariff bindings through import substitution are subject to countermeasures as a violation of GATT commitments. Such subsidies may include, but are not limited to, regional development grants, research and development grants, government provision of infrastructure services and government financing of commercial enterprises, including provisions of loans and guarantees on non-commercial terms.

(4) Export subsidies on industrial products to third markets are subject to countermeasures, as are export subsidies on agricultural products which displace the exports of others or involve material price under-cutting in a particular market.

(5) Developing countries for the first time are agreeing to phase out the use of export subsidies as part of their obligations, commensurate with their competitive needs, under the new code.

(6) These provisions are complemented by new rules regarding the use of countervailing duties, and by the adoption of an injury test in U.S. law.

We have also made substantial progress in other MTN codes. The United States is pleased that one of the most difficult elements in the U.S.-Canadian phase of the MTN talks has been resolved favorably, with Canada's tentative decision to sign the Customs

Valuation Agreement. This is a welcome sign that Canada is willing to take even very difficult steps to reduce barriers to trade between our two countries. Canada's adherence to this code will greatly help to eliminate a significant nontariff barrier to trade among all developed, and some developing, countries.

Future of U.S.-Canadian Economic Relations

The agreements worked out multilaterally in the MTN, and which the United States and Canada are seeking on a bilateral level, will promote a continuation of positive trade and investment relations between our two countries as trade and investment flows continue to grow.

It is clear that both countries are anxious to obtain the greatest possible economic benefit from international trade and investment. Hence, we must not lessen our attempts to eliminate obstacles to them. This is true not only because of the resulting benefits to our bilateral relationship, but because it is also clear that any bilateral actions we take -- such as an agreement to regulate investment incentives -- may well set a pattern for broader, perhaps even global, arrangements at a later time.

This is not an easy task. But the U.S. Government firmly believes that heightened cooperation between the United States and Canada in the area of trade and investment will provide benefits that will reach beyond our own borders. It could set the stage for more effective international approaches to problems that beset all nations, and could pave the way for greater international economic cooperation in the future.

Department of the TREASURY NEWS

WASHINGTON, D.C. 20220 TELEPHONE 566-2041

IMMEDIATE RELEASE
March 30, 1979

CONTACT: Charles Arnold
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STATEMENT BY DEPARTMENT OF THE TREASURY

As a consequence of the failure to raise the Nation's debt limit this week, the following actions have been taken:

1. The auction of $6.0 billion of 91-day and 182-day bills originally scheduled for Monday, April 2, 1979, was postponed. In addition to this auction postponement, the Treasury Department has postponed five offerings of bills, notes and bonds since March 20, 1979. These postponements were necessary because without legislation to raise the temporary debt limit the Treasury could not assure delivery of the securities. After March 31, 1979, the Treasury Department cannot issue any Treasury obligations until final Congressional action is completed on the debt limit legislation, and it is signed into law.

2. Effective Monday, April 2, all sales of U.S. Savings bonds are suspended because bonds cannot be issued.

3. All of the Treasury's funds in tax and loan investment accounts with commercial banks have been called in order to maximize operating balances at Federal Reserve Banks.

4. All available securities in the Exchange Stabilization Fund have been redeemed in order to allow the Treasury to borrow approximately $3 billion from the Federal Reserve without exceeding the current debt ceiling.

5. The Federal Reserve Board has been requested to accelerate from April 3 to April 2 its regular monthly payment of earnings of approximately $700 million to Treasury.

6. Beginning Monday, April 2, cash inflows into the Social Security, Civil Service and other trust funds will not earn interest.

Present cash projections confirm Secretary Blumenthal's statement March 12 that without an increase in the temporary debt ceiling, the easury will be unable to meet its obligations on Tuesday, April 3.

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

FOR IMMEDIATE RELEASE March 30, 1979

TREASURY POSTPONES WEEKLY BILL AUCTIONS

The Treasury today announced it was postponing the weekly bill auctions totaling $6,000 million originally scheduled for Monday, April 2, 1979. This postponement is necessary because Congressional action on legislation to raise the temporary debt limit to allow delivery of the bills is not at this time assured.

If feasible, these auctions will be held on Tuesday, April 3. 1979. Interested investors are advised to look for notice of any rescheduling of these auctions in the financial press or to contact their local Federal Reserve Bank for such information.

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B-1502

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

FOR IMMEDIATE RELEASE March 30, 1979

TREASURY TO SUSPEND SAVINGS BONDS SALES

As a result of the inaction of the Congress to increase the debt limit, the Department of the Treasury today announced that the sale of U. S. Savings Bonds, Retirement Plan Bonds and Individual Retirement Bonds would be suspended effective April 2, 1979, until further notice. Without new legislation to increase the public debt limit, the Government lacks authority to issue new debt obligations.

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.

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B-1503

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

For Release Upon Delivery
Expected at 10:00 a.m.
April 3, 1979

STATEMENT OF
DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY OF
THE TREASURY (TAX LEGISLATION)
BEFORE THE SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON PRIVATE PENSION PLANS
AND EMPLOYEE FRINGE BENEFITS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear before you today to present the Treasury Department's views regarding additional tax incentives for savings by individuals as well as certain other retirement plan issues. It is our understanding that the Subcommittee is interested in the Department's reaction to four areas: tax deductions for employee contributions to qualified plans or for contributions to IRAs by those participating in such plans, deductible IRA contributions by spouses, revisions to the income tax treatment of lump sum distributions from plans and tax credits for small employers who establish qualified plans.

DEDUCTIBLE CONTRIBUTIONS BY ACTIVE PARTICIPANTS

S. 75, introduced by Senators Dole and Nelson, Section 203 of S. 209, introduced by Senators Williams and Javits, and S. 557, introduced by Senator Bentsen, would allow a deduction for employee contributions by active participants in employer-sponsored plans. Both S. 75 and S. 209 allow deductible contributions to be made by any participant earning below a specific level, with contributions by those earning above the safe harbor amount deductible only if the plan is nondiscriminatory.

S. 557 would allow deductible contributions by any participant without regard to satisfaction of a nondiscrimination test.

We would first like to examine the basic objectives of these bills and to discuss certain general tax policy issues involved in achieving these objectives.

Present law allows employees who are not active participants in qualified plans to deduct up to $1,500 annually for contributions to an Individual Retirement Account (IRA). Denial of a deduction for IRA contributions by an employee who is an active participant in a qualified plan is based on the assumption that such employees do not need an IRA to provide for retirement. This assumption may not be in accord with the facts.

Some participants in an employer-sponsored plan will receive little or no benefit from the plan at retirement. These participants are in plans which provide minimal benefits either to all participants or to those in lower wage brackets; they are also in plans which provide deferred vesting which does not generate benefits for them because of frequent job changes. These employees will tend to oppose the establishment of qualified plans or will seek to opt out of such plans in favor of individual IRAs. We believe this interferes with the long-run goal of retirement security for all workers which can be better achieved through employer-sponsored plans. Thus, we are sympathetic to one of the objectives of these bills -- to reduce the attractiveness of IRAs to those who have an option to participate in an employer plan.

We agree that any narrowly targeted solution to this dilemma will be either intolerably complex or inequitable. For example, the small benefit problem could be alleviated by allowing participants to "make up" the difference between the employer contribution on their behalf and the maximum deductible IRA contribution they could make. The difficulty here is that any attempt to determine the amount an employer contributes on behalf of an employee under many types of defined benefit plans either will be extremely complex or will involve rough approximations which may not be equitable. While it is less burdensome to determine the amounts allocated to a participant under a defined contribution plan, limiting the availability of "make up" IRAs only to participants in defined contribution plans would be an unacceptable distinction on grounds of equity and would be a further preference for defined contribution plans which we believe to be less able to provide adequately for retirement.

Further, any attempt to provide for deductible contributions while a participant has no vested interest could lead to pressure from long service employees for a slower vesting schedule, which is obviously contrary to the goals of ERISA.

Since it is not feasible to narrowly focus on those participants who will eventually receive little or no benefit from the qualified plan, we need to examine a more far-reaching approach: encouragement and broadening of retirement savings in general.

We support the objective of broadening retirement savings, but we continue to insist that there must be adequate assurance of nondiscriminatory coverage and benefits. Nondiscrimination in the enjoyment of tax benefits associated with savings for retirement is essential.

Under an income tax, income is subject to tax when earned, whether it is consumed immediately or put aside for a rainier day. Tax incentives for retirement savings work to defer tax until income is spent, presumably after retirement. This departure from the goal of a progressive income tax system can only be justified as a means of furthering nontax social policy goals. In this case, we believe the goal is the assurance that employees at all levels of compensation will be provided with retirement protection, protection which is particularly difficult to plan and save for at low income levels. As evidence of this goal, favorable tax treatment is generally allowed only if contributions or benefits provided by employer contributions do not discriminate in favor of officers, shareholders and highly compensated employees.

Without this nondiscrminiation requirement the tax system is ill-equipped to provide for those with low or moderate income. The higher a taxpayer's income, the greater the benefits of favorable tax treatment. Thus, the absence of a requirement that low-income employees receive benefits under a tax-favored program leads, quite logically, to unequal utilization of the tax benefit. This result is dramatically illustrated by the most recent figures available regarding the utilization of the current IRA deduction. Treasury estimates that of employees able to utilize an IRA in 1977, over 52 percent of those with adjusted gross income of $50,000 or more did so, while the average utilization rate was was under five percent for those with $20,000 or less of adjusted gross income. (Tables 1 and 2.)

In turning now to the specific proposals to be considered today, we will approach each bill on the assumption that it will be acceptable only if low paid workers--those who are most in need of retirement savings as well as least able to plan and save for retirement--actually participate in substantial numbers.

S. 557 - Deductions by Any Active Participant

As noted above, S. 557 allows an active participant to make a deductible contribution to a qualified plan or to an IRA. The deductible limit is the lesser of 15 percent of compensation or $1,500, the same as the current limits on contributions to IRAs. S. 557 would not apply to participants in government plans or to employees of tax-exempt organizations who participate in salary reduction tax sheltered annuity plans.

Although we acknowledge that S. 557 would probably encourage some additional retirement savings, we believe it does not pass the test set out above that it be designed to assure or encourage savings by relatively low-paid workers.

As noted above, utilization of tax benefits increases at higher income levels since the benefit of a deduction is greater as income increases. Since the tax benefit for high paid employees is not predicated on substantial savings by other employees, we believe the effect of S. 557 will be much like that of the current IRA--utilization at income levels above $50,000 will be more than 10 times higher than utilization at levels of $20,000 or less. Moreover, there are proportionally more active participants than nonparticipants among those at high income levels. Therefore, we oppose S. 557.

S. 75 and Section 203 of S. 209: Deductions by All Active Participants, Subject to an Antidiscrimination Test for High Paid Employees

S. 75 and Section 203 of S. 209 would allow active participants earning below a specified level to make deductible contributions of up to $1,000 to their employer's plan or to an IRA, while participants above the specified income level will be allowed a deduction for contributions only if contributions are also made, on a nondiscriminatory basis, by employees earning lesser amounts.

Under S. 75, the specified pay level is Step 1 of GS-14, which is currently $32,442; under S. 209, the level is Step 1 of GS-12, currently $23,087. In addition, each bill allows into the safe harbor those earning above the specified income level if their compensation is within the lower two-thirds of all participants.

This approach raises the following issues:

(i) Assuming a nondiscrimination test is to be applied to the allowance of deductions for high-income individuals, does it make sense to waive the test for those at lower income levels?

(ii) If so, how should the cut-off point be determined?

(iii) What criteria should be utilized in developing a staisfactory test of nondiscrimination?

Determining the Cut-off Point

As indicated above, a tax deduction for retirement savings is much more likely to impact on those at high-income levels who have both the ability to save and significant tax savings from doing so. The lower income group will be covered in qualified plans not necessarily in response to the tax savings offered to them alone but because it is essential to do so in order for the high-income group to obtain their tax savings.

The non-discrimination test is thus aimed at the behavior of high income employees and there may be no need to apply it to the lower paid. Withholding tax benefits from the top one-third, unless there is nondiscriminatory coverage, may be sufficient incentive to assure the widespread participation we seek. Setting the cut-off point based upon income level can only be acceptable if this type of incentive remains.

We estimate that over 96 percent of all employees in the United States have salaries and wages of $32,000 or less, and that over 94 percent have salaries and wages of $23,000 or less.* Based on these statistics, we believe the presently proposed safe harbors are too high. Since most of the population would be able to take advantage of the tax break without regard to participation by others there will be little encouragement of savings by workers in

* These figures include government employees.

the lowest paid group which is the goal of the favorable tax treatment. Moreover, we are concerned with the effect on tax equity if the safe harbor level is as high as $32,000. Our experience with IRA utilization levels indicates that the preponderance of use will be among those at the top of the eligible group. While people at that income level are certainly not rich they are in the top 4 percent of all earners and it is difficult to support what amounts to a tax deduction for this group and not to those earning less.

Thus, we are not willing to support a safe harbor unless it is targeted to a much smaller group; those employees who are most in need of encouragement to save for retirement. Our statistics show that over 75 percent of all workers (including government employees) would be covered by a safe harbor of $15,000. We believe a safe harbor in this general area would allow significant numbers of employees to take advantage of favorable tax treatment for retirement savings while maintaining the incentive for widespread coverage and limiting the disproportionate utilization of the tax benefit by higher paid employees.

With respect to those above this level, an antidiscrminiation test is essential to permit them to deduct their contributions. If such a test is believed to be difficult to administer, we could limit the deductibility of contributions to only those earning at or below the safe harbor level. However, if we assume that allowing deductible contributions by higher paid employees when an antidiscrimination test is met will have the effect of giving these employees an incentive to encourage savings by low-paid employees, then an antidiscrimination test should be included in the bill in order to achieve a wider breadth of savings.

Testing for Discrimination

Under current law and administrative practice, an equal dollar for dollar comparison is not necessary to satisfy the antidiscrimination requirements of qualified pension plans. For example, in defined contribution plans, the rule is that employer contributions which are allocated to participants' accounts are acceptable if they are equivalent as a percentage of compensation. S. 75 and S. 209 test for discrimination by comparing the level of contributions for all highly compensated employees as a group with the contribution level of all other employees. However, even within this approach, S. 75 and S. 209 depart from the general standard of equality and allow greater percentage contributions for highly compensated employees than are made by the remaining individuals. We recognize that some exceptions are allowed from the equal percentage test of equality as, for example, under the provisions allowing a defined contribution plan to be "integrated" with the employer's Social Security contributions. We also note that the antidiscrimination tests reflected in S. 75 and S. 209 are adopted from the test for cash or deferred profit sharing plans added to the Code by the Revenue Act of 1978. However, we do not believe it is necessarily appropriate to incorporate these tests in the area of deductible employee contributions to qualified plans.

The tests adopted for cash or deferred profit-sharing plans reflect in part the historical background of such plans. Under Internal Revenue Service rulings, cash or deferred plans were deemed acceptable if one-half of the contributions to the plan come from the bottom two-thirds of employees. This allowed the top one-third of employees to contribute twice as much as the average contribution from the bottom two-thirds. In order to revise these rules, it was necessary to effect a compromise measurement of discrimination, and this compromise is reflected in the 1978 Act provision.

Furthermore, we believe it is clearly inappropriate to measure limited contributions made by an employee as a percentage of his or her total compensation. Limiting deductible employee contributions to the lesser of 10 percent of compensation or $1,000 reflects an intent to focus on replacement of the first $10,000 of earnings. A substantial limit on contributions without a limit on the salary taken into account for the computation is inconsistent with this purpose since it results in high-paid employees making the maximum deductible contribution without generating a significant contribution for low-paid employees. For example, a $100 contribution for an individual earning $10,000 would permit the maximum $1,000 contribution for an individual earning $100,000.

If an antidiscrimination test based on compensation is used, the appropriate measurement is one which limits the compensation taken into account to the level which permits the maximum dollar amount of contributions. Therefore, in S. 75 and S. 209, the deferral should be determined on the basis of an employee's compensation up to $10,000.

Contributory Plans

Once the approprate safe harbor level and antidiscrimination test are determined, the most significant remaining issue is the treatment of employee contributions to plans under which employer contributions, or benefits derived from employer contributions, are geared to contributions by employees. We refer to these plans as "contributory."

Under Section 203 of S. 209, deductibility of employee contributions to contributory plans would be limited to plans in effect on January 1, 1978; under S. 75, all contributory plans, including those established after enactment, would be acceptable vehicles for deductible employee contributions.

We have a number of concerns relating to allowing deductible contributions to contributory plans.

First, there will be a substantial revenue loss attributable to contributory plan deductions without a corresponding increase in savings. For example, of the $1.1 billion revenue loss we estimate for S. 557 in the current calendar year, the largest portion--about $850 million--will be for employee contributions which are currently made on a nondeductible basis.

We are also concerned that allowing deductions for contributions to these plans will encourage their establishment, and that this may lead to a potential loss of retirement security for low paid workers. While we know of no detailed study, it is reasonable to believe that the level of participation in contributory plans among eligible employees increases as income rises. We do not believe that any of the arguments advanced in favor of contributory plans are forceful enough to justify them if, in fact, they deviate from the overall goal of retirement security.

In this connection, we would like to review four areas of the Internal Revenue Code applicable to contributory plans, which we believe should be considered.

First, a contributory plan may take advantage of a special safe harbor arithmetical test available for determining whether its coverage meets the minimum requirements of the Code. This test allows a plan to meet the coverage requirements if at least 70 percent of all employees who have met the plan's minimum age and service requirements are eligible to participate and 80 percent of the employees who are eligible do participate. For example, if 100 employees have met a plan's age and service requirements for eligibility, then only 70 employees actually must be eligible to participate, and only 80 percent of those employees--or 56 individuals--need to participate to satisfy this test.

If a plan does not meet the arithmetical safe harbor coverage tests, then it may still satisfy the minimum participation requirements by satisfying what is referred to as a fair cross section test. Under this test, the employer may show that the plan covers employees in all compensation ranges and that those in the middle and lower brackets are covered in more than nominal numbers. We believe that a plan which covers only the top 55 percent of employees would not satisfy the fair cross section test; thus it seems incongrous that a plan which covers only one more percent may satisfy the arithmetical test.

Second, the Code requires that a plan must provide for vesting in employer contributions at a rate or rates which satisfy certain tests based on an employee's years of service (or a combination of age and years of service.) However, service with an employer during a period in which an employee was eligible to make contributions to a contributory plan but did not contribute may be excluded in determining an employee's years of service for vesting purposes. Thus, to the extent an employee is prevented by outside economic pressures from participating in a plan, he or she will lose not only the employer derived benefits attributable to his or her contributions for that period but also vesting credit for service with the employer which may affect the employee's entitlement to employer benefits for those periods he or she is able to contribute.

Third, the rules relating to the allocation of a participant's accrued benefit between the portion derived from employee contributions and the portion derived from employer contributions in a contributory plan are often extremely unfair to younger participants. The Code generally requires that an employee's accrued benefit must grow at an equal or near equal rate for each year he or she is credited with service under a plan. However, ratable accrual focuses on the total accrued benefit of the participant under the plan. In effect, allocation of employer- and employee-derived benefits based on a participant's total benefit defeats the equal accrual rate requirement since the employer derived portion of a benefit may not be significant until a participant nears retirement age. A younger employee may be entitled merely to the return of his or her own contributions.

Fourth, a plan may provide that a participant who withdraws his or her contributions from a contributory plan will forfeit the employer benefit attributable to those contributions. Although ERISA denies this forfeiture once a participant has a 50 percent vested interest in employer contributions, the forfeiture provision may still work a substantial hardship on the withdrawing employee.

These rules lead us to two conclusions. First, it seems that contributory plans may be suspect as a means of avoiding many of the participant protections provided by ERISA. Second, since low-paid employees are most likely to be subject to significant outside economic pressures which will interfere with their ability to make contributions to a plan, we believe these employees are most likely to be adversely affected by the encouragement and continuation of contributory plans. Accordingly, we would prefer to limit the deductibility of employee contributions to those made on a voluntary basis, that is, employee contributions which do not generate employer contributions or benefits.

Mechanism for Employee Contributions

Finally, we would also like to comment on the issue of how employee contributions should be handled. Under S. 75 and Section 203 of S. 209, an employee may contribute either to an IRA or to his or her employer's qualified plan. It is not clear whether it is intended that an employee's contributions to an IRA may be taken into account in determining whether the employer's plan satisfies the nondiscrimination tests.

If an approach to the general issue of deductible contributions is adopted which does not involve an anti-discrimination test, we have no objection to allowing employees to contribute directly to IRAs without employer involvement. However, if an antidiscrimination test is adopted, then we believe that employee-established IRAs should not be counted in determining whether the anti-discrimination test is met, unless there is some way of checking on the IRAs both by the employer and by the IRS. If an acceptable mechanism can be established for certifying and verifying "outside IRAs" we would have no objection to this approach.

DEDUCTIBLE IRA CONTRIBUTIONS BY SPOUSES

S. 94 is concerned with a different aspect of retirement security than S. 75, Section 203 of S. 209 or S. 557. S. 94 is concerned with the security of a spouse who either does not work outside the home or earns less than $10,000 per year from such work. It would allow the spouse of an employee to make deductible contributions to an IRA based upon compensation equal to his or her spouse's compensation.

The bill would also repeal the current spousal IRA provisions of the Internal Revenue Code which allow up to a $1,750 deduction by an employee if equal contributions are made on behalf of the employee and his or her nonemployee spouse.

Treasury estimates the revenue loss of S. 94 would be $336 million for the current calendar year, rising to over $1 billion by 1984.

Although we recognize the goal of extending tax favored retirement savings to spouses, we believe the utilization of these IRA deductions would be similar to the utilization under current law which, as noted above, is over 52 percent for employees with more than $50,000 of adjusted gross income and less than 5 percent where adjusted gross income is below $20,000. In addition, there are many who believe that the two-worker family is overtaxed as compared to the one-worker family or unmarrieds living together. Therefore, we do not feel tax equity necessarily would be served by allowing up to a $3,000 IRA deduction for married persons in one-worker families outside the context of an overall solution to the relative tax burden of married and single persons. For these reasons, we oppose S. 94.

REVISIONS TO LUMP SUM DISTRIBUTION RULES

Section 201 of S. 209 modifies the aggregation rules contained in the Internal Revenue Code relating to the special tax treatment given lump sum payments from qualified plans. In general, the aggregation rules require that the balance to the credit of an employee must be paid from all deferred compensation plans required to be aggregated, or no lump sum treatment is possible. Generally, the present law requires the aggregation of all pension type plans and the separate aggregation of all profit sharing type plans. In the case of multiemployer plans, the bill would divide the various plan forms into defined benefit plans and defined contribtuion plans. In all other cases, the bill retains the present law, i.e., a division between pension types and profit sharing types. The significant change under the rules contained in the bill is that a defined contribution money purchase pension plan will not have to be aggregated with a defined benefit pension plan if they are both multiemployer plans.

Treasury is not opposed to this change. However, we believe that lump sum treatment should depend upon an aggregation of qualified plans of all types. Thus, we would favor the computation of tax, in the case of a lump sum distribution from one class of plan, as if the value of benefits held in all other classes had already been distributed. The effect of this would be to apply a higher rate of tax to a lump sum distribution if a benefit is being held in another type of plan for later distribution.

Section 202 of S. 209 addresses the question of the status of an employee covered by a multiemployer plan who terminates his service for one of the contributing employers. The bill provides that when the employee has not worked (for any employer) in service covered by the plan for six months after severing his employment relationship with a participating employer, he will be deemed to have separated from service, and thus be eligible for a lump sum distribution.

Treasury supports the amendment.

TAX CREDITS FOR ESTABLISHING PLANS

Section 204 of S. 209 provides a tax credit for "small business employers," both corporations and unincorporated businesses or partnerships, equal to a portion of the deductible contributions they make to newly established qualified retirement plans. The credit begins at 5 percent of the deductible plan contribution, and ends at 1 percent in the fifth year after the plan is established. No credit is allowed for contributions of employer securities to the plan, or apparently for cash contributions to the extent the cash is used to acquire employer securities.

For purposes of qualifying for the credit, a "small business employer" is an incorporated or unincorporated business with a monthly average of fewer than 100 employees in the year before the first credit year, and with earnings and profits (or in the unincorporated case, net profits) not greater than $50,000 in the year before the first credit year. Although no credit is allowable under the bill for any taxable year in which a qualified plan is terminated, there is no limitation on the credit if a qualified plan is terminated and a "new" plan is established in the next taxable year.

As we have previously testified,* we share the desire reflected in this provision of S. 209 to expand the coverage of the private pension system. Based on currently available statistics, we estimate that not much more than one-half of the nation's labor force is now covered under the private pension system, and we believe that employees working for small employers tend to be among those who are least likely to be covered. However, there is not to our knowledge sufficient information regarding both the numbers of employees who are not covered by plans and the reasons for their exclusion from the private pension system to determine if an additional tax incentive can be targeted so that it will increase coverage without providing a windfall to employers or an unreasonably large revenue cost.

We are currently working with the Internal Revenue Service in an effort to analyze the group of taxpayers who neither maintain an IRA or participate in a qualified plan. We are, in addition, soliciting the information which may be available at national accounting and consulting firms regarding

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* February 6, 1979, before the Senate Human Resources Committee.

coverage and exclusions from coverage as well as demographic information concerning the American work force. We also understand that the President's Commission on Pension Policy and the Office of Planning Policy and Research in the Department of Labor will be studying the coverage and noncoverage of employees during 1979 and 1980.

Without clearer information as to the gap in coverage of employees and the portions of the gap which could be affected by new incentives, we cannot evaluate the appropriateness of Section 204 of S. 209. We feel it is premature to act now on such a proposal. With the information our studies and those being conducted by other agencies and Congressional staffs will provide, perhaps an efficient system of incentives which is narrowly targeted to expand coverage under the private pension system will be possible.

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

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Table 1

Individual Retirement Accounts, 1977:
Estimate of Utilization Rate by Income Class

Adjusted gross income class	Number of returns with salaries and wages 1/	Estimated number of taxpayers with salaries and wages 2/	Estimated number of taxpayers eligible to use IRAs 3/	Estimated number of IRAs 4/	Utilization rate
($000)	(.................. Numbers in millions			..................)	(.. percent .)
0 - 5	20.1	20.7	17.6	0.04	0.2%
5 - 10	16.5	19.0	13.3	0.18	1.4
10 - 15	13.0	17.5	10.5	0.35	3.3
15 - 20	10.7	16.3	7.4	0.40	5.4
20 - 50	15.8	24.9	6.2	1.35	21.8
and over	1.1	1.4	0.4	0.21	52.5
Total	77.2	99.8	55.4	2.53	4.6%

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fice of Tax Analysis

March 27, 1979

ıpublished data from 1977 tax returns.

ıcludes 2 spouses when both have salaries and wages.

cludes persons covered by public or private retirement systems.

lows for 2 individual retirement accounts on some returns.
sed on number of Forms 5329 filed. Some of these accounts
ceived no deductible contributions during 1977.

Table 2

Individual Retirement Accounts, 1976:
Estimate of Utilization Rate by Income Class

Adjusted gross income class	Number of returns with salaries and wages 1/	Estimated number of taxpayers with salaries and wages 2/	Estimated number of taxpayers eligible to use IRAs 3/	Estimated number of IRAs 4/	Utilization rate
($000)	(.................. Number in millions			...................)	(.. percent
0 - 5	20.3	21.2	17.1	.04	0.2%
5 - 10	17.3	20.6	13.5	.19	1.4
10 - 15	13.4	19.1	11.8	.30	2.5
15 - 20	10.6	15.7	6.5	.34	5.2
20 - 50	12.9	18.6	6.1	.90	14.8
50 and over	0.9	1.2	0.4	.18	45.0
Total	75.4	96.4	55.4	1.95	3.5

Office of the Secretary of the Treasury
Office of Tax Analysis

February 16, 1978

1/ Unpublished data from 1976 tax returns.

2/ Includes 2 spouses when both have salaries and wages.

3/ Excludes persons covered by public or private retirement systems.

4/ Allows for 2 individual retirement accounts on some returns. Based on number of Forms 5329 filed.

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

FOR IMMEDIATE RELEASE
EXPECTED AT 10:00 A.M. EST
TUESDAY, APRIL 3, 1979

STATEMENT BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

STATEMENT: WORLD BANK GROUP

I. Amounts Requested

Mr. Chairman and Committee members, I am honored to appear before you today to seek your support for the Administration's FY 1980 appropriations request for the World Bank Group. The total request is for $2,151.2 million, broken down as follows:

A. International Bank for Reconstruction and Development (IBRD)

The Administration is requesting $1,025.8 million for the IBRD to complete the second installment of the Selective Capital Increase and to make the third and final installment. The Administration will not request any funding for the IBRD for FY 1981 if this request receives favorable treatment. $502.8 million, or half of the total, represents an unfunded but authorized past pledge -- half of the request is for new money. Further, only 10 percent of the request, $102.6 million, is for paid-in capital. The $923.2 million balance is for callable capital.

B. International Development Association (IDA).

The Administration is requesting $1,092 million for IDA. $292 million of the request will complete the last payment of the fourth replenishment of IDA (IDA IV). The $800 million balance is for the third and final installment of IDA V. Note that this year's IDA request is $166 million smaller than the amount actually appropriated by the Congress last year.

C. International Finance Corporation (IFC).

The Administration's request for the IFC is for $33.4 million to complete the third and final installment of the IFC's capital increase.

Mr. Chairman, I wish to submit a table summarizing these amounts:

($ million)	IBRD	IDA	IFC	Total
New Request	$523.0	$800.0	$ 33.4	$1,356.4
Unfunded Past Pledge	502.8	292.0		794.8
Total Request	1,025.8	1,092.0	33.4	2,151.2
Of Which Paid-In	102.6	1,092.0	33.4	1,228.0
Of Which Callable	923.2			923.2

II. The Importance of the Developing Nations

The less developed countries (LDCs) are of vital importance to the United States. They are important sources of raw materials and growing users of the earth's limited resources and environment upon which we all depend. They occupy strategic geography and their military concerns and conflicts can seriously affect U.S. interests and could potentially involve the great powers. Some LDCs even have nuclear military capability. Moreover the LDCs have tremendous potential as a market for U.S. exports, provided they are able to attain sufficiently high standards of living.

Secretary Blumenthal devoted considerable attention to the importance of the LDCs to the U.S. in the statement he submitted when he appeared before this Subcommittee on March 14, three weeks ago. I shall not attempt to improve on the points he made; rather I commend his statement to your further attention.

III. The Record of the World Bank Group

The multilateral development banks in general and the World Bank Group in particular have performed well in serving U.S. interests. The IBRD was conceived in 1944 and began operations in 1946. The IBRD contributed significantly to the reconstruction of post-War Europe and Asia, but by the early 1950s the emphasis had already begun to shift to development projects in the LDCs.

The IFC was created in 1956 as a financially independent affiliate of the IBRD. Its purpose is to strengthen the role of the private sector in LDCs by taking non-guaranteed debt and equity positions in commercial enterprises.

In 1960 IDA was created as a second financially independent affiliate of the IBRD, with the purpose of providing development resources on a concessional basis to countries too poor to afford the IBRD's commercial lending terms.

The accomplishments of the World Bank Group are impressive. The IBRD had extended loans totaling $44.7 billion by June, 1978, and IDA credits totaled $13.7 billion. Both the IBRD and IDA have perfect repayment records -- neither has ever lost a penny on any loan or credit. Cumulative IFC gross commitments reached $2.0 billion by June, 1978.

The MDBs have become the leading institutions in the field of international economic development, and the World Bank Group is pre-eminent among the MDBs. In FY 1978 the World Bank Group made commitments in nearly 80 countries totaling over $8.7 billion -- nearly four times the regional banks combined. Disbursements rose to $3.8 billion.

But the World Bank Group is far more than a highly successful financier. Because of its pre-eminent position in the field of international economic development, the World Bank Group is able to exert considerable influence for policy improvements in borrowing members. It provides technical assistance as a component of some of the projects it finances or makes separate technical assistance loans. It chairs or otherwise participates in over 20 aid coordination mechanisms, and contributes importantly to the harmonization of programs of international organizations including the regional banks, UNDP, WHO, IFAD, and many others. The World Bank conducts or funds research on development problems and its reports are available to member governments and international organizations. The World Bank's Economic Development Institute conducts courses in Washington and abroad on development policy issues and management for officials of member governments.

Each of the three institutions deserves U.S. support for its specialized role in the development effort.

A. IBRD

The IBRD directs its loans to developing countries which can afford to borrow at commercial rates by virtue of per capita GNP or balance of payments strength but which are not in a position to rely entirely on commercial banks or other lenders. These countries tend to be the developing countries of greatest economic importance to the United States such as Mexico, Brazil and Korea. The IBRD also lends significant sums to very poor countries who cannot meet their development needs fully from concessional resources such as IDA, e.g. Egypt and India.

The IBRD is project-oriented. It lends to governments for specific development projects and activities, except in very unusual circumstances. But it is not an implementing agency, despite the fact that its loans are project specific. It offers counselling and advice on what policies are necessary for project effectiveness and how projects can best be implemented. Actual project implementation must be performed by the borrower. This permits the IBRD to economize on its own personnel, and strengthens government and other institutions in borrowing countries. The borrower is deeply involved in the project from start to finish so that the new facilities or programs will be adequately managed after the last dollar of IBRD money is disbursed.

The Bank's first industrial forestry project is a good illustration. It is a successful project that was carried out in Zambia over an 8-year period. The goal of planting 16,000 hectares was met one year early despite a slow start, 600 jobs were created instead of the estimated 400, conservation measures were taken, and economic and financial rates of return are above the original estimates. The demand from the mining sector is not growing as fast as expected but, in combination with other government programs, the project has stimulated interest in establishing local forest industries. The Government succeeded in implementing the project within its own framework and as part of a well defined forestry program. The substantial cost overrun due to inflation was covered by the government. A follow-on Bank project has been approved to expand plantings, increase logging and sawmilling capacity, and conduct research on more efficient plantation management techniques.

In FY 1978 IBRD lending reached $6.1 billion. As I shall discuss momentarily, IBRD lending is increasingly directed to sectors having the greatest impact on reaching the poor. It also has an important role in the oil and gas areas. But a great deal of IBRD lending is still for critically important infrastructure such as roads and railways, telecommunications facilities, hydroelectric installations and so on, which require significant amounts of foreign exchange.

B. IDA

IDA lends to the world's poorest countries on extremely concessional terms. In FY 1978, 90 percent of all IDA credits went to countries with per capita GNP lower than $280. These credits are interest-free but with a service charge of 3/4 percent per year. The credits have 50 year maturities with 10 years grace.

IDA spends most of its money in the rural areas of its borrowing countries because that is where the majority of all the people, and of the poorest people, live. As one would expect, agriculture typically supplies over half of the national income and local industry is built around its production. Increasing agricultural output will, therefore, increase the supply of food and raw materials for the country as a whole and will increase the income of the majority of the poorest people.

There are many kinds of agricultural projects. Some are designed to increase production of a single crop. Some are designed to train farmers in all aspects of management. Some include building farm-to-market access roads and credit programs; these are "integrated" projects. Some are directed toward research on crops and soils of particular regions.

New style rural development projects expand the integrated project concept outward to include improvements in all aspects of rural life. In addition to increasing agricultural production, they aim to create employment in a variety of activities, improve health and education, expand transportation and communication, and improve housing.

IDA estimates that its FY 78 agricultural projects will result in an increase in production of agricultural goods worth about $1,186 million and that about 6.6 million rural families will benefit directly from training and new or expanded facilities. Most of these families are in the lowest income level. In addition, about twice as many families will benefit indirectly as a result of investments in farm related research and facilities and in social services. Increasing employment opportunities go hand in hand with all of these activities.

Some examples of IDA projects can best illustrate the approach and its impact.

In India, a series of projects involving research and farm extension services aimed at small farms has increased wheat yields by almost one ton per hectare to 2.0-2.3 tons per hectare.

In Senegal farmers are being helped to increase livestock production through animal health and husbandry improvements. Another livestock project in Somalia includes building market places, establishing feedlots, developing water supplies, and constructing veterinary centers.

A more comprehensive agricultural project is underway in the Yemen Arab Republic. Irrigation systems are being constructed to control seasonal flooding. High-yielding seeds have been made available to the farmers through improved research and extension services. Farm credit has been increased. Access roads have been built to ensure that produce reaches the market, which in turn encourages the farmer to grow more. IDA estimates that these improvements will eventually help to double the area's output.

IDA reaches the poor through its agriculture and rural development projects, but it has also increased its efforts to help those living in the slums of the overcrowded cities. Urban development programs support construction of low-income housing and public facilities in new areas, as well as improvement of existing slums and encouragement of small-scale and cottage industries which provide employment.

For example, in El Salvador, IDA is helping to finance a low-income housing project which will serve as a model for the country. A local private organization is the executing agency and is also providing capital. The project will construct 7,000 dwellings and provide extension of electricity, water, sewerage, education and community facilities.

Two sectors receiving increasing attention are education and energy. Lending in energy other than power development is a new activity that is part of the World Bank's overall program to increase energy development in the LDCs, including support for geologic surveys and exploratory drilling. Education projects have been funded for many years but will be expanded; they attempt to introduce classwork that directly relates to the conditions and needs of the local region and the country.

C. IFC

I have already outlined the role of the World Bank and IDA in helping to meet the needs of the LDCs through loans and concessional credits. The International Finance Corporation complements the IBRD and IDA by identifying and developing economic opportunities requiring a commercially oriented approach.

IFC is a kind of investment bank with development goals. It makes loans as well as equity investments in LDC enterprises that will contribute to overall development efforts. IFC also provides assistance to local firms and government agencies on financial, legal and other technical matters.

IFC's most important function, however, is its ability to play a catalytic role in increasing the number of investors interested in funding LDC enterprises. IFC never finances the entire cost of a project. Instead it seeks to mobilize and supplement private capital. Therefore it looks for projects that cannot attract sufficient capital on reasonable terms from other sources. Of the new investments approved during FY 78, the IFC provided \$338 million to projects whose overall cost was \$1,872 million -- a ratio of less than 20 percent. The difference was made up by other investors, mostly in the LDCs themselves.

As a result of the role of matching private capital with development needs, the IFC has come to be an important, neutral third party to negotiations between the private sector and national governments. These negotiations are often fraught with misunderstandings and distrust. Especially in natural resource development sectors like mining and energy, equity participation by IFC has been important in bringing together capital and management to meet the appropriate investment opportunity.

IFC does not accept a government guarantee of repayment but will not make an investment without the agreement of the government of the country where the venture is located. An investment is undertaken only when IFC is assured of repatriation of its payments and earnings on its money. The IFC now invests in some government owned enterprises since in many LDCs the private sector is still very limited and the highest priority projects may be in the public sector. While the Corporation does not take active part in management even when it has made an equity investment, it does review an enterprise's activities through field visits and consultations with management as well as by regular monitoring of reports.

IFC's operations have been very successful. The write-off rate is very low and would be a good showing for any venture capital enterprise, but is outstanding when one considers the difficulties involved in many of the poor countries where management skills are scarce and physical and capital infrastructure are inadequate. IFC chooses its investments with great care and then helps them to succeed through effective technical assistance and policy advice as necessary. But if IFC took no losses, it would not be doing its job.

Thus the World Bank is much more than a bank -- it is a well-rounded, broadly-based development institution capable of providing a wide range of services to its members. It is fundamental to world development efforts.

IV. The Need for Funds

A. IBRD

The IBRD's loanable funds derive primarily from bond sales on world financial markets, paid-in capital from member governments, loan repayments, and retained earnings. Bond sales are overwhelmingly the most important.

By the mid-1970s it was evident that the IBRD would require a capital increase in order to expand its borrowing and hence lending power. Without a capital increase, it was clear that the IBRD would hit its statutory lending limit by 1982 -- to avoid the disruption of an abrupt drop in lending at that time, lending would have had to level off starting in 1977 or 1978.

In 1976, the United States and other members concluded negotiations for a Selective Capital Increase (SCI) of $8.3 billion. Of this sum, 90 percent or $7.5 billion is callable or guarantee capital. The paid-in portion is about $830 million.

The SCI had two purposes: 1) to provide a small amount of capital to the IBRD pending agreement on a General Capital Increase, and 2) to adjust relative country shares to parallel changes in the IMF and thereby better spread the burden of providing financial resources to the Bank. The issue of relative country shares is an important one, and I shall return to it presently. The negotiated U.S. share was only 19 percent, compared with a cumulative U.S. share of 25 percent before the SCI was negotiated. When the SCI is concluded, the U.S. capital share of the IBRD will be 23 percent and U.S. voting power will decline to 21 percent. This decrease in the U.S. share is consistent with the U.S. desire for other members to expand burdensharing but, the United States will then have only a narrow margin of safety protecting its effective veto over charter amendments and Board expansion.

The U.S. share of $1,569 million ($157 million paid-in and $1,412 million callable or guarantee capital) was to be subscribed in three equal installments. Unfortunately the United States fell behind on the first installment and even further behind on the second. These unfunded past pledges account for the apparent gap between last year's appropriation and this year's request. Only $523 million -- about half of the present request -- is before you for the first time this year.

The leverage provided by this capital increase is enormous. In the SCI now before you, each dollar paid-in by the United States is matched by four dollars from other donors and 45 dollars borrowed in capital markets -- each U.S. taxpayer's dollar paid into the SCI supports 50 dollars of IBRD lending. In fact, over its entire history, the IBRD has made more than

$45 billion worth of loans but U.S. taxpayers have paid-in only about $820 million, a ratio of over 50 to 1. This leverage makes the IBRD an excellent investment in world development for the U.S. taxpayer.

B. IDA

IDA IV dates from 1973. Despite the critical needs of the world's poorest countries, member governments had permitted IDA's resources at that time to dwindle to the point that lending had to be trimmed. In 1974, IDA lending dropped nearly twenty percent in nominal terms. IDA IV permitted a resumption of lending growth and has been a vital factor in helping the poorest LDCs adjust to the 1974 oil price increases and ensuing world recession. The last commitments from IDA IV were made in mid-1977.

IDA V, agreed in 1977, provided IDA with continued real lending growth. The last commitment from IDA V will come in 1980.

There is great need to fully appropriate both the full $292 million for IDA IV and the full $800 million for IDA V. In the case of IDA IV, appropriating the requested funds would end a continuing U.S. default on a legally binding international obligation. The commitment undertaken by the previous Administration to contribute $1.5 billion to IDA IV was not conditioned on obtaining the necessary appropriations. Other IDA donors made their unqualified commitments in full reliance that the U.S. commitment was also unqualified. It was based on this understanding that IDA IV became effective in January of 1975 when the United States agreed to make its contribution. Loan commitments have already been made and the U.S. is the only government in arrears. The U.S. doesn't make unqualified commitments like this any longer, but we must make good on pledges that were made in this way.

In the case of IDA V, the entire lending program would halt if the U.S. payment of $800 million is not made. We agreed to this condition in IDA V in order to assure the other donors that equitable burdensharing of the replenishment would be maintained, despite our -- at that time, new -- policy of making all U.S. pledges to the banks, "subject to appropriation." Therefore, failure to provide our share of the last installment of $800 million would stop the lending program of the largest concessional loan institution in the world. This would seriously hurt the less developed countries as it would also hurt us badly in the eyes of the rest of the world.

C. IFC

The IFC replenishment, which became effective in November 1977, is the first since the original capitalization of the Corporation in 1956. It will enable the Corporation to undertake a greater variety of projects and to establish a presence in a greater number of countries, including many of the poorest LDCs.

The entire U.S. subscription to the replenishment is $111.5 million out of a total of $469 million allocated to members for subscription. As a result of the replenishment, the U.S. share in the IFC has declined from 32 percent to about 25 percent.

This year's request, $33.4 million, will complete our share of the current replenishment.

V. Policy Concerns

A. Reaching the Poor.

1. IBRD and IDA

It became increasingly apparent in the 1960s that rapid overall growth in the LDCs could bypass their poorest people unless a special effort was made to reach directly those in absolute poverty. Many Americans have little idea what absolute poverty means:

-- It means that one will probably not live longer than age forty-five.

-- It means that one will probably suffer from malnutrition or some untreatable disease most of those forty-five years because there is often only one doctor per 20,000 people.

-- It means that one will probably not have safe or adequate drinking water or a clean place to bathe.

-- It means that one will probably never learn to read or write.

That is what absolute poverty means to the individual human being. What it means to the country is that the country's greatest resource -- its population -- is wasted by disease and ignorance.

Starting in about 1972 the IBRD and IDA began to dramatically alter the nature of their lending. Activities were designed to reach directly the poorest and to insure that the poorest were not systematically excluded from the benefits of more traditional projects. In FY 1978, over 45 percent of IBRD lending went for agriculture and rural development, education, population and nutrition, urban development, and water supply and sewerage, compared with only 16 percent for those same sectors in FY 1972.

The change in IDA has been just as dramatic. In 1972, 40 percent of IDA credits were in agriculture, education, population and health, urbanization, and water supply and sewerage. By FY 1978 the fraction was around 65 percent.

The Congressional Research Service study which this Committee released last year was very clear on this point:

> "...one is struck by the shift that has taken place in sectoral allocations between fiscal year 1972 and fiscal year 1977." (page 73)

The change in emphasis by sector has been accompanied by increasing emphasis within sectors on reaching the poor. To quote the CRS study once more:

> "There has obviously been a shift in intended beneficiaries of projects in the agriculture, urban, and education sectors ... there is also an obvious

> poverty focus in the Bank's urban development projects ... Education projects were also being directed toward the poor ... Population and water projects were also being designed so as to directly benefit poor people." (page 89)

The U.S. Government strongly influenced this change in direction, and the Congress played a major part in so doing. The U.S. was able to attract wide support within the Bank and among member countries for the reaching-the-poor thrust, and the progress made is inarguable. The impact of this shift on benefits reaching the poorest appears to be substantial, although it is too early to measure results in detail.

2. IFC

The U.S. spearheaded the action to increase the Corporation's capital from $110 million to $650 million, to enable the IFC to greatly expand the geographical distribution of its activity and to reorient it more toward meeting the needs of the poorest countries and the poorest peoples.

The IFC Five Year Program for FY 79-83 accordingly has the following major objectives:

-- a more than doubling of its investment level and expansion to a greater number of countries.

-- greater involvement in the least developed countries.

-- a greater variety of co-financing arrangements in order to increase its catalytic effect and to maintain the one to four historical ratio of IFC investments to other investment resources.

-- an increase in the level of its equity financing, particularly in the poorer countries where it is very difficult for ventures to raise equity money.

-- investment in a greater number of sectors, with more emphasis on development of natural resources and the support of commercial agriculture and service sectors.

-- expansion of its financial markets development program with special attention to finding new ways to fill the financial needs of small and medium scale enterprises.

-- strengthening of its ongoing promotional and project related technical assistance programs including non-project related policy assistance to improve the environment for private enterprise.

B. U.S. Infuence

It is no easy task to maintain U.S. influence in the MDBs while simultaneously reducing the U.S. share in these institutions, particularly while we have fallen so far behind in making our payments on these reduced obligations. Nevertheless, U.S. influence so far remains strong.

Let me give just two examples of how World Bank Group activities are helpful to U.S. interests just as they are for the interests of most countries. Last week President

Sadat and Prime Minister Begin met here in Washington for what must be one of the most historic moments in this generation -- the signing of the Egypt/Israel Peace Treaty. As a result of this accord, the capacity of poor countries in the entire region to make good use of development resources will increase. The United States will respond with large bilateral flows of various kinds. Peace will also make it possible for the World Bank Group to expand its activities in the region.

Another example is how the World Bank is trying to stimulate increased energy production in the world. The 1974 oil price jump and subsequent increases gave rise to re-evaluation of the world energy situation. It was clear that, at the new higher prices, many countries might be able to produce oil economically which had not been able to do so at lower prices.

If this oil (and other energy sources as well, such as coal and hydro) could be exploited, it would bring world supply in better balance with world demand to the advantage of all countries.

The United States and other countries saw a role for the World Bank in expanding energy exploitation in the non-OPEC LDCs, and discussed the possibilities with other donors at the London Summit and CIEC Ministerial in 1977. In July 1977, the World Bank Board approved a lending program of $400-$450 million in fuel minerals for FY 1980.

The United States then joined with other major donors at the Bonn Summit (1978) in asking the Bank to re-evaluate its energy prospects. As a result, the Board approved an expanded program to accelerate petroleum production in developing countries. The Bank is now aiming for an FY 1983 energy lending level of $1.5 billion which will make it a major catalyst for expanding LDC energy production.

C. Salaries

A major issue that has been of concern to both the Congress and the Administration is that of salaries, benefits, and administrative costs within the multilateral development banks. Of these issues, the predominant one has been staff salaries. With the strong support of the United States, the management of the World Bank and the IMF formed a Joint Committee of Executive Directors on Compensation Issues. This Committee was given responsibility to study the compensation situation of all IMF/IBRD employees and to make appropriate recommendations to the Executive Boards of the two institutions. The Committee met on numerous occasions through 1977 and 1978, employed professional compensation firms to obtain necessary data for comparative purposes and finished its work in late December. Its final report has been printed, and copies were sent to the Congress on February first.

This report and its recommendations provide the framework for an objective determination of salaries based on public and private salary levels in member countries.

It advances three basic recommendations:

--salaries in the main professional grades will be determined as the average of those in the U.S. private sector and the U.S. Civil Service, plus a premium of ten percent. This premium is necessary to adjust for regional differences of pay within the United States and to make the salaries competitive on an international as well as an East Coast basis. Data from the U.S. private sector were used because the costs involved are U.S. costs and the necessary data were available.

--salaries in the management levels will be determined by setting a moderate differential for each successive grade over the preceding grade, to arrive at a rational management structure.

--tax reimbursement paid American staff will be calculated from the net salaries, using the average deduction for that income level, rather than the standard deduction as heretofore.

The net effect of these recommendations would be to bring Bank and Fund salaries into line with comparable public and private sector salaries, as directed in Section 704 of Public Law 95-118. We are cooperating with other countries to complete this work.

D. Accountability

This topic was discussed at length during last week's oversight hearings. Here I would only add that every IBRD and IDA project is reviewed a year or so after the loan has been completely disbursed. All the benefits -- social and economic -- are re-estimated and compared with the projected ones. Projects are reviewed first by the staff who shepherd the project through its implementation, and then by the Operations Evaluation Department. The final reports are circulated through the Bank and to the Executive Directors and used as the basis for revisions in project design and implementation methods.

Experience with past projects are leading the staff to place greater emphasis on analysis of broad sectoral policies and of socio-economic aspects of the local areas where the projects are to have their impact. Borrower governments are being brought into the full process of planning, monitoring and evaluation to a much greater extent than before to ensure full understanding and cooperation by them. Training and institution building have become much more important goals in recent projects. This is especially true of the new style projects which attempt to bring social and economic benefits directly to the very poor.

One hundred nine projects were covered in the last review. They accounted for loans and credits of $2.2 billion. Ninety percent of the projects were proving themselves worthwhile and more than half showed economic re-estimates that were equal to or better than what had originally been estimated. Congress played a major role in enhancing the independence and quality of the Operations Evaluations system, since it was partly as a result of legislation that the Department was created as an independent unit that reports directly to the Board of Directors.

Now that it is beginning a major expansion, IFC is setting up an evaluation system similar to the Operations Evaluation Department of the IBRD and IDA. It will produce project completion reports on a country or sector basis to gain insights into the problems and successes peculiar to certain types of projects or countries. The first reports are expected to be given to the Executive Directors for review during this year.

E. Capital Saving Technology

The World Bank tries to make maximum use of local talent, material and technologies in its projects. Where available technology is not appropriate for the task, a new or different technology is developed or applied to local conditions. Several of the rural development projects in particular have funds to support research in new technologies and to find existing technologies that would apply to local projects.

For example, a project in Sri Lanka developed a method of pumping water from existing canals to irrigate 2,600 hectares of land in the island's dry area. Farmers could then enlarge their small plots by more than 60 percent. This enabled them not only to grow more crops but to grow a variety of crops which would increase their surplus.

Another example of IDA's support of capital saving technology is an education project in Guyana which established a program to study use of local materials for construction.

All of the agricultural and rural development projects that are aimed at increasing the small farmer's production are capital saving technology projects. The farmers are not given sophisticated tractors, sprinklers and other equipment. Instead they are trained in how to use more efficiently what they have. Western technology is applied when appropriate, for such purposes as increasing the availability of water, eradicating the diseases which affect the people and the animals, and providing better seeds. Pilot projects are used to demonstrate what can be done on the land with more water, healthy animals and better seeds, and the farmers are then taught how to improve their own production.

IFC too selects its investment projects on the basis of its potential contribution to the development needs of the country. Therefore, it supports ventures that encourage the use of local labor, materials and technologies.

Mr. Chairman, I believe that you are to be personally congratulated on the role you have played in increasing sensitivities to capital saving technologies both in aid organizations and in developing countries throughout the world.

F. IBRD Veto

The IBRD charter provides that charter amendments and expansion of the number of seats on the Board of Directors must pass by 80 percent of the vote. Because the United States has always had more than 20 percent of the vote, it has power of veto. The United States has never had to use this muscle, but simply having it available has been an important element in U.S. influence.

At the outset of this statement, I alluded to the problem of relative country shares. While the United States has fallen behind in subscribing to only a fraction of the capital we agreed to take, other nations are seeking larger shares.

In the past month, fourteen countries have requested special capital increases in the IBRD above and beyond amounts agreed in the SCI. Eleven countries asked for subscription increases costing $254 million to parallel their increases in the IMF resulting from the Seventh Quota negotiations. Yugoslavia complained that it had not been able to take up as much capital as it would have been permitted when it joined the IBRD, and now wished to correct this old shortage with a special increase of $91 million. Japan asked for and received increased shares worth $483 million in order to reflect its increased importance in the world economy and the strength of its support for the entire World Bank Group. $229 million of additional capital has been made available for France so that it may maintain parity with Germany and Japan. The increases I have discussed so far total $1,057 million beyond the SCI. Our appropriations request is for $1,026 million within the SCI.

Eight other countries have also requested special increases, but too few unallocated shares remain. Any other special capital increases must be deferred to a future time.

With or without these special increases, the U.S. veto would be in jeopardy if the United States subscribes no more shares. Moreover it would not be prudent to merely assure ourselves of 20.01 percent of the vote -- we must leave at least a small cushion of safety against future developments.

VII. Summary

I would like to conclude by re-emphasizing the commitment to the less developed countries which this Administration is carrying on from past Administrations. An improved standard of living for the peoples of these countries will contribute to the overall growth and stability of our international systems. The World Bank Group with its three pronged approach is the primary international institution for achieving this. It is therefore in the U.S. interest that the Group be able to maintain its leadership role in channeling money from the developed to the developing countries, guiding LDC governments in rational policy making and conducting valuable research in economic development problems.

Through the Group, the U.S. can share responsibility in the financing of development work and in exerting influence on LDC government policy.

We hope that this request for $2,151.2 million will receive your careful, serious attention both in terms of the needs of the LDCs and the importance of the Bank Group as a means to meeting these needs.

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STATEMENT OF THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
OF THE
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

African Development Fund

Mr. Chairman, I would like to turn now to our appropriations request for the African Development Fund.

For FY 1980 we are seeking $41.7 million as the first of three installments of a $125 million U.S. contribution to the second replenishment of the Fund, which will cover AFDF lending in the calendar year 1979-81 period. The U.S. share of the $713.5 million total pledged to the second replenishment is 17.5 percent -- well below the level of our contributions to the soft loan windows of the other development banks.

The Administration's appropriation request for the African Development Fund for FY 1980 reflects the growing importance of Africa to the United States:

B-1506

-- The United States has a strong humanitarian interest in aiding the 400 million people who live in Africa. Africa lags far behind other developing regions, let alone the developed world, on almost all indicators of development. Not only do many countries have per capita incomes below $280; they also have growth rates well below those of developing countries in other regions of the world.

-- The United States also has increasingly important economic interests in Africa. U.S. investment in Africa has more than quadrupled since 1965. During the past decade, U.S. exports to Africa have grown from $1 billion to over $5 billion, and this trend will continue as incomes and consumer demand increase in the future. U.S. imports from Africa also are increasing rapidly and include many important raw materials. In recent years, almost 70 percent of our manganese ore and cobalt imports have come from Africa, and Nigeria is now the second largest source of U.S. oil imports.

-- Finally, Africa is of growing political interest to the United States. Recent developments in the horn of Africa and in southern Africa have underscored the need to strengthen our ties with African nations.

The African Development Fund and the FY 1980 Appropriations Request

The African Development Fund (AFDF) was established in 1973 as the concessional loan affiliate of the African Development Bank. The Bank itself was founded on September 24, 1964, with the governments of twenty-two independent African states as members, to promote investment of public and private capital in Africa. It had initial capital resources of $300 million and a staff of 45. During its fifteen years of operations, the authorized capital stock of the Bank has increased to $960 million, its membership to 48 African nations and its staff to well over 400 persons.

Over the years, the African Development Bank has made a considerable effort to increase its effectiveness, and that of the Fund, through cooperation with other international organizations and bilateral agencies. The African Bank and Fund have frequently cooperated with the World Bank in the development and financing of projects and programs. Other organizations with which the AFDB has worked closely include the United Nations Development Program, the World Health Organization and the Food and Agriculture Organization.

I would like to briefly mention at this point that, after fifteen years during which the membership in the African Development Bank has been restricted to African countries, negotiations are now underway on the membership of the United States and other non-African countries in the Bank. We will be consulting with the

Congress later on the details of participation in the Bank, looking toward the submission of legislation next year. We are now envisaging a U.S. capital subscription on the order of $360 to $400 million (of which seventy-five percent would represent callable capital) to be contributed over a five-year period beginning perhaps in FY 1981.

The Bank faces an extremely challenging task because Africa is the world's least developed continent. Over half of the twenty-five poorest, least developed countries in the world are in Africa. About 75 percent of the African population is engaged in subsistence agriculture. Africa's average per capita GNP in 1975 was only $390 and over a third of the continent's nations have a per capita GNP of $200 or less. In few African countries do the numbers of individuals in absolute poverty number less than one-third of the population. Life expectancies in Africa average 43 years -- almost 10 years less than in other developing countries and 30 years less than in the U.S.

Because of the serious problems facing Africa, many African countries need concessional aid in addition to the loans of the Bank offered at market-related interest rates. To meet the need of many countries for softer lending terms, the Bank decided to establish a source of concessional funds.

The Bank undertook discussions with developed countries to establish a concessional facility associated with the Bank in 1966. After six years of negotiations, and with U.S. assistance in drafting the Charter, the African Development Fund was inaugurated in July 1973. Members of the Fund currently include the Bank itself -- representing all of its member countries -- the United States, Canada, Brazil, Japan, Kuwait, Saudia Arabia, and thirteen European donors.

The Fund's total initial resources, consisting of contributions by fourteen non-African donor countries and the African Development Bank, amounted to $89 million. Adding subsequent subscriptions received by acceding countries and resources from two replenishments, total ratified contributions to the Fund amounted to $463.3 million as of September 30, 1978.

Congress authorized U.S. membership in the AFDF in May 1976 with a contribution of $25 million. It appropriated $5 million of this amount in the FY 1976 Foreign Assistance Appropriations Act and $10 million in the FY 1977 Act. Thus the United States joined the Fund on November 18, 1976 with a $15 million contribution. The remaining $10 million authorized by the Congress in May 1976 was appropriated in the FY 1978 Appropriations Act. This $10 million contribution raised the U.S. share of Fund resources to somewhat under 6 percent, tying the United States with Norway as the sixth largest donor.

A U.S. contribution to the first general replenishment of the Fund was authorized by the Congress in October, 1977 and $25 million was appropriated in the FY 1979 Appropriations Act. As a result of this contribution, the United States has now become the third largest donor in the Fund with 9 percent of AFDF resources behind Japan (17 percent) and Canada (14 percent).

Fund lending has increased from $47 million in 1974 to over $172 million in 1978. Since its establishment the Fund has made 111 loans totaling $533 million in 31 countries. On a cumulative basis, agriculture accounts for 33 percent of all loans, transportation--30 percent, public utilities--18 percent and health and education--19 percent.

Since the African Development Fund, at its present lending rate, would exhaust its commitment authority by the end of 1978, discussions of a second general replenishment of the Fund to finance its 1979-81 lending program began in December, 1977 and were completed in May 1978.

Donors have agreed to a $780 million target for the replenishment to which $713.5 million has been pledged to date. The Administration's $41.7 million appropriations request for FY 1980 represents the first of three installments of a $125 million U.S. contribution to the second replenishment for which authorizing legislation has been submitted to Congress. The proposed $125 million contribution is 17.5 percent of total resources pledged to the second replenishment -- a substantial increase in our contributions to the Fund, but well below our share in the soft loan windows of the other development banks. Moreover, on a cumulative basis, the U.S. will remain considerably below Japan which will continue to be the largest donor in the Fund. This contribution reflects both the increased priority placed on Africa in U.S. foreign policy and the Administration's commitment to equitable burdensharing among donors.

Appropriation of the full $41.7 million requested for the African Development Fund for FY 1980 is particularly important because the contributions of other donors are linked to that of the United States. Appropriation of our first installment to the second AFDF replenishment is needed to trigger the full amount of the second installment of other donors. Any reduction in the FY 1980 appropriations request could lead to a proportional reduction in the contributions of other donors, thereby reducing the Fund's ability to contribute effectively to Africa's development.

Key Policy Issues

Mr. Chairman, I would now like to turn to several key policy issues of interest to the Congress concerning the activities of the African Development Fund.

Reaching the Poor

The U.S representative to the African Development Fund participated in a working group of the Board of Directors which drafted new lending guidelines for the Fund during the second replenishment period. These guidelines will serve to intensify the AFDF's efforts to focus on the poorest countries and poorest peoples.

With respect to the countries which will be eligible for AFDF loans, it was agreed that, except under the most unusual circumstances, loans will not be given to countries with a 1976 per capita GNP above $580. Moreover, in recognition of the fact that scarce concessional resources should be allocated to those countries most in need, it was agreed that not less than 80 percent of the Fund's resources will be targeted to countries with a 1976 per capita income of $280 or less during the second replenishment.

In terms of the types of projects which the Fund will finance, preference will be given to projects which directly help meet basic human needs and increase the productivity of poor people. These include:

-- integrated rural development projects;

-- projects aimed at meeting basic food requirements which include such elements as production, storage, marketing, distribution and transportation;

-- projects aimed at the effective utilization of human resources by deploying them to meet the real needs of a region, including projects focused on training at a basic level in areas like agriculture and cottage industry;

-- projects aimed at basic health requirements including health services, infrastructure and training;

-- projects aimed at developing institutions such as co-operatives, agricultural banks, and rural financing funds.

The nature of the Fund's efforts to reach the poor can best be shown, however, by a concrete example of its activities. A representative African Development Fund project is a $7.8 million loan to finance a rural primary health care project in Sudan.

Sudan suffers from a severe lack of proper health care services. It has a high infant mortality rate and limited number of physicians to meet the needs of its 16 million people. Life expectancies in the Sudan average 49 years -- compared to 72 years in industrialized countries.

Sudan's Primary Health Care Program, a priority element in the National Health Plan, is designed to bring health services, suitably integrated with other community services, to rural populations who do not presently have access to health care. The aim is to make available simple medical care and health prevention and promotion activities such as safe water, human waste disposal, adequate nutrition, and immunizations. Major endemic diseases (malaria, schistosomiasis, tuberculosis and leprosy) which afflict rural residents will also be brought under control through the network of primary health care services to be created under this project. Health education in rural communities, carried out through close and frequent contact by the health workers, is expected to produce important attitudinal changes towards disease and health and encourage villagers to adopt better hygiene, cooking and eating habits. Children and adults, once freed from poor nutrition and disabling and debilitating endemic diseases, should materially improve, qualitatively and quantitatively, the manpower resources needed for the socio-economic development of Sudan.

The African Development Fund loan will assist Sudan's effort to improve health care by building the dispensaries needed to reach the poor, and by financing necessary equipment and vehicles. The project will provide all of the dispensaries needed in the three provinces of the Blue Nile and North and South Darfur, and almost half of the dispensaries needed in the White Nile Province. It is thus designed to bring primary health care to 28 percent of Sudan's population.

Capital Saving Technology

The Agreement establishing the African Development Fund requires the institution to ensure that its lending operations make the most effective contributions to the economic and social advancement of its member countries. In this connection, the management ensures that the techniques used in the formulation and implementation of projects are appropriate to the development needs and local conditions of the member countries. Most African countries are characterized by a relative scarcity of investment capital and abundance of unskilled labor. The management of the Fund, therefore, as a matter of policy, views the choice of technologies which involve the use of small-scale labor intensive processes, and equipment and tools which are less complex and costly than those usually used in the developed world, as most desirable.

In the two-and-a-half years that the United States has been a member of the African Development Fund, the United States has intervened in meetings of the Board of Directors, consulted with Fund management and staff and urged other member countries at annual meetings to promote the concept of the appropriate use and application of capital saving technology through Fund activities. The U.S. representative to the Fund has actively contributed to increasing the flow of information on capital saving technology and the policies and publications on the subject from the other development institutions.

An excellent example of a project designed to increase agricultural productivity on a wide scale through the use of capital saving technology is found in the Somalia Agricultural and Farm Management project. The total cost of the project is $22 million, of which $8.8 million will be financed by an AFDF loan. The project will develop a functioning and dynamic extension service through the establishment of several training centers, demonstration farms, fellowships abroad, expatriate technical assistance, research capabilities, and management support.

The revitalized extension service will concentrate on the introduction of basic methods and technologies. Changes introduced will be simple without involving any initial increases in cash expenditure by the farmer. Moisture conservation, row planting, increased and homogeneous plant population will be stressed. Farmers will be progressively introduced to seed dressing, plant protection, alternative cropping systems and animal traction. Introduction of animal traction will bring the average size of cropped holdings from five to seven hectares. As yields rise, producing a marketable surplus, purchased inputs such as insecticides, improved seeds, and, where applicable, fertilizers will be introduced.

On the average rainfed farm of 5 hectares income will increase from the present $242 to $341 with extension as the only additional input; to $389 with the introduction of animal traction; and to $576 with the introduction of marketed inputs. These benefits will be realized by 180 thousand farm families at an average project cost of $122 per family.

Evaluation/Auditing at the African Development Fund

At the May, 1978 annual meeting of the African Development Fund, the U.S. representative stressed the importance of strengthening the Fund's evaluation and auditing of projects. Since that time, the Fund has taken steps to improve the quality of its evaluation and auditing functions. Since August, 1978 a Price Waterhouse consultant has been working with Fund management to establish an internal auditing unit within the Fund's organizational structure. We are encouraged by these initiatives and we will continue to emphasize the vital role which strong evaluation and auditing procedures have to play in improving the effectiveness and efficiency of Fund operations. We fully recognize that development is a learning experience, in which insights gained from earlier projects can lead to improvements in the design of future programs.

Conclusions

Mr. Chairman, we have strong humanitarian, political and economic interests in Africa which require us to strengthen our relationships with African countries. U.S. participation in the African Development Fund is an important way of strengthening these ties by demonstrating our willingness to join with African nations in an African institution to further their development.

I therefore strongly recommend appropriation of the $41.7 million requested for the African Development Fund for FY 1980.

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ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
OF THE
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

Inter-American Development Bank

Mr. Chairman, I am pleased to testify on the request for funding of U.S. participation in the Inter-American Development Bank. This year, we are making a new request for $687.3 million for capital subscriptions and $175 million for the Fund for Special Operations.

Of the $687.3 million capital, $51.5 million (7.5 percent) will be paid-in and $635.8 million is for callable capital. Both of these amounts represent the first of four years' subscriptions and contributions which were agreed to in the replenishment negotiations concluded late last year. In addition, $150.3 million is needed to fund requests for the Fund for Special Operations which have been authorized but not approved in prior years. Appropriation of these funds will enable the Bank to meet the needs of its members and to continue its innovative approach to development in the hemisphere.

Importance of Latin America and the Caribbean to the U.S.

Latin America and the Caribbean have achieved significant growth and economic transformation during the last fifteen years. This growth has enabled the region to assume a much more significant role in the world economy. Many of the economic indicators demonstrate the area's progress -- economic growth rates, GNP, international trade expansion and investment. Some countries have achieved the status of advanced developing countries with a vital and growing stake in the future of the world economy; others have not shared fully in the region's progress.

Economic growth rates in the region, after averaging 6.2 percent during the 1970-76 period, fell to 4.5 percent in 1977 and an estimated 4.1 percent in 1978. Real per capita GNP has increased by more than half since 1965 to $1,100, substantially higher than most of the developing areas of the world.

The growing importance of the region to the U.S. is demonstrated by the fact that since 1965 it has tripled its exports to the U.S. to $25 billion in 1977, while the region's imports of our products increased to almost $20 billion. Latin America and the Caribbean provide 26 percent of the petroleum, 23 percent of the iron ore, 88 percent of the bauxite, 40 percent of the copper and 50 percent of the sugar which we import. The area also provides about

70 percent and 80 percent of our total supplies of coffee and bananas respectively. U.S. investment in the area has more than doubled since 1960 and now exceeds $20 billion. The character of this investment has changed during this period away from mining and petroleum toward manufacturing, trading and finance. All these figures show that Latin America has assumed an important place in the economic relationships of the United States. Prospects are that its economic relationship with the United States and with the rest of the world will continue to expand.

This visible progress helps to mask the fact that there is much unfinished business before the region reaches maturity. Per capita GNP is only one-sixth that of the United States. Income distribution patterns remain unbalanced. Urban problems have grown with the inflow of people to the cities -- nearly one of every four people live in cities of one million inhabitants or more, compared with one-in-ten in 1950. The region has the fastest growing labor force in the world and must be able to generate about 3 million jobs annually merely to absorb the projected increase in the labor force.

Lending Activities and Resources

The year 1978 marked the close of the 1975-78 programming cycle provided for in the IDB's fourth replenishment. The lending targets agreed to for that period, as well as the sectoral distribution, were met -- with 21 percent of lending going for agriculture, 20 percent for industry and mining, 28 percent for energy, 12 percent for transportation and communications, 16 percent for social infrastructure and 3 percent destined to other sectors.

In 1978, the IDB approved a total of almost $1.9 billion in new loans, raising the cumulative net lending as of December 31, 1978 to almost $14 billion. This lending has been devoted to financing projects with a total value of more than $57 billion, with the Latin American countries themselves providing most of the additional resources. Of the total amount loaned by the Bank, over $7.1 billion has been from capital resources, about $5.9 billion from the FSO and nearly a billion dollars from other funds which the Bank administers, including the Social Progress Trust Fund and the Venezuelan Trust Fund.

The Bank meets the needs of its members principally from its capital window, which lends on near-market terms, and from its soft window (the FSO) which lends on concessional terms. In addition, the Bank administers a variety of special funds. In recent years, it has performed an important intermediary role in attracting and associating private lending with its own to channel greater amounts of funds to its borrowers.

Lending through the capital window is financed primarily from the proceeds of borrowings in the international capital markets and the paid-in capital subscriptions of the Bank's members. The borrowings are backed by members' callable capital subscriptions which have never resulted in budgetary outlays, and are virtually certain never to be needed to meet Bank obligations to bondholders. Therefore only the paid-in amount of $51.5 million in the FY 1980 capital request truly represents a budgetary obligation.

Complementary financing is a means of mobilizing private capital for development by associating it with IDB lending. It requires no appropriations from member governments or use of the IDB's own funds since the funds are all provided by private lenders. These loans complement Bank loans and help borrowers by assisting countries to enter directly the international credit system. The Bank was able to mobilize $133 million for its borrowers through this mechanism in 1978.

FSO loans are extended entirely from resources contributed by the members of the Bank. The FSO enables the Bank to provide concessional resources to its poorest member countries and for projects which benefit low income groups.

The IDB also serves as administrator for thirteen special funds totaling nearly $1.2 billion, which are provided by both member and non-member countries. Of these, the two largest are the $525 million Social Progress Trust Fund placed under the Bank's administration in 1961 by the United States and the $500 million Venezuelan Trust Fund established in 1975.

In 1978, the Bank began a new program which enables it to provide financing to small projects and to individuals in productive pursuits who have previously lacked access to credit. Non-profit intermediary institutions or associations of producers channel the resources to sub-borrowers engaged in small productive projects.

The Replenishment

The lending cycle covered by the previous replenishment ended in 1978. The Bank's convertible resources in both capital and FSO available for lending are now nearly exhausted. At the annual meeting of the Bank last April, negotiations to replenish the Bank's resources and to chart the course of the Bank for the next four years, 1979-1982, began. The negotiations, which were protracted and difficult, were finally concluded last December when the Governors agreed to forward the replenishment arrangements to the member governments for approval. In my view, the terms of the replenishment represent a very significant and favorable shift in the Bank's mobilization and use of resources for lending in the region.

The replenishment is characterized by three important advances -- increased devotion of lending to the poorest countries in the Hemisphere and to poor people in all recipient countries, increased burden-sharing by the non-regional and advanced developing member countries, and a further shift in emphasis from the concessional FSO to the capital resources of the Bank. The improved burden-sharing, and shift toward greater emphasis on capital lending, markedly reduce the impact of the replenishment on the U.S. budget. As a result, the United States will provide 80 percent of its contribution in the form of capital subscriptions as compared to 73 percent in the 1976 replenishment and to 45 percent in the 1970 replenishment.

Let me review briefly the progress we were able to make in these three areas.

The increased emphasis on lending to the poor is characterized by a number of changes, the cumulative effect of which will be quite significant. First, the replenishment embodies the understanding that the Bank will further concentrate its concessional FSO resources on the poorest developing countries of the region. During 1979-1980, at least 75 percent of the FSO convertible resources will go to the countries which are the poorest in the region. This share for the poorest will rise to 80 percent during the last two years. These targets will continue to assure that these countries receive the lion's share of FSO. In 1973 these countries received only 50 percent of the FSO convertible resources. Furthermore, all convertible FSO resources destined to countries other than the poorest shall directly benefit low income groups.

Second, it has been agreed that the IDB will devote one-half of total Bank lending over the replenishment period to projects which provide benefits directly to low income groups. The Board of Executive Directors is working hard to develop an implementation plan to assure that this target is met. We are working closely with the Bank and its other members to ensure that the implementation plan developed is satisfactory and will provide a concrete operative program to guide the Bank.

Third, during prior replenishments five countries -- Argentina, Brazil, Mexico, Trinidad and Tobago and Venezuela -- agreed to cease borrowing convertible currencies from the FSO. For the 1979-82 period Chile and Uruguay have agreed to join this group. In addition, the financing requirements of the Bahamas may be served by requesting only the Bank's conventional resources, except for small amounts of technical assistance. This voluntary withdrawal from FSO financing will permit its scarce concessional resources to be concentrated even more on the poorest countries.

Fourth, the replenishment will permit the growth rate of the Bank's lending to increase in real terms in 1979-1982 but at a somewhat slower rate than in recent years. However, that growth will be concentrated in the less developed countries of the region because annual lending for the more developed borrowing countries (Argentina, Brazil and Mexico) will remain constant over the period. The total lending program for the other countries, from both capital and concessional funds, will thus be permitted to continue the real increases of the last few years -- although FSO lending in convertible currency, taken by itself, will decline from $556 million in 1978 to an average of about $500 million in 1979-82 because fewer Latin American countries now need its concessional terms.

As regards increased burden sharing, both non-regional and regional members have agreed to carry a larger share of the load. The non-regional members will subscribe 11 percent of the IDB capital increase, almost two and one-half times larger than their current aggregate share. The non-regional members have also agreed to take a 30 percent share of the FSO replenishment, maintaining their original high level for that window.

All the borrowing member countries will pay two-thirds of their paid-in subscriptions to the capital window in con-- vertible currency, whereas in the 1976-78 replenishment one-half was convertible. In addition, the more advanced countries of Latin America (Argentina, Brazil and Mexico), in recognition of their greater level of development, have agreed to enlarge their support for the less developed countries of the region by increasing the convertible proportion of their contributions to the FSO from 25 percent in the 1976-78 replenishment to the equivalent of 75 percent during 1979-82. As in the past, Venezuela and Trinidad and Tobago will make their entire FSO contributions convertible.

These major changes in the IDB lending program and burden-sharing arrangements will permit a reduction in United States' paid-in and FSO contributions from $240 million annually in the 1976-78 replenishment to $226.5 million in the 1979-82 replenishment, while enabling the Bank to continue to play its proper role in the development of Latin America. This is an absolute reduction of $13.5 million from the annual obligations of the last replenishment, which was negotiated in 1975. The reduction in real terms is, of course, much more substantial. For both capital and concessional funds, the actual budgetary outlays would as always be spread over a number of years because drawdowns are made only as needed to cover disbursements by the Bank on the basis of an agreed schedule.

In the FSO, the United States will contribute $175 million per year, an absolute reduction of twelve and one-half percent from the $200 million annual contribution which the United States agreed to make under the previous replenishment.

Only seven and one-half percent of the U.S. subscription to capital is to be paid-in, down from ten percent under the current replenishment. This means that $635.8 million of our annual capital subscription of $687.3 million will be in callable capital, requiring no actual outlays. The amount paid in for each year's capital subscription will be $51.5 million.

Overall replenishment levels amount to $1,750 million for the FSO and slightly more than $8 billion for the increase in authorized capital for the four-year period 1979-1982. The U.S. shares are within the ceilings set by the Sense of the Congress resolution included in the FY 1979 appropriations act -- 40 percent for the FSO and 34.5 percent for IDB capital.

We believe that the 1979-82 replenishment agreement represents substantial progress in meeting United States goals to increase lending to the poor, achieve more equitable burden sharing and place greater emphasis on lending from the capital windows which consequently reduces U.S. budget outlays. This package is a prime example of the way in which we have exercised great leverage in influencing the course of the banks' development. These changes will cause a significant shift in activity and emphasis -- we believe for the better -- within the IDB for many years to come.

Discussion of Bank Requests

As of December 31, 1978, the subscribed Ordinary Capital of the Bank was $9.7 billion -- $1.2 billion of paid-in capital and $8.5 billion of callable capital. The initial capital of $850 million in 1959 was successively expanded in 1964, 1967, 1970 and 1976 to reach its present size.

To accommodate the entry of non-regionals in 1976, a new series of capital stock, Inter-regional Capital, was created. Both regional and non-regional members may subscribe to this stock. Since this type of capital is free of the restrictive covenant that applies to the Bank's Ordinary Capital, which permits borrowing only against callable capital of the United States, the IDB is now able to raise funds in the private capital markets of the world backed by callable capital subscribed by other members with strong credit ratings. As of December 31, 1978, subscriptions to Inter-regional Capital stock totaled $1.9 billion consisting of $242 million of paid-in capital and $1.7 billion of callable capital.

The Fund for Special Operations was established under the Bank's Charter for making loans "on terms and conditions appropriate for dealing with special circumstances arising in specific countries or with respect to specific projects". Most of these resources are loaned for the benefit of poor people and poor countries of the region. The amortization periods for loans from the Fund have usually been longer, and the interest rates lower, than for loans from the Bank's capital resources. The Fund for Special Operations was initially established with contributions of $146.3 million.

A series of subsequent contributions raised the value of the FSO to $6.2 billion as of December 31, 1978.

The U.S. contribution we are requesting is required to enable the Bank to restore its depleted resources and complete its 1979 lending program, the first year covered by the replenishment. Available funds will not cover the Bank's lending beyond the second quarter of this year.

Our request can be summarized as follow:

-- Total request -- $1,012.6 million of which $150.3 million for the FSO was previously requested but unfunded.

The new money breaks down as:

- $687.3 million for callable capital
- $51.5 million for paid-in capital
- $175 million for FSO

If the United States does not subscribe to capital, other countries will be unable to subscribe because the U.S. voting power is near the limit in the charter. The U.S. could waive its right to maintain its voting power but the result would be a loss of our veto in the FSO, and we do not intend to use the waiver. Hence the practical effect of a failure to appropriate the full amount of capital requested would be to back out roughly $2 of other countries subscriptions for every $1 we failed to subscribe. I believe that the Congress took this consideration very much into account when it appropriated the full amount of IDB capital requested by the Administration for FY 1979 and I hope that it will do so again.

The FSO funds are urgently needed so that the poorest countries will be able to moderate the cost of their increased reliance on hard lending. In addition under the terms of the replenishment and to assure faithful implementation of the agreed burden-sharing formula, other donors can reduce their FSO contributions proportionately to any reduction in ours. A failure to appropriate the full amount could thus have a multiple negative effect on the FSO lending program.

Let me turn now to a review of some of the major concerns of Congress and this Administration with regard to the Bank -- in particular reaching the poor, capital saving technology, and salaries and administrative costs. We have already had an extensive discussion of the accountability issue during last week's oversight hearing.

Reaching the Poor

I have already enumerated the principal elements agreed to during the replenishment negotiations to make the Bank's program more effective in assisting the poorest people in Latin America. These include agreement that 50 percent of the Bank's total lending from its own resources be directed to the benefit of low income groups, a further concentration of concessional assistance on the poorest countries and use of concessional assistance in other countries only if it directly benefits low income groups.

The Bank's efforts to target increasingly large amounts of IDB funds to the poor are continuing. Treasury officials and the U.S. Executive Director and Alternate traveled extensively in the region in 1978 to inspect, first hand, projects which are helping to improve the lot of the region's poor people. An interesting example of the Bank's innovative efforts is the small project financing program established in 1978 to provide credit to low income groups engaged in productive activities.

In 1978, the IDB made a loan of $16.9 million to Ecuador to help finance an integrated rural development program in the Province of Zamora-Chinchipe in Ecuador designed to benefit some 42,000 low income persons. Ecuador is one of the few developing countries in Latin America with sufficient fertile land and appropriate climate to increase agricultural production at reasonable cost. The project area covers some 509,000 acres in southeastern Ecuador. The project will provide credit to farmers, carry out a study to exploit forests, give land property titles to farmers, establish research and extension services, set up marketing services, build local roads, provide support services, build schools and provide basic sanitation facilities.

Also in 1978, the IDB made a $32.6 million loan to finance a project to help improve the water system of La Paz and the sewerage system of Cochabamba in Bolivia. Sanitary conditions in Bolivia are seriously deficient. As a consequence, the nation suffers a high incidence of water-borne diseases and an infant mortality rate which is almost double the average for Latin America as a whole. About 40 percent of the population of La Paz gets its water through public taps, independent systems or tank cars. This population includes the city's poorest people who reside mostly in outlying areas. In Cochabamba only about 40 percent of the population is served by a sanitary sewerage system and this system has deteriorated badly.

Capital Saving Technology

In November 1976, the Inter-American Development Bank adopted a policy to promote the use of light capital technology by making it a significant component of development strategy. The U.S. Executive Director has actively promoted, in Board meetings and in more informal discussions, increased attention to the use of capital saving technology in project development and implementation. These efforts have resulted in the incorporation of capital saving technologies into a number of projects.

In 1978 the Bank made a $35 million loan to Haiti for storm drainage in Port-au-Prince. This project will consist of a series of subprojects which include: a) erosion control; b) collection and disposal of solid wastes; c) cleaning, repairing and realignment of the waste system and; d) expansion of the drainage system. The execution of the project will be characterized by appropriate labor intensive technology. The works will be carried out through small labor contracts under the direct supervision of an Executing Unit -- a special group set up through the Ministry of Public Works, Transporation and Communications. The materials to be used will be acquired by the Unit itself and will come, as much as possible, from the project area. These materials include sand, gravel, stone, cement and reinforcing bar. Most equipment will be elementary; some advanced equipment, such as trucks, loaders and concrete will be used only in certain activities which would be impossible or too costly to do without.

As another example, the Bank made a $13.2 million loan to El Salvador in 1978 for community development. This project will involve the construction of approximately 970 small scale public works and the granting of credit to low income persons in the northwestern region. The public works will include roads, schools, bridges, potable water, parks and other services. Their construction will be highly labor intensive and primarily local material will be used. The earth movement will be completely manual and only picks, shovels, and wheelbarrows will be used. Other elements include: a) maximum use of stone in construction; b) maximum use of arch bridges, which entail use of stone and manpower; and c) maximum use of baked dry bricks, manufactured by hand in small brickworks, and concrete blocks made by hand at the worksite. In the credit assistance program, attention will be given to the provision of credit for activities which take into account the abundant labor resource. Therefore, only machinery that can be manually operated or very easily operated (knapsack pumps, manual sprinklers, and animal-drawn plows) will be financed. In addition, in order to increase productivity and employment, and to reduce soil erosion, the provision of credit will aim at reducing the area sown to annual crops.

Salaries and Administrative Costs

As in the other MDBs, salaries and administrative costs in the IDB continue to be a major concern of this administration. The IDB has formed a committee to study the future levels of compensation appropriate to the institution and action within the IDB is expected to closely parallel actions taken in the World Bank in response to the Kafka Committee report.

On other administrative costs the IDB continues to make good progress. In the last year the IDB eliminated first class travel for all staff except the President and Executive Vice President. This policy was adopted in response to U.S. initiatives and resulted in administrative savings in 1978 of $50,000. As a further measure of savings, the IDB has also eliminated its spouse travel program.

Furthermore, partly in response to U.S. urging, the IDB has maintained its personnel levels essentially constant over the past three years while the volume of work has increased substantially, thus bringing IDB staffing ratios more in line with other MDBs.

Conclusion

The U.S. has achieved a number of very important objectives in the latest replenishment negotiation at the IDB. In order to carry out these improvements, we now need to come up with our negotiated contribution. The benefits we secured from these negotiations could be lost if we should be unable to fulfill our responsibilities to the institution and to the other member countries.

The support of the Congress in appropriating these funds will strengthen our hand in carrying out the understandings negotiated and in seeking further improvements in the Bank's management and operations. They are one of the most important components of our overall budget proposals for the MDBs for FY 1980.

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STATEMENT OF THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
OF THE
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

Asian Development Bank

Mr. Chairman, I would now like to testify in support of our requests totaling $419.5 million for the Asian Development Bank (ADB), and its concessional loan window--the Asian Development Fund (ADF). The total includes $248.2 million for the ordinary capital operations of the ADB and $171.3 million for the ADF. The request for ordinary capital contributions includes $203.6 million for our third contribution to the second general capital increase and $44.6 million in unfunded pledges from the FY 1979 request. The request for the ADF consists of two elements--$60 million for our third and final contribution to the first replenishment, authorized in 1977, and $111.3 million as the first of four equal annual installments to the second replenishment of the ADF, for which we are seeking authorization this year.

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Of the total $419.5 million, $223.4 million consists of callable capital and is virtually certain never to result in a budget outlay. Of this year's total requests, less than $15 million are expected to result in budget outlays during FY 1980.

The Asian Development Bank was created in 1966 to foster economic growth and cooperation in the developing countries of Asia and the Pacific. The Bank which is headquartered in Manila, has 43 member countries -- 26 developing countries and 17 developed. Besides the United States and Canada, the developed member countries include three regional members and twelve Western European members.

The United States was a major factor in the creation of the Bank, and has participated actively throughout its existence. The United States has subscribed to slightly more than $1 billion, or 11.9 percent of the Bank's capital, providing the U.S. with a 10.0 percent voting share. This compares with Japanese subscriptions of 17.5 percent of the capital, providing them with a voting share of 14.5 percent. We will restore the U.S. voting share to full equality with that of Japan, at 13.4 percent, by the end of FY 1981, if the Congress grants us full appropriation of our requests to the second general capital increase.

The United States has contributed $270 million to the ADF, 15.2 percent of the total resources, compared with Japanese contributions of $893.3 million or 50.3 percent of total resources. All countries, except Australia and the United States, have completed their contributions to the first replenishment. In the second replenishment the United States' share will total 20.7 percent, down from the 22.25 percent of the first replenishment and our 28.6 percent share of the original resource mobilization of the ADF, while Japan's share will increase from its 33.6 percent of the first replenishment to 36.8 percent.

We believe that the Asian and Pacific region is of great importance to the security and prosperity of the United States and the developed world. The region has a diverse mixture of countries, including some of the fastest growing, most successful developing nations with whom our trade and investment links continue to expand rapidly; along with some of the most populous and poorest nations in the world, needing all the capital and technical assistance that we can provide if they are to break out of their cycle of poverty. It also includes some small island nations in the Pacific having no multilateral source of external aid other than the ADB. The successful partnership of regional and non-regional, developed and developing countries, represented in the ADB is one that warrants our continued support.

Bank Lending Activities

The Asian Development Bank made its first loan in 1968. The Bank has now become an important contributor to the economic development of Asia and the Pacific. It is a major source of capital in the region and has played a vital role in mobilizing self-help resources in its developing member countries.

As of December 31, 1978, total loan funds committed by the Bank had reached over $5 billion for 359 individual development projects. Nearly $4 billion or over 70% came from the Bank's ordinary capital resources. These loans were financed at near market rates of interest at maturities from thirteen to thirty years, including from two to seven year grace periods. The remaining $1.5 billion in total lending consisted of concessional loans financed from the Asian Development Fund. These loans carry an interest rate of 1 percent with maturities of forty years. Countries receiving these loans are among the world's poorest. Almost ninety percent of the Bank's concessional funds have gone to countries having a per capita income of $200 or less.

In calendar year 1978, the Bank made new loans totaling over $1.1 billion. Of this amount, loans from ordinary capital amounted to $778 million with concessional loans accounting for the remainder. These loans went to eighteen of the Bank's developing member countries with five receiving loans exclusively from concessional resources.

Over its history, twenty-three developing countries have borrowed from the Asian Development Bank. The major recipients have been those countries in Asia which are important to the military, political and economic interests of the United States. For example, the largest borrowers from the Bank have been Korea ($836 million), the Philippines ($730 million), Pakistan ($713 million), Indonesia ($710 million), and Thailand ($517 million). These and other countries whose economic and social progress is significant to stability in Asia have benefitted from the Bank's resources at a relatively small cost to the United States.

Bank Financial Resources

The Bank's ordinary capital lending is financed primarily from the paid-in capital subscriptions of members and, to a much greater extent, the proceeds of borrowings in international capital markets. Members' callable capital subscriptions are used exclusively to guarantee these borrowings and are virtually certain never to be needed to meet the obligations to bondholders and thus to result in budgetary outlays.

The Bank's cumulative subscribed capital stock now amounts to $8.7 billion, consisting of 20 percent paid-in capital and 80 percent callable capital. This total stock results from the original subscriptions and the two general capital increases -- in 1971 and in 1976 -- along with special capital increases subscribed by various member governments during the Bank's lifetime. The U.S. subscription of slightly over $1 billion represents 11.9 percent of the total, as compared to Japan's 17.5 percent share.

The Bank has become an increasingly familiar and respected name in the world's capital markets. It has a triple A rating and can now borrow on virtually the same terms as the World Bank. Gross borrowings amounted to $350.3 million in 1978 and $112 million in 1977, none of which was raised in the United States. The Bank's funded debt now totals $1.6 billion, of which $295 million or 18.3 percent was raised in the U.S. capital markets. The corresponding figures for Japan and Western Europe were 26 percent and 45 percent respectively. Additional amounts were raised from foreign central banks and in the Middle East.

Of the $1.2 billion in U.S. resources already contributed to the Asian Development Bank and Asian Development Fund only $499 million will result in budgetary outlays. The remaining $736 million is callable capital -- a highly contingent liability virtually certain never to be used. These U.S. contributions have a multiplier effect for financing development projects in Asia by attracting private capital and by inducing burden sharing contributions from other developed countries.

Funds that the ADB lends are augmented by co-financing with other public and private institutions, together with the local costs provided by the recipient developing country itself. The amount of lending financed directly by the Bank's ordinary capital is some fifteen times greater than the United States' direct budgetary cost, with a smaller multiple in the ADF. However, since the Bank acts as a catalyst in mobilizing other funds, the total project costs financed by the Bank's ordinary capital and ADF windows have amounted to over $10.8 billion, at a total U.S. budgetary cost of less than $500 million. Therefore, every dollar of U.S. budgetary outlays has provided over twenty dollars in ADB developmental project funding. This ratio will increase in the future as the Bank's capital structure matures, and begins to lend reflows.

The second general capital increase, adopted by the Board of Governors in 1976, provides the Bank with some $3.8 billion in lendable resources, sufficient to increase the Bank's lending program from $625 million in 1977 to $975 million in 1981. Appropriation of the U.S. request will be required for the Bank to complete its planned 1980 and 1981 lending programs of about $1.9 billion. Any shortfall in U.S. appropriations will eventually be reflected in reduced Bank lending commitments.

Asian Development Fund

When the Bank was established, it was recognized that it should provide financing on commercial terms to meet the needs of the poorest developing member countries. Prior to 1973, special funds were contributed to the Bank's soft loan window on an unscheduled basis through bilateral arrangements between donor countries and the Bank. In 1973, the Bank's Board of Governors, with United States support, adopted a resolution creating a new multilateral special fund, the Asian Development Fund, to which contributions would be made and used on the same terms and conditions.

The U.S. share of the initial ADF mobilization was $150 million, or 28.6 percent of the $525 million total, to finance concessional lending over the period 1973-1975. These U.S. contributions were made in FYs 1974, 1975 and 1977.

The first replenishment of the ADF was negotiated in 1975 for lending in the 1976-78 period. The United States, following consultations with Congress, was eventually able to agree to a $180 million share of a $809 million replenishment, a 22.2 percent share, which resulted in a considerable reduction from our share in the original resource mobilization. Congress authorized these funds in 1977 and appropriated $49.5 million and $70.5 million in FY 1978 and FY 1979, respectively, for the Fund. All participating donor countries, except the United States and Australia, had completed their contributions to the first replenishment of ADF by the end of 1978. The United States is requesting appropriation of its final $60 million contribution to the first replenishment in FY 1980. At the end of calendar year 1978 the ADF had only $228 million left in uncommitted funds. Accordingly, a replenishment of ADF resources is needed if ADF lending is not to cease by mid-1979.

<u>The second replenishment of the Asian Development Fund</u>

During late 1977 and early 1978, international negotiations were conducted on the amount and conditions of the second replenishment of the ADB. The Bank's proposal was for a replenishment of $2.15 billion, to be committed over four instead of three years as for earlier ADF resource mobilizations. The four-year cycle allows for greater stability and forward planning of the Bank's activities.

Following a Presidential decision and Congressional consultations, the United States indicated it could not provide more than a $445 million contribution to the replenishment. It was eventually agreed that the replenishment would total $2 billion, but countries could make supplementary contributions sufficient to raise the total another $150 million. This goal was eventually reached when six countries offered to contribute the supplemental amounts. Of the total $2.15 billion for the second replenishment, the U.S. share of $445 million represents 20.7 percent, which is less than the 22.25 percent ceiling specified in last year's Foreign Assistance Appropriations Act.

The replenishment arrangements reflected to a considerable extent the goals the United States had sought. The Fund will give increased emphasis to the pressing needs of the poorest countries in the region, and will resume lending to certain important "marginally eligible" countries for projects which address basic human needs, through greater lending for agriculture and rural development. These countries still have large sections of their populations living in rural poverty.

The United States had urged throughout the negotiations that additional countries join in the replenishment. This was achieved when France agreed to contribute for the first time. Finally, the United States sought to have the Bank be more aggressive in obtaining cofinancing agreements, especially with the Middle Eastern countries, which the Bank agreed to do.

Appropriations requests for FY 1980 - Ordinary Capital

Under the terms of the second general capital increase adopted in 1976, the United States was to provide $814.3 million, or 16.3 percent of the total capital increase of slightly over $5 billion, 10 percent in the form of paid-in shares and the remaining 90 percent in callable capital. Appropriations were received in FY 1978 and FY 1979 for $168 million and $194.5 million, respectively. In FY 1980, we are requesting a total of $ 248.2 million ($24.8 million paid-in capital and $223.4 million callable capital).

Under the agreed arrangements, payment for the paid-in shares may be made in four equal installments over 1978 - 1981. The capital increase was designed to cover the needs of the Bank sufficiently to increase the annual lending from ordinary capital resources from $625 million in 1977 to $975 million in 1981.

The request for FY 1980 comprises our third tranche to the second general capital increase of $203.6 million, and $44.6 million in funds authorized but unappropriated in previous years. Of the U.S. paid-in portion, 40 percent ($9.92 million) would be in cash and 60 percent ($14.89 million) in non-interest bearing letters of credit to be drawn down as needed to meet the disbursement needs of the Bank. The callable capital portion does not increase Treasury outlays, but enables the Bank to raise funds in the world's capital markets on far better terms than it otherwise could at no real cost to the United States. Consequently, of the $248.2 million FY 1980 request for the Bank, less than $10 million or 4 percent will leave the Treasury during FY 1980 and only $25 million or 10 percent is ever expected to leave the Treasury.

The U.S. subscriptions are leveraged with the subscriptions from other members and borrowings from the capital markets to finance Bank lending. Since it began lending in 1968, the Bank has lent $3.9 billion from its ordinary capital window, over fifteen times the direct United States budgetary outlay for paid-in capital. However, the true developmental impact of the Bank's lending is much greater since Bank funds will generally be accompanied by co-financing from other official and unofficial sources, plus resources mobilized by the developing countries themselves.
As the Bank's capital structure matures, we expect this ratio to increase still further, as it has in the IBRD. Furthermore, the amount requested for paid-in capital in FY 1980 - $24.8 million - is about the same level in nominal terms, and twenty-five percent lower in real terms, than the amount the Congress appropriated for the Bank as far back as FY 1975.

If Congress appropriates the full request in FY 1980, our request for paid-in-capital in FY 1981 will fall to $20.4 million.

Appropriation of the requested funds will permit the United States to maintain and increase its influence in the Bank. The United States as a key founding member, and the second largest shareholder, has been able to substantially influence the directions of the Bank over the years, which has also accounted in part for the Bank's success to date. Continuation of that influence requires the United States to adhere to its burden-sharing arrangements, that have been negotiated with other member countries.

Appropriations requests for FY 1980 - Asian Development Fund

The United States is seeking the first of four annual installments of $111.25 million to the second replenishment of the ADF in FY 1980, together with our third and final installment of $60 million to the first replenishment. This results in a total request in FY 1980 of $171.25 million for the ADF, a one-time doubling up of the contributions to the first and second replenishments and the first contribution to the second replenishment. Full appropriation will reduce the lag in U.S. contributions, as compared to other donors, from two years to one year, and future appropriations requests will fall to $111.25 million per year in FYs 1981-83.

Appropriation of the full $111.25 million requested for FY 1980 is particularly important because the contributions of other donors are linked to that of the United States. Appropriation of our first installment is needed to trigger the full amount of the second installment of other donors. Any reduction in the FY 1980 appropriations request could lead to a proportional reduction in the contributions of other donors, thereby reducing the Fund's ability to play its full role in the development of Asia.

Payment of the U.S. contributions will be made by letters of credit to be drawn down as required to meet disbursements. Consequently, actual U.S. budgetary outlays during FY 1980 from the ADF appropriations request are estimated to be approximately $4 million, or 2 percent of the requested amount. The remaining amounts will be drawn down over the following ten or so years.

Reaching the poor

The Bank has historically been strong in basic infrastructure lending in such traditional sectors as electric power, transportation and communication, but in the last several years has moved towards increasing the share of lending going to agriculture and benefiting the poorest within developing member countries. The traditional areas of power and transportation have taken almost 47 percent of ordinary capital and 40 percent of total lending up through 1978. Meanwhile, 25 percent of the total and 50 percent of concessional lending has been channeled into agriculture.

With the scheduled adoption of a new agricultural sector policy and the larger share of concessional lending as a result of the new replenishment, there will be increased emphasis on lending to the agricultural sector both in dollar amounts and in effectiveness. This trend is already evident in 1978, when 55 percent of concessional lending and 27 percent of total lending went to the agricultural sector.

The Bank's new agricultural policy provides the following guidance for future lending: improved design of projects to assure more rural employment opportunities; concentration on rural infrastructure including feeder road networks; better support facilities for rural credit programs and improved arrangements for providing inputs and for marketing production; establishment and upgrading of extension services for rural women; strengthening small scale enterprises and better provision for health, nutrition and family planning assistance. In addition, it calls for greater emphasis on basic human needs of the rural poor, participation of the under-employed in bank-financed projects, and cost-reduction of projects through calculations of cost per beneficiary.

The increased emphasis on reaching the poor through agriculture is demonstrated by the Bali Irrigation Loan made by the Bank in September 1978. This $18 million irrigation loan emphasizes the need for active involvement of farmers through local irrigation associations which are called Subaks. These organizations are traditional in some rural areas of Indonesia and include in their membership all cultivators who own, sharecrop or rent land receiving water from a single source. Each member of the Subak has an equal vote and the leadership is democratically elected by majority vote or consensus. The ADB loan agreement specifically requires that the Subaks be directly involved in the allocation of water between Subaks and in the settlement of inter-Subak water rights disputes.

Capital saving technology

The United States, along with some other developed and developing member countries, has continued to promote the adoption of capital saving technologies. We believe there are very real and encouraging signs of success for our efforts.

The Bank's commitment to the use of capital savings technology in agriculture and aquaculture is noteworthy. This is important because of its potential impact in reducing rural poverty. The Bank is now making a concentrated effort to increase rural incomes and expand agricultural output through programs that take advantage of the large unused stock of human capital in rural Asia.

A good example of capital saving technology is an aquaculture development project in Thailand. This project is designed to increase the income and employment opportunities of small fish farmers through the production of fish and shrimp species easily adaptable to local conditions, using simple techniques. Those techniques chosen have been the most appropriate for the existing human and physical resources of the country.

The project is expected to provide direct benefits to 2,532 fishermen living at subsistence level or belonging to low-income groups, and to increase their incomes several-fold while providing the fish consumption requirements for 320,000 people.

The Bank also promotes capital saving techniques in its civil works wherever possible, particularly for secondary feeder road construction and maintenance. For example, the Mindanao Secondary and Feeder Road Project in the Philippines was specifically designed to maximize use of rural labor.

Accountability

Last year the ADB management took several steps to increase the accountability of its work to its member countries and increase its internal efficiency. The first was the expansion and strengthening of the Office of the Internal Auditor, and the second was the establishment of a Post Evaluation Office which reports solely to the President of the Bank.

The Internal Auditor's Office, which concerns itself primarily with the areas of loan disbursements and repayments and administrative expenses, has undergone a major strengthening in staff. We will monitor the results of this expansion. At the same time we propose to consider other areas that should be audited, such as broad program audits of the operational activities of the Bank.

The Post Evaluation Office performs independent post evaluations of bank-financed projects, and reports directly to the President. Until now the Bank has only performed post-evaluation reviews on a sample of completed projects. This practice will be expanded considerably as a result of the reorganization and strengthening of the Post Evaluation Office. All evaluation reports are available to the Executive Directors.

Salaries and administrative costs

The Bank's record on administrative costs is well known and needs little repeating. The Bank has the lowest administrative costs of any of the MDBs. The ADB operates with fewer professionals per project undertaken and at lower salaries, than in the other MDBs. We believe it is to the credit of Bank management, and an indicator of its responsiveness to U.S. concerns, that only 2.5 cents of every dollar lent is absorbed in administrative expenses.

On the question of salaries I would like to mention that U.S. nationals on the ADB staff are at a distinct disadvantage vis a vis expatriates from other developed member countries whose salaries are not subject to national taxation. Consequently, the after-tax incomes of Americans turn out to be well below those of other Bank employees and of United States Government employees in Manila, earning the same base pay. The situation has worsened, with recent changes in U.S. tax legislation, which heightens the prospect of a severe depletion in the number and quality of senior U.S. nationals on the Bank's staff. We are investigating possible solutions and hope that a remedy can be found before American presence in the Bank is severely eroded. The costs of an equitable resolution would not be large and Bank salaries and administative costs would remain the lowest of all the MDBs.

Procurement

The level of U.S. procurement from the Bank has been below our expectations. Consequently, we established an inter-agency working group to study the reasons for the disparity and recommend appropriate actions.

The working group has solicited the views of a large number of U.S. business firms about improving the flow of contract information. Bank management has taken measures including promotion of a forthcoming staff visit to selected U.S. Chambers of Commerce to advise U.S. firms of procurement opportunities with the Bank, and making available copies of its Monthly Operations Report to interested businessmen. This information on future business opportunities is also being published in Commerce Department publications for businessmen, and is being provided to U.S. embassies around the world.

As in other U.S. policy questions the Bank has been responsive to U.S. procurement concerns. We are confident that the lending procedures of the Bank are fair to U.S. suppliers and there is no institutional bias which limits the success of U.S. suppliers. The problem, as we see it, lies with increasing the awareness of the opportunities for U.S. firms. With the additional flow of information, there should be more aggressive bidding by U.S. firms. We are attempting to assure that such information is made available to them as quickly as possible.

Conclusion

The Asian Development Bank has become a key instrument in U.S. policy toward Asia. It is an effective and efficient institution that has shown responsiveness to U.S. concerns particularly through the sectoral and country distribution of its lending programs.

The Bank has successfully leveraged U.S. contributions employing the funds of other regional and non-regional developed countries, raising funds in world capital markets and co-financing projects with public and private institutions from the developed countries and the capital surplus countries of the Middle East. The Bank's programs have been implemented in a highly cost-effective manner, thereby contributing to the growth and stability of an area of the world of fundamental importance to U.S. economic and strategic interests.

The ADB is a successful example of a diverse mixture of developed and developing countries striving cooperatively to achieve development for the world's most populous region. Its efforts and continued accomplishments deserve our wholehearted support. The Administration recommends appropriation of the requested amounts.

GPO 938 766

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL ON WAGE AND PRICE STABILITY
WASHINGTON, D.C. 20506

OFFICIAL BUSINESS
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FIRST CLASS

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

FOR IMMEDIATE RELEASE
April 2, 1979

CONTACT: Charles Arnold
566-2041

SALE OF SAVINGS BONDS AND MAILING OF TAX REFUND CHECKS RESUMED

Following completion of Congressional action to raise the nation's debt limit today, the Treasury authorized all Federal Reserve Banks and some 40,000 other issuing agents to resume sales of U.S. Savings Bonds. Sales had been suspended because, in the absence of action to raise the debt limit, new bonds could not be issued.

The Treasury also resumed the distribution of Federal income tax refund checks. Because of the lack of action to increase the debt ceiling, the scheduled mailing on March 29 of $2.6 billion in refund checks dated March 30 had been withheld.

oOoOo

B-1509

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

FOR IMMEDIATE RELEASE April 2, 1979

TREASURY RESCHEDULES AUCTION OF $3,000 MILLION OF CASH MANAGEMENT BILLS ORIGINALLY ANNOUNCED MARCH 23, 1979

The Department of the Treasury, by this public notice, invites tenders for approximately $3,000 million of 76-day Treasury bills to be issued April 6, 1979, representing an additional amount of bills dated December 21, 1978, maturing June 21, 1979 (CUSIP No. 912793 Z2 5).

Competitive tenders will be received at all Federal Reserve Banks and Branches up to 12:30 p.m., Eastern Standard time, Thursday, April 5, 1979. Noncompetitive tenders will not be accepted. Tenders will not be received at the Department of the Treasury, Washington. Wire and telephone tenders may be received at the discretion of each Federal Reserve Bank or Branch. Each tender for the issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. The price on tenders offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

The bills will be issued on a discount basis under competitive 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 in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches.

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.

B-1510

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. Those submitting tenders 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. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately available funds on Friday, April 6, 1979.

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 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 may be obtained from any Federal Reserve Bank or Branch.

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

FOR IMMEDIATE RELEASE April 2, 1979

TREASURY RESCHEDULES OFFERING OF $1,500 MILLION
9% 14-YEAR 10-MONTH BONDS

In its original offering of March 22, the Department of the Treasury announced that the bonds would be auctioned Thursday, March 29, 1979, and issued Thursday, April 5, 1979. The Treasury hereby amends its original offering announcement by providing that the bonds will be auctioned Tuesday, April 10, 1979, and issued Wednesday, April 18, 1979.

As stated in the original announcement, the Treasury will auction $1,500 million of the 9% 14-year 10-month bonds to raise new cash. They will be an addition to 9% bonds, due February 15, 1994, which are currently outstanding. Additional amounts of the bonds may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Details about the offering, as amended, are given in the attached highlights of the offering and in the official offering circular.

oOo

Attachment

3-1511 (over)

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF RESCHEDULED 14-YEAR 10-MONTH BONDS
TO BE ISSUED APRIL 18, 1979

April 2, 1979

Amount Offered:	
To the public	$1,500 million
Description of Security:	
Term and type of security	14-year 10-month bonds
Series and CUSIP designation	9% Bonds of 1994 (CUSIP No. 912810 CF 3)
Maturity date	February 15, 1994
Call date	No provision
Interest coupon rate	9%
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	August 15 and February 15
Minimum denomination available	$1,000
Terms of Sale:	
Method of sale	Price auction
Accrued interest payable by investor	$23.97415 per $1,000
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, April 10, 1979, by 1:30 p.m., EST
Settlement date (final payment due)	
a) cash or Federal funds	Wednesday, April 18, 1979
b) check drawn on bank within FRB district where submitted	Tuesday, April 17, 1979
c) check drawn on bank outside FRB district where submitted	Tuesday, April 17, 1979
Delivery date for coupon securities.	Wednesday, April 18, 1979

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

FOR IMMEDIATE RELEASE April 2, 1979

TREASURY RESCHEDULES OFFERING OF $2,880 MILLION
OF 2-YEAR NOTES

In its original offering of March 14, the Department of the Treasury announced that the notes would be auctioned Wednesday, March 21, 1979, and issued Monday, April 2, 1979. The Treasury hereby amends its original offering announcement by providing that the notes will be auctioned Thursday, April 5, 1979, and issued Monday, April 9, 1979.

As stated in the original announcement, the Treasury will auction $2,880 million of the 2-year notes. These notes had been intended to refund approximately the same amount of notes which matured March 31, 1979.

In addition to the public holdings, Federal Reserve Banks, for their own account, held $640 million of the maturing securities. These securities were refunded by issuing short-term Treasury bills. These Treasury bills will then be exchanged by the Federal Reserve for 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 to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing securities held by them.

Details about the new security, as amended, are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-1512 (over)

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF RESCHEDULED 2-YEAR NOTES
TO BE ISSUED APRIL 9, 1979

April 2, 1979

<u>Amount Offered:</u>

To the public	$2,880 million

<u>Description of Security:</u>

Term and type of security	2-year notes
Series and CUSIP designation	Series R-1981 (CUSIP No. 912827 JN 3)
Maturity date	March 31, 1981
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 aucti
Interest payment dates	September 30 and March 31
Minimum denomination available	$5,000

<u>Terms of Sale:</u>

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

<u>Key Dates:</u>

Deadline for receipt of tenders	Thursday, April 5, 1979, by 1:30 p.m., EST
Settlement date (final payment due)	
a) cash or Federal funds	Monday, April 9, 1979
b) check drawn on bank within FRB district where submitted	Friday, April 6, 1979
c) check drawn on bank outside FRB district where submitted	Friday, April 6, 1979
Delivery date for coupon securities	Friday, April 20, 1979

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

FOR IMMEDIATE RELEASE April 2, 1979

TREASURY RESCHEDULES 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $3,340 million, of 362-day Treasury bills to be dated April 5, 1979, and to mature April 1, 1980 (CUSIP No. 912793 3F 1). This issue will not provide new cash for the Treasury as the maturing issue is outstanding in the amount of $3,346 million.

The bills will be issued for cash, and if desired by investors, in exchange for Treasury bills which will mature April 3, 1979. The public holds $1,666 million of the maturing issue and $1,680 million is held by Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities. The Federal Reserve's holding of such bills will be exchanged on April 3 for short-term Treasury bills. These bills will then be exchanged for the new annual bills at the weighted average price of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents of foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

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. This 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 12:30 p.m., Eastern Standard time, Wednesday, April 4, 1979. 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.

B-1513

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. 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 $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.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on April 5, 1979, in cash or other immediately available funds or in Treasury bills maturing April 3, 1979. 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 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, 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 April 2, 1979

TREASURY ANNOUNCES $6,000 MILLION OF CASH MANAGEMENT BILLS FOR AUCTION AND ISSUE TUESDAY, APRIL 3, 1979

(Additional Announcements to Follow)

The Department of the Treasury, by this public notice, invites tenders for approximately $6,000 million of 23-day Treasury bills to be issued April 3, 1979, representing an additional amount of bills dated October 26, 1978, maturing April 26, 1979 (CUSIP No. 912793 Y2 6).

Competitive tenders will be received only at the Federal Reserve Bank of New York up to 10:30 a.m., Eastern Standard time, Tuesday, April 3, 1979. Noncompetitive tenders will not be accepted. Tenders will not be received at the Department of the Treasury, Washington. Wire and telephone tenders may be received at the discretion of the Federal Reserve Bank of New York. Each tender for the issue must be for a minimum amount of $10,000,000. Tenders over $10,000,000 must be in multiples of $1,000,000. The price on tenders offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

The bills will be issued on a discount basis under competitive 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 in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches.

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.

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. Those submitting tenders 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. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank of New York in cash or other immediately available funds by close of business Tuesday, April 1979.

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 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 may be obtained from any Federal Reserve Bank or Branch.

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

FOR IMMEDIATE RELEASE April 2, 1979

TREASURY ANNOUNCES
REVISED FINANCING SCHEDULE

As a result of final action by the Congress on legislation to raise and extend the temporary debt ceiling, the Department of Treasury announced the following revised schedule of offerings:

... $6.0 billion of 23 day cash management bills, maturing April 26, to be auctioned at 10:30 a.m., Tuesday, April 3 for settlement also on April 3. Bids for these cash management bills will be accepted only at the New York Federal Reserve Bank in minimum amounts of $10 million.

... $4.0 billion of 15 day cash management bills, maturing April 19, to be auctioned at 12:00 noon on Tuesday, April 3 for settlement on Wednesday, April 4. Bids for these cash management bills will be accepted at any Federal Reserve bank in minimum amounts of $10 million.

... $6.0 billion of weekly Treasury bills ($3.0 billion of 3 month bills to mature on July 5, 1979, and $3.0 billion 6 month Treasury bills to mature October 4, 1979) to be auctioned at 1:30 p.m. Tuesday, April 3, for settlement Thursday, April 5. This represents a rescheduling of the auction of these bills originally scheduled for Monday, April 2.

... $3.3 billion of annual bills maturing April 1, 1980, for auction at 12:30 p.m., Wednesday, April 4 for settlement Thursday, April 5. This offering substitutes for the offering of the 52 week bills which the Treasury was unable to auction on Wednesday, March 28. The Federal Reserve will exchange its holdings of maturing annual bills for short term Treasury bills. These Treasury bills will then be exchanged by the Federal Reserve for new annual bills to be issued by the Treasury on April 5.

... $3.0 billion of 76 day cash management bills to mature June 21, to be auctioned at 12:30 p.m. Thursday, April 5 for settlement Friday, April 6. This represents a rescheduling of the previously announced June cash management bill originally scheduled to be auctioned on Friday, March 30.

... $2.9 billion of 2 year notes maturing March 31, 1981 to be auctioned at 1:30 p.m., Thursday, April 5 for settlement Monday, April 9. This represents the rescheduling of the previously announced 2 year note which was to have been auctioned Wednesday, March 21. The Federal Reserve will exchange its holdings of approximately $640 million of maturing 2 year notes for short term Treasury bills. These Treasury bills will then be exchanged by the Federal Reserve for new 2 year notes issued by the Treasury on April 9.

... $1.5 billion of reopened 14 year 10 month Treasury bonds, maturing February 15, 1994, to be auctioned at 1:30 p.m. on Tuesday, April 10 for settlement Wednesday, April 18. The auction of these bonds was originally scheduled for Thursday, March 29.

Separate announcements on each of the above will be issued.

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

FOR RELEASE AT 11:50 P.M. April 3, 1979

RESULTS OF AUCTION OF $6,005 MILLION
OF 23-DAY TREASURY BILLS

The Treasury has accepted $6,005 million of the $15,073 million of tenders received at the Federal Reserve Bank of New York for the 23-day Treasury bills to be issued April 3, 1979, and to mature April 26, 1979, auctioned today. The range of accepted bids was as follows:

	Price	Discount Rate	Investment Rate
High	99.375	9.783%	10.00%
Low	99.368	9.892%	10.12%
Average	99.370	9.861%	10.09%

Tenders at the low price were allotted 31%.

B-1516

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

FOR RELEASE AT 4:00 P.M. April 3, 1979

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $6,000 million, to be issued April 12, 1979. This offering will result in a pay-down for the Treasury of about $200 million as the maturing bills are outstanding in the amount of $6,215 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $3,000 million, representing an additional amount of bills dated January 11, 1979, and to mature July 12, 1979 (CUSIP No. 912793 2B 1), originally issued in the amount of $2,916 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,000 million to be dated April 12, 1979, and to mature October 11, 1979 (CUSIP No. 912793 2Q 8).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing April 12, 1979. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,071 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. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, April 9, 1979. 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.

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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. 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 must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on April 12, 1979, in cas or other immediately available funds or in Treasury bills maturi April 12, 1979. Cash adjustments will be made for differen 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, 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 April 3, 1979

RESULTS OF TREASURY'S 15-DAY BILL AUCTION

Tenders for $4,001 million of 15-day Treasury bills to be issued on April 4, 1979, and to mature April 19, 1979, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Price	Discount Rate	Investment Rate (Equivalent Coupon Issue Yield)
High -	99.593	9.768%	9.97%
Low -	99.585	9.960%	10.17%
Average -	99.587	9.912%	10.12%

Tenders at the low price were allotted 76%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS:

Location	Received	Accepted
Boston	$ 100,000,000	$ 72,800,000
New York	7,765,000,000	3,301,600,000
Philadelphia	---	---
Cleveland	---	---
Richmond	60,000,000	55,200,000
Atlanta	10,000,000	10,000,000
Chicago	1,045,000,000	521,600,000
St. Louis	10,000,000	10,000,000
Minneapolis	---	---
Kansas City	10,000,000	---
Dallas	---	---
San Francisco	465,000,000	30,000,000
TOTAL	$9,465,000,000	$4,001,200,000

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

FOR IMMEDIATE RELEASE
April 4, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES COUNTERVAILING
DUTY INVESTIGATION ON CERTAIN
FIREARMS AND PARTS FROM BRAZIL

The Treasury Department has started an investigation into whether imports of firearms and parts from Brazil are being subsidized.

A preliminary determination in this case must be made by August 22, 1979, and a final determination by February 22, 1980.

Imports of this merchandise during the first ten months of 1978 were valued at $8 million.

The investigation follows receipt of a petition alleging that manufacturers and/or exporters of this merchandise receive benefits from the Government of Brazil.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional customs duty equal to the subsidy paid on merchandise exported to the United States.

Notice of this investigation will be published in the Federal Register of April 5, 1979.

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B-1519

Department of the TREASURY NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041
THE DEPARTMENT OF THE TREASURY 1789

FOR IMMEDIATE RELEASE April 3, 1979

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 3,001 million of 13-week Treasury bills and for $3,003 million of 26-week Treasury bills, both series to be issued on April 5, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 5, 1979			26-week bills maturing October 4, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	97.589	9.538%	9.94%	95.202	9.491%	10.14%
Low	97.568	9.621%	10.03%	95.198	9.498%	10.14%
Average	97.575	9.593%	10.00%	95.199	9.496%	10.14%

Tenders at the low price for the 13-week bills were allotted 47%.
Tenders at the low price for the 26-week bills were allotted 94%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 75,765,000	$ 52,350,000	$ 69,925,000	$ 19,925,000
New York	5,018,040,000	2,555,340,000	6,160,330,000	2,573,145,000
Philadelphia	19,705,000	19,705,000	58,390,000	13,360,000
Cleveland	34,365,000	34,365,000	144,210,000	16,210,000
Richmond	29,670,000	29,670,000	31,075,000	19,575,000
Atlanta	36,290,000	36,290,000	24,420,000	20,920,000
Chicago	192,220,000	61,620,000	601,465,000	223,965,000
St. Louis	59,080,000	37,020,000	66,990,000	12,890,000
Minneapolis	15,895,000	14,305,000	20,555,000	5,555,000
Kansas City	27,630,000	27,630,000	21,090,000	20,270,000
Dallas	25,330,000	20,030,000	9,595,000	9,595,000
San Francisco	378,125,000	97,065,000	498,160,000	47,060,000
Treasury	15,265,000	15,265,000	20,805,000	20,805,000
TOTALS	$5,927,380,000	$3,000,655,000a/	$7,727,010,000	$3,003,275,000b/

a/Includes $ 438,725,000 noncompetitive tenders from the public.
b/Includes $ 289,270,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-1520

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

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
APRIL 5, 1979

STATEMENT OF PAUL H. TAYLOR
FISCAL ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON
PUBLIC BUILDINGS AND GROUNDS OF THE
HOUSE COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION

Mr. Chairman and Members of the Subcommittee:

I am glad to be here this morning to discuss fiscal aspects of the John F. Kennedy Center revenue bonds, which were purchased by the Secretary of the Treasury pursuant to section 9 of the Kennedy Center Act.

That provision authorized the Center's Board of Trustees to issue revenue bonds to the Secretary in an amount not exceeding $20.4 million. The proceeds were to be used to finance the Center's parking facilities and the bonds were to be repaid from revenues accruing to the Center. Interest was required to be computed to reflect the cost of market borrowings by the Treasury. The Act permits deferral of payment of the interest

B-1521

with the approval of the Secretary of the Treasury, but stipulates that interest so deferred will bear interest after June 30, 1972. Deferred interest was not, however, to be considered a reduction of the borrowing limitation. The first bond was issued on July 1, 1968 in the amount of $1.5 million and carried a maturity date of December 31, 2017. Attachment A to my statement shows the obligations, their interest rates and maturity dates.

The bonds provide that principal and interest are to be paid from parking revenues. However, because these revenues were insufficient to meet the current interest on the bonds (partially because a substantial portion was diverted to repay a $3.5 million loan from the parking concessioner), the Center's Board, in December 1968, and annually thereafter, requested and was granted a deferral of the interest by the Secretary of the Treasury. Attachment B shows the computation of deferred interest from December 31, 1968 through December 31, 1978. In February 1979 the Department granted a further one-year deferral after the Center indicated its intent to seek a legislative solution to their financial problem. In this connection, H.R. 13579 of the 95th Congress would have provided for an accommodation between the Center and the Treasury whereby the Board would undertake to repay, in equal annual installments, the $20.4 million principal on the bonds and the Secretary would release the Board from its obligation to pay deferred and future interest thereon. The proposed legislation was not considered, however, and we understand that your Committee is now reviewing ways to provide some relief for the Center's financial dilemma.

Apropos this point, on December 20, 1977, the Comptroller General transmitted to the Secretary of the Treasury a report on the financial operations of the Center. The report pointed out that one of the Center's largest financial obligations is the $15 million in interest and deferred interest owed to the Treasury on the revenue bonds. The report concluded that only the Congress can determine the "future financial course" of the John F. Kennedy Center for the Performing Arts. We concur in that assessment, recognizing that that determination will require an accommodation between the Center and the Treasury. We believe the Center's status as a national memorial and cultural center requires us to view their financial impairment in a different light than would be the case with respect to normal business-type operations of the Government. Therefore, the Department supports the write-off of the Center's interest obligation to the Treasury. We also believe that a firm schedule for repayment of the principal should be adopted.

That concludes my prepared statement, Mr. Chairman. I will be glad to respond to any questions.

Attachments

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Attachment A

John F. Kennedy Center for the Performing Arts
Loans, John F. Kennedy Center, Parking Facilities
Revenue Bonds - 12/31/78

Rate	Bond No.	Due Date	Calendar Year Advanced	Accrued Face Amount	Interest to December 31, 1978 No. of Days From	To	Interest
5-1/8%	2-5	12/31/2017	1968	3,800,000	12/31/77	1 yr	194,750.00
5-1/4%	1-6	12/31/2017	1968	2,900,000	12/31/77	1 yr	152,250.00
5-3/8%	7 & 8	12/31/2017	1968	1,200,000	12/31/77	1 yr	64,500.00
5-3/4%	9 & 10	12/31/2018	1968	2,200,000	12/31/77	1 yr	126,500.00
5-7/8%	11 & 14	12/31/2018	1969	4,300,000	12/31/77	1 yr	252,625.00
6%	15	12/31/2018	1969	1,000,000	12/31/77	1 yr	60,000.00
6-1/4%	16 & 17	12/31/2018	1969	1,300,000	12/31/77	1 yr	81,250.00
6-1/2%	18 & 19	12/31/2018	1969	1,900,000	12/31/77	1 yr	123,500.00
6-5/8%	20	12/31/2018	1969	800,000	12/31/77	1 yr	
	21	12/31/2019	1970	1,000,000	12/31/77	1 yr	
				1,800,000			119,250.00
	GRAND TOTAL			20,400,000			1,174,625.00

John F. Kennedy - Deferred Interest
Revenue Bonds - 12/31/78

Year Deferred	Interest Deferred		Deferred Rate	Interest on Deferred Interest	Int. on Deferred Interest Deferred	Total Int. Deferred
12/31/68	114,176.57		5-1/2%	6,279.71		
12/31/69	775,852.06		7-1/8%	55,279.46		
12/31/70	1,152,844.18		6-5/8%	76,375.93		
12/31/71	1,174,625.00		5-7/8%	69,009.22		
12/31/72	1,174,625.00		6-1/8%	71,945.78		
12/31/73	1,174,625.00		6-7/8%	80,755.47		
12/31/74	1,174,625.00		7-3/4%	91,033.43		
12/31/75	1,174,625.00		7-1/2%	88,096.88		
12/31/76	1,174,625.00		6-1/8%	71,945.78		
12/31/77	1,174,625.00		7%	82,223.75		
	10,265,247.81			692,945.41		
Interest on Deferred Interest Deferred		12/31/72	6-1/8%	103,472.16	6,337.66	
" " " " "		12/31/73	6-7/8%	285,227.76	19,609.41	
" " " " "		12/31/74	7-3/4%	385,592.64	29,883.43	
" " " " "		12/31/75	7-1/2%	506,509.50	37,988.21	
" " " " "		12/31/76	6-1/8%	632,594.59	38,746.42	
" " " " "		12/31/77	7%	743,286.79	52,030.08	
				2,656,683.44	184,595.21	
						877,540.62

SUMMARY

Interest 12/31/78	1,174,625.00
Deferred Interest to date	10,265,247.81
Interest on Deferred Interest	3,349,628.85
Interest on Deferred Interest Deferred . . .	184,595.21
	14,974,096.87
Principal owed	20,400,000.00
Total Interest owed	14,974,096.87
Total owed 12/31/78	35,374,096.87

Attachment B

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

FOR RELEASE UPON DELIVERY
Expected at 10:00 A.M.
Wednesday, April 4, 1979

TESTIMONY OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE APPROPRIATIONS SUBCOMMITTEE ON TREASURY,
POSTAL SERVICE AND GENERAL GOVERNMENT

Mr. Chairman and Members of this Subcommittee:

I appreciate this opportunity to discuss the current state of the economy and the prospects for the dollar at home and abroad.

As I pointed out when I appeared before the full Appropriations Committee earlier this year, the American economy is at a critical juncture. Since the deep recession of 1974-75, we have enjoyed an impressive recovery of employment and production. We have had less success in maintaining the value of our currency at home and abroad.

This imbalance in our achievements cannot persist. Either we shall right the balance ourselves by bringing inflation under orderly control, or events will reassert equilibrium for us, by bringing the economic recovery itself to a disorderly close. There is no doubt which alternative best serves the public interest.

Recent Economic Developments

The events of recent months have made it even clearer that the program of fiscal and monetary restraint announced last January was the appropriate and necessary course. Recent economic statistics show that real growth in the fourth quarter of 1978 was almost 7 percent at an annual rate, much higher than anticipated in January, more than double our estimate of the economy's long-term growth potential, and well above the 5 percent average rate of real growth during the current expansion. Coming as it did in the fourth year of cyclical recovery, with only very narrow margins of unutilized skilled labor and industrial capacity remaining, this unexpected upsurge in real growth was reflected in a more rapid rise in costs and prices. In combination, real growth and inflation added up to more than a 15 percent annual rate of increase in gross national product at current prices--a rate exceeded only twice before in the current expansion.

The pace of economic activity has slowed somewhat in the early months of this year. Some of this slowing has reflected adverse weather, some has reflected a normal let up in consumer spending following the surge in buying in late 1978. At the same time, we have seen a scramble by businesses to rebuild inventories, to accelerate ordering as delivery times lengthen, to borrow more heavily to finance outlays. Worst of all, we have seen an acceleration in inflation. With worldwide demand for industrial materials quickening, with costs rising, with capacity limits being reached in some key industries, prices of some commodities are again rising at a double-digit rate.

The emergence of excess demand pressures after four years of cyclical expansion threatens to disrupt the orderly and generally well-balanced nature of the recovery.

The Recent Inflation Record

The rate of advance in prices in recent months is running far above acceptable levels. Consumer prices rose 0.9 percent in January and 1.2 percent in February. Over the two-month span, the index was up at an annual rate of about 13 percent. This compares with a 9 percent rise in 1978 and just under 7 percent during 1977.

In part, the recent bad news on the inflation front reflects special unfavorable developments in farm and food prices. Part of the sharp January rise in food prices was due to severe weather in the Midwest and strikes in California. Meat prices rose nearly 5 percent in February alone. Some of these and other special factors will not be present later in the year.

But acceleration has also been taking place across a broad range of other prices. Clearly, the recent acceleration is not all due to special factors.

The recent wholesale price statistics have been particularly disappointing. The price index for finished goods rose at a 15 percent annual rate in January and February, and at a 12-1/2 percent annual rate with foods excluded. Farther down the production chain at the intermediate and crude materials levels, rates of increase have been even faster. This has built up pressures which will push up retail prices for the next few months. With delivery times slowing and rates of capacity utilization relatively high, particularly in the materials producing sectors, demand pressures are clearly a major factor behind the recent deterioration in price performance.

Late last summer, there were some early warning signs that the economy was entering a zone of excess demand which could make the control of inflation an even more difficult task. Since then, I regret to say, the signs of excess demand are even more apparent. The index of crude nonfood materials prices is often used as a sensitive measure of demand pressures. It rose at more than 30 percent, annual rate, in the first two months of this year, on top of nearly a 20 percent annual advance in the final three months of 1978.

More bad price news is possible in the months to come. Hopefully, however, the policy actions already put in train will result in some moderation as the year progresses.

-- Business firms will have used up a large part of the price increases that are allowable under the wage-price program and the program has been tightened so as to spread allowable price increases more evenly throughout the program year.

-- The steps taken to moderate the use of six-month money market certificates should contribute to a gradual easing of activity in the homebuilding sector where demand and cost pressures have been intense.

-- The most severe feedback effects on domestic prices from last year's depreciation of the dollar have already been felt, and the stabilization of the dollar since our November 1 actions will alleviate some of the pressure on domestic prices induced by a weakening dollar.

As these measures take hold and some of the special factors fade from the picture, the latest upsurge in inflation should begin to moderate. In addition, the policies of restraint already embarked upon--a reduced budget deficit and tighter monetary policy--will contribute to a gradual reduction of aggregate demand pressures. Real growth is expected to taper off during the course of the year. Indeed, some economists in the private sector are projecting an actual recession. We do not expect a recession, but we do expect--and the economy badly needs--some relief from excess demand.

The Policy of Restraint

While some abatement in inflation is expected, we have to recognize that significant and enduring abatement requires persistent application of restraint. There is no quick cure for an inflation that has been building for over a decade. And there are no easy ways out. Unless the growth of aggregate demand is reduced, demand-pull inflation will merge with cost-push, and inflation will accelerate even further.

Incomes policies, such as the voluntary wage/price deceleration program, can play an important part in containing inflationary pressures. But they can be effective only in the context of macro economic policies that limit growth in aggregate demand to our resource availability.

While the inflation rate will be coming down later this year, there is a real risk that the current temporary burst of inflation will greatly complicate our task. If the recent burst of inflation is built into current wage demands, the wage-price spiral will be ratcheted upwards another notch.

Wage restraint in upcoming negotiations will be crucial if we are to achieve the progress toward lower rates of inflation that the situation demands.

Profits grew very rapidly in the fourth quarter after virtually no growth in the third quarter. But profits typically show large increases in periods of sharply rising activity. The Council on Wage and Price Stability is intensifying its monitoring efforts to insure business compliance with the standards of the price deceleration program.

The Need for a Strong and Stable Dollar

The dollar's value cannot be protected at home if it is weak abroad, and we cannot maintain its integrity abroad if it is shrinking at home. Last year, that maxim received a sharp and painful illustration. The acceleration in domestic inflation served to weaken the dollar on the foreign exchange markets, and this in turn raised the domestic price level even further--as the cost of imported goods rose and provided an umbrella for domestic price increases.

The President moved forcefully on November 1st to put an end to this vicious cycle. He endorsed the imposition of greater monetary restraint domestically and arranged with Germany, Switzerland and Japan a program of closely coordinated intervention in the foreign exchange markets. The U.S. has mobilized most of the $30 billion in foreign exchange resources being used to finance our share of this effort.

These funds have been obtained partly through use of U.S. reserves and partly by borrowing, including the issuance of foreign currency denominated securities.

Conditions in the foreign exchange market have clearly improved since November 1. The severe and persistent disturbances which characterized the markets last fall have been overcome. From its low point on October 31, the dollar has recovered on a trade-weighted basis by about 10 percent. Against the DM, the Swiss franc, and the yen, the dollar has appreciated by 9 to 21 percent.

Uncertainties regarding oil supplies and prices are the principal source of concern in the foreign exchange market at this time. These uncertainties have created some nervousness as market participants attempt to assess the potential consequences for various currencies. While the dollar has been quite firm during this period of uncertainty, the continued long-run health of both our currency and our economy requires a clear, firm and constructive energy policy.

The Treasury Department has recently concluded an investigation under Section 232 of the Trade Expansion Act of 1962 to determine whether crude oil and products are entering the U.S. in such quantities or under such circumstances as to threaten to impair the national security.

In 1975, acting under the same Section 232 authority, Treasury Secretary Simon found that at <u>that</u> time the nation's dependence on imported oil was so great as to threaten to impair the national security. That conclusion is, unfortunately, even more valid today.

The nation's dependence on imported oil has increased dramatically since the 1975 finding. At that time, 37 percent of the United States demand for oil was supplied from foreign sources. In 1978, oil imports accounted for 45 percent of oil consumed in the United States.

The rising level of oil imports adversely affects our balance of trade and our efforts to strengthen the dollar; in 1978, outflows of dollars for our oil imports amounted to $42 billion, $15 billion more than in 1975 and offsetting much of the rise in our exports of industrial and farm products.

Our growing reliance on oil imports has important consequences for the nation's welfare. Recent developments in Iran have dramatized the consequences of this excessive dependence on foreign sources of petroleum.

The continuing threat to the national security which our investigation has identified requires that we take vigorous action at this time to reduce consumption and increase domestic production of oil and other sources of energy. To the extent feasible without seriously impairing other national objectives, we must encourage additional domestic production of oil and other sources of energy, and the efficient use of our energy supplies, by providing appropriate incentives and eliminating programs and regulations which inhibit the achievement of these important goals. The President will shortly be announcing additional steps this nation must take to solve our energy problem. All of us must unite behind him in support of a program that will liberate our economy from the continuing threat to our economic welfare and security posed by our over-dependence on foreign oil.

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

FOR IMMEDIATE RELEASE April 3, 1979

DAVID J. SHAKOW APPOINTED
ASSOCIATE TAX LEGISLATIVE COUNSEL AT TREASURY

Secretary of the Treasury W. Michael Blumenthal today announced the appointment of David J. Shakow of New York City as Associate Tax Legislative Counsel.

Mr. Shakow, 33, has been attorney-advisor to the Tax Legislative Counsel in the Treasury Department since August 1977. Before joining Treasury, he was an associate at the New York law firm of Davis Polk & Wardwell. Mr. Shakow also served as a law clerk to the Honorable William H. Hastie, late Chief Judge of the Third Circuit Court of Appeals.

As Associate Tax Legislative Counsel, Mr. Shakow will assist the Tax Legislative Counsel in heading a staff of lawyers and accountants who provide assistance and advice to the Assistant Secretary of the Treasury for Tax Policy. The Office of Tax Legislative Counsel participates in the preparation of Treasury Department recommendations for Federal tax legislation and also helps develop and review tax regulations and rulings.

Mr. Shakow was graduated from Harvard College in 1967 with a B.A. degree. He received a J.D. degree from Harvard Law School in 1970. In 1976, he received an LL.M. (in Taxation) degree from New York University School of Law.

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

FOR IMMEDIATE RELEASE
April 5, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES FINAL DETERMINATION
IN COUNTERVAILING DUTY INVESTIGATION
ON OLEORESINS FROM INDIA

The Treasury Department today announced a final determination that exports to the United States of oleoresins from India are being subsidized.

The Countervailing Duty Law requires the Secretary of the Treasury to collect an additional duty equal to the subsidy paid on merchandise exported to the United States. However, because this merchandise is eligible for duty-free entry into the United States, the U. S. International Trade Commission must make an injury determination before countervailing duties can be collected.

As a result of its investigation, Treasury found that manufacturers of this merchandise received subsidies consisting of a rebate under the "Export Cash Assistance Program." The amount of the subsidy has been determined to be 4.23 percent of the f.o.b. price of oleoresins exported to the United States.

Notice of this action will appear in the Federal Register of April 9, 1979.

Imports of this merchandise from India during 1978 were valued at about $1.5 million.

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B-1524

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

FOR IMMEDIATE RELEASE

April 4, 1979

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,344 million of 52-week Treasury bills to be dated April 5, 1979, and to mature April 1, 1980, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS: (Excepting 1 tender of $500,000)

	Price	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)
High -	90.719	9.230%	10.09%
Low -	90.719	9.230%	10.09%
Average -	90.719	9.230%	10.09%

Tenders were allotted 91%.

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

Location	Received	Accepted
Boston	$ 56,235,000	$ 11,235,000
New York	6,155,695,000	3,197,595,000
Philadelphia	8,725,000	3,725,000
Cleveland	50,935,000	9,935,000
Richmond	9,635,000	9,635,000
Atlanta	22,320,000	20,870,000
Chicago	284,965,000	25,245,000
St. Louis	45,370,000	15,430,000
Minneapolis	14,505,000	4,505,000
Kansas City	34,555,000	19,910,000
Dallas	5,270,000	5,270,000
San Francisco	273,555,000	13,195,000
Treasury	7,195,000	7,195,000
TOTAL	$6,968,960,000	$3,343,745,000

The $3,344 million of accepted tenders includes $197 million of noncompetitive tenders from the public and $1,599 million of tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities accepted at the average price.

B-1525

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For Release
Friday, AMs, April 6, 1979

THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE U.S. TREASURY
ADDRESS BEFORE
THE UNIVERSITY OF CALIFORNIA (BERKELEY)
APRIL 5, 1979

Nothing has given me greater pleasure than being named alumnus of the year by my alma mater.

With the dollar emerging from an all time low, with the national debt at an all time high, with the nation confronted by double-digit inflation, it was perfect timing for the University Fathers to call to the world's attention that it was here at Berkeley that the Secretary of the United States Treasury received his training in banking and international finance.

In 1947, right here in San Francisco, I first set foot in this country. I had $60 in my pocket, a tenth grade education and all the wisdom a young man could pick up on the streets of Shanghai.

I had learned quite a bit of English and Chinese during my eight years in Shanghai, not as an intellectual pursuit but as a matter of sheer survival.

My English helped me survive when the U.S. Navy arrived at the Whangpoo River and then, two years later, it naturally was of great help when I arrived at the Golden Gate. But it wasn't until a few weeks ago that my Chinese came in handy.

In the banquet room of the Great Hall of the People, I was called upon to deliver the toast. The first few minutes were devoted to the traditional bland pleasantries expected at international affairs. I decided to make those pleasant opening remarks in Chinese. Much to my chagrin, the interpreter immediately translated my Chinese into English so that, as he explained, the officials at the banquet could understand it.

It was the only lapse of Oriental tact that I ever encountered.

When I landed in San Francisco, 32 years ago at the age of 21, the last thing on my mind was a college education. I was more concerned about where my next meal was coming from. I consulted the help wanted ads, and hustled up a job at the National Biscuit Company where I was assigned the task of adding up the cookies that drivers would take out on their morning rounds. I excelled at it. Yet somehow it left me with a vague feeling that I was capable of greater achievement! But I went through quite a few jobs before I hit the jackpot.

B-1526

That was at Lake Tahoe, toward the end of my final semester at Berkeley. I landed a job handling the stage lights for a famous striptease dancer.

It was there, in the saloons of Lake Tahoe, that I learned the difference between appearance and reality.

The stripteaser's name would be immediately recognizable to you but let gallantry prevail -- she had seen better days. She came out on the stage fully dressed and as she discarded each article of clothing, my job was to change the color of the spotlight. The less she wore, the darker it became. It was glamorous and the audience loved it.

Between the acts, I was the bus boy at the club. I had to run out with the dishes and bring in the new glasses of water. My only problem was that on the way to the kitchen I would see this famous stripteaser leaving the stage and walking toward her dressing room. While the spectators were still wildly applauding her glamorous stage appearance -- I had a direct and unobstructed view of the real thing. That was how I learned the difference between appearance and reality.

Ladies and gentlemen, I got my degree at Berkeley but I got my education at Harold's.

In preparing for this occasion, my thoughts went back to the time I arrived in this country in 1947. Today, the world is beset by a multitude of seemingly insoluble problems, the energy shortage, inflation, the menace of nuclear power plant failure, pollution, the rising cost of health care and the threat it all means to our way of life and standard of living.

It is tempting to look back on the good old days when I arrived in this country as a lad of 21.

A piece of paper I carried instead of a passport said I was a displaced person. I set foot on American soil, after years in Nazi Germany and war time China. This was the land of milk and honey and unlimited opportunity. When I got my first job two days after I landed, I recall that I felt all was right with the world. It was a good world. Or was it? I checked the front page of the New York Times for that day I arrived in America in 1947.

It wasn't a very good day for a man named Nikola Petkov in Bulgaria. He was hanged that morning by the Communist government for refusing to cooperate. The head of the United Nations was pleading, without too much success, for unity. General MacArthur, the head of the Allied occupying force in Japan, was telling the Japanese they could expect less food from the United States that year because of world conditions; President Truman was urging Americans to eat less so there'd be enough to go around, the White House was concerned about an Arab Threat of the Jewish homeland.... in fact, the only bright little bit of news I saw on the front page of the New York Times in 1947 was the price.... it was selling for three cents a copy!

The day I was graduated from Berkeley in June 1951, things hadn't changed all that much. There was a national cry to raise the cultural level of TV, consumer groups were threatening a boycott of beef, there was national concern over the use of drugs on campus, the war in Korea, and the H Bomb was tested for the first time. Income taxes were going up and General MacArthur was saying that our foreign policy was being set by other countries. That all sounds familiar. The only thing that had changed between the time I arrived in the United States and the time I left here with a diploma is that the price of the New York Times had gone up to five cents a copy and the incidental fee had gone up from $35 to $42.50.

But the nation and the world have changed greatly since then. The Gross National Product of the United States was only $290 billion in 1950; today we are a two trillion dollar economy. The population has increased by 66 million. American women have been liberated from their traditional place in society and now make up fully half of the work force. Our music, our art, our literature . . . all have gone through mutations of sorts. Even the role and the conduct of the nation's highest office -- the Presidency -- have changed radically.

Internationally, the difference is equally remarkable. Western Europe is not only on its feet, but is strong and moving further toward political, economic and monetary integration. The Cold War has given way to "competitive coexistence" and detente. China has shaken off the dogmatism of Chairman Mao to embark on a course of economic modernization and political adjustment. What once was a disparate collection of nomadic desert sheikdoms has become a stronghold of economic power known as OPEC.

We cannot today review the panoply of all the changes of the last two and a half decades. But here are two which I would like to share with you. Not only because both are timely, but also because they are important tests of America's ability to adapt to change. The first is the problem of inflation. The second relates to the normalization of our relations with China.

Inflation

There is no question that inflation poses the most serious threat to America's prosperity. Inflation reduces the living standards of all people, especially of the poor, the unemployed, the retired. It distorts business planning and capital formation. It generates unproductive forms of economic activity. It impairs the international competitiveness of our industry. It weakens the dollar and undermines our leadership in world affairs.

We all know this. We know we cannot have growth, we cannot have reduced unemployment, indeed we cannot sustain a free enterprise system, if inflation is allowed to continue on its present course. The question is: What can we, what are we doing about it?

When President Sadat was in Washington two weeks ago, he reported to the Chamber of Commerce that World Bank officials had told him that the Egyptian economy had to be cleaned up. Sadat was reminded of the old business adage that it takes as long to undo a mess as it took to make it. To which he replied, "Well, the Egyptian economy has been in the making 7,000 years!"

Fortunately the history of our inflation has not been that long in the making. But the problem is nevertheless a deeply rooted one and has been around long enough to breed a novel psychology of expectations: Prices which increase in one sector of the economy are not offset elsewhere, for prices and wages throughout the economy are flexible only in an upward direction. Rising prices in turn erode profits and the purchasing power of wages. Higher prices and enlarged wage demands ensue.

The process became noticeable in the mid-50's and a whole generation of buyers, sellers and elected officials have come to expect and accept it. Inflation has become a pattern of behavior, a way of thinking. Thus labor simply assumes that, try as the President may, the prices workers pay at the counter will continue to rise. So they demand still higher wages. Industry raises prices in anticipation of inflation in order to preserve real profit margins. In the same way, government budgets for greater expenditures. Private borrowers expect that inflation will bail them out regardless of debt levels, so they borrow more. Similarly, sellers of dollars in the foreign exchange markets take for granted that inflation wil continue to erode the value of our currency. Together, these practices become self-fulfilling prophesies.

Add to this the inflationary impact of the Vietnam War, the oil crisis, the uncontrolled spread of regulatory interference and costly growth of government bureaucracy and you have a pretty good picture of what our inflation is all about.

The dilemma we face today is that of exorcising a deeply engrained psychology of inflation. This is a monumental task. It will require action on all fronts. In my view, this effort must respect at least five key principles:

- -- First, it must be a voluntary effort. There must be no controls, for we cannot afford the distortions and damage controls have on a free enterprise system;
- -- Second, we must continue to work on the fundamentals. The size of government must be reduced. Unnecessary regulation must be eliminated. The energy economy must be rationalized. We must find ways to restore productivity. We must find new incentives to capital formation;
- -- Third, we must think ahead and invest in the future. The President's efforts in the energy area are a case in point;

-- Fourth, the burden of wringing inflation from our system must be shared equally. Sacrifices will have to be made by labor, by business, by government;

-- Fifth, the sacrifices must be made over time. It will not take 7,000 years to do the job well, but it may take five, or seven, or ten.

The President is striving to provide the leadership needed on all these fronts. He has outlined in clear relief his anti-inflation program. It calls for a tight budget and tight money. For reducing the growth of government. For bringing and end to needless regulation. For eliminating the existing system of inefficiencies and disincentives in energy production. And for voluntary wage and price restraint. This is not an easy job. This surely is a change from the 1940's and 1950's when Presidents waged war on tangible enemies. It is infinitely more difficult to rouse the people to fight something so invisible and complex. Yet it must be done.

China

The other change I wish to touch on is that which has taken place in our relationship with China. It is now easy to forget that thirty years ago we were arguing over who lost China. Today we are working hard to develop a new relationship with her.

The process of change begun by President Nixon in the famous Shanghai Communique of 1972 culminated on March 1 of this year when the United States joined over 100 other nations in officially recognizing the existence of the People's Republic of China. The opening up of an American Embassy in Beijing now provides us with a formal diplomatic framework within which to develop our political relations, promote increased trade and insure the protection of U.S. citizens and interests.

What are the economic opportunities presented by rapprochement with China?

There are those who think of China in terms of a huge market with unlimited potential. Those dreams are really no different than they were 30 or 40 years ago. One of the first books I read in China in 1939 was a book by an American named Carl Crow. The title of the book was Four Hundred Million Customers. Crow had a vision of 400 million eager customers lining up for whatever we had to sell. Now there are a billion or so Chinese and there are those who feel similarly today.

There is another school of thought -- which holds that the lack of purchasing power, the low per capita income in China, and the lack of foreign exchange make for no market at all; that the Chinese have nothing to sell and nothing to buy anything with.

As in most matters, reality lies somewhere between these extremes. There are opportunities which developed properly could spell a mutually profitable economic relationship between our two countries. But they are certainly not unlimited.

The Chinese do have things to sell. They can develop some of their raw materials -- oil, tin, manganese, coal and metals. They can draw on the skill and intelligence of the people to assemble and export products from raw materials and components imported from other countries. They can develop a tourist industry.

Finally, the Chinese have an opportunity to enter the world market for light manufacturing. I visited a factory in Shanghai last month which is a case in point: The Forever Bicycle Factory. That factory is a veritable rabbit warren of small, dank buildings and bamboo huts where bike parts are made on home made machines and carried from building to building by hand to be made into bicycles. By American standards the production technology there is turn of the century. But Forever Bicycle turns out 1,700,000 high quality bicycles a year. It takes 3,900 people to do so, but it turns them out. With a little technology and management know-how the Forever Bicycle Factory could easily export to the United States or anywhere else.

For our part there is the potential to sell the Chinese the plants, equipment and technology that they will need to succeed in their modernization effort. They clearly need and are eager for American managerial, financial and technical know-how. But though they need much, they clearly are limited in resources. They will first have to turn their high hopes and hard work into cash and credit to finance purchases of things they wish to buy from abroad.

To succeed, great obstacles will have to be overcome. China is still a very poor country, which has lost a whole generation of teachers, of scientists, of technocrats and which remains difficult to coordinate and manage. Whether or not the process of development now underway can ever be stopped; whether or not a political change of so fundamental a nature can ever be reversed; whether or not the Chinese people will have the patience to stay the course and to accept the inevitable setbacks nobody knows.

But it is clear that the United States has an opportunity to develop a fruitful relationship after so many years of interruption. It is, I think, in the interests of both countries that the opportunity be pursued.

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Tonight, I talked about two challenges imposed on us by changes in our country and in the world. There are many others. But these two -- one in domestic and the other in foreign policy -- have special meaning for this audience. Inflation is the most pervasive and the most pernicious threat to our economy and to our way of life. The new relationship with China, of course, has special significance, not only to me, but also to the University and to this region of our country.

Will we have the courage, the ingenuity and the wisdom to meet these challenges -- and the many others we must face, now and in the years to come?

I have unbounded optimism that we will. For one thing has remained unchanged: we still have the same precious assets we have marshalled so successfully in the past in the pursuit of great tasks.

In the world, the United States still stands as the single strongest and most dynamic power. Our natural resources are vast. Our technology remains second to none. The optimism and pragmatism of our people are unimpaired. And while not perfect, we are still looked upon by others as the example to follow in maintaining a free society and a productive free market economy.

Again and again we have shown that the drive and dynamism of Americans can be harnessed to deal with our critical problems, once we put our minds to the job. We did it when we sent a man to the moon and we are doing it in reordering our civil rights. We are doing it in opening up equal opportunity to women and to our minorities to share equally in a better life, and we showed that we can stand together and support our government in providing leadership on such difficult international problems as promoting the peace process in the Middle East.

We have the resources and we can harness them to meet the other challenges of a changing world. So we can lick inflation, solve our energy problems and establish a new relationship with China, if we face up squarely to the task.

On the Berkeley campus today, I sense the same gratifying preservation of the best things I found the first day I arrived in this country and at this University. There remains the opportunity for the highest qualtiy education for all citizens regardless of race, religion or origin. And although the incidental fee is no longer $35, it is still being provided at bargain rates.

The University today, as when I first came, is still the meeting place for students and scholars from all parts of the world, and it remains an outstanding center of learning and scholarship, as it has been for so long. It must never be otherwise.

At a critical point in my career, I had the privilege of studying under Robert Aaron Gordon, an international authority of business cycles and manpower policy who, as a champion of strong policies to achieve full employment, gave me much of the background and insight which I was able to use in business and in the government. And, of course, there were others equally eminent, like Howard Ellis, still writing and researching at the age of 81, not to speak of Jack Letiche who, I understand, is still teaching international economics and economic development, much as he taught me about these areas in which I worked ever since.

These, and others like Andrew Jaszi, who introduced me to the pleasures of German literature and poetry, or Hans Kelsen, the eminent scholar of international law, or Bob Scalapino, who today, as then, is still influencing scholars and students with his work on China and the Far East -- are what make Berkeley a great University.

In these important ways our alma mater has not changed. Nothing gave me greater pleasure today than to see that these things have remained the same. The University still is a place that exudes vibrancy and excitement, and where all manner of students are welcome to study.

How this would have pleased George Berkeley for whom the town wa named, I do not know. For a bit of checking tells us that is was his aim to find, as he put it, "an educational institution for the evangelization and education of aboriginal Americans." Happily, that stricture is being interpreted as liberally today as it was in my day Obviously, I am glad and proud that this is so and equally pleased that so many of my fellow "aboriginal Americans" are here with me thi evening. This diversity has been one of the great strengths of the University of California and I hope that it will always remain so.

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

FOR IMMEDIATE RELEASE April 5, 1979

RESULTS OF TREASURY'S 76-DAY BILL AUCTION

Tenders for $3,001 million of 76-day Treasury bills to be issued on April 6, 1979, and to mature June 21, 1979, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Price	Discount Rate	Investment Rate (Equivalent Coupon Issue Yield)
High -	97.974	9.597%	9.96%
Low -	97.968	9.625%	9.99%
Average -	97.970	9.616%	9.98%

Tenders at the low price were allotted 71%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY
FEDERAL RESERVE DISTRICTS:

Location	Received	Accepted
Boston	$ 90,000,000	$ 42,100,000
New York	6,954,000,000	2,649,650,000
Philadelphia	---	---
Cleveland	---	---
Richmond	25,000,000	4,000,000
Atlanta	---	---
Chicago	477,000,000	193,750,000
St. Louis	5,000,000	1,000,000
Minneapolis	60,000,000	20,000,000
Kansas City	---	---
Dallas	---	---
San Francisco	495,000,000	90,000,000
TOTAL	$8,106,000,000	$3,000,500,000

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

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FOR IMMEDIATE RELEASE April 6, 1979

REVENUE SHARING FUNDS DISTRIBUTED

The Department of Treasury's Office of Revenue Sharing (ORS) distributed more than $1.7 billion in general revenue sharing payments today to nearly 36,500 State and local governments.

Currently legislation authorizes the Office of Revenue Sharing to provide quarterly revenue sharing payments to State and local governments through the end of Federal fiscal year 1980.

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

FOR IMMEDIATE RELEASE

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April 6, 1979

REVENUE SHARING DATA RELEASED TODAY

The Office of Revenue Sharing today released the data to be used to allocate funds for Entitlement Period Eleven of the General Revenue Sharing Program.

The U.S. Department of the Treasury's Office of Revenue Sharing is sending the latest available figures on population, per capita income, local adjusted tax collections and intergovernmental transfers to each eligible unit of local government.

State governments are being provided their most recent data for population, urbanized population, per capita income, state and local taxes, general tax effort, state individual income tax collections and Federal individual income tax liabilities.

All recipient governments may review the figures and notify the Office of Revenue Sharing if they believe the figures are inaccurate. Data correction proposals should be received by the Office of Revenue Sharing by May 15, 1979.

General revenue sharing funds are allocated according to formulas set by the revenue sharing law. These formulas use data provided primarily by the Bureau Census, the Bureau of Economic Analysis, the Internal Revenue Service and the Bureau of Indian Affairs.

Quarterly payments for Entitlement Period Eleven will be made in January, April, July and October 1980, to approximately 39,000 units of State and local government. Approximately $6.85 billion will be distributed during the eleventh entitlement period.

Since the General Revenue Sharing Program was authorized in 1972, more than $45 billion has been distributed.

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

FOR IMMEDIATE RELEASE April 5, 1979

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $2,881 million of $5,951 million of tenders received from the public for the 2-year notes, Series R-1981, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	9.66%1/
Highest yield	9.70%
Average yield	9.68%

The interest rate on the notes will be 9-5/8%. At the 9-5/8% rate, the above yields result in the following prices:

Low-yield price	99.938
High-yield price	99.868
Average-yield price	99.903

The $2,881 million of accepted tenders includes $730 million of noncompetitive tenders and $1,408 million of competitive tenders from private investors, including 18% of the amount of notes bid for at the high yield. It also includes $743 million of tenders at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities. The $743 million for foreign and international monetary authorities is equal to the aggregate amount of their holdings of notes that matured March 31, 1979.

In addition to the $2,881 million of tenders accepted in the auction process, $640 million of tenders were accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing short-term bills, and $9 million of tenders were accepted at the average price from Federal Reserve Banks as agents for foreign and international monetary authorities. The $9 million is new cash and represents the amount by which the aggregate tenders from foreign and international monetary authorities exceeded the aggregate amount of their holdings of notes that matured March 31, 1979.

1/ Excepting one tender of $25,000

B-1530

General revenue sharing funds are allocated according to formulas set by the revenue sharing law. These formulas use data provided primarily by the Bureau Census, the Bureau of Economic Analysis, the Internal Revenue Service and the Bureau of Indian Affairs.

Quarterly payments for Entitlement Period Eleven will be made in January, April, July and October 1980, to approximately 39,000 units of State and local government. Approximately $6.85 billion will be distributed during the eleventh entitlement period.

Since the General Revenue Sharing Program was authorized in 1972, more than $45 billion has been distributed.

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9 5/8% TREASURY NOTES OF SERIES R-1981

DATE: April 5, 1979

HIGHEST SINCE:

LAST ISSUE:

9.85% FEB. 1979

LOWEST SINCE:

9.36% NOV. 1978

TODAY:

9.68%

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

FOR IMMEDIATE RELEASE April 9, 1979

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $3,000 million of 13-week Treasury bills and for $3,001 million of 26-week Treasury bills, both series to be issued on April 12, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 12, 1979			26-week bills maturing October 11, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	97.576a/	9.589%	9.99%	95.171	9.552%	10.20%
Low	97.550	9.692%	10.10%	95.157	9.580%	10.23%
Average	97.561	9.649%	10.05%	95.161	9.572%	10.23%

a/ Excepting 2 tenders totaling $770,000

Tenders at the low price for the 13-week bills were allotted 38%.
Tenders at the low price for the 26-week bills were allotted 83%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 40,470,000	$ 40,470,000	$ 60,965,000	$ 25,105,000
New York	4,134,385,000	2,394,985,000	5,263,050,000	2,550,800,000
Philadelphia	23,955,000	23,955,000	21,325,000	11,325,000
Cleveland	39,110,000	39,110,000	86,025,000	25,025,000
Richmond	33,570,000	33,570,000	23,600,000	21,600,000
Atlanta	45,255,000	45,255,000	36,240,000	36,240,000
Chicago	218,835,000	148,835,000	271,590,000	95,240,000
St. Louis	43,970,000	29,970,000	39,520,000	15,520,000
Minneapolis	28,315,000	28,315,000	27,650,000	17,650,000
Kansas City	49,185,000	49,185,000	21,260,000	20,930,000
Dallas	19,640,000	19,640,000	16,805,000	12,805,000
San Francisco	261,600,000	120,360,000	421,875,000	143,185,000
Treasury	26,390,000	26,390,000	25,690,000	25,690,000
TOTALS	$4,964,680,000	$3,000,040,000b/	$6,315,595,000	$3,001,115,000c/

b/Includes $524,310,000 noncompetitive tenders from the public.
c/Includes $339,280,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-1531

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 10:00 A.M.
WEDNESDAY, APRIL 11, 1979

STATEMENT OF JOHN R. KARLIK
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL ECONOMIC ANALYSIS
BEFORE THE
SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

Mr. Chairman and Members of the Committee:

It is a pleasure for me to testify today regarding the proposed amendment of the International Investment Survey Act of 1976.

In order for the Department of the Treasury to continue to carry out the provisions of the Act mandating portfolio investment surveys, we agree that Section 9 needs amending. We are currently conducting a survey of foreign portfolio investment in domestic securities and a feasibility study of alternative approaches to surveying U. S. residents' portfolio investment abroad. In order to continue this work during fiscal year 1980, expenditures for these purposes must be authorized and appropriated.

A year ago when I testified before this Committee I explained our plans to conduct portfolio investment surveys mandated by the Act. During the last year we made significant progress. I would like to briefly summarize this work before presenting our budgetary requirements.

B-1532

On August 9, 1978, the Office of Management and Budget approved our survey of foreign portfolio investment in domestic securities. The survey will measure foreigners' holdings as of December 31, 1978. In November we mailed 10,600 survey questionnaires to banks, brokers, and corporations in the United States. We also completed a separate mailing to associations and other interested organizations, so that the survey would receive maximum publicity. We conducted these mailings well in advance of the December "as-of-date" to give prospective respondents an opportunity to organize their data information systems to provide the requested information at a minimum cost.

Firms were asked to return the completed questionnaire by March 31, 1979. To date over 3,000 completed questionnaires and 2,000 valid exemptions have been received. A follow-up letter has been printed and will be mailed to firms who have not responded. We are currently in the process of identifying these firms and will conduct the follow-up campaign within a few days.

While we were temporarily delayed by the hiring freeze last fall, our staffing for the survey is on schedule. All of the permanent staff and approximately one half of the temporary personnel needed for processing the questionnaires, analyzing them and writing the report to Congress have been hired. Installation of the computer facilities required for entering responses, editing for accuracy and compiling a final data base is complete. With the completion of necessary software forthcoming, we plan to begin data processing in a few weeks.

The 1976 Act also requires a survey of U. S. portfolio investment abroad. No such survey has been conducted since 1943. Given changes in the volume and structure of international financial investment flows, there is a lot to learn about conducting an outward survey. We have initiated an analysis of how to best go about surveying U. S. residents' portfolio investment abroad. Since the Act defines portfolio investment to mean any international investment other than direct investment, this is a most difficult, although challenging, technical task. Therefore, the feasibility analysis must carefully cover all aspects of conducting such a survey -- information requirements, existing data collection mechanisms, current data deficiencies, survey coverage and methodology, resource requirements, public reporting burden, and questionnaire design.

The Act requires that a balance between costs, burden to the public, and the need for information must be fully considered before implementing any data collection program. We consider this a sound principle, and each possible approach will fully take into account those considerations. In this regard, diverse and responsible views from qualified persons representing business, labor, academia, and other Federal user agencies will be actively solicited. We would also appreciate the views of this Committee regarding the uses to which data resulting from a survey of outward portfolio investment would be put. Such knowledge is essential to balancing the costs and benefits of collecting information on U.S. residents' holdings of foreign securities.

Conclusions and recommendations derived from the feasibility study will not be available for several months. However, a decision to undertake an outward survey and its particular design will be adopted only after consultation with the Members and staff of this Committee.

We anticipate that the same staff will be able to simultaneously complete the survey of foreigners' portfolio investment now under way, analyze the survey results, and complete the study of the options for conducting a survey of U. S. portfolio investment abroad. Therefore, the estimated expenditures for fiscal year 1980, compared to 1979, include no personnel increases, but additional amounts needed for data processing and for expert advice and consultation. A firm estimate of expenditures for fiscal year 1981 cannot be made until the decisions regarding an outward survey are reached.

We, therefore, request that to fulfill Treasury's responsibilities for conducting portfolio investment surveys, expenditure authorization be granted in the amount of $1.6 million for the fiscal year ending September 30, 1980.

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

RELEASE ON DELIVERY
Expected 2 P.M. EST

REMARKS OF
THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
AT THE
SIXTH ANNUAL INTERNATIONAL TRADE CONFERENCE
DALLAS, TEXAS
APRIL 10, 1979

Studying the agenda for this conference aroused some twinges of nostalgia. It was not many years ago when I too attended conferences on the problems of multinational management in an interdependent world, when I too was concerned with revising corporate strategy following a major round of tariff adjustments, when I too concerned myself with the difficulties of launching business activities in Socialist countries.

My views on these matters, of course, have broadened since I moved from the private world of the Bendix Corporation to the Treasury. But the change in my perspective does not result in major differences in the concerns or considerations that go into policy formulation. The unknown is as much unknown for the government official as it is for the business executive. The frustrations with bureaucratic delays in planning and in implementation of plans is certainly no less in government than in a large business organization. And the difficulties of reconciling disparate views is certainly no less when one is dealing with the Congress and a multitude of government agencies and departments than it is when reconciling employee and shareholder interests.

What is strikingly different is the difficulty, in government policy making, of measuring success. There is, in government, no single "bottom line" that provides an unequivocal measure of the performance of management. Instead, there are multiple objectives to be achieved, and no one can be satisfied with anything less than a passing grade in every aspect of policy. And too, the entire system in Washington is constructed so as to force decision-makers to emphasize the politically expedient. Just as inflation forces businessmen to concentrate investment on projects offering quick payouts rather than on longer-term capital outlays needed to enhance productivity, so too does Washington force policy makers to concentrate their efforts on projects with two to four year returns.

B-1533

Success in Two Critical Areas . . .

How, then, do we measure up in managing those areas of immediate concern to this conference: inflation, trade and the dollar? As a summary report card, I would suggest that we've achieved a remarkable degree of success in two of the three, but are still failing in the third.

Two successes out of three would be a good batting average in most leagues. But it isn't good enough in economic policy.

This is not to denigrate our successes. We have enjoyed a significant improvement in our trade balance, and the dollar has strengthened significantly.

Over the past year, our trade deficit has been reduced by almost 40 percent. Indeed, between the first quarter and fourth quarters of 1978, the physical volume of U.S. exports grew at a 22 percent annual rate. The volume of imports rose at only a 1 percent rate. U.S. exports of goods and services continue to grow strongly. And the recently announced energy program will significantly reduce oil imports. Thus even taking into account the recent actions taken by OPEC and the decisions of the new Iranian government to curtail military purchases, a substantial reduction in our current account deficit to about $10 to $12 billion can be expected in 1979.

Longer term, the prospect for an improved trade performance has been enhanced by the President's commitment to trade, despite considerable political costs. For example, despite the political capital that he could accrue by giving in to protectionist forces in the Congress, the President has remained steadfast in his commitment to a successful MTN. The benefits that that agreement will bring to the United States through reductions in trade barriers and the interventionist practices of foreign governments will continue to assure a vital free trading system.

On the foreign exchange front we have met with striking success in the dollar's sharp recovery from last year's lows. On a trade-weighted basis, the dollar now stands 11 percent above the levels reached just before the November 1 action. Since November 1, the dollar has risen by 21 percent against the Japanese yen, by 16 percent against the Swiss franc and 10 percent against the German mark. We have in place the resolve and the tools to assure that the strength of the dollar is maintained.

. . . Failure in the Third

Thus, on the trade and foreign exchange fronts, we have clearly made progress. But continued progress in our international economic affairs is threatened (as is the domestic progress we have made in creating new jobs and in reducing unemployment) by insufficient progress in the third vital area -- inflation. The modest abatement in inflation that we enjoyed in late 1978 has been succeeded by a reacceleration in prices this year. The increase in consumer prices thus far this year -- at an annual rate of 13 percent -- has been one and a half times its rate during 1978. The increase in February alone was the largest monthly rise in 4-1/2 years. Worse yet, the course of wholesale prices does not offer much hope of an early reversal of inflation trends. Sharp increases recorded in materials prices and for goods at intermediate stages of processing are yet to carry through to the retail level.

What is most alarming about the recent burst in inflation is that it comes on the heels of a sharp rise in prices last year. A sporadic surge in inflation reflecting transient factors that push prices up from a base of reasonable stability is annoying but not alarming. But the 9 percent increase in prices last year, and the even more rapid rise so far this year, come after a decade of inflation, a decade in which each successive wave of demand pressures brought the rate of inflation to new crests. Moreover, even when market pressures abated, each cyclical trough in inflation was higher than the preceeding one.

The generation which has recently entered the labor market as full-time participants in our economic life has grown up in an environment of ever upward-trending inflation.

Is it any wonder that this generation prefers to spend, rather than save?

Is it any wonder that this generation is willing to incur record debt-repayment burdens in order to acquire the houses and other tangible assets that seem to offer the best insulation against inflation?

Is it any wonder that today's generation of business executives increasingly focuses investment plans on quick pay-out projects, rather than on the longer-term capital outlays we need to restore productivity growth?

Is it any wonder that businesses have begun to scramble for inventories, to over-order to guard against the prospect of higher prices?

Is it any wonder that our export performance is lagging others?

Inflation is distorting our economic behavior and thwarting us, individually and collectively, in achieving our legitimate and otherwise attainable goals. We must not, and cannot reconcile ourselves to living with inflation.

<u>What Must Be Done?</u>

So what do we do? First, with your cooperation, and with the full range of government policies all directed to the same end, we must contain inflationary pressures without putting the economy through the wringer of a severe recession. For those who are skeptical that anything short of a recession will prove futile in ending the spiral of costs and prices -- and I recognize that there are many skeptics in the business community -- I would remind you that the last effort to cure inflation by recession achieved only limited success and that at great economic cost. The 1974-75 recession, the worst economic downturn since the Great Depression of the 1930's, did cut the inflation rate in half, but it still left us with an underlying rate of inflation double that of the mid-1960's. Six is better than twelve, but it is still not an acceptable inflation rate for the long term.

Our objective must not be, and is not, only to bring the rate of inflation down from the double-digit range. It is to set in place a complex of policies dedicated to continued, persistent reduction in inflation over time.

-- This is why the President is pursuing a policy of continued reduction in the share of the nation's output absorbed by Government spending.

-- This is why the President has submitted the first proposal ever to the Congress to begin a long-overdue process of evaluating the costs of regulatory interference.

-- This is why we are continually reviewing our tax structure to seek ways to encourage investment in more efficient capital equipment.

-- This is why the President has taken action to deregulate the price of oil.

With inflation and inflationary expectations so deeply embedded in our society, success in containing inflation will not come easily or rapidly. There is no "quick-fix" to a problem that has been festering so long. We must summon the resources of character that will support persistent pursuit of the objective. We must develop priorities and stick to them. And we must develop the patience to stay with the long cure.

We must learn to avoid grasping for new policies with every jiggle of an economic curve. The current situation is a case in point. After racing at an unsustainable 7 percent pace in late 1978 economic activity has moderated in the early months of this year.

But almost all of the moderation has been in consumer spending for homes and goods and, consequently, in industries directly serving the consumer. This is not an unusual development; frequently after a buying surge the consumer has wisely retrenched to catch up on the bills that come rolling in a month or so after a spending spree. Business spending for materials and ordering of new capital goods continues apace.

Because of the slowdown in consumer spending and the drop in housing starts -- both in part weather related -- the voices of alarm are beginning to sound. Concern is expressed that the economy is too fragile to withstand fiscal austerity and monetary restraint. Myopic monetarists, guided only by the monetary aggregates, are widely predicting recession, despite the evident ability of the banking system to obtain funds in sufficient quantity to support a very rapid rate of expansion in bank credit.

This is typical of the obstacles we will face in maintaining policies appropriate to the longer-run eradication of inflation. We must not panic and reverse course at the first signs of a pause in the pace of economic activity, however attractive this might be in political terms. The inflation problem won't be solved unless we persevere with our policies of fiscal and monetary restraint.

This is not to deny that austere policies run the risk of recession. But we can be sure that there is no viable alternative: encouraging inflationary forces, or passively accepting them, will assuredly lead to recession.

We therefore must take the risks entailed in maintaining and, if necessary, intensifying our anti-inflation measures. And we must demonstrate patience in waiting for these measures to yield the desired results.

It is somewhat out of character for me to be counseling patience. I have not been known among my colleagues -- either at Bendix or at the Treasury -- for that quality. Indeed, like most CEO's I have constantly prodded for a faster pace of progress, criticized efforts that seemed too timid, pushed for success that is always so slow in coming. But I do recognize that we are in a long-term struggle, that success will come only if we exercise patience and persistence.

Is It All Bad News?

While I am not renowned for my patience, neither am I identified with gloom and despair. I see some evidence to support my optimism that inflation will indeed be brought under control.

One heartening factor is the reduction in domestic price pressures stemming from the renewed strength of the dollar. The decline in the exchange value of the dollar last year was costly to us in terms of the impact on our price levels, for it directly raised the costs of imported goods, and provided an umbrella permitting increases in the prices of import-competing goods produced here. Estimates of the price effects of depreciation vary, but most analysts conclude that the decline in the dollar's value contributed about one percentage point of the 9 percent inflation from which we suffered in 1978.

This influence on our price structure should be reversed this year as the dollar strengthens. Exchange markets have, belatedly, recognized the major improvement that has taken place in our international trade balance and that the improvement has been real, not just a reflection of inflated values.

Similarly, the exchange markets now know that the President's commitment to a national energy economy is real and not just rhetorical. There is no doubt in my mind that the markets agree with the President that the program he announced last week will make a significant contribution to curbing long run inflation, improving our trade balance and, through this, to sustaining the strength of the dollar.

Oil Policy is Key

As many of you know, the Treasury Department recently concluded an intensive year-long study of the effects on our economy and on our national security of our heavy dependence on imported oil. The results of this investigation are summarized in this excerpt from my report and recommendations to the President:

> "The continuing threat to the national security which our investigation has identified requires that we take vigorous action at this time to reduce consumption and increase domestic production of oil and other sources of energy. To the extent feasible without impairing other national objectives, we must encourage additional domestic production of oil and other sources of energy, and the efficient use of our energy supplies, by providing appropriate incentives and eliminating programs and regulations which inhibit the achievement of these important goals."

The President's program will achieve these goals. We are ending the subsidization of oil imports which, by keeping domestic oil prices artificially low, has encouraged excessive use of imported oil and been a deterrent to increased domestic output. We will be dismantling the existing system of entitlements that has saddled us with channeling huge sums of money under rules and regulations so intricate that it takes a hoard of lawyers, accountants and bureaucrats to administer.

The phased decontrol path -- with complete abolition of controls by September 30, 1981 -- provides major incentives to encourage higher domestic oil production, even after taking account of the windfall profits tax proposed by the President. The program recognizes the additional costs associated with new exploration for oil, and will immediately permit the price of newly discovered oil to rise to the world level. Incremental production resulting from enhanced recovery methods will also be permitted to receive the world price. In addition, production from marginal wells will enjoy a much higher price than under present conditions. These substantial incentives for increased domestic production should result in significant savings in our oil import bill.

At the same time, by raising the price of domestic oil to its true replacement cost, we will be encouraging more prudent use of the important national asset represented by our domestic oil reserves. The conservation benefits flowing from the gradual rise in oil prices will be supplemented by a number of specific measures, both mandatory and voluntary, to reduce energy use.

Finally, the program provides major incentives to encourage greater use of alternative energy sources, and will provide the funding for development of new energy sources and technologies.

While decontrol will provide the incentive to increase production, the President's program calls for a windfall profits tax to make sure the American people recover some part of the additional oil company revenue. I know well that the business of taxing is a controversial one. Let me comment on it briefly. We anticipate that the tax proposed by the President will result in a net increase of $1.6 billion in tax receipts in FY 81 and $3.0 billion in FY 82. Those tax receipts will be placed in an Energy Security Fund. The Fund will be used to give financial assistance to people hit hardest by energy price increses, to help finance additional energy-saving mass transit and to help pay for an increased commitment to finding and developing alternative energy sources. I feel as the President does that this is a reasonable and just approach.

I can assure you that within the Congress what is considered Texas' gain in this program is considered with equal vehemence to be New England's loss. Not everyone is pleased; nor can they be when they focus only on their own immediate interests. But the implications for our trade balance and for the dollar are clear. We expect that import savings in the first full year of the program's operation (1980) will be over a million barrels a day. And these savings will mount steadily and sharply in the years beyond.

In the short-run, to be sure, the effect of decontrol will be a modest upward push to the inflation rate. There is no way, in our market-based economy, to provide production and conservation incentives without permitting prices to adjust to clear the market. There is no free lunch.

In the longer-term, by encouraging domestic production, by encouraging domestic conservation and alternative energy source use, by investing the recaptured "economic rents" in research on new energy technologies, and by freeing ourselves from the inflationary results of dependence on a cartel's pricing decisions, we will be reducing the rate of inflation in this country. The cost of phased decontrol is trivial relative to the costs we are already paying for excessive dependence on imported oil, and the even higher costs to which we would remain exposed unless we reduce this dependence.

This program deserves -- and needs -- your full support. Our efforts to curb inflation deserve -- and need -- your full support. The President has made some tough decisions. He will stick to them. Cattle raiser or oil producer, investment banker or industrialist, labor leader or management executive, your interests will best be served by the success of these programs.

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

FOR RELEASE AT 4:00 P.M. April 10, 1979

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $6,000 million, to be issued April 19, 1979. This offering will result in a pay-down for the Treasury of about $8,207 million as the maturing bills are outstanding in the amount of $14,207 million ($8,002 million of which represents two issues of cash management bills; $4,001 million of 48-day bills issued March 2, and $4,001 million of 15-day bills issued April 4). The two series offered are as follows:

91-day bills (to maturity date) for approximately $3,000 million, representing an additional amount of bills dated January 18, 1979, and to mature July 19, 1979 (CUSIP No. 912793 2C 9), originally issued in the amount of $2,911 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,000 million to be dated April 19, 1979, and to mature October 18, 1979 (CUSIP No. 912793 2R 6).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing April 19, 1979. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,429 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. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, April 16, 1979. 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-1534

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. 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 must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on April 19, 1979, in cash or other immediately available funds or in Treasury bills maturing April 19, 1979. 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, 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 April 10, 1979

RESULTS OF AUCTION OF 14-YEAR 10-MONTH 9% BONDS

The Department of the Treasury has accepted $1,500 million of the $2,649 million of tenders received from the public for the 14-year 10-month 9% bonds maturing February 15, 1994, auctioned today. The range of accepted competitive bids was as follows:

	Price	Approximate Yield
High -	99.09	9.10%1/
Low -	98.69	9.15%
Average -	98.79	9.14%

The $1,500 million of accepted tenders includes $107 million of noncompetitive tenders and $1,393 million of competitive tenders from private investors, including 65% of the amount of bonds bid for at the low price.

1/ Excepting two tenders totaling $7,000.

B-1535

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

FOR RELEASE ON DELIVERY
EXPECTED AT 11:00 A.M.
April 12, 1979

DEPARTMENT OF THE TREASURY
OFFICE OF THE SECRETARY
NEW YORK CITY LOAN GUARANTEE PROGRAM

INTRODUCTORY STATEMENT OF THE HONORABLE ROGER C. ALTMAN
ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE)
BEFORE THE SENATE SUBCOMMITTEE ON HUD - INDEPENDENT AGENCIES
OF THE SENATE APPROPRIATIONS COMMITTEE

Mr. Chairman and Members of this distinguished Subcommittee:

I appear before you today to discuss the activities and plans of the Treasury Department as they relate to the administrative expenses of its Office of New York Finance. My testimony this morning will cover three major areas:

-- A brief history of the New York City Loan Guarantee Act and its administration by Treasury's Office of New York Finance;

-- A review of Treasury's additional responsibilities imposed by P.L. 95-497 in monitoring pension fund participation in the City's Four Year Financial Plan; and

-- The level of appropriations Treasury believes necessary to enable it to effectively carry out its statutory responsibilities in the 1980 fiscal year.

B-1536

<u>The Guarantee Act</u>

The New York City Loan Guarantee Act of 1978 (P.L. 95-339), authorizes the Secretary of the Treasury, during the 1979 - 1982 period, to issue up to $1.65 billion of Federal guarantees of City long-term debt. These Federal guarantees are the core of an overall four-year $4.5 billion long-term borrowing plan. Only $750 million of the Secretary's guarantee authority is actually scheduled to be used as part of the $4.5 billion plan. The balance of $3.75 billion in long-term financing will be provided on an unguaranteed basis by the local clearinghouse banks, City and State employee pension funds, local savings banks and insurance companies, and by the public markets. The remaining $900 million of guarantee authority, therefore, is on a standby basis in 1981 and 1982, to be used only if the public markets are not available to the City or MAC long-term bonds in those years. Table I presents this four year borrowing Plan in detail:

<u>Table I</u>

Bond Issues per Four Year Plan
($ in millions)

	1979	1980	1981	1982	Total
Guaranteed City:	$ 500	$ 250	--	--	$ 750
Unguaranteed City:	--	--	$300*	$650*	950
MAC Private Placements:	401	537	537	325	1,800
MAC Public Issues:	500	500	--	--	1,000
Total	$1,401	$1,287	$837	$975	$4,500

*Backed up by standby guarantee authority up to $900 million if City and/or MAC bonds cannot be sold publicly.

On November 17, 1978 Treasury issued the first $200 million of guarantees and issued the next $150 million on February 15, 1979. Prior to the extension of each round of Federal guarantees, the Guarantee Act requires that the Secretary make a series of fourteen findings the most important of which are as follows:

-- the City has the capacity to repay the Federally guaranteed City indebtedness;

-- the City is unable to obtain credit elsewhere in sufficient amounts and on reasonable terms;

-- that a financing plan satisfying the City's short- and long-term needs exists and is sound; and

-- that the City is making substantial progress towards truly balancing its budget in accordance with generally accepted accounting principles (GAAP) by its fiscal year 1982.

The Guarantee Act also requires the City to obtain both its long- and short-term financing in the public credit markets as soon as practicable. In January, 1979 the City re-entered the public credit markets for the first time in four years by successfully selling $125 million of its short-term notes. A public sale of another $150 million in notes took place on March 1, 1979, at an interest rate more favorable to the City than its initial public issue. Both issues were oversubscribed.

Treasury has provided the staff of the Subcommittee with copies of the Secretary's findings, and supporting documentation, prepared in connection with the most recent issuance of $150 million of Federal guarantees on February 15, 1979. The same determinations must be made anew in May when another $150 million in guarantees are scheduled to be issued, and thereafter whenever the Federal guarantees are requested pursuant to the Guarantee Act.

In order to carry out these responsibilities, the staff of the Office of New York Finance must monitor, on a continuous basis, the fiscal activities of the City, the State and Federal governments as they relate to the City. This involves:

-- review and analysis of monthly and quarterly City financial statements and related reports;

-- tracking the City's daily cash flow requirements and assessing the time schedule and amounts required for seasonal financing;

-- studying the effects of urban legislation enacted by the 95th Congress and proposed to the 96th Congress;

-- contact with (1) credit rating services with respect to investment grade rating of City securities, and (2) the financial community and the City's financial advisor with respect to receptivity of the public markets to the City's debt securities;

-- meeting with the City and agencies assigned to monitor the City, e.g., Financial Control Board, Office of the Special Deputy Comptroller (State), MAC and GAO; and

-- liaison with New York State officials with regard to the State's commitment of continued support for New York City, along with other cash flow and budgetary matters.

The Secretary's November 9, 1978 report to Congress covering Treasury's activities under the Guarantee Act is included as Exhibit I. The next such report is due to be submitted to Congress on May 8, 1979.

Companion Legislation

The companion legislation to the Guarantee Act is P.L. 95-497. This affords certain City and State pension funds with protection in purchasing City and MAC indebtedness pursuant to the City's Four Year Financing Plan. The funds' tax exempt status for failure to satisfy certain sections of the Internal Revenue Code is assured, provided they comply with the requirement of P.L. 95-497. Without this legislation, the pension funds would not have committed to purchase securities as part of the City's $4.5 billion of the Four Year Financial Plan.

Treasury's responsibilities under P.L. 95-497 are several. Initially, the Secretary was required to not disapprove the purchase agreements entered into by each of the participating City and State pension funds for the purchase of City or MAC indebtedness. P.L. 95-497 imposes standards that must be satisfied in order for the Secretary to make that determination.

The two most significant are:

-- that the issuance of indebtedness by the City will not jeopardize their ability to make future pension fund contributions; and

-- that the purchase of City indebtedness will not endanger the ability of the pension funds to pay future pension benefits.

The staff of the Subcommittee has been provided with copies of the determinations made by the Secretary in regard to the Guaranteed Bond Purchase Agreement, the Bond Purchase Agreement, and the Loan Agreement. These agreements put into place the City's $4.5 billion Four Year Financial Plan.

In addition, the Treasury has an ongoing monitoring function under P.L. 95-497. Whenever an acquisition of City or MAC indebtedness is made pursuant to one of the purchase agreements, the Secretary must find that the acquiring fund does not hold more than 50 percent of its assets in City and MAC indebtedness, and does not have a negative cash flow. This, too, requires extensive monitoring by Treasury's Office of New York Finance.

Structure of the Office of New York Finance

In order to carry out its responsibilities, Treasury's Office of New York Finance maintains two offices-one in Washington and one in New York City. In addition, the services of an accounting consultant--currently Arthur Andersen & Co. are used, although reliance upon such outside services, has decreased and will continue to do so.

The Washington office has several responsibilities:

-- Analysis of Federal aid to New York City;

-- Economic forecasting and impact of national economic trends on New York City's economy;

-- Preparation of the Secretary's determinations with respect to the Guarantee Act and P.L. 95-497;

-- Preparation of testimony and background materials in conjunction with Congressional oversight and requests; and

-- Administration of the office, e.g., budget, contracts, procurement.

The staff located in New York City has primary responsibility for Treasury's day-to-day dealings with the City, State, and State agencies monitoring the City's finances. In addition, the New York Office conducts reviews of the City's budget and programs, audits and verifies the reports received from the City and its monitors and, if necessary, recommends changes and improvements to the reports. In addition, the office inspects accounts, books, records and other financial documents of the City or any financing agency participating in the financing needs of the City.

Administrative Expenses

Our appropriation under the New York City Loan Guarantee Act of 1978, in fiscal year 1979, is $1.050 million. In addition, we are requesting a supplemental of $34,000 to accommodate the FY 1979 civilian pay increase as authorized by Executive Order 12087 dated October 7, 1978. This increase, coupled with a $50,000 reduction, amounts to a request for $1.034 million for fiscal year 1980.

The fiscal year 1979 budget is on track. Even with several large obligations yet to be incurred such as an upgrading of communications equipment, involuntary relocation of both Washington and New York offices and additional consulting contracts, the Office will be able to operate within its budget. Presently, our professional, secretarial and clerical staff totals 16.

The administration is requesting that you appropriate only $1.034 million to fund 1980 requirements. Of this amount, approximately 66 percent, $683,000, is allocated for personnel compensation and benefits, $25,000 for travel, $20,000 for rent, utilities, communication, supplies, equipment and $306,000 for services provided to the Office by Treasury budget and personnel offices, and consultants.

Last year, before this Subcommittee, I committed to decrease Treasury's dependence upon outside experts while increasing the internal capabilities of its Office of New York Finance. Thus far, consulting expenditures contracted to date have been reduced. We project that approximately 32 percent of our FY 1979 appropriations will be spent on outside consultants versus 55 percent in FY 1978. Our FY 1980 budget allocates only roughly 25 percent of the requested appropriation for consulting.

Finally, let me note that the Guarantee Act requires the City to pay to the Treasury a guarantee fee of .5 percent per annum on the outstanding principal amount of Federally guaranteed City bonds. Over the maximum period during which guarantees will be outstanding - Fiscal years 1979 - 1993 - approximately $25 million in guarantee fees may be paid by the City to the Federal Government. This should offset by a more than 3 to 1 ratio the Treasury's administrative expenses under the Act over that same period. In fiscal year 1980, for example, we expect to receive $3.618 million in guarantee fees compared to the $1.034 administrative budget. To date, we have received approximately $462,000 in guarantee fees from the City.

This concludes the prepared portion of my testimony. I will be pleased to respond to any questions.

Thank you.

EXHIBIT 1

THE SECRETARY OF THE TREASURY

WASHINGTON 20220

NOV 9 1978

Dear Mr. Chairman:

On August 8, 1978, President Carter signed the New York City Loan Guarantee Act of 1978 (Public Law 95-339). Section 108 of the Guarantee Act entitled "Reports to Congress" requires that "within three months after the date of enactment of this title, ... the Secretary shall transmit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance, and Urban Affairs of the House of Representatives a report containing a detailed statement of his activities under this title."

I welcome this opportunity to relate the efforts of the Department of the Treasury in connection with the Guarantee Act over the past three months.

Background

In the spring of 1978 the Administration requested Congressional authority, subsequently granted in the form of the Guarantee Act, to provide Federal guarantees for New York City indebtedness based on the following principles:

-- Preserving New York City's Solvency: We were convinced that the effects of a bankruptcy would be extremely serious for the residents of the City and State, the market for all municipal securities, and for foreign confidence in the United States. A concerted effort in the form of the City's \$4.5 billion Four-Year Financial Plan, the cornerstone of which was the availability of Federal guarantees up to \$1.65 billion of City indebtedness, was generated to prevent bankruptcy and to allow the City to achieve financial self sufficiency within a reasonable time.

-- Maximum Budget and Financing Efforts by the Local Parties: Primary responsibility for New York City's financing rests with the local elected officials and the relevant private parties at the City level. Beyond that, the City is the responsibility of New York State. The Federal financing assistance in the form of guarantees was provided only under extraordinary circumstances and was limited to issuance over a four-year period.

-- A Truly Balanced City Budget is a Prerequisite to Ending this Crisis: New York City lost access to conventional borrowing sources because it incurred large budget deficits, financed operating expenses with capital borrowings, could not control its chaotic record keeping systems and otherwise lost control of its finances. In the past three years, these deficits have been reduced significantly. The City has also installed an integrated, data-based financial reporting and record keeping system. We believe that achievement of true budget balance is the key to restoring the City's access to the credit markets. The financing plan is conditioned upon achievement of a budget balanced in accordance with Generally Accepted Accounting Principles ("GAAP") by 1982.

-- The New York City Financing Crisis Should be Resolved Once and For All: The only acceptable plan for future financing of the City is one which will restore permanently the ability of New York City to finance itself.

Four-Year Plan - Financing

The overall objective of the Four-Year Financing Plan is to enable the City to return fully to the credit markets for seasonal and long-term needs after Guarantee Act authority expires on June 30, 1982. In order for this to occur, it was necessary for the City to take several fundamental steps to reform its finances. These include:

-- An accelerated phase-out of the "capitalized expense items" over a period of three years instead of the eight permitted under State law. This would enable the City to return to the capital markets that much earlier by reducing the time the City would be operating at a deficit, according to GAAP. This is one of the key factors restricting market access.

-- Elimination of the need for the State to advance $800 million in aid in the last quarter of each City fiscal year (which, in fact, was the rolling over of prior years' deficits). This action would also reduce to below $1 billion annually the amount of City seasonal borrowing. The exceedingly high level of short-term borrowing is another element blocking market access.

In addition to these basic reforms, the City needed sufficient long-term funds during the Plan period in order to maintain its physical plant and to make needed investments for future economic development. Funds were also needed by MAC in order to issue refunding bonds so as to lower MAC debt service in the later years of the Plan and, thus, reduce the City's overall debt service burden during FY 1979-1982.

The Four-Year Financing Plan, covering FY 1979-1982, has evolved to include the following elements:

Purpose	Amount ($ in millions)
City expenditures for bricks and mortar	$2,300
Phase-out of capitalized expense items	900
MAC Refunding bonds	600
Bonding out the State advance	400
Bonding the MAC capital reserve fund	300
Total City Financing Plan	$4,500

Most significantly, the participants reflect the overwhelming involvement of local parties. In fact, over 80 percent of the $4.5 billion will be privately placed with or underwritten by New York institutions. The components of the $4.5 billion in financing will be supplied in the following approximate amounts:

Sources		Amount ($ in millions)
MAC Bonds		
New York Financial Institutions:		
City & State Pension Funds	$625	
Clearinghouse Banks	625	
Savings Banks	300	
Insurance Companies	250	
		1,800
Public Issues		1,000
City Bonds		
Public Issues		950
Guarantee Bonds purchased by City and State Pension Funds		750
Total		$4,500

Last week, agreement was reached on the remaining major open issues in the Four-Year Financing Plan. All parties are proceeding to complete the formal documentation as soon as possible and the first closing is expected during the next two weeks. Copies of all the final documents will be forwarded to you when available.

Finally, a discussion of the City's short-term, seasonal financing is appropriate. The City's seasonal financing is no longer of the large dimension ($3 billion) it was in the recent past. The reduced seasonal needs of the City are now estimated to peak at $800 million for FY 1979.

Four-Year Plan - Budget

The Treasury's Office of New York Finance commenced its review of the City's FY 1979 Budget and Budget Plan for the subsequent three years with the submission of the initial Plan to me on January 20, 1978. My staff and our consultants, Arthur Andersen & Co., reviewed both the assumptions underlying the projections of baseline estimates and the estimates, themselves. Reports prepared by the New York State Financial Control Board and by the Special Deputy State Comptroller for New York City were also analyzed. Similar studies have been conducted of the Executive Budget and Budget Plan, issued by the City on April 25, 1978, as well as the major updates to that Plan issued on August 24, September 25 and on October 6, 1978.

The latter two modifications were in response to my requests for the formulation of detailed, recurring programs for City initiated actions to close projected budget gaps instead of reliance on third party actions, such as Federal or State aid. The Financial Control Board has scheduled a meeting for November 9, 1978 to review the last two plan revisions.

In conducting budget reviews our staff assesses the reasonableness of the budget gaps presented and the City's plans to close those gaps. Our consultants have confirmed to us that the plans and modifications were developed on a consistent basis especially as related to assumptions made by the City and methodologies used.

Our staff has participated in many meetings with key City internal accountants, staff of the City's independent auditors and staff from the various other monitoring agencies to discuss and resolve accounting issues raised relative to the City's budget and treatment of items therein. Most of these issues have been resolved and are reflected either in the City's Audited Financial Statements for its fiscal year ended June 30, 1978 (appended hereto) or in the revised Plans.

Current General Activities

During the past three months, the Treasury has been especially active in assisting efforts to formally implement the City's Four-Year Financing Plan in conformity with the requirements of the Guarantee Act.

The Deputy Secretary, the General Counsel and the Assistant Secretary for Domestic Finance have been actively involved in the negotiating process. Indeed, this $4.5 billion massive undertaking with over one hundred participants has required and will continue to require coordination by many of the most seniorTreasury officials.

A Special Assistant to the General Counsel has devoted all of his time to the drafting, preparation and review of the various financing documents, certifications, legal opinions and other corrollary instruments. He also participated on numerous occasions in key stages of negotiation, tracked the enactment of relevant local, State and Federal legislation and had discussions with members of the underwriting industry and the rating agencies. Among the parties to this negotiation are the following:

1. New York City
2. Municipal Assistance Corporation
3. 11 Commercial Banks
4. 36 Savings Banks
5. 10 Insurance Companies
6. 6 Pension Systems
7. Financial Control Board
8. New York State
9. Advisors and counsel to all parties

The Acting Assistant General Counsel for Domestic Finance is now working full time on final arrangements for the closing of the financial agreements.

The professional staff of the Office of New York Finance also has been actively monitoring the progress of the negotiations and participating in them as its own market access, economic or budgetary analysis was required. It is performing the following tasks on a continuing basis, all of which involve responsibilities of the Treasury under the Guarantee Act:

(a) liaison with committees of the Congress;

(b) review and analysis of the City financial statements and related reports;

(c) assistance in completion of the City's audited financials for FY 1978 and review of relevant municipal accounting issues for the FY 1979 audit;

(d) compliance determinations concerning the conditions of eligibility under the Guarantee Act;

(e) contact with (1) credit rating services with respect to investment grade rating of City securities and (2) the financial community and the City's financial advisor with respect to accessibility of the City's debt instruments to the public markets;

(f) liaison with New York State officials with regard to the State's commitment of continued support for New York City, along with other cash flow and budgetary matters;

(g) study the impact of urban legislation enacted by the 95th Congress; and

(h) tracking the City's daily cash flow requirements and assessing the time schedule and amounts required for seasonal financing.

The Director of the Office of New York Finance, and other senior members of my staff will be delighted to meet with your staff at their mutual convenience to amplify information contained in this report.

Sincerely,

Mike

W. Michael Blumenthal

The Honorable
William Proxmire
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D. C. 20510

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

FOR IMMEDIATE RELEASE
April 13, 1979

Contact: Del Dobbins
202/566-5211

TREASURY ISSUES SIXTH DISC ANNUAL REPORT

The Treasury Department today released its sixth Annual Report on the "Operation and Effect of the Domestic International Sales Corporation Legislation" (DISC). This report covers income tax returns for DISCs with accounting periods ending between July 1, 1976, and June 30, 1977, referred to as DISC year 1977.

Highlights of the report are:

-- The revenue cost to the Treasury was $750 million for DISC year 1977, compared to $1.2 billion for DISC year 1976. The reduction in the revenue cost in DISC year 1977 was due to the curtailment of DISC benefits required by the Tax Reform Act of 1976.

-- Total U. S. exports are estimated to have been $3.9 billion higher in DISC year 1977 than they would have been without the DISC program. The reduced incentive to export under the Tax Reform Act may not be reflected in the $3.9 billion DISC effect because of the delayed reactions to a reduction in export incentives. Moreover, the Tax Reform Act was not passed until October 1976, but was made effective retroactively to January 1976. This $3.9 billion estimate has not been adjusted to take account of either flexible exchange rates or the possible displacement of non-DISC exports by DISC exports, both of which tend to diminish the ultimate impact of DISC.

-- The ten largest beneficiaries of the DISC program realized 21 percent of the total tax saving.

The DISC report examines foreign export tax practices, the Multilateral Trade Negotiations (MTN) Subsidies/Countervailing Measures Agreement, and the General Agreement on Tariffs and Trade (GATT) prohibition against rebating corporate income and ohter direct taxes to exporters. Because

(MORE)

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direct tax burdens are generally higher in foreign countries than they are in the United States, the report notes that allowing all countries to rebate direct taxes to exporters would have the initial effect of worsening the U. S. competitive position.

Copies of the sixth DISC Annual Report are available for purchase from the Superintendent of Documents, U. S. Government Printing Office, Washington, D. C. 20401. When ordering, use Stock No. 048-044-01608-7.

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

FOR IMMEDIATE RELEASE April 16, 1979

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $3,000 million of 13-week Treasury bills and for $3,001 million of 26-week Treasury bills, both series to be issued on April 19, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 19, 1979			26-week bills maturing October 18, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	97.578 a/	9.582%	9.98%	95.147 b/	9.599%	10.26%
Low	97.564	9.637%	10.04%	95.123	9.647%	10.31%
Average	97.570	9.613%	10.02%	95.133	9.627%	10.29%

a/ Excepting 2 tenders totaling $80,000
b/ Excepting 1 tender of $250,000

Tenders at the low price for the 13-week bills were allotted 63%.
Tenders at the low price for the 26-week bills were allotted 98%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 36,085,000	$ 34,975,000	$ 22,375,000	$ 22,375,000
New York	4,727,610,000	2,325,210,000	4,902,615,000	2,542,615,000
Philadelphia	29,060,000	29,060,000	12,185,000	12,185,000
Cleveland	41,250,000	36,000,000	28,685,000	28,685,000
Richmond	34,285,000	31,025,000	21,460,000	21,460,000
Atlanta	34,430,000	34,430,000	25,235,000	25,235,000
Chicago	454,705,000	119,705,000	268,615,000	73,615,000
St. Louis	41,540,000	28,800,000	34,865,000	24,865,000
Minneapolis	5,500,000	5,500,000	5,770,000	5,770,000
Kansas City	35,895,000	34,795,000	17,655,000	17,655,000
Dallas	29,495,000	29,495,000	14,940,000	14,940,000
San Francisco	403,520,000	262,520,000	302,745,000	182,745,000
Treasury	28,500,000	28,490,000	28,885,000	28,885,000
TOTALS	$5,901,875,000	$3,000,005,000 c/	$5,686,030,000	$3,001,030,000 d/

c/ Includes $ 547,855,000 noncompetitive tenders from the public.
d/ Includes $ 321,925,000 noncompetitive tenders from the public.
1/ Equivalent coupon-issue yield.

B-1538

DATE: April 16, 1979

	13-WEEK	26-WEEK
TODAY:	9.613%	9.627%
LAST WEEK:	9.649%	9.572%
HIGHEST SINCE:		
8-26-74		9.930%
LOWEST SINCE:		
4-3-79	9.593%	

direct tax burdens are generally higher in foreign countries than they are in the United States, the report notes that allowing all countries to rebate direct taxes to exporters would have the initial effect of worsening the U. S. competitive position.

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FOR IMMEDIATE RELEASE
April 17, 1979

Contact: Jack Plum
202/566-2615

STUDY OF GEOGRAPHIC RESTRICTIONS ON BANKING

The Treasury Department today released an outline of work and a background paper prepared for the study of geographic restrictions on banking required by the International Banking Act of 1978.

The work outline presents a framework for evaluating the major policy options for governing the power of despository institutions and their holding companies to establish and acquire branches and subsidiary banks.

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B1539

COMMERCIAL BANKING UNDER THE MCFADDEN ACT

A Summary of Issues and Findings

March 2, 1979

Mark G. Bender
Office of Capital Markets Legislation

Contents

I. Introduction

At the national level, policy regarding the ability of commercial banks to expand geographically through branching is specified in the McFadden Act of 1927, as amended by the Banking Act of 1933. These statutues provide that the branches of national banks are to be limited to the same geographic areas as permitted to state banks by the various state laws. The net result of this policy of over forty years duration has been the current heterogeneous banking structure of the nation: unit banking in some states; statewide branching in other states; and limited branching in the remainder.

In recent years the pressures to reassess and revise McFadden have risen measurably. The Hunt Commission, for one, explicitly recommended in 1971 that "the power of commercial banks to branch, both de novo and by merger, be extended to a statewide basis, and that all statutory restrictions on branch or home office locations based on geographic or population factors or on proximity to other banks or other branches thereof be eliminated." Liberalized branching was again the subject of various financial reform proposals of the Congress in the 1970's. Also, in its analysis of electronic banking terminals the EFT Commission in 1978 recommended that "State and federally chartered depository institutions should have the power to offer debit services anywhere in the country through terminal-based EFT systems," while "deposit-taking through EFT terminals should be gradually expanded." Finally, the gradual growth of the service powers of nonbank depository institutions which are not limited in branching by McFadden has introduced additional pressures for the realization of "competitive parity" for commercial banks.

Many of the issues surrounding McFadden are as much political as economic in nature and pertain to the "dual banking system" rubric. Such issues include: (1) to what extent federally chartered institutions ought to be restricted by state laws governing state-chartered institutions; (2) whether state boundaries should constitute the ultimate limit on branching by banks; (3) how the competitive balance of different classes of federally-chartered institutions can be maintained within particular states; and (4) how the competitive balance between federally-chartered and state-chartered institutions can be maintained within particular states.

Other McFadden issues are more directly related to the overall comparative economic performance of commercial banks in the different branching environments. Among others, these issues include: (1) whether or not bank safety and soundness is significantly different by branching environment; (2) whether the convenience and needs of the public are better met in liberal as opposed to restrictive branching states; (3) how concentration and monopoly power vary by branching statutues; (4) whether bank operating economies vary significantly by branching or nonbranching status; (5) how other forms of multi-office banking are related to variations in banking statutes; (6) how the urban-rural allocation of credit is impacted by branching; and (7) what are the implications of new banking technology for traditional bank branching policy.

Most of the foregoing McFadden issues have been the subject of extensive debate and investigation for a good many years, resulting in a substantial literature. The most recent major effort at reassessing McFadden was undertaken in 1976 by the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs of the United States Senate. That Compendium and other source materials provide the background upon which this summary of McFadden issues and findings is based.

II. National Branching Policy

For the greatest part of the nineteenth century branch banking was of little or no concern as a national policy issue. Most banking markets were highly localized and only required a single head office; communication and transportation systems were not yet highly developed; bank notes could be widely dispersed geographically from any single location; and the widespread adoption of "free banking laws" provided a model for single-establishment banking.

It was not until the onset of the Civil War that the structure of commercial banking became a national policy concern. Even then, however, the concern was more one of financing the War and also of restoring the public's confidence in circulating currency than it was of other attributes of the banking system. In fact, neither the National Currency Act of 1863 nor the National Banking Act of 1864 -- which together laid the foundations for the national banking system -- ever bothered to address branch banking per se. Still, the National Banking Act has been interpreted as preventing branch banking by national banks. This is so because in two critical provisions where location was referenced it was done so in the singular.

With the passage of time branch banking grew in importance as an issue. By the early 1900s large urban areas presented new incentives for bank expansion; communication and transportation facilities had improved measurably; and deposit banking, which was amenable to the geographic extension of banking facilities, had clearly displaced bank notes in importance. Furthermore, following the lead of California in 1909, many states passed favorable branching legislation for state-chartered banks. As a consequence, national banks, which perceived themselves to be at a competitive disadvantage relative to state banks, sought redress with respect to branching as well as other restrictions.

The McFadden Act of 1927

The McFadden Act of 1927 was the first major effort at the formulation of a national policy regarding the issue of branching by commercial banks. The Act followed upon the 1922 "teller's windows" ruling of the Comptroller of the Currency which allowed national banks to set up and operate limited service offices and agencies in those places where they were already permitted to conduct business. On balance McFadden was favorable to city-wide branching as opposed to out-of-town branching. For example, Section 7(c) states that "A national banking association may, after the date of the approval of this Act, establish and operate new branches within the limits of the city, town, or village in which said association is situated if such establishment and operation are at the time permitted to State banks by the law of the State in question." Also, in Section 7(f) the term "branch" was held "to include any branch office, branch agency, additional office, or any branch place of business located in any State or Territory of the United States or in the District of Columbia at which deposits are received, or checks paid, or money lent."

McFadden also addressed the problems of national bank competition with state banks which might have numerous out-of-town branches (as in California) by trying to curb the capacity of state banks to acquire or establish additional out-of-town branches. Furthermore, the Act provided that no

Federal Reserve member bank, national or state, could establish out-of-town branches after February 25, 1927, nor absorb other (nonmember) banks having out-of-town branches established after that date without relinquishing such branches. Also, state banks seeking Federal Reserve membership were required to relinquish all out-of-town branches established after the 25 February, 1927 date. However, no restriction on out-of-town branching by state nonmember banks was attempted. Finally, Section 7(a) of McFadden served to ligitimize the heretofore legally dubious status of national bank "teller's windows."

Whether or not McFadden intended to confer complete competitive equality between types of institutions, or whether or not it intended to confer relative supremacy over branching policy to state or federal authorities has been long debated. From their own review and analysis of the literature Fischer and Golembe concluded that, "the McFadden Act was never intended to establish <u>complete</u> branching equality between state and national banks. It was also not aimed at giving the states control over Federal branching policy... The object was not to limit just national bank branching but to limit branching."

<u>The Banking Act of 1933</u>

The anti-branching sentiment manifest in the McFadden Act receded somewhat during the economic difficulties and the banking collapse of the late 1920s and early 1930s. To many observers the better record with respect to failure demonstrated by branch banks was viewed as proof positive that unit banking was inherently less sound (although others pointed out that unit banking was largely carried on in agricultural-oriented regions and the failure rate of unit banks was a natural by-product of the disproportionately large burden of depression visited on those regions). The growth in sentiment favorable to more liberalized branching was not sufficient to carry the day, however, once the "bank soundness" argument was pre-empted by proposals for deposit insurance.

The Banking Act of 1933 (Glass-Steagall) which was finally passed in response to the "bank crisis" is most notable for its provision of a federal system of deposit insurance, credited by some observers with not only "saving" the dual banking system but with also "unifying" commercial banking to an unprecedented degree under federal supervision. The Glass-Steagall Act also broadened the branching power of national banks moderately by de-emphasizing city-wide branching in favor of branching anywhere in a state as authorized by that state for its own state-chartered banks.

The 1956 Douglas Amendment

Efforts to circumvent restrictions on bank expansion through branching led to a renewed interest in group banking as the economy recovered from the economic distress of the late 1920s and early 1930s. Bank holding companies, rather than bank chains, had by now become the most popular and the economically most significant form of group banking.

The Banking Act of 1933 did take a first step in the direction of Federal regulation of bank holding companies by requiring the latter to solicit the permission of the Federal Reserve Board before voting in the selection of the directors of affiliated banks. But major shortcomings of the 1933 legislation were that (1) companies holding only one bank were excluded from coverage; (2) BHC systems consisting of state banks only were not required to register with the Federal Reserve and could therefore expand within and beyond state borders; and (3) the effect on competition was not a condition to be considered by the Federal Reserve in the registration of BHCs.

By 1956 substantial pressures had grown for the enactment of more restrictive bank holding company legislation, due especially to concerns about concentration of resources and the statewide and interstate expansion of some multi-bank holding companies. The Bank Holding Company Act of 1956 was the first Federal legislation to focus exclusively on the holding company form of organization. More specifically, Section 3(d) of the Act, known as the Douglas Amendment, prohibited multi-bank holding companies from chartering or acquiring a bank in another state. In 1970 the legislation was extended to cover one-bank holding companies. Currently, therefore, other than for those domestic and foreign holding companies which have received "grandfather" privileges, the interstate expansion of banking is effectively prohibited.

III. Previous Policy Recommendations

Commercial bank branching policy at the national level has remained virtually unchanged in the four-and-a-half decades since Glass-Steagall; and, in the wake of substantial economic and technological advances, this has only served to increase the intensity of the branching debate. In recent years, for example, the Commission on Money and Credit (1961), the Advisory Committee on Banking to the Comptroller of the Currency (1962), the Hunt Commission (1971), the FINE Discussion Principles of the House Banking Committee (1975), and the EFT Commission (1977) have all, in one form or another, recommended more liberalized branching.

Commission on Money and Credit

In its 1961 Report the Commission on Money and Credit recommended that:

- the provisions of the National Banking Act should be revised so as to enable national banks to establish branches within trading areas irrespective of state laws;
- state laws should be revised to provide corresponding privileges to state-chartered banks;

- branching privileges recommended for national banks should be made available to federally-chartered mutual savings banks and savings and loan associations, and
- state laws should be liberalized to conform.

The Commission nevertheless qualified its recommendations by observing that the chartering authority should adopt a number of practices in the exercise of its power. These were (1) that it should avoid undue concentration in the local market; (2) that it should give new entrants a chance to compete even if their business must be partially bid away from existing competitors, and should place considerable reliance on the applicant's integrity, managerial competence, and his judgment in regard to earnings prospects of the new branch; and (3) that it should treat the applications for new branches on a par with new unit bank applications.

Advisory Committee to the Comptroller

The Report of the Advisory Committee to the Comptroller in 1962 found that "the expanding needs of our economy for banking facilities and services requires a re-examination of both Federal and State laws with respect to the branching privileges of banks." The basic question according to the Committee was whether or not, on the national level, the public interest would be best served if Congress authorized the establishment of branches by National Banks under Federal standards irrespective of the law of the State in which the National Bank is located." The Advisory Committee recommended that:

- the law should be amended so that any national bank, in addition to its present right to branch in accordance with state law, may be permitted, 2 years after the amendatory bill is effective, to establish branches within a limited area within the state in which the principal office of the particular national bank is located; and

- initially, branching within a fixed radius of 25 miles from the principal office ought to be permitted.

Committee on Financial Institutions

The 1963 Report of the President's Committee on Financial Institutions expressed strong support for bringing legislative uniformity to the federal statutory standards which govern all significant types of structural change in banking -- charters, branches, mergers, holding company acquisitions and any other form of affiliation which might be regulated.

More specifically, with respect to the branching issue, the Committee found that "extreme limitations on branching... may impede the provision of banking services and effective competition" although "it is important to avoid excessive concentration of banking (and other financial) facilities through branching." The Committee concluded that:

- the federal and state governments, within their respective authorities, should review present restrictions on branching with a view to developing a more rational pattern, subject to safeguards to avoid excessive concentration and preserve competition;

- the statutory standards applicable to granting of charters and approval of new branches should explicitly include "the effect on competition";

- in the case of each application for charter, branch, membership in the Federal Reserve System, and admission to deposit insurance, the banking agencies not directly concerned and the Justice Department should have the opportunity to submit an advisory opinion on the effect of the proposed action on competition;

- federally supervised savings and loan associations should be subject to federal standards regarding charters, branches, mergers and holding company supervision similar to those applicable to banks; and

- the Federal Savings and Loan Insurance Corporation should be given authority to pass on branching applications of state-chartered insured associations in a manner parallel to the authority of the FDIC over insured state banks.

The Hunt Commission

The Hunt Commission reported its findings in 1972. With respect to branching, the Commission "rejected proposals to permit interstate branching or metropolitan area banking by federal legislation" although it urged the states to be "progressive in changing their laws." The Commission felt that the failure of states to act "could encourage the use of inferior organizational and technological means for extending markets." It was specifically recommended that:

- by state laws, the power of commercial banks to branch, both de novo and by merger, be extended to a statewide basis; and

- all statutory restrictions on branch or home office locations based on geographic or population factors or on proximity to other banks or branches thereof be eliminated.

FINE "Discussion Principles"

In 1975 Congressional efforts to advance comprehensive financial institution restructuring resulted in the "discussion principles" of the Financial Institutions and the Nation's Economy study of the House. With respect to the branching of depository institutions, the FINE study recommended that:

- all federally insured depository institutions should be allowed to branch across state lines if not in conflict with state law;
- where a conflict with state law exists, branches should be allowed in SMSAs of two million persons or more for both out-of-state and intrastate institutions;
- where branching is prohibited, depository institutions would be allowed branches in all SMSAs with populations of two million or more; and
- depository institutions would be prohibited from branching across state lines via mergers.

The EFT Commission

In its 1977 Report, the National Commission on Electronic Fund Transfers found reason to regulate the hardware of electronic banking services -- the EFT terminal -- differently than the hardware of traditional banking services -- the brick and mortar branch. The Commission also found reason to regulate the different classes of EFT services differently. Thus the traditional "information services" such as check authorization, check guarantee and file look-up would not require new regulation. But the "funds transfer services" such as the various types of debit functions, credit functions and deposits would require regulation.

The Commission found that "the rules governing the deployment of off-premise EFT terminals should be separate and distinct from and less restrictive than the rules regarding the establishment of conventional branches," and these rules "should be no more restrictive than the rules governing that institution's ability to offer EFT services." Regarding EFT services, the Commission recommended that:

- no restrictions be imposed on the availability of the EFT based credit services of debit overdraft, point of sale credit purchase, and cash advance;
- state and federally chartered depository institutions should have the power to offer the debit services of cash withdrawal, bill or loan payment, and point of sale purchases anywhere in the country through terminal-based EFT systems;
- state and federally chartered depository institutions should be free to deploy EFT terminals on a statewide basis for deposit taking;
- state and federally chartered depository institutions should be allowed to cross contiguous state lines for the deployment of deposit-taking terminals in "natural market areas" following reciprocal approving legislation by the states; and
- the Congress should establish a date after which federally-chartered institutions may cross state lines in natural market areas for deposit taking irrespective of state legislation.

Nader's Concentration Limit

In contrast to the series of liberalizing branching policy options reviewed above, Ralph Nader has proposed a much more cautious approach. In his 1975 testimony on the FINE study Nader expressed concern over the potential for greater deposit concentration in large banking organizations if branching were allowed on an interstate basis. For example, many large banking organizations already have extensive interstate networks of nonbank offices which could rapidly assume all banking functions. As of 1975 Bank of America had 336 nonbank offices in 32 states, Citicorp had 284 nonbank offices in 34 states, Manufacturers Hanover Corp. had 151 nonbank offices in 15 states, and Chemical New York Corp. had 121 nonbank offices in 15 states.

Potentially, the interstate deployment of EFT terminal networks in combination with existing nonbank office networks could lead to "nationwide networks of control [that] would result in the McDonaldization of the banking industry...and a cartelized banking structure." This "unhealthy concentration of power undermines competitive financial markets, distorts the market allocation of credit, and thereby infects the entire economy." Nader specifically recommended that:

- interstate acquisitions be prohibited under Section 4 of the Bank Holding Company Act unless expressly authorized by state law;
- interstate EFTS terminal deployment be prohibited unless expressly authorized by state law; and
- limit commercial banks to 10% of total nationwide commercial bank deposits.

IV. Major Issues and Findings

Efforts to treat the McFadden issue in a more systematic manner have been assisted in recent years by the growing body of literature pertaining to important subissues. The latter include the relationships of branching/nonbranching to operating efficiency, the convenience and needs of the public, bank safety and soundness, alternate forms of multi-office banking, competition with nonbank depositories, and the nature of the dual banking system, among others. These major subissues are discussed below.

Operating Efficiency

The hypothesis to be tested is that branch banking organizations are more efficient in terms of costs per unit of output than are unit banking organizations. If the hypothesis can be accepted on the basis of empirical findings it follows that the position of pro-branching advocates would be strengthened and vice-versa. According to Guttentag, the relevant question in this respect "is whether a branch bank has lower costs than a group of unit banks of the same aggregate size which provide the same number of offices and other outputs."

A large number of studies of bank operating efficiency have been done in recent years, during the course of which earlier differences regarding the appropriate definitions of inputs, outputs, type and size of samples, and so on have tended to diminish. Longbrake has probably done the most recent comprehensive analysis of bank operating efficiency by branching structure. He finds that unit banks of less than $15 million in deposits are more efficient than branch banks with branch offices of the same average ($15 million) size. However, as the number of branches increases, the cost disadvantage of the branch banking organization decreases. Thus, a branch bank with five $10 million offices has costs 8.7% above those of five $10 million unit banks, while a branch bank of twenty-five $10 million offices has costs only 1.9% above those of twenty-five $10 million unit banks.

Longbrake also finds that for offices with deposits more than $15 million, branch banks are the more efficient and their advantage increases with the number of offices. Accordingly, a branch bank with five $50 million offices is shown to have costs 1.6 to 2.9% lower than five $50 million unit banks; a branch bank with 25 such offices has costs 7.6 to 9.0% lower than 25 comparable unit banks.

The net result of these findings on overall bank efficiency, however, may still be indeterminate. The outcome would seem to hinge on whether or not the typical branch bank in a liberalized branching environment could achieve an average office size of $15 million or more. New banking technology, on the other hand, may well bring that average office size requirement down.

It is Guttentag's opinion that "[I]f growth prospects are sufficiently favorable to allow branch banks to reach a size where costs are below those of unit banks, allowing such growth obviously will promote efficiency."

Credit Allocation

Another major point of departure in the evaluation of the desirability of branch banking relative to unit banking is that of credit allocation. Here, a number of hypotheses are generally introduced for testing: First, that branch banks provide a relatively more economical means of transferring funds from surplus to deficit areas than unit banks. Second, that branch banks make a greater proportion of their resources available to meet local credit needs. Third, that branch banks pursue a loan policy more favorable to large customers than to smaller ones. Finally, that branch banks tend to favor their head-office cities at the expense of their branch-office locations.

A survey of the empirical evidence by Guttentag and Herman strongly supports the hypothesis that branch banking more economically transfers funds between areas. Apparently, this is because such transfers occur "within firms, whereas comparable transfers between unit banks are market transactions subject to transaction costs and other 'frictions'." Unit banks' correspondent relationships do not seem to shift funds to deficit areas as readily as branch banking, and other inter-bank credit flows entail institutional frictions.

As regards the proportion of resources branch banks tend to allocate to local credit needs, Guttentag and Herman again find that the available evidence tends to support the hypothesis in favor of branch banking. It seems that "branch banks made more loans in relation to assets than unit banks and that this applies as well to business loans, consumer installment loans, and mortgage loans." In an even more specific analysis of business loans only, Eisenbeis finds that "statewide branching has resulted in a greater proportion of business loans to locally limited business than either unit banking or limited branching."

Empirical evidence does seem to support the hypothesis that branch banks favor the large business customer over the smaller one by allocating relatively more of their business loan portfolio to the former. But, even given this fact, it may nevertheless be true that large banks are as good a source of credit to small business as small banks since, overall, they place a larger proportion of their resources into loans.

The final hypothesis holds that branch banks will discriminate in favor of the head-office location to the detriment of branch-office locations. Studies by Johnson and Kohn and Kaye have not found this to be true. Rather than simply using outlying branches as a source of funds, the evidence seems to indicate that branch banks have higher loan ratios than unit banks in the same areas, while unit banks acquired by branch banks generally tended to increase their loan ratios.

Concentration

In many ways the single most important economic issue pertaining to the McFadden controversy is that of the concentration of resources. Two hypotheses are of relevance here: first, that branching tends to increase concentration in banking; and, second, that increased concentration in banking will manifest itself in higher service prices.

For the most part, concentration is measured in terms of the share of deposits held by the largest one, three, or five banking organizations in the market. On occasion variables other than deposits may be used; for example, the share of specific credit granting product lines held by the dominant firms. Also, to appropriately define the relevant market can itself be a significant problem: is it highly localized, statewide, or geographically larger? Should the market be defined in terms of all bank services, or specific product lines? Should it be defined in terms of inter-bank competition only, or should it be extended to include non-bank competitors?

Numerous studies of the concentration and pricing hypotheses have been done in recent years. The hypothesis that bank performance in terms of prices and profits is positively related to concentration has found widespread empirical support. In 1977 Rhoades published a paper which summarized and evaluated those major structure-performance studies done since 1959 which utilized price or profit as an indicator of performance. Thirty of some 39 studies established a statistically significant relationship between measures of bank performance and market structure. This is to say that higher prices and/or profit levels were found to coincide with higher levels of concentration, as has almost always been the case in studies of the industrial sector of the economy.

A recent study by Beighly and McCall was unique in that it focused solely on commercial bank installment lending and made use of the Lerner index as a measure of the degree of market power. According to the authors, "Bank market power, as measured by the Lerner price-marginal cost index, tends to be greater: (1) the greater the inequalities among individual bank shares; (2) the larger the market share held by the leading bank group; and (3) the fewer the number of commercial banks." It is concluded somewhat more tenuously that the market power of banks "tends to be greater in large, local markets where branch banking is permitted and where the loan interest rate ceilings are lower," and that "there are in general greater inequalities among individual bank market shares, larger shares held by the leading bank group, and fewer banks in markets where branch banking and lower loan interest rate ceilings exist."

While Beighley and McCall defined their relevant market in terms of metropolitan areas, Greer arrived at similar conclusions in his state-by-state analysis of installment lending done for the National Commission on Consumer Finance in 1974. In this case statistically significant relationships were found with respect to personal loan rates, automobile loan rates, and other consumer credit rates and a four-bank concentration ratio.

Whereas the concentration-pricing hypothesis has received significant support in the literature, the concentration-branching hypothesis has not garnered the same degree of consensus. The difference in viewpoints tends to revolve around (1) whether the analysis emphasizes established branching status or changing branching status as being most relevant to competition, and (2) whether the most appropriate market is defined in terms of larger metropolitan or statewide areas as opposed to much smaller highly localized areas.

Studies of statewide and large metropolitan area concentration in banking have almost universally found significantly higher levels of concentration in states which permitted statewide branching than in either limited branching or unit banking states. For example, in a 1972 examination of the effects of branching on competition and performance Gilbert and Longbrake found that the concentration of commercial bank deposits was greater and the number of banks smaller in statewide branching states. More specifically, "Between 1961 and 1969, the average proportion of deposits held by the five largest banking organizations increased from 72.1% to 74.2% in statewide branching states, decreased from 41.6% to 39.0% in limited branching states, and decreased from 37.2% to 33.8% in unit banking states."

Guttentag, also, found that "banking concentration is higher on both a state basis and a metropolitan area basis under branching." For example, "at the end of 1974 the five largest banks in each state on average held 75% of deposits in state-wide branching states compared to 41% in limited branching states and 34% in unit banking states." And in 1976 Heggestad and Rhoades reported on a study of changes in bank market structure in 228 major SMSAs. The authors found that "markets in unit banking states experience less increase or more decrease in concentration than markets in statewide branching states -- and by inference, than markets in limited branching states." It is suggested that this result may be attributable to the fact that "unit banking markets generally have significantly more firms and thus a larger competitive fringe."

It is often argued, nevertheless, that bank markets are highly localized and that large-area concentration ratios are relatively unimportant. Rather, it is held that the local market, protected through regulation from the entry of new competitors, is the appropriate focal-point for concern, and that new entry is easier under branching than under unit banking. In this respect, a recent study by McCall and

Peterson did find that prior to new bank entry into markets in restricted branching states, the existing banks rendered relatively poorer service to the community than was the case in liberal branching states. Accordingly, it was concluded that the greater threat of entry in the branching environment served to deter existing banks from as great a degree of exploitation as was the case in unit banking states.

Safety and Soundness

From the initial days of the dual banking system it has been argued frequently that branch banking is inherently more stable than unit banking. The correctness of this hypothesis hinges largely on whether or not branching can be shown to erode profitability, increase or decrease deposit variability, or alter the number and size of bank failures.

In a recent review of the empirical evidence available, Gilbert found that branching does not appear to "adversely affect the profitability of an institution or of its competitors." Furthermore, it is concluded that "competition may be increased substantially without endangering profitability by permitting branch institutions to open de novo offices in local markets." As suggested here, the maintenance of profitability in a branching environment would serve to support the branching-stability hypothesis. Also, an analysis of the evidence with respect to deposit variability by Lauch and Murphy found that branching was favorable to lessened deposit variability and, hence, to bank stability.

With respect to the number and size of bank failures, Gilbert found that in the period 1960-1975 "the percentage of total banks that failed...was highest in unit banking states, although not much higher than in the other categories;" but "Unit-banking states had the lowest deposit volume of failed banks, both in terms of percentage of deposits of all failed banks (11%) and percentage of deposits of all banks in that category (.02%)." On the surface at least, the lower number of bank failures in branching states would tend to support the branching-stability hypothesis while the larger size of failures in branching states would undermine the hypothesis. Nevertheless, Gilbert and others argue that any systematic relationship between recent bank failures in branching states and branching *per se* is tenuous at best. Rather, the explanation seems to be more related to the activities associated with larger banks in recent years and the latter, by chance, are more frequently located in branching states.

Convenience and Needs

The question of whether or not the public's convenience and needs are better served with branch banking than with unit banking generally involves the examination of a two-part hypothesis. First, that branching brings a wider range of bank services to the public; and, second, that branching makes more banking facilities available to the public. Branch banking, for example, is conducive to larger institutions, and it is argued that larger institutions can efficiently offer a wider range of services as well as provide more banking facilities to the public.

According to Guttentag and Herman, the available evidence supports the hypothesis that the range of services offered to the public is greater under branch banking than it is under unit banking. Typical large-institution services include "revolving credit, trust services, special checking accounts, payroll services to business customers, and foreign exchange transactions." Still, it is recognized that the offering of such services may be just as much a function of demand as it is institutional capability, since unit banks can normally meet requests for special services through the correspondent system.

There has been much less doubt, especially in the light of recent empirical evidence, that branch banking makes more facilities (offices) available relative to population than does unit banking. In a survey of the data Guttentag found clear evidence "that in metropolitan areas branch banks provide many more offices relative to population than unit banks," in fact, roughly twice as many on average. Even where small towns or nonmetropolitan areas are concerned, "more recent (and improved) studies indicate a larger margin for branch banks." The availability of a greater number of more convenient facilities has generally been considered to be a significant benefit to the public and, apparently, this is favored by branching.

Small Banks

Almost by definition alone the liberalization of branching would be expected to result in a lesser number of relatively larger banking organizations. Accordingly, the survival capabilities of small unit banks under liberalized branching has become a major subissue of McFadden. The hypothesis to be examined is that branching denies small unit banks the economic capability to compete.

A number of relatively recent studies have considered the ability of small unit banks to successfully compete in a branching environment. Kohn concluded that the small bank can compete due to the facts that (1) economies of scale in branching organizations are not so great as to overwhelm the cost competitiveness of the small bank; (2) many customers are not so interest-rate sensitive as to rapidly substitute institutions for reason of rate differentials; (3) many customers do not demand the wider range of services offered by large institutions and will not shift accordingly; and (4) many small banks are well established in terms of convenient locations, knowledge of the local market, and highly personalized customer relationships. Also, Gilbert and Longbrake found that the profitability of unit banks was not necessarily adversely impacted by the entry of branch banks into their markets. Finally, McCall and Peterson, in their study of de novo market entry, found that established unit banks could not only compete, but that their performance in terms of loans made and rates charged improved to the benefit of the local community.

According to Guttentag, "the available evidence indicates that the declining number of unit banks associated with branch banking stems largely from increased opportunities to merge and reduced incentives to charter new banks, as well as from a tendency for some unit banks to become branch banks." And, "There is no evidence that unit banks are driven out by predatory competition from large branch systems."

Branch Office Alternatives

Students of banking have long recognized that branching is but one of a number of ways to achieve multi-office banking networks. Chain banking, for example, was a significant form of multi-office banking up to the time of the Depression. Group banking, in the form of holding companies, has grown steadily in importance. And more recently, the development of electronic banking terminals has provided another alternative for the realization of multi-office banking.

An examination of the hypothesis that limitations on branching lead to a relatively greater emphasis on alternate forms of multi-office banking was undertaken by White in 1976. He found that most states which took restrictive legislative action with respect to bank holding companies did so following the Bank Holding Company Acts of 1956 and 1970. Furthermore, it was found that currently the majority of the states with restrictive legislation relative to bank holding companies pertain to that group of 31 states which had little or no holding company activity in 1957. In fact, within these states "policies on branching and multi-bank holding companies are clearly correlated" and "Restrictions or privileges for one form of banking organization are generally accompanied by similar policies regarding the other multi-office form."

Still, White notes that not all of the states which had very little holding company activity prior to the 1956 Act followed up with their own restrictive legislation, and he finds that this "may be regarded as a step toward liberalizing multi-office opportunities." Also, viewed from a different perspective, it is interesting to note that "States which have liberalized branching statutues since 1956 have usually allowed for multi-office banking through the formation of holding company groups for a number of years prior to making branching status changes effective."

In the case of electronic banking terminals, the intention of states with respect to liberalizing or restricting multi-office banking can generally be found in whether or not terminals are defined as branches for deployment purposes. In short, if an electronic banking terminal were to be considered equivalent to a bank office then that terminal's location would be governed by the existing branching statute of a given state. In this respect, current data suggest a somewhat more liberal policy overall for multi-office banking through EFT than would be apparent from branching statutues only. For example, as of early 1978 Krabill found that: (1) of twenty-two states (and the District of Columbia) that permitted statewide branching, statewide terminal deployment was also permitted; (2) of seventeen limited branching states three allowed statewide terminal deployment while the remainder restricted terminals as they did branches; and (3) of twelve unit banking states one-half allowed statewide terminal deployment, one allowed limited terminal deployment, and five prohibited any off-site terminal deployment.

Non-Bank Branching

Another concern of commercial banks faced with limitations on branching is their competitive status relative to other depository institutions which may have greater actual or potential branching freedom. In this respect, White reported that in many states the branching privileges of savings and loans, for example, are more generous than those for commercial banks. Currently, only West Virginia and Montana appear to seriously restrict branches or other off-site limited facilites for savings and loans. The other states allow branching either statewide or within limited geographic areas.

The difference in treatment of thrifts and commercial banks also occurs with respect to federally-chartered institutions. National banks must abide by the branching statutes of those states in which they operate; but federally-chartered thrift institutions need only abide by the branching regulations imposed by the Federal Home Loan Bank Board which generally coincide with state policies. Technically, federally-chartered savings and loan associations have been afforded a more liberal branching policy than have been federally-chartered commercial banks.

Dual Banking

Perhaps the final, but by no means the least debated, of the McFadden issues involves the nature of the dual banking system itself. The hypothesis is frequently put forth, for example, that any major change in the McFadden principle would serve to severely damage the dual banking system. Any judgment to be made with respect to this hypothesis, therefore, requires a better understanding of exactly what is meant by the "dual banking system."

According to Brown, "dual banking refers to a system under which states and the Federal Government have approximately equal rights regarding chartering, supervision, and examination of privately operated commercial banks." And the core of dual banking amounts to the provision of "more than one route of entry into the commercial banking business with the chartering authority supervising operations of banks authorized by it." Inherent to dual banking is the freedom existing banks have to switch from one chartering authority to another and thereby to switch supervisory frameworks.

Brown points out, however, that the maintenance of different terms of market entry, which was a major objective of dual banking, has already been compromised somewhat by the virtual necessity of a new bank's acquiring FDIC deposit insurance. Accordingly, the FDIC has gained "a potential veto over entry into banking by new state-chartered institutions not members of the Federal Reserve," while "the Federal Reserve can veto deposit insurance for banks which seek it through the Federal Reserve membership route."

Yet even though federal deposit insurance effectively deprived the dual banking system of one of its objectives -- control over new bank entry -- the system still provides bank organizers a choice in terms of applications for charters and their supervisory and regulatory framework. But, argues Brown, "if regulation were uniformly applied by all three Federal agencies, or if all policy making was concentrated in one agency...all escape routes could be closed to commercial banks." In either of these cases, "dual banking would cease to exist."

Although the states have lost considerable control over market entry via new bank chartering, they still retain authority over entry via branching. This is most evident in the authority of the states to determine the geographic limitations on all banks operating within their boundaries, per the McFadden principle. In this respect, one of the primary characteristics of dual banking -- state determination of banking structure -- appears to remain intact. But even within the context of their own branching laws, notes Brown, "the authority of the states to decide on individual branching applications is far more restricted than that of the Federal Government." This is so because as long as federal deposit insurance is involved the federal agencies can veto state bank applications, but the states cannot veto national bank applications under any circumstance. The result is that while states can determine the nature of branching inside their boundaries the federal agencies can significantly affect the actual composition or pattern of branching. Federal antitrust activities and federal regulation of bank holding companies have further contributed to an erosion of state primacy with respect to structure.

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COMMERCIAL BANKING UNDER THE MCFADDEN ACT

A Proposed Work Plan

March 20, 1979
Revised April 10, 1979

Department of the Treasury
Office of Capital Markets Legislation

This paper outlines a framework for evaluating the major policy options in the system of rules which govern the power of depository institutions and their holding companies to establish and acquire branches and subsidiary banks. In general, we believe that the debate in this area has been of sufficiently long standing that the current need is for the intelligent assessment of various policy options rather than additional extensive background analysis.

The policy options ultimately chosen must be closely linked to the degree to which they advance the purposes of the commercial banking system and the commonly accepted objectives of financial system reform. The Administration's approach should

(1) avoid excessive concentration of economic resources;

(2) promote economically optimum price, profit and output levels;

(3) assure a continued major role for small banks and preserve the vitality of the dual banking system;

(4) promote diversity of approach and responsiveness to local economic and social conditions;

(5) improve the overall efficiency of the banking system;

(6) minimize regulatory inconsistencies between bank and nonbank financial institutions;

(7) preserve the liquidity and solvency of financial institutions so as to protect their safety and soundness;

(8) decrease the cost and increase the availability of services to consumers to enhance the convenience and needs requirements of the public;

(9) strengthen the effectiveness of Government stabilization policies in the financial area; and

(10) assure a steady and adequate flow of funds to housing and preserve the stability of specialized lenders serving the mortgage markets.

Each policy option under serious consideration by the task force should be assessed in terms of its overall impact on the objectives of financial reform, over both the short and long term.

Current Policy Options

Conceptually, the policy options open for consideration run the gamut of merely maintaining the status quo to permitting unrestricted deposit taking and lending on a nationwide basis on the one hand, or "McFaddenizing" all types of financial services by banks on the other. The range of options currently includes, but is by no means limited to, the following:

1. Maintain the status quo:

   -- the states should continue to have the final word regarding the geographic location of the banking offices of both state and federally-chartered banks within their boundaries.

2. Establish a state-federal advisory committee for further study:

   -- an advisory committee made up of the appropriate state and federal banking authorities should be established to review the inconsistencies in current policies in this area and, within a specified time period, should report on mutually acceptable ways to rationalize geographical restrictions on bank operations.

3. Banks should be permitted to operate within specified and limited "trading areas". For example:

    -- banks should be permitted to have branches or subsidiaries anywhere within a specified radius of their head office (e.g., 25-50 miles) irrespective of state laws, or

    -- banks should be permitted to have branches or subsidiaries anywhere within the state of their head office irrespective of state laws, or

    -- banks should be permitted to have branches or subsidiaries within their "natural market areas", such as SMSAs, and to cross contiguous state lines within natural market areas irrespective of state laws.

4. Geographical restrictions on bank operations ought to vary according to "product line" or functional criteria. For example:

    -- banks should be allowed to have branches or subsidiaries without regard to geographic location for the provision of all wholesale banking services irrespective of state laws, or

    -- banks should be allowed to have branches or subsidiaries without regard to geographic location for the provision of all non-deposit-taking wholesale and retail banking services irrespective of state laws.

5. The expansion of banking organizations through branching or subsidiaries should be restricted only by limits on concentration and/or by the need to otherwise maintain competition. For example:

    -- banks should be permitted to have branches or subsidiaries without geographic restrictions within a state, provided that the group does not possess more than a fixed percentage of statewide banking deposits; or

-- branches and subsidiaries should be permitted nationwide, subject to such restrictions as

  o general antitrust standards, or

  o a fixed percentage of nationwide bank deposits, or

  o a maximum asset size, or

  o subject to a regulatory determination that the establishment of a branch or a subsidiary is not anticompetitive, or

  o such expansion may be done only on a <u>de novo</u> basis.

6. <u>Banks should be allowed to expand by the liberalized establishment and deployment of EFT terminals and systems</u>. For example:

-- banks should be permitted to deploy off-premise EFT terminals under rules less restrictive than those regarding the establishment of conventional branches.

7. <u>Bank organizations should be allowed to expand only through subsidiaries, either newly established or acquired</u>:

-- bank holding companies should be permitted to establish or acquire additional banks and banking offices without regard to geographic location irrespective of state laws, or

-- bank holding companies should be permitted to establish or acquire additional banks and banking offices subject to one or more of the limitations referred to in other options.

8. <u>No restrictions should be placed on the geographic expansion of banks through branches or subsidiaries</u>.

9. All bank financial services should be subjected to the McFadden principle:

   -- the statewide or interstate expansion of banking and bank-related activites by banks or bank holding companies should be governed by state rules applicable to bank branching.

Suggested outlines for the analysis of the impact of the alternative policy options considered above on each of the major objectives of financial reform follow.

1. Bank Concentration

Content Requirements

1. Review and analyze the evidence:

   a. What is the most appropriate measure of competition and/or concentration?

      -- share of deposits
      -- share of wholesale/retail service lines
      -- presence of other bank competitors
      -- presence of nonbank competitors
      -- degree of capital market integration

   b. What is the most relevant definition of the market?

      -- local
      -- metropolitan
      -- statewide
      -- natural trading areas
      -- nationwide

   c. What is the current status and degree of concentration in banking?

      -- state by state concentration ratios
      -- other market concentration ratios
      -- concentration by state branching statute
      -- concentration by type of banking organization (unit, branch, holding company)

   d. How and why have concentration ratios changed recently?

      -- due to changes in state policies
      -- due to changes in bank organizational form

   e. How important or effective are alternative barriers to entry?

      -- geographical restrictions
      -- capitalization/other requirements
      -- home office protection laws
      -- currently dominated markets/entrenched institutions

Paper (Cont.)

f. How does the McFadden Act of 1927 relate in terms of legislative history to the creation and/or maintenance of the dual banking system?

g. What is meant by the dual banking system in terms of its major attributes or characteristics?

h. In what specific ways has the dual banking system contributed to a more efficient commercial banking structure in the U.S.?

i. Can the dual banking system be effectively maintained in the absence of the McFadden Act?

j. If the McFadden Act is necessary to sustain the dual banking system should it be allowed also to govern bank expansion through "proxy" branching such as EFT terminal deployment and/or other multi-office forms?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

2. Bank Prices, Profits and Output Levels

Content Requirements

1. Review and analyze the evidence:

   a. How has banking structure affected the price, profit, and output performance of banking organizations?

      -- unit banks
      -- branch banks
      -- holding companies
      -- wholesale services
      -- retail services

   b. How has the degree of competition affected price, profit, and output performance?

      -- presence of other bank competitors
      -- presence of nonbank competitors

   c. How have recent changes in state statutes or the form of banking organizations affected performance?

      -- liberalization of branching laws
      -- liberalization of holding company laws
      -- formation of multi-bank holding companies
      -- formation of one-bank holding companies

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

3. Diversity of Approach and Responsiveness to Local Economic and Social Problems

<u>Content Requirements</u>

1. Review and analyze the evidence:

   a. What is the current status of small banks in the United States?

      -- number
      -- location
      -- "typical" community served
      -- extent of small bank "monopolies"
      -- presence of other bank/nonbank competitors

   b. How well have small banks performed in recent years?

      -- price levels
      -- profit levels
      -- output levels
      -- deposit rate paid

   c. How have recent changes in state statutes or the form of banking organizations affected the performance of small banks?

      -- liberalization of branching laws
      -- acquisition of multi-bank holding companies
      -- conversion to one-bank holding companies

   d. What lessons can be drawn about the potential structure and performance of small banks in the U.S. from other experiments in financial structure?

      -- price deregulation in U.S. securities industry

      -- nationwide branching in Canada

   e. What are the qualitative attributes or the "social values" of the maintenance of a vigorous small bank community?

Paper (Cont.)

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

4. Bank Credit Allocation Practices

Content Requirements

1. Review and analyze the evidence:

   a. How does the distribution of bank loans/prices by class of borrower differ according to bank structure?

      -- low income borrowers
      -- farmers
      -- small businessmen
      -- state and local government

   b. How does banking structure affect overall loan-to-asset or loan-to-deposit ratios?

   c. Does the allocation of bank credit to the financial institution competitors of banks differ according to bank structure?

      -- bank loans to consumer finance companies
      -- bank loans to commercial finance companies
      -- bank loans to affiliated companies with competitive product lines

   d. How does bank structure affect the overall sources and uses of funds?

      -- the flow of aggregate savings
      -- the composition of savings between deposits and other instruments
      -- competition for the savings dollar
      -- funds for capital formation
      -- funds for "new" enterprises
      -- funds for consumption purposes

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

5. Bank Operating Efficiency

Content Requirements

1. Review and analyze the evidence:

   a. How do bank economies of scale and operating efficiencies differ according to bank structure?

      -- unit banks
      -- branching
      -- limited branching
      -- multi-bank holding company
      -- one-bank holding company

   b. Are the production costs of certain bank services more sensitive to banking structure than other bank services?

      -- deposit services
      -- third party payments
      -- commercial loans
      -- consumer loans
      -- trust services
      -- mortgage loans
      -- other

   c. What externally imposed restrictions might have as significant an influence on bank operating efficiency as the particular form of bank organization?

      -- capitalization requirements
      -- liquidity requirements
      -- other bank regulations
      -- required reserves
      -- monetary policy

   d. Are there significant cost differences between transfers of capital "internal" to a multi-office banking organization as opposed to through "external" correspondent relationships?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

6. The Regulation of Bank and Nonbank Financial Institutions

Content Requirements

1. Review and analyze the evidence:

   a. In what major ways do state banking statutes differ from one another and from the National Banking Act? In what major ways are they similar?

   b. How do state statutes and the National Banking Act confer competitive advantages and/or disadvantages on their respective institutions?

   c. In what significant ways are banking organizations handicapped by state and national regulations relative to their major nonbank competitors? What are the reasons for differences in treatment?

   d. In what ways are the operations of domestic banking organizations and foreign banking organizations in the U.S. differentially impacted by statutes such as the McFadden Act, the Douglas Act, the Edge Act, or others?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

7. Bank Safety and Soundness

Content Requirements

1. Review and analyze the evidence:

   a. How has banking structure impacted on the safety and soundness of bank operations?

      -- unit banks
      -- limited branching
      -- branching
      -- multi-bank holding company
      -- one-bank holding company

   b. Have there been significant differences in bank failure rates associated with regulatory factors other than branching or other multi-office restrictions?

      -- state or national capitalization requirements
      -- state or national reserve requirements
      -- state or national liquidity requirements
      -- state or national portfolio restrictions

   c. Has federal deposit insurance virtually eliminated concern with the impact of bank structure on the safety and soundness of bank operations?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

8. Convenience and Needs/Services Availability

<u>Content Requirements</u>

1. Review and analyze the evidence:

   a. How have different bank branching restrictions affected the availability of bank financial services to the public?

      -- by type of financial service
      -- by number of branches per capita
      -- by size of market
      -- by consumer income distribution

   b. How have different bank branching restrictions affected the relative status of banks and nonbank financial intermediaries as providers of financial services to the public?

   c. On balance, after bank and nonbank financial service providers are taken into consideration, is there evidence that bank branching restrictions have resulted in a net deficit of services to the public when compared against liberal branching?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

9. Government Stabilization Policies

Content Requirements

1. Review and analyze the evidence:

   a. In what ways might banking structure impact on the effectiveness of monetary and credit allocation policies?

   b. Are there currently any discernible differences with respect to the efficiency and the institutional burdens of monetary policy depending upon the bank branching environment?

   c. How may alternative forms of multi-office banking other than branching, such as holding companies or EFT terminal deployment, affect government stabilization policies?

   d. If liberalized branching leads to greater concentration in banking how will the monetary policy responsibilities of the Federal Reserve be affected?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

10. Housing Credit

Content Requirements

1. Review and analyze the evidence:

   a. How do differences in bank branching restrictions impact on the mortgage lending operations of thrift institutions?

      -- unit banking
      -- limited branching
      -- statewide branching

   b. Do branch banks or other multi-office forms of bank organizations (such as holding companies) divert relatively more or less deposit funds from their thrift competitors than do unit banks?

   c. If a general liberalization of restrictions on bank branching were implemented would thrift institutions require compensating powers in order to remain competitive? If so, what types of compensating powers would be required?

2. Estimate the net benefit or the net cost to be attributed to the alternative policy options.

3. Differentiate the impact of policy options according to the near-term (2-5 years) and the long-term (10-20 years).

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

FOR IMMEDIATE RELEASE April 2, 1979

TREASURY ANNOUNCES $4,000 MILLION OF CASH MANAGEMENT BILLS FOR AUCTION TUESDAY, APRIL 3, AND ISSUE WEDNESDAY, APRIL 4, 1979

The Department of the Treasury, by this public notice, invites tenders for approximately $4,000 million of 15-day Treasury bills to be issued April 4, 1979, representing an additional amount of bills dated October 19 ,1978, maturing April 19, 1979 (CUSIP No. 912793 X9 2).

Competitive tenders will be received at all Federal Reserve Banks and Branches up to 12:00 noon, Eastern Standard time, Tuesday, April 3, 1979. Noncompetitive tenders will not be accepted. Tenders will not be received at the Department of the Treasury, Washington. Wire and telephone tenders may be received at the discretion of each Federal Reserve Bank or Branch. Each tender for the issue must be for a minimum amount of $10,000,000. Tenders over $10,000,000 must be in multiples of $1,000,000. The price on tenders offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

The bills will be issued on a discount basis under competitive 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 in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches

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.

B-1540

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. Those submitting tenders 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. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately available funds on Wednesday, April 4, 1979.

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 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 may be obtained from any Federal Reserve Bank or Branch.

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

FOR RELEASE AT 4:00 P.M. April 17, 1979

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $6,000 million, to be issued April 26, 1979. This offering will result in a pay-down for the Treasury of about $6,198 million as the maturing bills are outstanding in the amount of $12,198 million ($6,005 million of which represents 23-day cash management bills issued April 3). The two series offered are as follows:

91-day bills (to maturity date) for approximately $3,000 million, representing an additional amount of bills dated January 25, 1979, and to mature July 26, 1979 (CUSIP No. 912793 2D 7), originally issued in the amount of $3,005 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,000 million to be dated April 26, 1979, and to mature October 25, 1979 (CUSIP No. 912793 2S 4).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing April 26, 1979. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,249 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. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, April 23, 1979. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. 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 must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on April 26, 1979, in cash or other immediately available funds or in Treasury bills maturing April 26, 1979. 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, 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.

Filing

Remarks by
F. Lisle Widman
Deputy Assistant Secretary
for International Monetary Affairs
U.S. Treasury Department

before the
Chase World Executive Forum
on
International Trade and Credit: What Lies Ahead?
New York, April 17, 1979

U.S. International Monetary Policy and its
Impact on U.S. Exporters

Let me begin with a reverse twist on the usual speaker's opening: I am very glad to see you here. This nation must increase its exports and I welcome the opportunity to participate in a conference which is so closely directed to that end. I simply hope that I can help.

Mr. St. Phalle has outlined the Administration's export promotion policy and export financing policy. I've been asked to talk about U.S. international monetary policy and its impact on U.S. exporters. This is a very broad topic but provides a setting for more specific discussions to come later. I will offer some general observations about the world outlook and outline the Administration's approach to international monetary policy. Then I will invite your questions.

Recent pricing and production decisions by OPEC members have reminded us of the dramatic changes in world trade and finance patterns that have taken place since the October 1973 announcement by OPEC of an oil embargo and staggeringly large increases in the price of oil. In the aftermath of that announcement and the quadrupling of oil prices in January 1974, many observers in businesses and governments around the world recognized the impact this action would have on growth, inflation and payments balances. Many saw only gloom and doom ahead -- a catastrophic global depression; a massive $500-700 billion accumulation of assets by OPEC members; a drying up of world trade as nations scrambled to erect import restraints and devise export subsidies in order to pay for the sudden increase in oil bills.

This time, in the wake of the OPEC decision to raise prices by some 19% on April 1 -- on top of a 5% rise last January -- we are not hearing the gloom and doom predictions. Perhaps this fact by itself demonstrates the success with which the international monetary system has dealt with sudden alterations in the economic outlook. It would be wrong to say the world had not suffered; the recession was the worst since the 1930s; the inflation a record for many nations. We are still a long, long way from conquering inflation. Many industrial countries still have high rates of unemployment which could be alleviated by faster real growth, and there are a few nations whose financial position is very, very shaky. But the patient is not dead; the slow recovery process continues.

Despite the latest round of oil price increases we see prospects for better economic growth in most other industrial countries and for a pick up in real investment. We expect a more sustainable pattern of real growth which is less dependent on continued government stimulus. We look for an average growth rate in industrial countries excluding the U.S. of 3 1/2 to 3 3/4% in 1979, as compared with 3.4% in 1978. There should continue to be reasonably good growth in most LDCs -- perhaps about 6 1/2% on average.

Inflation rates should slow a bit on average in the LDCs but after the oil price increases we expect inflation to rise by 1% above last year's 6 1/2-7% rate in the industrial countries.

The world payments pattern should see the OPEC surplus back in the $30 billion range after nearly disappearing in mid-1978, with the offsetting shift in deficits widely dispersed. The OECD area could experience an aggregate deficit of $10-15 billion following last year's first surplus since 1973. At the same time we see improvements in the distribution of imbalances among OECD countries. The Japanese surplus should decline markedly with other surpluses in Germany, France, Italy down somewhat. The U.S. deficit should decline substantially.

The same factors which enabled the world economy to escape more serious crisis in the wake of the 1974-75 shock provide the foundation for the current economic outlook. First, the ability of private capital markets to adjust to the large and sudden demands for intermediation of funds between OPEC investors and oil importers surprised most observers. Our analysis suggests that more than three-quarters of the international financing needs in the aftermath of the earlier oil shock were met by the private market. Most of us had a good deal of faith in the genius and adaptability of private markets, but few of us had "that much" faith. Those markets are still functioning efficiently.

Second, official institutions responded to the new economic environment quickly and forcefully. Members of the OECD -- prodded by the U.S. -- pledged themselves to forego beggar-thy-neighbor policy responses to the large trade and current account deficits into which most of the oil importing nations were plunged. The pledge will probably be renewed in June.

The IMF established a special oil facility of roughly $8.3 billion to provide longer-term unconditional financing in the early months. Joint funding of the oil facility by some OPEC members and the stronger industrial countries provided an important source of intermediation of capital between the strong countries and those in weaker financial positions. IMF quotas were increased by roughly one-third and provision was made for countries in exceptionally difficult circumstances to draw larger sums than the normal rules would allow. One-sixth of the IMF's gold stock was put on the auction block with the profits to be used as a source of funds for balance of payments financing on concessional terms to low income countries.

More recently, with the oil facility no longer available, another source of official intermediation has been established through the Supplementary Financial Facility of the IMF. This borrowing facility, which amounts to roughly $10 billion, was conceived to provide relatively large amounts of conditional balance of payments financing for countries whose needs were particularly large in relation to their quotas. Thus the IMF has substantial resources.

But the primary actions were those of individual countries. Economic interdependence became the new "buzz word" in international discussions. Coordinated economic policy action became a major goal of international meetings of the IMF and the OECD. Governments more fully realized that their economic and political well-being depended not only on their own policy actions but also on the actions of others. In both trade and finance economic pressures in one nation are transmitted almost instantly throughout the world. Economic summits were initiated to assure that policy responses in the largest developed countries were mutually consistent. The OECD developed differentiated but coordinated strategies for pursuit of economic goals. Countries became more aware of how their individual national policies could -- if not coordinated -- work to offset the policy efforts of others.

We will have another OECD Ministerial in June and a 7-nation Summit in Tokyo later that month.

In terms of the international monetary system, impressive changes -- and improvements -- have taken place since 1973-74. The newly amended Articles of Agreement of the IMF incorporate those changes into the internationally agreed rules of the game and provide the framework for the future development of the system. Those amendments formally recognized the end of the par value exchange rate system and gave each nation the right to adopt an exchange rate regime of its own choosing. But the amendments also imposed on member countries an obligation to pursue exchange rate stability by focusing on stabilization of underlying economic and financial conditions. The IMF was assigned the task of surveillance over the policies of all members to ensure that there was compliance with the new obligations and no manipulation of exchange rates on the system. U.S. international monetary policy reflects a deep commitment to both the letter and the spirit of the revised Articles.

The Administration's basic international monetary policy is rather straightforward. We believe that exchange rates must be allowed to reflect basic changes in underlying economic conditions among countries, but we are prepared to act forcefully to prevent excessive or disorderly movements.

If underlying price relationships and other conditions change, exchange rates should change too. We should all work for domestic economic stability and sustainable payments patterns. If we succeed, exchange rates should -- and can -- be stable. But if one country fails, or falls farther short of that objective than its trading partners, fixed exchange rates will produce, first, distrotion of investment and trade and, second, financial crisis.

To a considerable degree, today's global economic problems have roots in the efforts during the 1960s to pursue the Bretton Woods fixed rate system in the face of serious domestic policy failures on the part of several countries. In countries such as Japan and Germany, whose exchange rates became increasingly undervalued, domestic investment in export industries became the most attractive sector in which to earn profits. The rate for the yen was set at 360 to the dollar in 1949 and remained unchanged until December 1971. When exchange rates remained fixed while domestic price levels, competitive costs and productivity rates persistently diverged, business decision makers received false signals from the marketplace as to the most profitable sector for investments in the longer run. The overvalued dollar produced a situation in which U.S. consumers were over-stimulating foreign production and U.S. firms were encouraged to build their new plants abroad. In economic terms, severe resource misallocations were taking place on a worldwide scale.

Now that exchange rates can more freely reflect relative economic conditions, the incentives for misallocation of investment have disappeared but the world is left with considerable excess capacity in some export sectors abroad, partly as a result of that overinvestment many years ago. The existence of this unprofitable excess production capacity has complicated policy decisions in many countries. It is responsible for a lot of difficulties with dumping and subsidized imports. In a period of high unemployment it is politically very difficult for governments to adopt policies aimed at reducing jobs in the export sector. Yet resource shifts are necessary to move productive capacity away from export toward domestic consumption. For the same reason the U.S. finds itself with a lack of capacity in the export sector. That is not simply a lack of capacity in plants -- it extends to the organization of our firms and to personnel training and experience. Structural adjustments are essential, both in the surplus countries and in the U.S. Such adjustments take time. But we will press for policies here and abroad to stimulate such adjustments.

We do not want a recurrence of frozen exchange rates leading to resource misallocation. We do not want other nations to impose such a situation on us. This was one of our concerns about the European Monetary System when it was in its formative stage. Would the members attempt to fix an EMS-dollar exchange rate and seek to prevent that rate from moving even if underlying relationships changed? Our

European friends have assured us that this is not their intent. Thus we are able to welcome the efforts of EMS participants to achieve the greater convergence in economic performance among members which will be needed to make EMS work.

Thus we do not foresee a return to a global fixed rate system -- or even to target zones. Our commitment to exchange rate flexibility does not mean that we consider the exchange rate unimportant. It is not a commitment to a free float or to "benign neglect" as it has been called. If nothing else, exchange rate movements can be a signal that economic conditions call for changes in macro economic policy.

It is also apparent -- from the experience of last fall -- that market perceptions of policy, or of the appropriateness and adequacy of policy, can lead to flows of funds which move a rate well beyond what might be justified by underlying conditions. Had we, for instance, failed to react strongly to the situation which developed last fall, rate movements would have occurred which would have caused misallocations of investment and severe disruption to private economic decision-making as well as more domestic inflation and world financial turmoil.

Exchange markets can obviously become disorderly -- rates can move quickly and movements can be disruptively large and excessively persistent in one direction. This condition is conducive to the steady growth in world trade or financial flows which is the ultimate goal of international economic policy. At times markets can develop a "herd psychology" where no one is willing to act independently of the prevailing trend even if conditions do not warrant the existing rate relationships. Sometimes economic indicators lag policy response and/or markets remain unconvinced of the effectiveness of policy decisions. In such a situation, exchange markets left to themselves can "over shoot" the rate relationships that reflect underlying factors. We are determined to prevent a return of such conditions. Other major nations share this goal and will work closely with us to achieve it.

Our commitment then is to an open, liberal system of trade and payments where exchange rates can and do reflect underlying conditions, where intervention is aimed at preventing disorder and where economic investment or trade decisions can be undertaken with confidence in the equitable operation of the system.

Capital flows across international boundaries are another vital aspect of a properly functioning monetary system. The only way that credit will smoothly flow between countries is through a smoothly integrated intermediation structure which reallocates savings from surplus countries toward the financing needs of deficit countries. A basic tenet of our international monetary policy is to assure conditions that will foster continued orderly, safe operation of money and capital markets.

I should touch on one more point. The dollar dominates international trade and finance. A high percentage of world trade is invoiced in dollars; traders and businesses keep a high percentage of their international working balances in dollars. Central banks keep 80% of their foreign exchange reserves in dollars.

The role of the dollar is the natural product of the post-war economic order. A relative reduction in that role could be a natural consequence of the growing economic strength of other nations. If change comes in a gradual, orderly fashion so that it does not destabilize economies or exchange markets, and if it is seen to enhance stability, it will be fully acceptable to us. Actually, I do not expect dramatic change. The dollar is likely to remain the world's major currency for the foreseeable future.

In addition to focusing on the smooth, orderly operation of foreign exchange markets, our international monetary policies aim at providing a climate of economic policies in the world economy conducive to the smooth workings of the adjustment process. The working of the system to reduce imbalances in external positions is a vital aspect of the question of the global economy.

The revised articles of agreement of the IMF rest a substantial power in the IMF to surveil the economic policies of member countries. This surveillance is not aimed narrowly at the direct exchange rate policies -- i.e., the intervention policies -- but at the constellation of policies that affect external positions and exchange rate relationships. The aim is to assure that countries do not thwart the adjustment process or gain unfair competitive advantages over their trading partners.

Under the fixed rate system the burden of adjustment fell largely on the deficit countries. As foreign exchange reserves were run down they were forced to undertake policies aimed at reducing external deficits. The new surveillance procedures seek to provide a more symmetrical process where surplus countries also share more effectively the responsibilities of adjustment. This more balanced approach -- which is still being developed -- has very important potential benefits. For example, prolonged surplus would be prima/facia evidence of an undervalued exchange rate. The moral suasion of these new policies -- or the possibility of public censorship are powerful tools.

I believe that Japan's response to international concern about an impact of its current account surplus on the world system is evidence of the potential power of surveillance.

We have made clear that the United States is prepared to participate in an IMF review of this country's policies. We will consider most seriously policy advice which the IMF may wish to offer.

We will continue to work with other nations -- at the Summit, in the IMF and OECD and other international fora -- to improve the international environment for growth of world markets based on sustainable, non-inflationary growth of our domestic economies.

Our international monetary policies have greatly improved the opportunities for U.S. exporters. We will exert every effort to ensure that U.S. exporters are not placed at a competitive disadvantage in world markets because of differences across countries in such things as access to official export credit firms or facilities; the impact of domestic regulatory activity and bureaucratic procedures and investment incentives which favor domestic production over imports.

We will seek early ratification of the MTN agreement which will open up substantial new markets for U.S. exports through reduction of both tariff and non-tariff barriers, and opening of government procurement for foreign bidding.

There is an old saying -- "you can lead a horse to water, but you can't make him drink". We in government can help provide the framework for a healthy and competitive export sector, and the opportunities to export, but we can't actually get out there and do the selling. A constant theme we hear in talks with other nations (especially those with records of strong export performance) is that U.S. firms don't really care about the export market. The stories we hear -- you've heard them too -- lend to support this view

Perhaps, through efforts of groups such as this, the situation will change. U.S. skills at merchandising, distribution, advertising, etc., are surely not unique to this market. Our exports are now running at more than $150 billion annually but if we could just regain our 1975 share in world export trade, they would be roughly $35 billion larger. The MTN package will open up to bidding by U.S. suppliers some $20 billion in foreign government procurement alone. These figures suggest the magnitude of the opportunity.

There is also a risk which is much harder to measure. Our trade deficit -- $34 billion last year -- and other large payments imbalances -- such as the $24 billion trade surplus recorded by Japan -- are placing severe strains on the open, liberal trade and payments system I have described. These strains are being reflected in calls for a retreat from the open system -- for less free trade, for more overt government interference in the international economy. I do not believe such calls are responsible. They are not in the U.S. interest. But they will mount if we don't make further progress in reducing the deficit.

Conclusion

We have made it clear that we want a strong dollar. That may seem inconsistent with the view that rates should be allowed to reflect underlying conditions. It may seem inconsistent with a policy of strong support for exports.

It is not. A strong dollar is an outgrowth of a strong domestic economy -- an economy that is growing sufficiently to provide jobs for its people and a gradual improvement in standards of living within a non-inflationary environment. A strong domestic economy is an economy which achieves these objectives without draining large amounts of resources from the rest of the world. To achieve and maintain such a position the United States needs exports.

In short, a sound, non-inflationary domestic economy is good for the dollar and good for exports too.

The heart of our international monetary policy is our domestic policy: it is to curb inflation, to moderate growth to a sustainable level, to conserve energy and develop alternative sources of supply to reduce our dependence on imports, and to encourage exports so as to reduce our external payments deficit. It is a policy of cooperation with other nations in seeking mutually supportive policies and it is rooted in a firm belief in an open, liberal trade and payments system, We trust that these policies will provide the framework you need for success in penetrating and holding foreign markets, increasing export earnings, and reducing the U.S. trade deficit. The selling job is yours.

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

FOR IMMEDIATE RELEASE
April 18, 1979

Press Contact: Alvin M. Hattal
202/566-8381

TREASURY PUBLISHES FIRST AND SECOND QUARTER, 1979
TRIGGER PRICE MANUAL

The Treasury Department today published a First and Second Quarter, 1979, Trigger Price Manual which consolidates in one publication all trigger prices and adjustments that have been announced to date.

Because of the large number of pages involved, the entire manual is not published in the Federal Register, available copies will be distributed by the Department of Treasury to persons on the Department's steel mailing list. Other copies may be obtained from the Government Printing Office.

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B-1542

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

FOR IMMEDIATE RELEASE
April 18, 1979

Contact: Robert E. Nipp
202/566-5328

TREASURY ANNOUNCES RESULTS OF GOLD SALE

The Department of the Treasury announced that 1,500,100 troy ounces of fine gold were sold yesterday to 20 firms and individuals who bid successfully at a sealed bid sale.

Awards of 1,000,000 troy ounces of gold in 400 ounce bars whose fine gold content is 99.5 to 99.94 percent were made to 16 successful bidders at prices from $230.13 to $232.10 per ounce, yielding an average price of $230.96 per ounce. Bids for this gold were submitted by 18 bidders for a total amount of 2.3 million ounces at prices ranging from $227.50 to $232.10 per ounce.

Awards of 500,100 troy ounces of gold in 300 ounce bars whose fine gold content is 89.9 to 91.7 percent were made to 13 successful bidders at prices from $229.27 to $231.53 per ounce, yielding an average price of $230.17 per ounce. Bids for this gold were submitted by 18 bidders for a total amount of 1.1 million ounces at prices ranging from $225.95 to $231.53 per ounce.

Gross proceeds from the sale were $346.1 million. Of the proceeds, $63.3 million will be used to retire Gold Certificates held by Federal Reserve Banks. The remaining $282.7 million will be deposited into the Treasury as a miscellaneous receipt.

The list of the successful bidders and the amount of gold awarded to each is attached. The General Services Administration will release details on the individual awards later.

The current sale was the twelfth in a series of monthly sales being conducted by the General Services Administration on behalf of the Department of the Treasury. The next sale, at which 750,000 ounces of gold will be offered, will be held on May 15.

The amount of the monthly sale is being reduced in light of improved conditions in the foreign exchange markets and the fact that gold no longer appears to be a destabilizing factor in these markets. Sales in the magnitude maintained in recent months -- 1,500,000 ounces monthly -- do not appear to be needed under current circumstances.

Gold sales remain a significant factor in reducing the U.S. deficit on current account. Domestic demand for gold continues to exceed current gold production in the United States by a substantial amount, and the Treasury expects to continue to sell at least 750,000 ounces monthly until further notice. The actual amount and grade of gold to be offered at each sale will continue to be announced about four weeks in advance.

The gold to be offered at the May sale will be in bars whose fine gold content is 89.9 to 91.7 percent. The minimum bid for these bars will be 300 fine troy ounces.

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		OUNCES
BANK LEU NEW YORK	NY	7600
BANK OF NOVA SCOTIA TORONTO	CANADA	4800
BRODY, WHITE & CO. NEW YORK	NY	100000
CREDIT SUISSE ZURICH	SWITZERLAND	23300
DERBY & CO. LONDON	ENGLAND	10000
DEUTSCHE BANK AG FRANKFURT	WEST GERMANY	269200
DRESDNER BANK FRANKFURT	WEST GERMANY	110000
E. F. HUTTON & CO. NEW YORK	NY	153000
GERALD METALS INC. NEW YORK	NY	6000
GOLD STANDARD CORP. KANSAS CITY	MO	400
J. ARON & CO., INC. NEW YORK	NY	33000
METALS QUALITY CORP NEW YORK	NY	64800
MOCATTA METALS CORP. NEW YORK	NY	39800
PHILIPP BROS. NEW YORK	NY	99000
REPUBLIC NATIONAL BANK OF NY NEW YORK	NY	59900
SAMUEL MONTAGU INC. NEW YORK	NY	8000
SHARPS PIXLEY INC. NEW YORK	NY	28800
SWISS BANK CORP. ZURICH	SWITZERLAND	392,000

	OUNCES
UNION BANK OF SWITZERLAND ZURICH SWITZERLAND	82400
WESTWAY METALS CORP. ENGLEWOOD CLF NJ	8100

Stockpile Information

April 20, 1979 GSA #P-2467

FOR IMMEDIATE RELEASE

The General Services Administration, in consultation with the Department of the Treasury, today announced the award of a total of 1,500,100 fine troy ounces of gold from U.S. Treasury stocks. The award consisted of Item 1 for 1,000,000 fine troy ounces of 995.0 to 999.4 fineness and Item 2 for 500,100 fine troy ounces of 899.9 to 917.0 fineness.

The sale of this material resulted from the sealed bid offering of U.S. Treasury gold conducted at 11 a.m., Washington, DC time on April 17, 1979. The gold was available from the U. S. Assay Office, New York, New York.

The acceptable bids are as follows:

Firm	Item	Approximate Fine Troy Ounces	Price Per Fine Troy Ounce
Bank Leu	1	1,600	231.98
New York, NY	1	2,000	231.62
	1	2,000	231.12
	1	2,000	230.61
Bank of Nova Scotia	2	1,200	230.37
Toronto, Canada	2	1,200	230.17
	2	1,200	230.03
	2	1,200	229.53
Brody, White & Co.	1	40,000	231.10
New York, NY	1	40,000	230.70
	1	20,000	230.30
Credit Suisse	1	4,800	231.60
Zurich, Switzerland	1	2,000	230.25
	2	3,300	231.53
	2	6,600	231.07
	2	6,600	230.77
Derby & Co.	1	2,000	232.10
London, England	1	2,000	231.90
	1	2,000	231.60
	1	2,000	231.15
	1	2,000	230.55

U.S. General Services Administration - Central Office
18th & F Sts., NW, Washington, DC 20405 (202) 566-0512

Firm	Item	Approximate Fine Troy Ounces	Price Per Fine Troy Ounce
Deutsche Bank AG Frankfurt, West Germany	1	24,000	231.83
	1	10,000	231.77
	1	10,000	231.73
	1	24,000	231.67
	1	10,000	231.63
	1	12,000	231.57
	1	10,000	231.53
	1	10,000	231.47
	1	24,000	231.43
	1	12,000	231.37
	1	10,000	231.33
	1	12,000	231.27
	1	10,000	231.23
	1	10,000	231.07
	1	10,000	231.03
	1	10,000	230.93
	1	10,000	230.77
	1	12,000	230.67
	1	32,000	230.47
	1	7,200	230.13
Dresdner Bank Frankfurt, West Germany	1	16,000	231.26
	1	16,000	230.99
	1	16,000	230.71
	1	32,000	230.49
	2	15,000	230.01
	2	15,000	229.59
E. F. Hutton & Co. New York, NY	2	51,000	230.26
	2	51,000	230.16
	2	51,000	229.36
Gerald Metals Inc. New York, NY	2	1,500	229.53
	2	1,500	229.53
	2	3,000	229.33
Gold Standard Corp. Kansas City, MO	1	400	231.50
J. Aron & Co., Inc. New York, NY	1	4,800	231.41
	1	4,800	231.26
	1	1,600	231.12
	1	2,000	230.42
	2	9,900	230.26
	2	9,900	230.01

-M O R E-

Firm	Item	Approximate Fine Troy Ounces	Price Per Fine Troy Ounce
Metals Quality Corp.	1	40,000	231.40
New York, NY	1	8,000	231.28
	1	8,000	231.10
	1	4,800	230.50
	1	4,000	230.28
Mocatta Metals Corp.	1	20,000	230.30
New York, NY	2	19,800	230.33
Phillipp Bros.	2	99,000	230.61
New York, NY			
Republic National Bank of NY	1	10,000	230.76
New York, NY	1	10,000	230.52
	2	39,900	230.26
Samuel Montagu Inc.	1	8,000	231.00
New York, NY			
Sharps Pixley Inc.	1	4,000	230.65
New York, NY	1	4,800	230.45
	1	8,000	230.27
	1	6,000	230.17
	2	6,000	229.51
Swiss Bank Corp.	1	32,000	231.77
Zurich, Switzerland	1	32,000	231.47
	1	32,000	231.27
	1	32,000	231.06
	1	10,000	231.05
	1	14,800	231.00
	1	10,000	230.75
	1	32,000	230.73
	1	2,000	230.70
	1	2,000	230.55
	1	40,000	230.50
	1	10,000	230.45
	1	32,000	230.27
	1	40,000	230.25
	1	10,000	230.15
	2	15,000	230.47
	2	15,000	230.13
	2	15,000	229.78
	2	15,000	229.53
	2	1,200	229.27

-M O R E-

Firm	Item	Approximate Fine Troy Ounces	Price Per Fine Troy Ounce
Union Bank of Switzerland Zurich, Switzerland	1	6,000	231.70
	1	8,800	231.25
	1	4,000	230.90
	1	4,800	230.70
	1	10,000	230.50
	1	4,000	230.40
	1	2,800	230.15
	2	6,000	231.10
	2	6,000	230.85
	2	6,000	230.65
	2	6,000	230.35
	2	6,000	230.15
	2	6,000	229.75
	2	6,000	229.55
Westway Metals Corp. Englewood Cliffs, NY	1	2,000	230.90
	1	2,000	230.40
	1	2,000	230.15
	2	2,100	229.40

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

FOR IMMEDIATE RELEASE
April 18, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY ANNOUNCES TWO ACTIONS UNDER
STEEL TRIGGER PRICE MECHANISM

The Treasury Department today announced its final determination that exports of carbon steel plate from Poland produced by Stahlexport Przedsiebiorstwoa (Stahlexport) are being sold at "less than fair value" in the United States. The Treasury also announced that it was initiating a "fast-track" antidumping investigation with regard to certain steel wire nails from Korea based on information collected through the Trigger Price Mechanism (TPM) to monitor imports of steel mill products.

With regard to carbon steel plate produced by Stahlexport, the Treasury is now referring the case 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. The investigation was initiated in October 1978 after evidence had been developed indicating that Stahlexport was selling significant quantities of carbon steel plate to the United States at prices significantly less than the applicable trigger prices, and, according to information developed in administering the TPM, apparently 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.

However, the Antidumping Act does not permit the use of prices in either the home market or to third countries when the country in which the product was manufactured in a state-controlled economy, such as Poland. In those cases, fair value is determined from the home market prices, or prices to third countries, of that product manufactured in a market economy country at a comparable stage of economic development. For purposes of this action, the Treasury Department used home market prices of carbon steel plate in Spain.

The investigation revealed that sales of carbon steel plate from Stahlexport to the United States were made at less than fair value, finding a weighted average margin of 8.53 percent, although in some transactions margins were as high as 44 percent.

(MORE)

B-1544

In February, Treasury had anncunced that appraisement of Stahlexport's carbon steel plate shipments would be withheld and bonds sufficient to cover potential dumping duties would thereafter be required of importers.

The Treasury Department is initiating its investigation concerning certain steel wire nails from Korea based on information collected through the TPM to monitor imports of steel mill products. That information indicates that significant quantities of steel wire nails are being sold to the United States at prices less than the applicable trigger prices, and, according to infcrmation developed in administering the TPM, apparently at less than "fair value." Eleven nail manufacturers were determined to have sold nails to the U. S. at not less than trigger price and have been excluded from the investigation. They are:

Blobcar Ltd.
Dae Bong Industries
Daeger Trading Company
Daewo Industrial
Don-A-Nails Company
Jesse Industries
Kang Wan Industries
Lee Chun Steel Company Ltd.
Pacific Chemical Company
Sunkyong Ltd.
Ton Myung Industries

All other Korean firms manufacturing nails are to be included in the investigation.

Information developed by the Customs Service indicates dumping margins of up to 8.5 percent on sales to the United States by these companies.

This case is being referred to the U. S. International Trade Commission,since a "substantial doubt" exists of injury or likelihood of injury to a domestic industry in the United States by reason of the imports of these nails. This determination was based upon a number of factors, including those cited in the February 1979 decision by the U. S. International Trade Commission that the U. S. steel wire nail industry was not being injured by imports of nails from Canada.

Should the Commission find, within 30 days, that there is no reasonable indication of injury, the investigation will be terminated; otherwise, it will continue. As with all cases initiated in conjunction with its administration of the TPM, the Treasury will make every effort to expedite its investigation and issue a tentative determination before the statutory due date of October 20, 1979.

(MORE)

Notice of these actions will appear in the Federal Register of April 20, 1979.

Imports of steel wire nails from Korea were valued at approximately $36 million in the first 10 months of 1978.

Data with regard to the imports of carbon steel plate from Poland produced by Stahlexport is confidential business information and not available to the public.

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

FOR RELEASE AT 4:00 P.M. April 18, 1979

TREASURY TO AUCTION $2,500 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $2,500 million of 2-year notes to refund $1,833 million of notes maturing April 30, 1979, and to raise $667 million new cash. The $1,833 million of maturing notes are those held by the public, including $593 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 $159 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 to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing securities held by them.

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-1545

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED APRIL 30, 1979

April 18, 1979

Amount Offered:	
To the public..........................	$2,500 million
Description of Security:	
Term and type of security...........	2-year notes
Series and CUSIP designation........	Series S-1981 (CUSIP No. 912827 JP 8)
Maturity date..........................	April 30, 1981
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..............	October 31 and April 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.....	Tuesday, April 24, 1979, by 1:30 p.m., EST
Settlement date (final payment due)	
a) cash or Federal funds.......	Monday, April 30, 1979
b) check drawn on bank within FRB district where submitted..................	Friday, April 27, 1979
c) check drawn on bank outside FRB district where submitted..................	Thursday, April 26, 1979
Delivery date for coupon securities.	Tuesday, May 8, 1979

Department of the TREASURY NEWS

WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RÈLEASE AT 4:00 P.M. April 19, 1979

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $3,020 million, of 364-day Treasury bills to be dated May 1, 1979, and to mature April 29, 1980, (CUSIP No. 912793 3G 9). This issue will not provide new cash for the Treasury as the maturing issue is outstanding in the amount of $3,025 million.

The bills will be issued for cash and in exchange for Treasury bills maturing May 1, 1979. The public holds $1,473 million of the maturing issue and $1,552 million is held by Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities. Tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities will be accepted at the weighted average price of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents of foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them.

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. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20226, up to 1:30 p.m., Eastern Standard time, Wednesday, April 25, 1979. 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.

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. 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 $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.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on May 1, 1979, in cash or other immediately available funds or in Treasury bills maturing May 1, 1979. 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 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, 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
April 19, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT TO START ANTIDUMPING INVESTIGATION ON SODIUM HYDROXIDE FROM FRANCE, ITALY, THE FEDERAL REPUBLIC OF GERMANY, AND THE UNITED KINGDOM

The Treasury Department today said it will start an antidumping investigation of imports of sodium hydroxide from France, Italy, The Federal Republic of Germany and the United Kingdom. Treasury's announcement followed summary investigations conducted by the U. S. Customs Service after receipt of a petition filed by Linden Chemicals and Plastics, Inc., Cranford, N. J., alleging that firms in those countries are dumping sodium hydroxide in the United States.

The petition alleges that imports of that merchandise are 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.) The Customs Service will investigate the matter and make a tentative determination by October 20, 1979.

If sales at less than fair value are determined by Treasury, the U. S. International Trade Commission will subsequently decide whether they are injuring or likely to injure 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 April 20, 1979.

Imports of sodium hydroxide in 1978 were valued at $9.2 million.

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B-1547

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

FOR IMMEDIATE RELEASE
April 19, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY TO START ANTIDUMPING INVESTIGATION OF STEEL WIRE COAT AND GARMENT HANGERS FROM CANADA

The Treasury Department today said it will start an antidumping investigation of imports of steel wire coat and garment hangers from Canada.

Treasury's announcement followed summary investigations conducted by the U. S. Customs Service after receipt of a petition filed by Laidlaw Corporation of Mesa, Calif., alleging that firms in Canada are dumping that merchandise in the United States.

The petition alleges that those imports are 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.) The Customs Service will investigate the matter and make a tentative determination by October 20, 1979.

If sales at less than fair value are determined by Treasury, the U. S. International Trade Commission will subsequently decide whether they are injuring or likely to injure 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 April 20, 1979.

Imports of the merchandise in 1978 were valued at $17,000.

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B-1548

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

FOR IMMEDIATE RELEASE

April 23, 1979

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 3,006 million of 13-week Treasury bills and for $3,000 million of 26-week Treasury bills, both series to be issued on April 26, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 26, 1979			26-week bills maturing October 25, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	97.699	9.103%	9.47%	95.312	9.273%	9.89%
Low	97.693	9.127%	9.50%	95.292	9.313%	9.94%
Average	97.696	9.115%	9.49%	95.301	9.295%	9.92%

Tenders at the low price for the 13-week bills were allotted 16%.
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	$ 98,615,000	$ 43,915,000	$ 46,750,000	$ 36,750,000
New York	6,598,370,000	2,622,385,000	4,871,110,000	2,669,100,000
Philadelphia	50,490,000	25,490,000	70,715,000	23,715,000
Cleveland	49,620,000	32,540,000	30,320,000	27,320,000
Richmond	42,730,000	30,730,000	20,670,000	20,670,000
Atlanta	43,340,000	40,280,000	29,435,000	29,030,000
Chicago	291,005,000	64,395,000	231,550,000	30,750,000
St. Louis	38,480,000	16,480,000	35,180,000	13,180,000
Minneapolis	21,620,000	10,260,000	16,985,000	16,985,000
Kansas City	40,180,000	26,675,000	29,225,000	29,225,000
Dallas	15,120,000	13,620,000	14,215,000	9,215,000
San Francisco	480,805,000	54,985,000	427,370,000	70,570,000
Treasury	23,920,000	23,910,000	23,510,000	23,510,000
TOTALS	$7,794,295,000	$3,005,665,000a/	$5,847,035,000	$3,000,020,000b/

a/Includes $503,615,000 noncompetitive tenders from the public.
b/Includes $338,720,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

B-1549

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WASHINGTON, D.C. 20220 TELEPHONE 566-2041
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REMARKS BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
AT ROSARY COLLEGE
RIVER FOREST, ILLINOIS

The United States and the World Economy

I am pleased to be with you today to discuss the interdependence of the United States and the world economy. The Midwest is a particularly appropriate region of our country in which to hold such a discussion. Conventional wisdom has long held that the Midwest is the area of the United States most isolated from the world at large and least affected by it. But in fact this area, like the United States as a whole, increasingly is influenced by, and benefits from, an open world economy.

Indeed, the entire United States is becoming increasingly dependent on the world economy. The benefits of the open global economic system for the United States, and U.S. economic policy which best responds to our growing dependence on the world economy, are the focus of my remarks today.

B-1550

U.S. Dependence on the World Economy

The United States is deeply involved in the international economy. This involvement translates into significant economic gains for the United States:

-- In 1978 exports accounted for more than 6-1/2 percent of U.S. Gross National Product (GNP) and imports for nearly 8-1/2 percent. The total share of trade in U.S. GNP (15 percent) has nearly doubled in the past decade, demonstrating the growing importance of trade to the U.S. economy.

-- The United States is the world's largest exporter, selling more than $140 billion a year of U.S. goods abroad. When combined with U.S. exports of services, this figure is approximately $176 billion, as compared to $142 billion for West Germany and $96 billion for Japan, the second and third most active trading nations.

-- One out of every eight manufacturing jobs in this country produces for export. That's more than 2 million jobs in the economy as a whole which depend on exports. For example, in 1976 exports accounted for:

- 63 percent of total U.S. production of oilfield machinery;
- 43 percent of U.S. production of construction machinery;
- 35 percent of U.S. aircraft production;
- 32 percent of U.S. production of turbines and turbine generators;

- 26 percent of all computers and related equipment we produce;
- 24 percent of U.S. pumps and compressors; and
- 18 percent of U.S. farm machinery.

-- One out of every three acres of American farm land produces for export. In fiscal year 1977 we exported:

- 60 percent of our soybeans and soybean products;
- 58 percent of our cattle hides;
- 58 percent of our almonds;
- 55 percent of our rice;
- 45 percent of our cotton;
- 40 percent of our wheat; and
- 30 percent of our tobacco.

-- It has been estimated that every additional $1 billion in U.S. exports results in a total GNP increase of $2 billion. Exports are critical to the performance of the U.S. economy -- about 14 percent of all U.S. goods produced are exported.

-- Exports have been one of the fastest growing sectors of the U.S. economy. Between 1972 and 1976 total U.S. production of manufactured goods grew by 57 percent, while exports of manufactured goods grew more than twice as fast. Agricultural exports during this period nearly tripled, as compared to a growth of about 70 percent for domestic agricultural production as a whole.

-- On the other side of the equation, the United States imports more than $170 billion in goods from abroad, more than any other nation--and over twice the value of imports by Japan, the United Kingdom, or France.

-- Imports provide essential inputs for U.S. industries, including more than one-fourth of U.S. consumption of twelve of the fifteen key industrial and raw materials. For example, we import 98 percent of our manganese and cobalt; more than 85 percent of our platinum, chromium, aluminum, and tin; and 60-70 percent of our nickel, mercury, zinc, and tungsten.

-- Nearly half of U.S. imports do not compete with U.S. industries, and many other imports fill gaps in domestic supplies, or offer alternatives in terms of technological advancement, quality, and styling. The major portion of U.S. imports therefore create jobs in import-dependent industries.

-- Finally, almost one out of every three dollars of U.S. corporate profits now derives from the international activities of U.S. firms, including their foreign investments as well as their exports.

Illinois, more than any other state except perhaps California, illustrates the vital importance of exports to the U.S. economy. In 1976, Illinois ranked third among states in value of exported manufactured goods, accounting for nearly $6.9 billion in exports. This represents a growth of 129 percent from the value of exported manufactured goods in 1972. Exports are estimated to account for fully 8.6 percent of total Illinois production of manufactured goods. Equally important, Illinois led all states in fiscal year 1977 in exports of agricultural products. In that year, Illinois exported about $2.5 billion in agricultural goods, or 44.6 percent of its total farm sales -- a higher percentage than any other state. The value of agricultural goods exported by Illinois increased 2.3 times from 1972 to 1977.

The strength and vitality of the U.S. economy, and of the economy of Illinois, is thus inextricably intertwined with the strength and vitality of the world economy. To be sure, our deep involvement in the world economy can bring problems as well as benefits. Differences in national rates of growth and inflation can have an immediate and potentially large impact on the direction and magnitude of trade and financial flows. Lagging economic growth in the rest of the world, for example, depressed U.S. exports by at least $13 billion in 1977 and retarded U.S. economic growth by about 1 percent. Surges of imports can cause severe adjustment problems for firms and workers in particular industries. Frosts in Brazil can drive up the price of coffee. Speculation against the dollar can drive up the price of imports, increase inflation in the U.S. economy, and damage the climate for investment.

U.S. Policies

What should U.S. policies be in the face of rapid change in the world economy and our strong dependence on developments overseas? How can our international economic policies best reflect our own best interests?

U.S. policy is based on the following basic principles:

-- an open trade and investment system;

-- a flexible monetary system;

-- assistance to the developing nations; and

-- close cooperation with other nations to resolve mutual problems.

Let's look at each of these areas in turn.

(1) Trade and Investment Policy

The Administration and, I believe, the Congress and the nation as well, place basic reliance on the free market system. The private market is the most efficient way to allocate scarce resources at home and abroad, as long as it is truly free of distortions due to governmental interference.

The free movement of goods, services and capital is essential to the efficient functioning of the global economy. Only in this way can our citizens purchase goods produced by the most efficient and lowest priced firms world wide, thus minimizing the price level within our own borders. Only in this way can our producers have access to the widest possible market for their products, thus maximizing jobs for our workers.

The competitive environment nourished by the relatively open trade posture of the United States over the past forty years has spurred American industries to make steady improvements in the range and quality of available goods. Import barriers, by contrast, permit protected industries to raise prices and reduce incentives to improve the quality of their output.

When import penetration raises serious problems for a domestic industry, it is always sensible for the Government to consider helping that industry to improve its competitive ability directly as an alternative to providing insulation from the forces of the marketplace.

But <u>trade relations must be reciprocal</u>. Goods must be allowed to move unencumbered out of the United States to other markets, as well as into the United States. In many areas -- far too many -- the hard realities are that governments are deeply involved in what should be basically private market decisions. For example, subsidies to domestic producers distort investment and trade flows. In such cases it is incumbent upon the U.S. Government to offset such distortions, both to defend our own producers and to try to deter others from interfering in these markets themselves.

Our efforts in the recently concluded round of Multilateral Trade Negotiations focused on the further reduction of both tariff and non-tariff barriers to trade in agricultural and industrial products alike. We achieved an overall reduction in industrial tariffs of approximately 30 percent from current levels, as well as important understandings or codes on the use of government standards, procurement, and subsidies. The new package of agreements should help assure that international trade is both more open and more fair for all nations -- and it should further increase export opportunities for American firms and farms.

Similarly, U.S. policy on international investment is to (1) neither encourage nor discourage inward or outward investment flows and (2) avoid intervention in the investment activities of individual companies. This is based on the principle that investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces.

From time to time, various individuals and groups in our society challenge this approach. Some say that we should restrict U.S. firms from investing abroad on the grounds that it results in losses of American jobs and exports. Others advocate encouraging investments in this country from abroad, arguing that it creates jobs and helps our balance of payments. Still others want us to restrict foreign investments here on the grounds that it poses some kind of threat to our economic independence and well-being.

We have carefully examined the cases made by advocates of each of these points of view and concluded that there is no basis for a change in policy. It is not clear that either positive or negative government intervention in the international investment process would be to our advantage, but we are certain of the benefits we derive from adhering to the free market principles.

To be quite candid, other governments do not share our philosophy. Nations are increasingly using a variety of measures -- including investment incentives, and various types of performance requirements -- to distort normal investment flows. Such practices can directly affect trade, jobs, and future growth in the affected industries.

Rather than emulate or retaliate against such practices, the United States has sought to promote international cooperation to avoid the spread of beggar-thy-neighbor policies. There is at present no common international set of rules governing international investment policies, however, as there is for international trade and monetary relations. Closer international cooperation to head off further competition in this area is important. It will not be achieved overnight, but will emerge from a long process of discussion and negotiation. The United States is now urging other nations to move in this direction in both bilateral and multilateral forums.

(2) International Monetary Policy

U.S. policy in the monetary area is also based upon the belief that markets should remain as open as possible, with a minimum of government intervention except where necessary to offset seriously disruptive trends. The United States was a leading supporter of the recent reforms in the international monetary system which resulted in the adoption of more flexible exchange rates. The new system permits exchange rates to move in relation to basic changes in the underlying economic situation in individual nations, rather than freezing rates until a crisis forces exchange rate changes, as occurred so often in the 1960s and early 1970s.

At the same time, excessive speculation which causes exchange rates to move well out of line requires intervention by governments to avoid a serious disruption of the global economy. The United States undertook such action in support of the dollar last fall, when it had fallen far beyond a level reflective of underlying economic realities -- thus adding sharply to inflation in our economy, and disrupting the world economy severely because of the central role played by the dollar in international finance.

That fall of the dollar was initially triggered by the sharp deterioration of the U.S. trade balance which occurred between 1975 and 1977-78. In 1975 the United

States recorded a trade surplus (on a balance of payments basis) of $9 billion. By 1977 our trade position had deteriorated to a record deficit of $31 billion. The deficit in 1978 rose to approximately $34 billion, due in large part to heavy imports of goods other than oil during the first part of the year. By the second half of 1978, however, the trend had clearly turned and we expect the trade deficit to fall further this year, depending upon final oil prices and import volumes, as non-oil imports continue to grow at a slower pace and U.S. manufactured exports accelerate.

Clearly the largest single factor in our trade deficit is energy imports, which grew from under $5 billion in 1972 to over $45 billion by 1977. Increasing oil imports fueled the major portion of the 26 percent annual growth in total U.S. imports between 1975 and 1977, while U.S. exports were only growing at about 6 percent per year. Fortunately, U.S. exports began to grow more rapidly in 1978, tripling to an annual growth rate of 18 percent while import growth slowed to 16 percent.

We expect this trend to continue and to help reduce the overall deficit during 1979. Indeed, we expect a much more rapid rise in manufactured exports than in non-oil imports, representing a further strengthening of the U.S. competitive position in the world economy. For the longer run, of course, success in the battle against internal inflation is the single most crucial factor in maintaining our competitive position and assuring continued stability for the dollar.

Further improvement in international monetary arrangements is still desirable. We will consider with others whether such improvements are necessary and desirable. But the essential elements remain sound internal policies, particularly in the major industrial countries, and international cooperation to assure that the international monetary system -- as well as the trade and investment systems -- function effectively for the benefit of all nations.

(3) The Developing Nations

The developing nations have become the focal point for a number of industrial nations' frustrations with the process of economic change. As these nations develop new industries and new export capabilities, in particular, their goods increasingly compete at a substantial cost advantage in world markets. Industries in industrial nations seek "protection" from this competition when it threatens jobs, production, and profits.

Yet this process of change will continue, as a healthy sign of the development process itself. We, as well as other nations, must adjust to it rather than raise new barriers to trade or reduce our foreign aid commitments in an effort to slow the development process.

The developing countries are growing more rapidly than the rest of the world. They have an enormous need for the goods and services that will allow them to provide an acceptable standard of living for their populations. They are becoming increasingly important markets for U.S. goods -- and their appetite for the machinery and capital goods in which the United States has its clearest international advantage is potentially insatiable over the longer term. Indeed, the United States exports $2 worth of manufactured goods to developing countries for every dollar we import.

Change in the world economy has affected not only the relationship between industrial countries and developing countries -- it has also created a wide divergence in income and growth levels among the developing countries. Those developing countries that have progressed most rapidly are now members of a new "international middle class" of advanced developing countries which in many respects are much farther removed from the poorest countries of the Fourth World than from today's mature industrialized powers.

Latin America provides a good example. Brazil and Mexico, with abundant endowments of natural resources and strong economic and export performances, clearly belong among the advanced developing countries. Brazil is the world's tenth largest economy. But Latin America also contains some of the poorest and least developed areas in the world. For example, the level of protein intake in Haiti is the lowest in the world, and its caloric intake is next to the lowest. Infant mortality rates throughout the region are three times as high as those in the United States. Clearly, we will need to continue to grant concessional assistance to those countries, motivated not only by our economic self-interest, but also by a recognition of our responsibility to help provide a decent standard of living to the world's poorest.

For its part, the United States is making a major contribution to growth in the developing countries. Among other things:

-- We have agreed to lower our import barriers -- subject to Congressional concurrence -- in the Multilateral Trade Negotiations, opening our market further to exports from developing countries;

-- We allow preferential duty-free entry into the United States of many products exported by developing countries. Over $5 billion in LDC exports entered the United States in 1978 under this program;

-- We have indicated our willingness to support international commodity agreements benefitting developing countries which would help stabilize prices and assist both producing and consuming countries.

-- We have strongly supported an expansion of international balance of payments financing through the International Monetary Fund.

At the same time, we must continue to maintain our foreign aid commitments, especially our contributions to the multilateral development banks -- the World Bank, the Inter-American Development Bank, the Asian Development Bank and the African Development Fund. These institutions are particularly effective at promoting economic growth and development of less developed countries, thus contributing importantly to the single most rapidly expanding export market for U.S. goods and services. And they assure an equitable sharing of the burden of development aid. For every $1 which we put into these banks, other donor countries contribute $3.

In addition, U.S. participation in the development banks contributes positively to our own economy. During the period 1972-1977, as a direct result of procurement for bank financed projects, the U.S. Gross National Product increased annually by between $2.40 and $3.40 for each dollar we contributed. This amounts to between $1.2 billion and $1.8 billion and 50,000 to 100,000 jobs for each of those years. In balance-of-payments terms, the banks over their histories have put $2.4 billion more into the United States than we have put into them. We don't provide development assistance through the banks primarily for these reasons.

But it would be a mistake to view our outlays for the banks as an economic loss. Those outlays benefit both the less developed countries and the United States. They should be continued.

(4) <u>International Cooperation</u>

Finally, U.S. policy is firmly based on the need for continued, improved international cooperation in <u>all</u> aspects of economic relations: in trade, investment, monetary policy, and our relations with the developing nations. Reductions in tariffs and improvements in monetary mechanisms cannot solve the more fundamental need for better policy coordination among governments.

We need, in effect, a new attitude -- a recognition that if nations want the benefits of an interdependent world with freedom of trade and payments, they must be prepared to give up some of the freedom they have enjoyed to manage their domestic economies without full consideration of the international environment. As part of an interdependent world economy, each country must accept greater responsibilities in exercising its economic management to coordinate better its policies and performance with those of other countries. Whatever the institutional arrangements, unless nations are prepared to accept these responsibilities of interdependence, they cannot expect to continue to receive its full benefits.

Doing so will require structural changes in our way of life. The United States will simply have to learn to live with higher oil prices and less use of energy. Our government and private sector both will have to devote much higher priority to exports to pay for the higher level of oil and other imports we can continue to expect.

More generally, we will have to understand that we are dependent on a wide range of nations around the globe, and that we must gear our policies accordingly. If we are to continue to foster economic growth beneficial to all of the United States, we must cultivate cooperative, constructive relationships with other countries. Even the United States cannot go it alone in the last quarter of the twentieth century.

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STATEMENT OF THE HONORABLE DANIEL H. BRILL
ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman, I am pleased to be here today to discuss with the Committee the Treasury Department's recent investigation of the U.S. oil import position and its impact on our national security.

Background

As you know, Mr. Chairman, the Treasury Department recently made public the result of an investigation of the national security implications of oil imports into the United States. Similar investigations were conducted in 1959 and 1975. The 1959 investigation found that oil was being imported in a manner which threatened to impair the national security and it will come as no surprise to you that each of the subsequent findings reached the same conclusion. In fact, the 1975 and 1979 findings concluded the threat had become more serious.

Investigation

Section 232 of the Trade Expansion Act of 1962, which authorizes the Secretary of the Treasury to make these investigations, couples in paragraph (c) the national economic welfare and national defense as a part of national security. The statute, indeed, goes beyond consideration of the obvious requirement of industrial capability to supply defense needs. It requires the recognition of "...the close relation of the economic welfare of the Nation to our national security, and ... consideration of the impact of foreign competition on the economic welfare of individual domestic industries; and any substantial unemployment, decrease in revenues of government, loss of skills or investment, or other serious effects resulting from the displacement of any domestic products by excessive imports ... in determining whether such weakening of our internal economy may impair the national security." It was within this framework of analytic considerations that the investigation was conducted.

In considering the possible impairment of the national security because of curtailed oil imports, we have to consider at least two contingencies: (1) an interdiction of supply and (2) price manipulation. I will touch only briefly upon the risks associated with the possiblity of interruption of supply by interdiction of sea lanes, political events in supplier countries or an embargo.

These possibilities are discussed in the Treasury Department's March 14 Report to the President. As stated in the Report, the risks are self-evident and we have had experience with the latter two--political events and a supplier embargo--in the last decade. Although we have not had to cope with complete interdiction of foreign supplies, I should like to point out the gravity of that worst case possibility. The United States relies upon oil for 23% of its energy demand of all types. However, this does not tell the complete story. Some sectors, such as transportation, are almost completely dependent upon oil, and imports supply about 45% of the Nation's oil supply. It is obvious that complete interruption of imports would be devastating to the national defense and the economy.

In our recent 232 investigation we asked the Commerce Department to assess the damage to the economy from the 1973/1974 oil embargo. Although the embargo was not very effective and there were other factors involved, there was a significant impact upon the petrochemical industry, and the inherent uncertainties led to a significant drop in automobile sales and services associated with automobile and air travel. There also was an adverse impact in the consumer durable and housing construction sectors.

The Department of Commerce also made an assessment of the economic impact of an oil supply interruption now or in the near future. In making this assessment the

Commerce Department assumed a 4 million barrel per-day reduction in crude oil imports occurring in the late 1970's or early 1980's. According to their findings, impacts of such a reduction (about 20% of estimated consumption) were estimated to be in the order of a $40 to $65 billion (in 1977 prices) decline in GNP. Key industries such as petroleum refining, petrochemical and automotive would be impacted severely.

Because the cost of oil imports represents such a substantial portion of the U.S. trade balance, we included a consideration of the international monetary impacts in our 232 investigation. We concluded that our present excessive dependence upon oil is making it more difficult to achieve U.S. domestic and international economic objectives. The rising price of imported oil increases domestic inflationary pressures by directly raising costs and heightening inflationary expectations, and the resulting uncertainties inhibit business investment required for non-inflationary growth.

Increasing oil imports have put greater adjustment burdens on other elements of the U.S. balance of payments and greatly increases the need for expansion of exports. Excessive and growing U.S. dependence on oil imports also increases the danger of reduced confidence in the dollar and makes the dollar more vulnerable to downward pressures in the foreign exchange market. Widespread loss of confidence in the dollar could lead to sudden and large scale international capital flows in ways that would be disruptive to our banking system and world financial markets. The danger of resort to restrictive measures that would jeopardize the open trade and payments system would be greatly increased.

The statute under which the Treasury Department's 232 investigation was conducted specifically requires an economic finding in determining whether there is a clear and present threat to our national security. The definition of national security, of course, may and does differ from one statute to another.

The language of the present Defense Production Act does not seem to make a strong economy a necessary prerequisite to achieve the purposes of the Act. As originally enacted the Defense Production Act of 1950 contained a broad policy declaration that included the stated determination to develop and maintain whatever military and economic strength was necessary to carry out the Act's purpose. The Act's preamble acknowledged the need to adjust the operation of the civilian economy to satisfy defense needs.

These broad references to the relationship between the Nation's economy and its defense were deleted from the declaration of policy by the 1953 amendments to the Act. In that year, Congress concluded that many of the economic controls authorized by the Act in 1950 were no longer necessary because of the winding down of the Korean Conflict. Thus, the Act was amended to delete existing powers to impose price, wage, and import controls. Accordingly, the Act was narrowed to more strictly military defense powers, and the declaration of policy was similarly narrowed.

In cases where it is necessary to implement the Defense Production Act, there could be a danger of drawing too tight and too simplified a relationship between economic health and national security. A strong economy clearly is a <u>necessary</u> condition for a strong national defense and security. It is not a <u>sufficient</u> condition, however, for war preparedness, since even under conditions of high resource utilization we might still not be able to meet certain wartime needs. During period of wartime, after all, we may need authority to undertake uneconomic activities that would not be considered in a peacetime economy even under extreme conditions of inflation or depression. The state of the

Nation's economy is an important consideration in assessing the ability of the economy to meet defense requirements. But it cannot be an overriding determinant when the national security is threatened, and drawing too tight a link between economic health and the national security might obscure the objectives of the Defense Production Act.

President's Energy Program

The continuing threat to the national security that was identified by the Treasury Department's 232 investigation was an important consideration underlying the program announced by the President to reduce consumption and increase domestic production of oil and other sources of energy. In his message of April 5, the President announced a series of proposed conservation measures to reduce total energy demand, particularly demand for oil. I will not repeat the list of these measures; however, it is estimated that if each of these short-term measures is fully implemented, the United States can reach the goal of up to a 5 percent reduction in oil consumption which the President has set.

At the same time, the President also announced new initiatives for encouraging the production and development of alternative sources of energy, including, importantly, the decision to end the subsidy to oil consumption inherent in the existing controls system which has kept the price of domestically produced oil below its replacement cost. The proposal to phase out price controls by 1981 will encourage reduced consumption and the development of new domestic energy supplies.

Clearly, one possible and likely alternative source of energy is synthetic fuels. Thus, the early development and production of synthetic fuels by private industry, utilizing coal, shale, and/or biomass conversion is consistent with the President's energy program.

In his report to the President on the Treasury 232 investigation, Secretary Blumenthal stated that we should provide appropriate incentives in order to encourage additional domestic production of oil and other sources of energy. The President in his April 5 energy message announced that he would seek enactment of a windfall profits tax, with receipts from this tax to be used to establish an Energy Security Fund. This fund will be used, in part, to help finance the development of alternative energy technologies, as well as to provide low-income assistance and mass transit assistance.
The receipts from the Energy Security Fund would supplement funds that the President has already requested for energy research and technology development, including a development program for synthetic liquid fuels which will be determined in the future. The activities financed

from both the Energy Security Fund and the President's budget requests should provide significant results in terms of demonstrating commercial technologies that have the capability of replacing imported oil.

The President's energy proposals would also encourage the development and production of synthetic fuels in one other way. By decontrolling the price of oil we can expect oil prices to rise. Higher prices for oil should help make synthetic fuels more competitive with oil and, therefore, provide incentive for private development and commercialization of such liquid fuels.

I am aware, Mr. Chairman that you have proposed a bill, H.R. 602 that would add a new section 305 to Title III of Defense Production Act of 1950 (DPA) which, among other things, would add synthetic fuels produced from renewable or nonrenewable resources to the existing provisions of Title III. It also grants authority for the President to make provisions for the purchase, resale and subsidy of synthetic fuels. Under certain conditions, the proposed legislation would authorize committments to be made to purchase synthetic fuels at or above currently prevailing market prices. Moreover, the government could furnish equipment to privately owned facilities or industries to process raw materials into synthetic fuels.

The objective of H.R. 602 seem to be consistent with the President's goal of encouraging alternative sources of energy. I do not believe that any harm is done by singling out synthetic fuels in this respect. However, I am advised by our General Counsel that the existing definition of a "metal, mineral or other material" as used in the Defense Production Act is sufficiently broad to already include synthetic fuels.

Therefore, the proposed bill H.R. 602 appears to be redundant, since in effect it provides the President authority already available to him under the Defense Production Act.

Any use of the authority under the DPA with regard to synthetic fuels would, of course, have to be closely coordinated with the Department of Energy, which has the primary responsibility for research, development, and commercialization of synthetic fuels.

Mr. Chairman, this concludes my brief formal statement. I will be happy to answer any questions that you or other members of the Committee may have.

REMARKS OF THE HONORABLE DANIEL H. BRILL
ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY
AT THE
GREATER BALTIMORE ECONOMIC AND BUSINESS OUTLOOK SEMINAR
APRIL 19, 1979

Let me start by disowning the title of my remarks as listed in the program. It would be presumptuous of me to endow my comments with such a grandiose title as "Inflation: The Administration's View". There is only one person authorized to present "The Administration's View"--and he's on vacation this week. Rather, I urge you to consider these comments as personal observations by one economist who has lived through several episodes of inflation and its aftermath, without having discovered either a preventive medicine or a palatable cure.

Perhaps even my credentials to speak as an individual are questionable. If my analytic ability were better, I would have ducked your kind invitation to participate today. A sign of my fallibility as a forecaster is my acceptance in early February of your invitation to speak on the subject of inflation in April, an acceptance that was based on the hopes that by now I could be the bearer of better tidings, rather than just another voice in the chorus of dismay.

And dismay it is, for the behavior of prices thus far this year is nothing short of dismaying. Inflation at a 13 percent annual rate--that's the average for January and February--is unacceptable. Continued for long, it would undo the significant economic progress of the past two years, two years of substantial economic growth, two years of record job creation, two years of major reduction in unemployment, two years in which Federal spending has been harnessed and the budget deficit reduced dramatically. We cannot--and I am sure we will not--allow these economic gains to be dissipated by inflation.

The question, then, is not <u>whether</u> we will curb inflation, but <u>how</u>: with what tools and at what pace. Let me immediately set out some boundaries within which this question can and should be addressed. That is, let us rule out the nonanswers.

I regard deliberately trying to cure inflation by recession as a nonanswer. First of all, it doesn't work. We've tried it, and the recession of 1974-75, the worst downturn this economy has suffered since the Great Depression of the '30's, didn't eradicate the inflation virus. True, it did bring inflation down out of the stratosphere, but it left a residue of underlying inflation at a rate still unacceptably high.

Second, whatever success the effort achieved in bringing inflation down from historic highs was at the tremendous social cost of 9 million workers unemployed and over a quarter of industrial capacity idle. This doesn't strike me as a cost/benefit ratio so rewarding as to be worth trying again.

The other nonanswer that we can rule out from the start is a program of mandatory controls. I'm still bemused by the conviction in so many circles that we are inexorably on the path to controls, a conviction so strong that I have almost given up arguing with those who express it. But let me try once again. First, we do not have the statutory authority to impose controls, and the fight to curb inflation would be lost the day a request was made for such authority. Second, the concept of controls is repugnant to the President and to his advisors. Third, no system of controls has done more than temporarily suppress inflation forces. If not supported by the appropriate macro-economic policies of restraint, and long-term policies directed at reducing costs and improving productivity, controls just delude all of us--policy makers, businessmen, labor and consumers--into confusing suppression of symptoms with fundamental cure of the illness.

Let us not waste any time in further consideration of nonanswers. Let's focus on the basic nature of the forces involved in the inflation process and on the <u>viable</u> options for dealing with them.

I hope it is not redundant of Joel Popkin's analysis to state the part of our current inflationary problem is the heritage of inflation. Over the decade since the mid-60's, the history has been one of ever upward-trending inflation. With fluctuations to be sure, but with each peak and trough in inflation rates higher than the preceeding ones. Before completing the process of unwinding from one jolt to the price system, another jolt has propelled prices upward again. It is no wonder, then, that expectations of further acceleration in inflation have come to play such an important role--perhaps a dominant role--in influencing private sector economic decisions.

The consequence of this history for the mid-1970's was a game of catch-up ball. Despite the slack in aggregate demands in 1975 and 1976, labor was still trying to catch up for the food and energy price explosion of 1973. Business was adjusting prices to catch up with current and prospective wage demands and declining productivity. And these price boosts and expectations of further price boosts fueled higher wage demands for the next round of collective bargaining. It was indeed a period of wages-chasing-prices-chasing wages.

To the extent this type of tail-chasing behavior explains the persistence of inflation, a program such as the voluntary wage/price deceleration program is eminently suitable. If everyone involved in the tail-chasing game can be persuaded to chase a little slower, no one loses position, society as a whole gains. That was and is the basic rationale for the guidelines. Labor could afford to accept more moderate contract settlements, because the reduced pressure of rising wage costs would permit business to slow the rate of price increase.

But something happened on the way to success. In fact, several things happened. For one, productivity growth practically vanished. Productivity in the private business sector grew by only 1/2 of a percent over the four quarters of 1978. This was only one-third the rate of advance during 1977 and way below the 2.7 percent rate for 1976. Without productivity gains to offset labor costs, which were rising both as a result of collective bargaining success and government mandated cost increases, unit labor costs rose 9.2 percent in 1978 compared with rates of around 6 percent in 1977 and 1976.

The recent bad news on the inflation front also reflects special unfavorable developments in farm and food prices. Part of the sharp rise in food prices so far this year was due to severe winter weather in the Midwest and strikes in California. Moreover, recent adverse and unexpected developments in the energy sector is another reason for the poor price performance. When the price/wage program was being formulated last fall we anticipated an increase in imported crude oil prices of around 7 percent. Price decisions adopted by OPEC at their December meeting and subsequent pricing decisions at the Geneva meeting in April, have placed the likely 1979 price increase for imported crude oil at about three times our initial expectations.

Finally, the economy surged forward with surprising strength in the fourth quarter of last year. Real growth in the fourth quarter was at an annual rate of almost 7 percent, more than double the current estimate of the economy's long-term growth potential, and well above the 5 percent average rate for the current expansion. Consumer expenditures for goods increased at a 11-1/2 percent annual rate, and business fixed investment, with a 9-1/2 percent annual rate of real growth, also showed considerable strength.

This surge came after nearly four years of cyclical recovery, with only very narrow margins remaining of unutilized skilled labor and industrial capacity. We had added significant demand-pull to the cost-push tail-chasing explanation of inflation.

The excessive rate of activity was reflected in prices and the impact carried over into early 79. The GNP deflator, the most comprehensive measure of inflation we have, moved up from the 7 percent rate, to which it had settled after the spring of 78 bulge, to an over 8 percent rate in the fourth quarter and to around 9 percent rate in the first quarter of this year.

The recent wholesale price statistics have been even more discouraging. The price index for finished goods rose at a 14 percent annual rate in the first three months of this year. Even with food excluded, that rate was 12 percent. Farther down the production chain, at the intermediate and crude materials levels, rates of increase have been even faster. This has built up pressures which will undoubtedly be reflected at the retail level for the next few months. With delivery times slowing and rates of capacity utilization relatively high, demand pressures have clearly been a major factor behind the recent deterioration in price performance.

Though more bad price news, particularly on the food price front, is anticipated for the next month or two, we do expect moderation later in the year as the impact of special factors influencing prices dissipate. The most severe feedback effects on domestic prices from last year's depreciation of the dollar are substantially completed. The rise in import prices in 1978 resulting from the decline in the dollar's exchange rate directly raised costs and indirectly provided an umbrella for increases in prices of import-competing goods. Perhaps as much as 1 percentage point of our inflation last year reflected the reduced value of the dollar in exchange markets. The recovery of the dollar since our November 1 actions will alleviate some of the pressure on domestic prices in 1979.

Moreover, the effect on costs of mandated increases in the minimum wage and social security taxes which went into effect at the beginning of this year will moderate as the year progresses.

Further, the tightening of the price standards, and the intensified monitoring program announced by CWPS will spread allowable price increases more evenly through the program year.

With the removal of some of the special factors affecting prices in recent months, the latest upsurge in inflation should begin to moderate. Among the more favorable portents for the inflation outlook is the slowing in economic activity that has taken place this winter. Admittedly, the slowing is from a torrid pace, a pace unsustainable in an economy with very slim margins of excess capacity. Admittedly, the slowing is in part attributable to adverse weather. Admittedly, the slowing has not been uniform across the economy, but has been centered mainly in housing and in certain categories of consumer spending, while business spending and ordering for inventory additions has accelerated.

Nevertheless, this respite from intense demands on resources is welcome after the strains on prices engendered by the surge in spending in the fourth quarter of last year. The task of governmental policies is to prevent another such surge in spending in the months ahead. I would neither anticipate nor welcome a rebound in consumer spending to the pace of late 1978, particularly when business spending for inventories is heating up. One can hope for--and legitimately anticipate--some revival in consumer spending from the sluggish retail sales in the early months of this year. But it is important that the rebound be on the moderate side. Similarly, it is important that manufacturers' accumulation of inventories, which accelerated sharply in January and February, moderate. A major factor sustaining the recovery over the past four years has been business prudence in maintaining inventories in close consonarce with sales. Inventory imbalance has usually been the proximate cause of the termination of a recovery, and while inventory/sales ratios are still on the low side, it doesn't take long before these ratios begin to signal trouble ahead.

It is clear, therefore, that curbing inflation <u>and</u> sustaining economic expansion calls for modertion in private sector behavior, along with government restraint on its own spending, lending and regulatory programs.

While some abatement in inflation is expected, we have to recognize that <u>enduring</u> abatement requires persistent application of policies of restraint. Our objective is not only to bring the rate of inflation down from the double-digit range, it is to set in place a complex of policies dedicated to continued, persistent reduction in inflation over time. That is why the President proposes continued reduction in the share of the nation's output absorbed by government spending. That is why we will continue to revamp our tax structure to encourage investment so as to modernize and expand our capacity and restore productivity growth. That is why we are reexamining our regulations to insure that they accomplish our social and economic objectives in the most cost-efficient manner possible. And finally, that is why we have embarked upon a policy of phased decontrol of domestic energy prices.

Although decontrol of energy may add slightly to our inflation problem in the short run, in the longer-term it is clearly beneficial. By discouraging domestic consumption, by encouraging domestic production, by investing the recaptured "economic rents" in research of new energy technologies, by strengthening the dollar in foreign exchange markets, and by freeing ourselves from the inflationary results of dependence on a cartel's pricing decisions, we will be making a long-run contribution to reducing the U.S. rate of inflation.

But equally, if not more, important to our long-run struggle against inflation is the need to improve the U.S. productivity performance. Essential to the achievement of this objective is the continued education and training of our labor force, the upgrading and modernization of our capital stock and the expansion of the share of our national resources devoted to research and development. That is why, despite the necessity for restraining the growth of federal outlays and reducing the size of the budget deficit, the fiscal 1980 budget provides for increased outlays--and in some cases for increased tax incentives--for basic research, for on-the-job training of the unemployed, unskilled and disadvantaged, and for stimulus to business fixed investment.

Encouraging and insuring the growth of business investment will, however, require more than mere tax incentives

It will require, above all, a stable and growing economy--free from episodes of boom and bust--and an adequate rate of return on investment.

Recently, profits have been growing rapidly, as they typically do in periods of sharply rising activity. If we take a closer look at these statistics, and adjust book profits for the effects of inflation on inventories and capital consumption allowances, the increase in fourth quarter corporate profits is much smaller than the near 50 percent annual rate cited in the newspapers. Moreover, if one examines the movement in corporate profits over the course of the entire year 1978, it can be noted that the increase in aggregate profits was under 20 percent.

An even more meaningful analysis of the 1978 corporate profit performance examines the movement in profit margins--that is, profits in relation to sales or capital investment--rather than in aggregate profits. Such statistics reveal little economy-wide widening of profit margins. The 1978 after tax rate of return on net capital stock (valued at replacement cost) was only 3.3 percent, slightly smaller than in 1977 and only half the rate that characterized the 60's. The short-run objectives of our anti-inflation program make it essential that profit margins do not widen during 1979 and 1980--and indeed intensified monitoring efforts by CWPS are designed to insure against such developments--but over the long-run some increase in the after-tax return to capital is needed in order to achieve our objective of increased productivity, lower unit labor costs and reduced inflation.

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STATEMENT BY H. DAVID ROSENBLOOM
INTERNATIONAL TAX COUNSEL
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and members of this distinguished subcommittee:

I am grateful for this opportunity to discuss information exchange and the use of tax havens by persons seeking to evade or avoid United States taxes. The subcommittee's interest in these important subjects is most welcome.

My testimony will address two different, though related, problems. The first is the use by United States persons of foreign bank accounts and other foreign financial facilities for the purpose of evading United States taxes. This is is not legal but it is possible, largely because foreign bank secrecy laws shield information from disclosure to United States tax authorities. One obvious question is the extent to which treaties permitting the exchange of this information can be negotiated.

The second problem is the use - principally by foreign persons but doubtless by some United States persons as well - of financial facilities in countries with which the United States has a double taxation convention in force. I refer to the practice known as "treaty shopping"; it involves the use of our tax treaties by persons other than true residents of the treaty partner, persons who are not intended to benefit from the treaty.

Although treaty shopping, particularly when engaged in by U.S. persons, may involve illegal tax evasion, in many cases the practice involves only tax avoidance made legal and possible by the existence of the treaty relationship. Treaty shopping raises several obvious issues of tax and treaty policy. At the same time, it must be recognized that the practice mitigates the impact of statutory withholding taxes which many persons believe are too high, and constitute an undesirable impediment to investment in the United States by foreigners. Treaty shopping therefore involves some complicated policy choices.

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Information exchange is best analyzed after considering the types of treaty arrangements that are available to us, the nature of our existing treaty arrangement with Switzerland - the principal "bank secrecy" jurisdiction with which we have treaties in force - and, finally, the prospects for securing information exchange treaties with other foreign jurisdictions.

There are three different types of treaty arrangements that might be used to gather more tax information about United States taxpayers from sources outside United States territory. These are (1) exchange of information provisions in double taxation conventions; (2) separate agreements for the exchange of tax information or for administrative assistance in tax matters; and (3) mutual assistance treaties that include coverage of tax matters.

The United States maintains bilateral conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to income taxes with 38 countries, as well as with seven territories of the United Kingdom and one territory of the Netherlands. In addition, we have in force 13 conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates.

Each of these conventions contains a provision requiring the exchange of tax information, but the scope of these provisions varies considerably. Some, like the convention with Canada, are broadly drafted to require the exchange of all information which the competent authorities "have at their disposal or are in a position to obtain under" their own revenue laws. Others, like the convention with the Netherlands, cover only information in certain defined categories, most commonly information "necessary for carrying out the provisions of the present Convention" and information "necessary for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of the present convention." Our current model income tax and estate and gift tax conventions, which serve as our opening position in negotiations, contain very broad information exchange provisions. They extend to any information "necessary for carrying out the provisions of this convention or the domestic laws of the contracting states concerning taxes covered by the convention insofar as the taxation thereunder is not contrary to the convention." The model conventions also provide that, for purposes of information exchange, the taxes covered by the convention are deemed to be all taxes imposed by a contracting state at the national level. Although we have no conventions in force which contain a provision quite this broad, several of our more recently negotiated conventions, signed but not yet ratified, reflect the models.

Exchange of information provisions typically include express limitations on the obligations of the parties to gather or exchange information. Ordinarily there is an "availability" provision expressly limiting obtainable information to that available under the laws of the requested state. Beyond this, a requested state is typically not required (1) to carry out administrative measures at variance with its laws and administrative practice or those of the requesting state; (2) to supply information not obtainable under the laws or in the normal course of the administration of either state; or (3) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or any information the disclosure of which would be contrary to public policy or "ordre public." These are standard limitations on a state's responsibility to place its public administration at the service of a sister state. They are found, for example, in the model tax conventions published by the Organization for Economic Cooperation and Development.

The information exchange article in our model conventions also restricts the use of information received to the purposes for which it was exchanged. Relatively few of our conventions in force contain such a restriction, but it is salutary and protective of United States interests. The recipient state may not disclose the information to parties other than those involved in the assessment and collection of the taxes involved.

A final feature of the U.S. model conventions is a specification of the manner in which a requested state should employ its information gathering powers on behalf of the requesting state. In general, information must be obtained in the same manner and to the same extent as if the tax of the requesting state were the tax of the requested State and were being imposed by the requested state. The requested state must render information "in the form of depositions of witnesses and authenticated copies of unedited original documents" to the same extent such depositions and documents can be obtained under the laws of the requested state. These provisions are intended to permit the exchange of information provision to function in a way that will ensure that material supplied will be usable as evidence by the recipient state.

In some circumstances agreement with another country on the substantive issues that comprise a double taxation agreement may not be possible. The concept of separate exchange of information agreements has arisen because it may still be possible to reach accord on procedural cooperation. To date, we have never negotiated a separate exchange of information agreement. Such an agreement would presumably include definitional provisions patterned on the provisions of a full-blown double taxation agreement; its core, however, would be an exchange of information article providing in substance what is provided in the exchange of information article of a double taxation convention.

The major impetus behind this idea is the difficulty we have in negotiating double taxation agreements with developing countries. Many countries refuse to enter into such agreements with developed countries unless the agreements contain concessions which the United States has traditionally not wished to grant. Such concessions include recognition of expansive source basis taxation, substantial formulary taxation, and credits for taxes not actually levied by the treaty partner. In addition, some jurisdictions with which it would be valuable to have an information exchange agreement may not have income or estate taxes, and therefore it is impossible to conclude a comprehensive double taxation agreement. It is conceivable that there could still be a basis on which to conclude a separate procedural agreement.

Mutual assistance treaties are a third type of agreement providing for information exchange. Under such a treaty, two states in essence agree to lend their administrative machinery to each other in connection with specified types of investigations. The United States has only one comprehensive mutual assistance treaty in force: the treaty with

Switzerland, signed May 25, 1973, and which entered into force in January 1977. This treaty covers only criminal matters.

Mutual assistance treaties are broadly conceived to overcome the various obstacles that may preclude access to information obtainable only by official action on foreign soil. Customary international law does not require one state to give assistance to another in connection with the first state's administrative, criminal, or other investigations or proceedings. Frequently, a state's domestic law will prohibit measures by a foreign state to collect information; such measures may be viewed as an infringement of sovereignty if undertaken in the absence of a treaty or other official sanction.

Although it has certain unique features, the mutual assistance treaty between the United States and Switzerland contains the basic features of a typical treaty of this sort. The treaty defines a general obligation to furnish assistance, and sets forth the most important acts included in the concept of assistance: taking testimony; effecting the production, preservation, or authentication of documents and records; locating persons; serving legal documents. Insofar as the negotiation of other mutual assistance treaties is concerned, we believe it would be appropriate to include some further actions in the list of basic elements of assistance - for example, general liaison between law enforcement officials.

The Swiss treaty defines the central authorities, the point of operational nexus between the treaty partners. In the Swiss treaty, the Attorney General is the central authority for the United States. The treaty expressly does not apply to tax crimes except in certain limited cases involving organized crime. The Secretary of the Treasury is the competent authority under double taxation conventions, and we believe, for a number of reasons, that where a mutual assistance treaty covers tax matters, the competent authority for tax matters should be the Secretary of the Treasury.

Beyond these basic provisions, a mutual assistance treaty spells out the steps a state must take to request assistance, and the obligations imposed upon the other state when a request is made. The treaty will usually contain special provisions for particular matters such as the production or authentication of documents, the location of persons, the service of judicial or other official documents by the requested state, the transfer of persons in custody in the requested state for an appearance in the requesting state, and the like. Our Swiss treaty contains provisions, which I believe most officials concerned with this matter deem essential, allowing the participation of officials of the requesting state at the appearance of a witness in the requested state, and setting forth the steps a requested state must take to determine the authenticity of documents supplied under a request. These measures are designed to ensure the admissibility of evidence obtained under the treaty.

A mutual assistance treaty will contain limitations on the obligations of a requested state parallel in many respects to the limitations set forth in the information exchange article of a double taxation convention. Thus, the Swiss treaty permits a state to refuse a request for assistance if it considers that execution of the request is "likely to prejudice its sovereignty, security or similar essential interests." Further, the treaty does not apply to political offenses or to military offenses, other than in circumstances involving organized crime. The Swiss treaty also contains limitations beyond those we would usually like to have in mutual assistance treaties: specifically, it does not apply to anti-trust or anti-cartel crimes, or to crimes growing out of what the Swiss view as "fiscal" offenses -- tax crimes, violations of customs laws, violations of exchange control requirements.

The Swiss mutual assistance treaty also has a number of other unusual features, which I shall advert to after a brief review of our practical experience with Switzerland. Most of that experience arises under a double taxation agreement.

* * *

Although that agreement contains an exchange of information article, we are not satisfied with the operation of that provision. The difficulties that have arisen are somewhat complex, but I would like to try to detail some of them, albeit in simplified fashion, because they are important both in themselves and as an indication of some of the problems that arise in the use of treaty arrangements to overcome bank secrecy and other obstacles to effective tax enforcement.

The information exchange article in our double taxation agreement with Switzerland is highly unusual. It is at once the broadest information exchange article to appear in any double taxation agreement executed by Switzerland, and the narrowest such article in any United States income tax agreement. The article requires the exchange of two categories of tax information: information "necessary for carrying out the provisions of the present convention"; and information "necessary . . . for the prevention of fraud or the like in relation to taxes which are the subject of the present convention." Only information "available under the respective taxation laws of the contracting states" is required to be exchanged; the information exchanged must be treated as secret, and may be disclosed only to persons "concerned with the assessment and collection" of the taxes subject to the convention; no information is permitted to be exchanged if it would "disclose any trade, business, industrial, or professional secret or any trade process." Neither party is required to "carry out administrative measures at variance with the regulations and practice of either contracting state," or which would be "contrary to its sovereignty, security or public policy"; and neither party is required to "supply particulars which are not procurable under its own legislation or that of the state making application."

The provision is broader than any other exchange of information provision agreed to by Switzerland, because of the inclusion of information necessary for the prevention of "fraud or the like." Most Swiss conventions contain no exchange of information provision. It is the official Swiss view that exchange of information provisions are unnecessary and inappropriate in double taxation conventions. The Swiss position, set forth in a reservation to the OECD model income tax convention, is that "a double taxation convention aims at avoiding international double taxation; the information necessary for the correct application and for the prevention of an abuse of such a convention can be exchanged already within the existing framework of its provisions on the mutual agreement procedure, the reduction of taxes withheld at the source, etc. Switzerland considers a particular provision on the exchange of information as unnecessary since even such an express clause could not, according to the purpose of the convention, provide for more than for an exchange of information necessary for the correct application and prevention of an abuse of the convention."

Only three Swiss conventions other than the U.S. convention contain any information provision at all -- those with Germany, France, and the United Kingdom. These three conventions all require only the exchange of information necessary to carry out the convention; and all three expressly place "banking" information among the category of professional or other trade secrets not required to be exchanged.

United States conventions, by contrast, generally contain exchange of information provisions much broader than the provision in the U.S.-Swiss treaty. As I indicated previously, our official position is that any double tax convention should require the exchange of all tax information necessary to carry out any domestic tax laws of the contracting states. The exchange provisions in most of our conventions are in fact limited to the taxes specifically covered; but they are still broader than the clause in our Swiss treaty. Many of our early treaties contain more limited clauses, restricting the exchange requirement to information necessary to carrying out the convention, and to a second category -- information necessary for the prevention of fraud or "for the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of the present convention." The Swiss treaty is one step more limited. It covers only information necessary for "the prevention of fraud or the like"; it does not explicitly reach information necessary for the administration of provisions aimed at minimizing the legal avoidance of taxes.

There is a substantial body of jurisprudence in Switzerland concerning the meaning of this exchange of information provision. While most countries view the operation of such provisions as largely administrative matters, to be handled by dealings between tax officials, Swiss regulations implementing the treaty contemplate that private parties will have the opportunity to express their views on United States requests for information, and to contest administrative decisions to provide information. Decisions of the Swiss Federal Tax Administration to give information are appealable, since 1962, to the Swiss Federal Court; prior to that date, they were appealable to the Swiss Federal Council. Excerpts of the written decisions of the Court and Council are sometimes publicly available and afford an insight into the theories by which the Swiss have interpreted the convention.

Three central interpretive problems have given rise to our differences with Switzerland concerning the scope of exchange of information under the convention. The first concerns the distinction in Swiss law between the Swiss notion of Steuerbetrug, roughly translatable as "tax fraud," and that of Steuerhinterziehung, roughly translatable as "tax evasion." The key fact is that "tax fraud" -- Steuerbetrug -- is a substantially more restricted term under Swiss law than under normal United States concepts. Steuerbetrug encompasses only the falsification or concealment of documents suitable or intended for proving a fact of legal significance. Switzerland simply does not view wilful failure to make a return, wilful misstatements on a return, or other deliberate efforts to obstruct proper tax assessment and collection as fraud. The United States does.

This matter has been of great significance in interpreting the tax convention because Switzerland, in a decree of the Swiss Federal Council in 1957, reaffirmed in a Federal Court decision in 1970, has taken the view that the "fraud or the like" language in our convention restricts the right of the United States to information which is relevant to investigations of acts which would constitute Steuerbetrug under the laws of Switzerland. The stated basis for this view is a provision in the convention to the effect that, in its application by one of the contracting states, "any term not otherwise defined shall, unless the context otherwise requires, have the meaning which such term has under its own tax laws." This interpretation by Switzerland obviously has the effect of greatly restricting the amount of information given the United States under the convention. It is an interpretation with which we disagree, for reasons I shall mention in a moment.

The second legal question of significance in applying the convention is the system of "discretionary assessment" prevalent in Switzerland. Most income taxes are collected at the cantonal level; there is a federal income tax, the Federal Defense Tax, which does not have its own set of procedural provisions. Assessment procedures differ greatly among the 22 cantons, and as between the cantons and the federal government. But almost all of the tax systems accord only very restricted powers to tax authorities to gather tax information from third parties. The taxpayer sets in motion the assessment procedure by filing his return. The authorities may request documentation, books and records, and the like, and may request that the taxpayer procure information from third parties; but they are not given plenary power to summons or otherwise gather information directly from third parties. Essential to the operation of this system are corollary powers granted the tax assessors to assess taxes on a discretionary basis, thus putting the taxpayer in the position of having to come forward with information and proof in order to avoid a tax liability he believes is too high.

These restrictions on the powers of Swiss tax officials become an obstacle to information exchange under the convention, which sets limitations on the obligations of a requested state. Contracting states need exchange only such information as is "available" under their domestic laws. A state is not required to carry out "administrative measures at variance with the regulations and practice of either contracting state"; or "to supply particulars which are not procurable under its own legislation or that of the State making application." Under the laws of some of the cantons, including notably the principal banking centers of Zurich, Basel, and Geneva, third-party information is available to criminal authorities prosecuting a case of tax fraud when it would not be available in the tax assessment process. The Swiss Federal Court and the Federal Tax Administration have mitigated some of the effects of the "availability" issue by ruling that, where information requested involves "tax fraud," as defined under Swiss law, and where a prosecution is involved, the availability standard is to be tested according to the laws of the three central banking cantons, Zurich, Geneva, and Basel. But even with this holding, the Swiss view of the availability standard constitutes a second obstacle to the full implementation of the tax convention, independent of the obstacle imposed by the Swiss interpretation of "fraud." The Swiss view requires not only that certain information or information gathering powers be at the disposal of Swiss authorities, but that they be at their disposal with respect to the particular proceedings, or particular suspected offense, to which an information request relates. This view imports into the tax agreement what is sometimes called a "dual criminality" standard.

A third obstacle to effective implementation of the tax agreement is created by Swiss bank secrecy law itself. "Bank secrecy" is a product of a variety of different features of the Swiss legal system. The Swiss believe that bank secrecy is an essential feature of rights of privacy protected by the Swiss Civil Code and Code of Obligations, and that it arises as an essential contractual duty of a bank upon the opening of an account. The heart of Swiss bank secrecy is Article 47 of the Swiss Banking Law, which imposes criminal penalties upon the unauthorized disclosure of confidential bank information by a bank employee. Also of importance, especially in the context of international information exchange, is Article 273 of the Swiss Penal Code, the so-called "economic espionage" law. This provision imposes criminal penalties upon the unauthorized disclosure of confidential trade information to foreign persons or authorities.

Swiss bank secrecy is superseded in a number of important instances under domestic Swiss law. The most important of these is criminal investigations, in which a banker has no privilege to refuse to testify on grounds that information is confidential. Other circumstances involve bankruptcy proceedings and other proceedings for the enforcement of debts, in which the theory is that a debtor should not be permitted to conceal his assets behind the bank secrecy shield. A third exception is proceedings for the settlement of estates, in which a bank is required to disclose information to designated persons having an interest in, or responsibility for administering, an estate.

Since 1970, the bank secrecy laws have not been an independent obstacle to implementation of the tax convention, because the Swiss Federal Court held that where the "availability" standard was met, bank secrecy does not preclude disclosure of information to foreign authorities. Prior to 1970, however, there were suggestions in Swiss decisions that bank information might be considered a "trade, business, industrial or professional secret." This view would be difficult to sustain in light of the difference between the wording in the U.S.-Switzerland convention and that in Switzerland's conventions with Germany, France, and the United Kingdom. But if we were ever to secure Swiss agreement with our views on the meaning of "fraud and the like" and the "availability" standard, bank secrecy might still be an issue. One Swiss commentator, in a publication not intended to reflect an official Swiss position, has suggested that where criminal procedure laws make bank information available, the information might not meet the "availability" standard, since that standard covers only information available under the respective taxation laws of the contracting states. Another suggestion is that bank information might fall under the provision which protects a state from having to carry out administrative measures "contrary to its sovereignty, security or public policy." The Swiss have not, however, invoked these points officially.

The United States has objected to the manner in which the Swiss interpret our double taxation convention. We do not believe that the "fraud or the like" language limits the information exchange provision in accordance with the narrow Swiss concept of Steuerbetrug. We believe it inappropriate, as an interpretive matter, for the Swiss to rely upon the provision to the effect that a state may define a term in accordance with its domestic law when it "applies" the convention, "unless the context requires otherwise." We believe that this provision is intended primarily for circumstances where a contracting state is determining the effect of a convention term in the context of analyzing its obligations toward a particular taxpayer. We do not believe that a contracting state is "applying" the convention when it receives a request from the other state for information under the convention. And even if it were, we believe it appropriate, in "context," for the requesting state's law to determine what constitutes "fraud or the like." The background of the convention -- particularly the fact that the "fraud or the like" language takes the place occupied in other conventions by language referring to fraud or the administration of provisions against legal avoidance -- indicates that the convention was not intended to limit United States rights in accordance with the restrictive Swiss concept of tax fraud.

We also do not believe that the "availability" and "procurability" standards warrant the importation of the kind of "dual criminality" standard which the Swiss have grafted onto the convention. We believe that in response to a United States request concerning information necessary to prevent tax fraud (under the United States concept of that term), the Swiss are required to furnish information that would be available if there were a prosecution for tax fraud in Switzerland, whether or not under the facts of the case fraud could be charged under Swiss law.

Finally, we do not believe that Swiss bank secrecy principles may permissibly be invoked under the clauses restricting information exchange where business secrets are involved, or under the provision reserving a state's right to refuse exchange to protect its sovereignty, security, or public policy.

Acceptance of these views by Switzerland would go a long way toward eliminating the barriers posed by Swiss law to effective United States tax enforcement. The United States would still not have rights to tax information as broad as those it has with many other treaty partners, but, at least with respect to most criminal prosecutions for tax violations, we would have substantial means of overcoming the impediments created by Swiss bank secrecy.

Unfortunately, we see little immediate prospect of Swiss acquiescence in our interpretation of the convention. The Swiss resistance to substantial cooperation with other nations in matters of taxation is rooted in principles which Switzerland takes very seriously. The Swiss view their refusal to cooperate with the "fiscal" enforcement efforts of other governments as a critical element in Switzerland's historical role as an asylum from all forms of religious and political persecution, and as an aspect of traditional Swiss concern for personal liberty.

Our differences with Switzerland on this matter raise some important and far-reaching questions. The first involves the degree of disagreement over the meaning of a convention's provisions that we will tolerate. This question, of course, is important for our entire bilateral tax convention program. The second question is the appropriateness, as a matter of principle, of treaty arrangements with countries whose commitment to the general idea of international tax cooperation is different in kind from the commitment made by most if not all other countries in our tax treaty network.

I have no reservations, of course, about the desirability of a treaty relationship with Switzerland. A tax convention is of great significance to the economies of both Switzerland and the United States, and to the roles played by both countries in international monetary and financial affairs. But this only underscores the importance of achieving meaningful agreement on the scope and application of the exchange of information provision.

Our experience with the mutual assistance treaty with Switzerland is much more limited, since that treaty entered into force only in January 1977. I am also somewhat less well equipped to speak in regard to experience under that treaty, since the central authority under the mutual assistance treaty is the Attorney General, not the Secretary of the Treasury. Nonetheless, it is worth reviewing briefly the tax aspects of that treaty.

As I noted previously, the Swiss mutual assistance treaty does not apply to "fiscal" crimes, including tax law violations, except where gambling, firearms, or narcotics violations are involved. Explicit exception is made by the treaty, however, for tax crimes involving "organized criminal groups," as defined by the treaty. The treaty expressly requires the use of compulsory information gathering measures by a requested state for tax investigations or proceedings with respect to individuals participating in the activities of such groups. But such assistance is available only if a whole host of conditions are met.

These conditions are defined by relatively loose terminology, which in most cases has no precise technical significance. For instance, it is required that the group "in a methodical and systematic manner" commit or threaten acts of violence <u>and</u> strive to obtain influence "in politics or commerce," and the person who is the focal point of the investigation must be "knowingly involved in the illegal activities of the group," and be either (1) a "member" of the group; (2) an "affiliate" of the group "performing supervisory or managerial functions . . . or other important services"; or (3) a "participant" in an "important activity" of the group. The person must belong to an "upper echelon" of the group or must be "participating significantly . . . in any important activity" of the group. The list of conditions is very long.

A request for assistance under the organized crime provisions must state information on which the various "suspicions" or "conclusions" required by the treaty are founded. The central authority of the requested state has the right to review the determination of the requesting state, and need not accept the latter's determinations "where the suspicion, conclusion or opinion underlying such determination has not been made credible." The treaty expressly provides that restrictions of municipal law on criminal procedures in tax cases do not apply to requests relating to organized criminal groups.

Perhaps the most salient characteristic of these provisions is the illustration they make of Swiss sensitivity about the disclosure of tax information. The provisions contain an elaborate series of conditions, most of which are framed in terms which have no precise meaning under any country's law -- "membership" in an organized criminal group; "supervisory or managerial functions" of such a group; striving to obtain "influence in politics or commerce"; and so forth. In addition, a requested state is given broad discretion to review determinations by the requesting state of determinations made with respect to these highly subjective and indefinite conditions. The net effect of the subjectivity of the conditions imposed and the discretionary powers conferred upon the requested state is to make compliance with the treaty provisions almost completely discretionary with the requested state. This is not to say that the provisions have no utility; it is only to point out potential limitations. Limited as the provisions may be, they aroused substantial public objection in Switzerland.

We understand that the Justice Department has been pleased with the operation of the treaty in nontax areas, and that this experience has spurred interest in negotiating similar treaties with other countries. It is appropriate to note, however, that even if the treaty operates to the fullest extent of its reach, in the tax area it will not be a comprehensive solution to the problem of obtaining tax information from Switzerland.

* * *

Switzerland is the most important "bank secrecy" nation with which we have treaty arrangements in force. You have asked, however, about the potential use of treaty arrangements with other countries, particularly other bank secrecy countries, to obtain information.

Attempting to secure satisfactory treaty arrangements with such countries is a difficult undertaking. To many countries, an offshore finance business can be an important source of revenue, and such countries are likely to view a treaty giving the United States access to information as a threat to that revenue. From the point of view of some countries, information exchange will be much more valuable to the United States than to them. We may have difficulty convincing such countries that the intrinsic bargain in an information exchange or mutual assistance agreement is a good one for them.

Considerations of this sort can, of course, be overstated. Some bank secrecy countries do stand to gain from an exchange of information with the United States. Even if they have little interest in tax information, they may be interested in an exchange of information concerning criminal matters. In such cases, there may be a basis for negotiation of a mutal assistance treaty. In addition, many countries are sensitive to public opinion in the United

States, and some may be willing to enter into agreements with the United States for that reason. The mutual assistance treaty with Switzerland appears to have been based at least in part upon Swiss concern about United States public opinion concerning Swiss bank secrecy. Finally, some countries that find no appeal in the "intrinsic" bargain in an information exchange or mutual assistance agreement may be attracted by extrinsic matters. Most countries will be concerned with their relations generally with the United States. In certain circumstances there may be particular concessions we may be able to offer, in the tax area or in other areas, as an inducement to some form of information exchange.

Therefore, I believe it is important to explore the possibilities for securing treaty arrangements with bank secrecy jurisdictions in order to overcome the obstacles to effective tax enforcement posed by their laws. In going forward with such a program, it will surely be advisable to develop a starting negotiating position which reflects our basic objectives. I think it only fair to say that we and the other agencies involved do not have a fully developed negotiating position at this time.

The situation that obtains with respect to double taxation agreements provides a useful point of contrast. Our model income tax convention and model estate and gift tax convention define our initial negotiation position. My office is responsible for negotiating such conventions, and we are in a fairly good position, working with the Congress, the State Department, and the Internal Revenue Service, to work out our essential negotiating posture. Conventions of this type have been with us for some time, and there is a depth of familiarity with the issues and problems that we encounter. Neither my office nor any other that I know of is in a comparable position with respect to mutual assistance treaties. We participated, along with representatives from the State Department, the Justice Department, and the SEC, in negotiation of the Swiss mutual assistance treaty; and I believe all those agencies will have to be involved in the development of an approach to, and negotiations concerning, further mututal assistance treaties. However, the development of an approach will require more work, and especially cooperative work, among the various agencies concerned.

As a general matter, if it is possible to reach a comprehensive double taxation agreement with a country, then I believe we should approach information exchange through such an agreement. Double taxation arrangements are the principal device used in the world today for achieving international tax harmonization and tax cooperation; we seek as broad a network of such agreements as possible. Under such agreements, information exchange takes place directly between tax authorities, who thereby develop valuable experience in dealing with each other. Double taxation agreements also create a basis for the administrative officials of different countries to become familiar with each other's tax systems. This familiarity may be of substantial benefit to practical information exchange.

In negotiating double taxation agreements with any jurisdiction having bank secrecy laws, we should take care to ensure that we have an information exchange article, and that the article is drafted to avoid the kind of interpretative problems that we have encountered with Switzerland. Our model convention language achieves this goal, as long as it is subject to certain understandings -- that the "availability" and "procurability" standards do not imply a "dual criminality" standard; that the professional and trade secret language does not apply to information kept secret under "bank secrecy" laws; and that the "sovereignty" and "security" language cannot be invoked to preserve the effects of bank secrecy. We must be careful in the negotiation of any new conventions with bank secrecy jurisdictions to ensure that these understandings are made clear in the negotiations and recorded as the intention of the parties. We must also insist upon a provision defining broadly and clearly the kind of information required to be exchanged. The model convention language, requiring exchange of all information necessary to carry out the convention or domestic laws, is adequate in this regard. We should not again agree to a standard subject to varying and restrictive interpretations such as those the Swiss have given to the "fraud or the like" provision.

If a bilateral double taxation agreement cannot be negotiated, then we should make the effort to secure information exchange through agreements limited to that purpose or through mutual assistance treaties. However, we should make this effort in the full knowledge that exchange of information agreements have not been achieved in the past, and that application of mutual assistance treaties to tax matters presents some complicated questions.

As I have noted, the U.S.-Swiss mutual assistance treaty does not, except in limited and elaborately defined circumstances, cover what the Swiss call "fiscal" crimes -- tax violations, currency and exchange control violations, and customs violations. This is in line with what we would have to concede is predominant international practice with respect to mutual assistance treaties. Criminal mutual assistance treaties are historically viewed as an adjunct to extradition treaties. Extradition treaties, by and large, have historically not covered fiscal or tax violations, and ancillary treaties of mutual assistance in criminal matters have been drafted accordingly. At least among the developed countries, however, attitudes appear to have changed very substantially in recent years with respect to covering tax matters in extradition treaties. Countries now appear to be not only willing but eager to cover tax crimes in extradition treaties.

In developing a United States approach to mutual assistance treaties, the three departments principally concerned -- State, Justice, and the Treasury -- appear to be in substantial accord that we should seek access to tax information. The departments also agree that, the Swiss convention notwithstanding, our goal should be mutual assistance agreements which cover civil and administrative matters as well as criminal matters. If we were to achieve comprehensive mutual assistance agreements of this nature, even civil tax matters would be covered.

These positions create issues for the negotiating process. Since many countries are sensitive about including civil or administrative matters, and independently sensitive about including tax matters, our negotiators will be in a difficult position: they must determine the importance of including tax matters in a mutual assistance convention in relation to other, essentially different, issues presented in the negotiating process. This determination will vary according to the particular circumstances of each negotiation. There are surely cases where the need for coverage of tax matters will be so great that we should be unwilling to enter agreement at all in the absence of an adequate provision for assistance in tax proceedings. In other cases, we might be willing to accept possible limitations on coverage of tax matters in exchange for concessions on other matters. In some cases we might be willing to agree to a convention which did not cover tax matters at all, in order to achieve an agreement which will secure assistance in other criminal or civil matters.

In negotiating mutual assistance treaties we should take care to incorporate protections against restrictive readings of the kind that have beset our tax convention with Switzerland. "Dual criminality" standards are a particular problem in this regard. Such standards are common in mutual assistance agreements, and one is included, in somewhat qualified form, in our treaty with Switzerland. Nevertheless, I believe that we should seek agreements that do not require "dual criminality," or that limit the requirement in certain ways. At a minimum, these agreements should give us the right to information in a tax case if the acts involved constitute a crime under the laws of both states, regardless of whether the crime under the law of the requested state is the same as the offense cited in the request. Beyond this, I think it appropriate for us to seek agreements which include a provision like that applicable to organized crime cases under the Swiss treaty -- that is, one that explicitly dispenses with a "dual criminality" requirement in specified circumstances.

Finally, as in the case of tax treaty negotiations, we should make clear that provisions protecting confidential or trade information, or guaranteeing the sovereignty, security, or <u>ordre public</u> of the requested state, do not give that state a right to withhold or refuse to gather information on the ground that it is confidential information under the state's domestic bank secrecy laws.

* * *

Now I want to pass from the subject of information exchange to the related subject of treaty shopping. It is no secret that some double taxation conventions maintained by the United States create exemptions or other protections from United States taxes without a corresponding transfer of revenue either to the government with which we maintain the convention or to its residents or citizens. The conventions in question are with "tax haven" jurisdictions, having low or no taxes either generally or with respect to particular categories of income. These conventions, and the practices that arise under them, raise some important questions.

The "tax haven" conventions we maintain are generally extensions of conventions with a European country to a Caribbean area which is or was at the time of the extension a territory of the European treaty partner. The first treaty extension to which the United States ever agreed was in 1955. This was an extension of our 1948 convention with the Netherlands to its territory, the Netherlands Antilles.

At the time of the extension, as now, the Netherlands Antilles had both an income tax, applicable to individuals, and a profits tax, applicable to corporations and analogous to our corporate income tax. Then, as now, the rate of profits tax was not insubstantial -- about 24% to 30% then, slightly higher now. These considerations were of significance from the standpoint of our treaty program, since it makes little sense to maintain "double taxation" conventions covering income taxes if the other jurisdiction has no income tax.

Shortly before the extension of the convention, the Netherlands Antilles adopted legislation creating special tax treatment for specified kinds of income derived by specified kinds of companies. The special categories included (1) business income earned by an Antilles corporation from a trade or business conducted in a foreign country where the business was "subject to" an income tax comparable to the Antilles profits tax; (2) dividends and interest earned by an Antilles company whose exclusive object was earning dividends or interest from investment in passive assets; and (3) royalties, rentals, and other licensing- or rental-type income derived by an Antilles company from without the Antilles. The special treatment provided in all cases was taxation at one-tenth of the otherwise applicable rate. This had the effect of reducing the tax rates on the specified income to about 2-3%.

The adoption of these provisions, and the extension of the convention, gave rise to the "Curacao investment company," a tax device that became widespread in the late 1950s. The coupling of treaty benefits and statutorily favored treatment in the Antilles offered the prospect of very substantial reductions in the rate of overall tax on United States source investment income. By statute, the United States imposes a 30 percent withholding tax on United States source interest, dividend, and royalty income. By virtue of the convention, the United States tax on dividends is reduced to 15% on portfolio investment dividends; to 5% on dividends from direct investment; and to zero on interest and royalties. With the combination of the convention and statutory benefits, an Antilles investment company would pay something like 17-18% on portfolio dividends; 7-8% on direct dividends; and 2-3% on interest and royalties.

The Antilles has liberal corporate law rules, the most notable feature of which is that they permit "bearer" shares. This means that it may be impossible to know precisely who owns an Antilles company. The Antilles thus became the scene of very considerable offshore financing activity, attracted to the Antilles principally to take advantage of the convention with the United States. Persons not resident in the Antilles would organize corporations there, transfer their United States assets to the corporations, and hold the assets through the Curacao holding company. They achieved substantial savings in taxes this way; for their overall tax burden was greatly reduced from what it would have been had their income been subject to the statutory withholding tax applicable in the United States.

The practice was viewed in the United States as undermining our treaty program, since it enabled residents of countries having no tax convention with the United States to secure the benefits of our convention with the Antilles. The practice also involved a revenue cost to the United States without a corresponding revenue gain to the Antilles or to bona fide Antilles persons. Some foreign countries, notably in Latin America, accused the United States of using the convention to encourage the importation of flight capital into the United States.

These concerns led to the negotiation of a protocol with the Antilles and the Netherlands in 1963. The terms of the protocol restricted the benefits of the dividend, royalty, and interest articles of the convention to companies other than those receiving favored treatment under Antilles law. There were, however, two exceptions to this restriction. First, if the Antilles company owned 25% or more of the U.S. company paying the dividends, interest, or royalties, the income could still qualify for treaty benefits. Second, if the Antilles company was owned entirely by Netherlands Antilles or Netherlands individuals, or by Netherlands corporations, the income would still qualify for treaty benefits.

The protocol restricted "treaty shopping," but did not eliminate it. Almost immediately after ratification of the protocol, the Antilles adopted a new form of favored statutory treatment, reducing its rate of tax on dividend income to 15 percent, and this income could be received by a company without its losing treaty benefits. Moreover, the direct investment exception, allowing a company owning 25% or more of a U.S. company to qualify for both treaty and statutory benefits, was widely exploited by third-country persons. In addition, a slightly different type of "treaty shopping" came into fashion. Third country persons would invest in U.S. equity securities through a Netherlands company which would be owned by a Netherlands Antilles parent. The dividends would be "routed" through the Netherlands, from which they could be redistributed to the Antilles parent. The Netherlands did not subject the routed dividends to tax, under investment company provisions similar to those applied in the Antilles; and the dividends accumulated in the Antilles, where they could be held in a bearer share corporation, subject to little or no taxation.

Soon after 1963, the Antilles became the center of another major financing activity which took advantage of the convention with the United States. This is the so-called "finance subsidiary" practice.

In the early 1960s, there began to develop in Europe a so-called "international" market for long term debt securities. The securities sold on this market were denominated in a currency, at that time almost always dollars, which was independent of the national markets in which the securities were sold. This feature qualified these securities for the familiar nomenclature of "Euro" or "Eurodollar" securities. The securities sold on this market, while long-term, were usually shorter term than securities sold on national markets; maturities at that time rarely exceeded 10 years, compared to typical maturities of 25 or 30 years for national market securities. Two other features of these securities were that to be marketable they virtually had to be issued in bearer form, and virtually had to be free of any withholding tax at source.

The development of this market was greatly hastened by the adoption of the interest equalization tax by the United States in 1962. The IET was an excise tax imposed on the purchase of foreign securities by a U.S. portfolio investor. The IET made it virtually impossible for foreign obligors to sell securities in the United States; so the "Eurodollar bond" or "Eurobond" market became an important source of capital for them.

It was not long before United States companies became eager to "tap" the "Eurobond" market for funds. To do this the obligors needed to find a way to issue the securities in a form that would free them of United States withholding tax. This could be achieved, if the funds obtained were used for investment in foreign affiliates, through the organization of a domestic company for this purpose. If the company, called a finance subsidiary, earned more than 80% of its gross income from foreign sources, its interest payments, under United States statutory law, are deemed to be foreign source income, and are therefore not subject to United States withholding tax.

The practice, developed during the 1963-68 period, had certain drawbacks from an obligor's point of view. Most serious among these was the need to invest the proceeds in assets that would earn foreign source income. The response was the creation of the so-called "foreign finance subsidiary," which involved the organization by a United States company of a subsidiary in a country with which the United States maintained a double taxation agreement providing for no U.S. withholding tax on United States source interest income. The subsidiary would issue its bonds on the "Eurobond" market, and would relend the proceeds to the United States parent. The parent would almost always guarantee the bonds, which were usually convertible into equity securities of the parent. Ordinarily, the bonds would contain a covenant that the obligor or parent would pay any United States withholding tax to which the bonds became subject during their life; and the bonds created rights on the part of the obligor to call them in the event they became subject to withholding tax.

The finance subsidiary practice depended upon the treaty exemption for interest paid by the U. S. parent to its finance subsidiary. The finance subsidiary could, at least in the Antilles, avoid any substantial tax because it would pay out virtually all of the interest it earned, and deduct the interest paid from its income for Antilles profits tax purposes. The interest payments could be made tax free from the Antilles because the Antilles does not have a withholding tax.

The use of finance subsidiaries became of far greater importance to United States corporations in 1968, with the inception of the foreign direct investment controls in the U.S. Under those controls, limits were placed on the amount of new direct investment U. S. companies could make abroad. But companies were allowed to exceed these limits in the amount of any "qualified long-term foreign borrowing" made by them. The original 1968 regulations permitted domestic finance subsidiary borrowings to qualify as long term foreign borrowings, but made no reference to borrowings through an Antilles or other foreign finance subsidiary. In 1970, however, the FDIC regulations were amended to permit foreign finance subsidiary borrowings to qualify as long-term foreign borrowings.

The "finance subsidiary" question raised important technical questions of U.S. tax law. Because of the elaborate involvement of the parent in the finance subsidiary's bond issue -- the guarantee of indebtedness; the virtual matching of the interest payments; the convertibility of the bond into the parent's stock -- a substantial argument could be made that, in substance, the interest payments were made by the parent rather than the subsidiary. In addition, the thin capitalization and lack of any real business activity of the typical finance subsidiary raised the question whether its corporate existence would be recognized. Either argument would have unwound the tax advantages of the entire device, because it would have made interest payments from the United States subject to withholding tax.

In 1969, however, the Internal Revenue Service laid to rest any substantial fears companies might have had about an attack on the practice along these lines. In a series of revenue rulings the Service held that, as long as the debt-to-equity ratio of the subsidiary did not exceed 5-to-1, the indebtedness would be recognized as indebtedness of the subsidiary, and the subsidiary would be recognized as an independent corporate entity.

The U.S. capital controls, both the IET and the FDIC regulations, lapsed in 1974. With their lapse, the IRS revoked the rulings setting forth the 5-to-1 test, and held that the validity of finance subsidiary practices would thereafter be determined on a facts and circumstances test, applied on a case-by-case basis.

These developments led to a substantial decline in United States companies' issuance of securities on the Eurobond market and, indeed, contributed to a major disruption of the Eurobond market as a whole. But in 1976 and 1977, the market recovered substantially, and issues by U.S. companies resumed in substantial amounts, about $1 billion annually. Virtually all Eurobond issues by U.S. companies are now structured through foreign finance subsidiaries, and the great majority of these are organized in the Netherlands Antilles.

One other "treaty shopping" use of the Antilles has come into prominence in the last few years. This is the use of the Antilles as a base for holding United States real property investments. Under the Antilles convention a taxpayer can make an annual "net election" with respect to his United States source real property income. This permits him on an annual basis to elect whether he will be taxed on this income on a net basis (taking deductions) or on a gross basis (at the statutory 30% rate). It is usually valuable to have net basis taxation of real estate operating profits, because the generous depreciation rules of U.S. law often permit a taxpayer to show tax losses on a real estate investment. When a domestic taxpayer sells real property on which he has claimed these generous benefits, he must pay a capital gains tax and must pay at ordinary income rates on the excess of amounts of accelerated depreciation previously deducted over amounts that he would have been able to deduct using a "straight-line" method of depreciation. Under the convention, however, an Antilles taxpayer, after electing net basis taxation in years when he claimed excess depreciation, may elect "gross basis" taxation in the year he sells his real property. Under gross basis taxation, he most likely will not be subject to any tax at all.

Another important "treaty haven" country is the British Virgin Islands. The U.S. convention with the BVI is an extension of our 1945 convention with the United Kingdom, which was extended to 20 British territories in 1959. At the time of the extension the BVI imposed a tax on corporate income of about 39.375 percent. In 1963, the BVI lowered this rate to 12%. The BVI raised the rate back to 15% in 1977. Taxpayers may claim a foreign tax credit against the BVI corporate income tax for income taxes paid to foreign governments.

The BVI convention provides relief from U.S. tax essentially similar to that available under the Antilles convention -- reduction in the rates of withholding tax on dividends; exemption of royalties from withholding; and an annual net election for real property investment income -- but it does not contain an interest exemption. A protocol with the United Kingdom executed at the time the convention was extended makes the interest article of the U.K. convention inapplicable to the territories to which the convention was extended. The low tax rates in the BVI perform a function similar to that performed by the special favored rates in the Antilles; they permit nonresidents to invest in the U.S. "through" the BVI, incurring a very low combined tax rate in the U.S. and the BVI. The absence of an interest exemption makes a BVI corporation unsuitable as a finance subsidiary, although it is still possible to keep U.S. taxation very low by having the subsidiary engage in a United States trade or business with which the interest earned from the parent is "effectively connected" under the Internal Revenue Code.

Until recently, the BVI was not used nearly so much as the Netherlands Antilles. The BVI does not permit bearer shares; it is therefore somewhat less suited than the Antilles as a place for shielding the identity of the ultimate investor. But the BVI has been actively promoted as a tax haven in recent years, so its use has been increasing. I note in passing that there is something of an active competition among jurisdictions with favorable tax conventions with the United States, to attract persons shopping around for such an arrangement.

Three other territories to which the 1945 U.K. convention applies -- St. Vincent, Barbados, and Grenada -- have adopted international business company provisions since the convention was extended. These provisions create a potential for "treaty shopping" comparable to the Antilles or BVI. This potential does not appear to have been exploited on a widespread basis to date.

The Netherlands Antilles and BVI are, almost assuredly, used to some extent by United States persons to evade taxes in this country. We are uncertain of the extent of these uses, however, and generally learn of them from the experience of IRS or the Justice Department in particular cases. Almost always these schemes involve an offshore foreign trust organized in a common law jurisdiction like Grand Cayman or the Bahamas. The ownership of the shares of a corporation organized in the Antilles is placed in the hands of the trust to conceal the identity of the true beneficial owner, who is a United States person. Many, if not most, of these schemes have as their ultimate objective the transfer of income from the U.S. person to the Antilles company. Many of these cases involve tax evasion by the United States taxpayer to the extent he is concealing his ownership of U.S. assets, or U.S. income, through the pyramiding of offshore trust and haven-country corporation. We do not believe that these uses take place to a large extent in the BVI, and have received assurances from the BVI government that it will take all measures within its power to detect and prevent practices by which U.S. persons try to take advantage of the convention. The Netherlands Antilles, however, has a more various and highly developed offshore business than the BVI; and the schemes uncovered in investigations leave little room for doubt that there is considerable activity by which U.S. persons attempt to exploit the our convention with the Antilles.

The tax haven conventions raise policy issues of considerable difficulty. The objections are, of course, easy to articulate. The practices that take advantage of those conventions involve a revenue cost to the United States, without the kind of corresponding gain usually achieved under a convention; they channel special tax exemptions and benefits in a manner we cannot control, since we do not know the identity of the ultimate beneficiaries; they undermine our efforts to broaden our tax convention network by removing incentives of foreign government to negotiate on behalf of their residents. Moreover, the practices raise questions about U.S. cooperation in international tax affairs. We must assume many persons investing in the United States through the Antilles are evading taxes in their home countries; and that much of the capital invested through the Antilles is "flight capital," acquired by illegal means in, or exported by illegal means from, the country of residence.

At the same time, it must be recognized that these haven conventions have come to be of substantial economic and financial importance to the United States. The conventions exert a profound influence on at least the pattern, and perhaps the volume, of foreign investment in the United States. I am submitting with my testimony a table prepared by the Treasury Department's Office of Tax Analysis, showing the aggregate of amounts reported on IRS Form 1042S for calendar years 1975 and 1976. Form 1042S is a withholding agent's return. The table shows amounts of income reported as paid to nonresident aliens and foreign corporations and subject to withholding taxes under sections 871 and 881 of the Internal Revenue Code. These amounts are shown by type of income, and by the country of residence of the recipient.

The table, I think, demonstrates the influence our treaty arrangements have on the pattern of foreign investment in the United States. The amounts shown on the table are income amounts, and, therefore, represent only roughly the distribution of foreign held assets in the United States; they also reflect only amounts required to be reported by withholding agents, and therefore do not include such exempt items as income from tax exempt municipal bonds, income derived by foreign governments, income on commercial paper of less than 6 months' maturity, and interest on United States bank deposits. Nevertheless, the figures reveal a marked impact of the tax haven conventions on investment in the assets subject to U.S. withholding taxes. The aggregate figures show, for example, that three financial centers -- Switzerland, the Netherlands, and the Netherlands Antilles - together accounted for 35.4% of reported 1976 income and 39% of 1975 income. Analysis of the various categories of income reveals more markedly the influence of the haven conventions. The amount of interest paid to Netherlands Antilles recipients is large even in regard to the already large share of total income paid to the Antilles. The Antilles' share of total reported income was 8.2% in 1975, and 6.4% in 1976; its share of total interest income in the two years was 24.5% and 18.4%. This reflects the role of the Antilles as the principal situs of "finance subsidiaries" through which United States corporations participate in the "Eurobond" market. The rather sharp fall in interest payments to the Antilles between 1975 and 1976 -- a drop of 27.6% - reflects a statutory change adopted in 1973, when Congress created a withholding tax exemption for certain finance subsidiary issues even if the parent assumed the subsidiary's indebtedness; in response to this change, a number of companies liquidated their subsidiaries and assumed the subsidiaries' indebtedness.

The distribution of dividend income between the Netherlands and the Netherlands Antilles is also interesting. As I previously mentioned, the 1963 protocol to the Antilles convention left it advantageous to hold U.S. equity securities through the Antilles if the Antilles company owned more than 25% of the U.S. company. This is possible in some cases. Where it is not, the response has been to hold such securities through a Netherlands subsidiary of an Antilles parent. Thus, while the Antilles received 8.2% of the total reported income in 1975, it received almost twice this percentage of direct investment dividends (14.3%) and a much smaller portion (2.2%) of portfolio dividends. In 1976, the Antilles received 6.4% of reported income, while receiving a very disproportionate share (22.2%) of direct investment dividends and a much smaller share, less than 1%, of portfolio dividends. The Netherlands, by contrast, received a disproportionate share of portfolio dividends -- 10.6% in 1975, compared to 7.7% of all income; 14.7% in 1976, compared to 10.4% of all income. The Netherlands' share of direct investment dividends was in both years proportional to its share of overall income.

Still another interesting feature of the table is the change between the two years, particularly in regard to the BVI and to real property and mineral income. Between 1975 and 1976, the amount of portfolio dividends paid to BVI recipients increased 461.3%; the amount of real property and mineral income increased 385.2%. These large increases started from a small base, but presumably they reflect the current vogue of the British Virgin Islands in international tax planning circles. It should be noted that the amount of real property and mineral income derived by Antilles recipients also grew rapidly (345.5%) in the one year; and that the aggregate amount of real property and mineral income derived by foreign persons grew very substantially -- by 57.5%. Even with this large growth in the total amount of such income reported, the share of such income derived by the Antilles more than doubled, from 2.1% to 5.1%; the share of the BVI went from about 0.2% to 0.5%.

Estimated U.S. indebtedness on Eurobonds currently amounts to $3.5 to $4.0 billion. The annual flows, at least during normal periods in the foreign exchange markets, are about $1.0 billion. The annual flows alone have a measurable impact on the U.S. balance of payments position, and make a substantial contribution to capital availability in the United States.

It does not seem inevitable that foreign investment in the United States should rest so heavily on a series of Caribbean tax conventions. There are, however, substantial questions concerning our statutory rules for taxing foreign investment, and the problems posed by the tax haven conventions must be addressed in the context of those larger questions. Although the larger questions carry far beyond the scope of my testimony, I would like to advert briefly to what the issues are, since an understanding of them is necessary to assessing our present attitude toward these conventions.

There is widespread perception that our statutory withholding tax rates are too high, particularly with respect to interest income, and that these taxes constitute an undesirable inhibition to the flow of foreign capital into the United States. The statutory interest withholding tax on interest raises only a relatively minor amount of revenue, about $27 million annually. This is because we have a broad network of tax conventions creating exemptions or substantial rate reductions for interest earned in the

United States, and because there are a large number of statutory and regulatory exemptions for income earned by nonresident aliens and foreign corporations on United States debt securities. The most prominent of these are exemptions for interest on bank deposits, and exemptions, under Proposed Regulations issued by the IRS, for original issue discount on short term commercial paper. In addition, there is the "finance subsidiary" practice, which enables corporations to shield a good deal of income on long term corporate indebtedness from U.S. withholding taxes.

A case can be made for eliminating or at least substantially reducing our withholding taxes, particularly the withholding tax on United States source interest. Supporters of this view maintain that international capital markets have become in some sense perfect, and that withholding taxes only serve to disrupt capital flows. This school holds that the limited practical reach of the interest withholding tax is an inevitable product of pressures brought to bear because of the perfection of the international market, and the need to free it from the inhibitory control which the withholding tax exerts. The present patchwork -- with the exemption for bank deposits and the proposed exemption for short term discount securities, together with a method for issuing longer term securities that is vulnerable to a variety of legal attacks -- distorts market forces by creating a strong bias against longer term investments. As I noted previously, finance subsidiary Eurobond issues are almost always shorter term than comparable domestic market issues. In addition, repeal of the interest withholding tax would be a triumph of tax simplification. It would permit repeal of the exceedingly complicated rules governing withholding on original discount, and repeal of the overly artistic rule that bank deposit interest paid by U.S. banks is "foreign source" if received by nonresident aliens; and would eliminate the dependence of U.S. corporations or the complicated "finance subsidiary" practice.

Another school of thought holds that both tax equity and economic efficiency require that some tax be imposed by the state where income is derived. On this view, neutrality with respect to international capital flows is achieved by allocating taxing power between source and residence states in such a way as to leave interest income taxed in a manner essentially similar to the manner in which other income is taxed. The optimum way of achieving this end is through a consistent and complete network of bilateral treaty arrangements governing the taxation of international income derived from capital. On this view, statutory withholding exemptions are unnecessary and unwise; constitute a subsidy to the import of capital; and represent an inequitable windfall to exporters of portfolio capital. In the view of this school, the way to "rationalize" the pattern of taxing United States source income is to eliminate the existing loopholes in such taxation, and to ensure that all U.S. source income is subject to reasonably similar taxation regardless of its type.

The questions posed by our conventions with tax havens are related to these broader questions, and cannot be fully resolved in the absence of a clear definition of our approach to taxing United States source income of foreign persons. This latter question has serious consequences for the United States economy.

* * *

I hope this discussion gives the subcommittee a basis for appraising the nature of our treaty arrangements with Switzerland and the Caribbean tax havens, as well as the policy problems that are raised by those arrangements. I am sure the subcommittee will appreciate my view that the technical details involved in these questions are not simple, and the policy questions raised are serious and of substantial difficulty. We welcome the subcommittee's views on, and interest in, these difficult and important matters.

* * *

Income Reported on IRS Forms 1042S Derived by Recipients in Tax Haven Treaty Countries by Type of Income, 1975 and 1976
(Dollar amounts in thousands)

Country (Code)	Total Income 1/ Amount	Total Income Percent of Total	Interest Amount	Interest Percent of Total	Portfolio Dividends Amount	Portfolio Dividends Percent of Total	Direct Investment Dividends Amount	Direct Investment Dividends Percent of Total	Royalties Amount	Royalties Percent of Total	Real Property Income Amount	Real Property Income Percent of Total	Other Income Amount	Other Income Percent of Total
1976														
Antigua (AC)	1,271	*	1,257	.2	6	*	0	0	7	*	0	0	*	*
Barbados (BB)	2,164	.1	4	*	92	*	0	0	1	*	0	0	2,067	1.0
Grenada (GJ)	3	*	0	0	1	*	0	0	0	0	0	0	2	*
Netherlands (NL)	350,111	10.4	15,141	2.8	294,138	14.7	27,876	10.3	7,370	2.5	69	.4	5,517	2.9
Netherlands Antilles (NA)	215,939	6.4	100,934	18.4	17,408	.9	60,162	22.2	37,212	12.4	975	5.1	2,769	1.4
St. Vincent (VC)	1	*	0	0	1	*	0	0	0	0	0	0	*	*
British Virgin Islands (VI)	1,026	*	147	*	738	*	0	0	27	*	104	.5	10	*
Total, Tax Haven Treaty Countries 1/	570,515	17.0	117,483	21.4	312,384	15.6	88,038	32.5	44,617	14.9	1,148	6.0	10,365	5.4
Switzerland	623,864	18.6	75,019	13.6	491,343	24.6	11,497	4.3	27,507	9.2	562	2.9	4,786	2.5
Total, All Other Countries	2,158,420	64.4	357,292	65.0	1,193,965	59.8	170,964	63.2	227,254	75.9	17,447	91.1	178,213	92.1
Total, All Countries 1/	3,352,799	100.0	549,794	100.0	1,997,692	100.0	270,499	100.0	299,378	100.0	19,157	100.0	193,364	100.0
1975														
Antigua (AC)	1,581	.1	1,571	.3	3	*	0	0	5	*	0	0	1	*
Barbados (BB)	173	*	5	*	73	*	0	0	22	*	0	0	74	.1
Grenada (GJ)	5	*	0	0	3	*	0	0	2	*	0	0	0	*
Netherlands (NL)	199,403	7.7	6,378	1.1	151,823	10.6	28,322	11.1	10,457	5.4	7	.1	1,910	1.3
Netherlands Antilles (NA)	212,101	8.2	137,567	24.5	31,086	2.2	36,740	14.3	5,416	2.8	257	2.1	1,269	.8
St. Vincent (VC)	1	*	0	0	1	*	0	0	0	0	0	0	1	*
British Virgin Islands (VI)	1,242	.1	99	*	160	*	29	*	199	*	27	*	728	.5
Total, Tax Haven Treaty Countries 1/	414,506	15.9	145,620	25.9	183,149	12.8	65,091	25.4	16,101	8.4	291	2.4	3,983	2.7
Switzerland	599,577	23.1	61,438	10.9	489,852	34.3	23,317	9.0	12,789	6.7	410	3.5	5,713	3.8
Total, All Other Countries	1,585,214	61.0	354,339	63.2	753,519	52.9	168,010	65.6	163,480	84.9	11,482	94.2	141,292	93.5
Total All Countries 1/	2,599,297	100.0	561,393	100.0	1,426,520	100.0	256,418	100.0	192,370	100.0	12,183	100.0	150,260	100.0

Office of the Secretary of the Treasury
Office of Tax Analysis

April 10, 1979

1/ Detail may not add to totals due to rounding and minor statistical discrepancies in underlying data.

* Less than $500 or 0.05 percent.

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

FOR RELEASE AT 4:00 P.M. April 24, 1979

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $6,100 million, to be issued May 3, 1979. This offering will result in a pay-down for the Treasury of about $200 million as the maturing bills are outstanding in the amount of $6,310 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately $3,000 million, representing an additional amount of bills dated February 1, 1979, and to mature August 2, 1979 (CUSIP No. 912793 2E 5), originally issued in the amount of $3,005 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $3,100 million to be dated May 3, 1979, and to mature November 1, 1979 (CUSIP No. 912793 2T 2).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing May 3, 1979. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold $3,409 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. 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, April 30, 1979. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must be for a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. 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 must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on May 3, 1979, in cash or other immediately available funds or in Treasury bills maturing May 3, 1979. 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, 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.

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press inquiries: 202-566-2615

FOR IMMEDIATE RELEASE April 24, 1979

FEDERAL FINANCING BANK ACTIVITY

Roland H. Cook, Secretary, Federal Financing Bank (FFB), announced the following activity for March 1 - 31, 1979.

New Section 108 Block Grant Loan Program

During March, FFB purchased the first two notes guaranteed by the Secretary of Housing and Urban Development under Section 108 of the Housing and Community Development Act of 1974. The purchases were pursuant to the commitment and guaranteed agreement executed by FFB and HUD in February of this year.

The City of Hazelton, Pennsylvania issued to the FFB a note to repay advances not to exceed $476,000 on June 30, 1979, with an option to extend to June 30, 1981. The first advance, for $6,000.00, was made on March 2 at an interest rate of 9.94%. Toledo, Ohio also issued a note to the FFB for not to exceed $5,212,041. Advances under this note are scheduled to be repaid on July 15, 1980, with an option to extend repayment to July 15, 1982.

Continuing Programs

FFB made 34 advances totalling $193,632,867.05 to 17 foreign governments during March under the DOD-guaranteed foreign military sales financing program.

Under notes guaranteed by the Rural Electrification Administration, FFB advanced a total of $222,367,000 to 28 rural electric and telephone systems.

On March 21, FFB purchased a total of $3,050,000.00 in debentures issued by 7 small business investment companies. These debentures are guaranteed by the Small Business Administration, mature in 3, 5, 7, and 10 years, and carry interest rates of 9.575%, 9.385%, 9.335% and 9.295%, respectively.

FFB provided Western Union Space Communications, Inc., with $4,975,000 on March 1 and $9,200,000 on March 20 at annual interest rates of 9.666% and 9.599%, respectively. The repayment of these advances is secured by NASA's obligations under a satellite tracking system procurement contract.

FFB purchased three General Services Administration participation certificates:

Series	Date	Amount	Maturity	Interest Rate
K-017	3/6	$1,714,809.04	7/15/04	9.28%
M-043	3/13	4,972,265.24	7/31/03	9.238%
L-052	3/16	554,730.63	11/15/04	9.262%

Department of Transportation Guarantees

The National Railroad Passenger Corp. (Amtrak) borrowed the following amounts from FFB under their Note #18, which matures March 30, 1979.

Date	Amount	Interest Rate
3/5	$10,000,000	9.904%
3/9	5,000,000	9.912%
3/14	10,000,000	10.01%
3/15	6,000,000	10.021%
3/19	5,000,000	10.021%
3/20	5,000,000	10.019%
3/27	6,000,000	10.019%
3/29	5,000,000	9.936%

On March 30, Amtrak extended the maturity on the $66,891,199 outstanding under Note #18 until June 29, 1979 at a new interest rate of 9.886%.

Under Notes guaranteed by DOT pursuant to Section 511 of the Railroad Revitalization and Regulatory Reform Act of 1976, FFB lent funds to the following railroads:

	Date	Amount	Maturity	Interest Rate
Trustee of The Milwaukee Road	3/15	$1,931,978.00	11/15/91	9.546%
Chicago & North Western 511-78-3	3/16	1,313,542.00	11/1/90	9.343%
Trustee of Chicago, Rock Island	3/21	1,324,637.00	12/10/93	9.573%

On March 22, FFB lent $11,015,000.00 to the United States `v Association at an interest rate of 10.064% under their which matures April 30, 1979.

Agency Issuers

On March 1, the Export-Import Bank sold FFB a $403 million note with a final maturity of March 1, 1989. Interest on the note is at a rate of 9.351%, payable quarterly.

FFB purchased two Farmers Home Administration Certificates of Beneficial Ownership:

Date	Amount	Maturity	Interest Rate
3/9	$545,000,000	3/9/84	9.574%
3/21	280,000,000	3/21/84	9.605%

Interest on these certificates is payable on an annual basis.

On March 30, FFB purchased from the Secretary of Health, Education and Welfare (HEW) a block of Health Maintenance Organization notes for a price of $20,847,647.49, payable in equal installments on March 30, April 27, May 25 and June 29 The notes are guaranteed by HEW pursuant to Title XIII of the Public Health Service Act, as amended. The FFB will receive a yield to maturity of 9.11% on this purchase.

Also guaranteed by HEW are the weekly short-term borrowings from FFB by the Student Loan Marketing Association (SLMA), a federally-chartered private corporation. SLMA raised $50 million in new cash and refunded $325 million in maturing securities. FFB holdings of SLMA notes now total $1,030 million.

The Tennessee Valley Authority sold FFB a $970 million 9.765% note on March 30, maturing on June 29, 1979. This sale refunded $760 million in maturing securities and provided TVA with $210 million in new cash.

On March 31, FFB purchased a Rural Electrification Administration Certificate of Beneficial Ownership in the amount of $283.3 million. The Certificate matures March 31, 2009, and carries an interest rate of 9.195%.

FFB Holdings

As of March 31, 1979, FFB holdings totalled $55.3 billion. FFB Holdings and Activity Tables are attached.

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FEDERAL FINANCING BANK HOLDINGS
(in millions of dollars)

Program	March 31, 1979	February 28, 1979	Net Change (3/1/79-3/31/79)	Net Change-FY 1979 (10/1/78-3/31/79)
On-Budget Agency Debt				
Tennessee Valley Authority	$ 6,075.0	$ 5,865.0	$ 210.0	$ 855.0
Export-Import Bank	7,131.3	6,898.3	233.0	563.0
Off-Budget Agency Debt				
U.S. Postal Service	2,114.0	2,114.0	-0-	-0-
U.S. Railway Association	356.9	345.9	11.0	0.1
Agency Assets				
Farmers Home Administration	25,985.0	25,160.0	825.0	3,710.0
DHEW-Health Maintenance Org. Loans	62.2	57.0	5.2	5.2
DHEW-Medical Facility Loans	163.7	163.7	-0-	-0-
Overseas Private Investment Corp.	38.0	38.0	-0-	-2.2
Rural Electrification Admin.-CBO	921.0	637.7	283.3	283.3
Small Business Administration	103.1	104.6	-1.5	-9.1
Government Guaranteed Loans				
DOT-Emergency Rail Services Act	22.4	22.4	-0-	4.9
DOT-Title V, RRRR Act	65.8	61.2	4.6	30.0
DOD-Foreign Military Sales	4,614.1	4,447.1	167.0	636.2
General Services Administration	319.6	312.3	7.2	49.4
Guam	36.0	36.0	-0-	-0-
DHUD-New Communities Admin.	38.5	38.5	-0-	-0-
DHUD-Community Block Grant	+	-0-	+	+
Nat'l. Railroad Passenger Corp. (AMTRAK)	454.8	402.8	52.0	-79.6
NASA	335.4	321.3	14.2	98.9
Rural Electrification Administration	4,961.7	4,735.4	226.4	770.2
Small Business Investment Companies	283.4	281.3	2.2	32.8
Student Loan Marketing Association	1,030.0	980.0	50.0	285.0
Virgin Islands	21.6	21.6	-0-	-0.2
WMATA	177.0	177.0	-0-	-0-
TOTALS	$55,310.4*	$53,220.9*	$2,089.5*	$7,232.9

+less than $.1 million.

*totals do not add due to rounding.

FEDERAL FINANCING BANK

March 1979 Activity

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST PAYABLE (other than s/a)
Department of Defense					
Thailand #2	3/1	$ 600,053.96	6/30/83	9.751%	
Thailand #3	3/1	1,120,520.00	9/20/84	9.648%	
Spain #1	3/7	823,501.45	6/10/87	9.442%	
Taiwan #9	3/8	1,600,000.00	7/1/86	9.455%	
Colombia #2	3/9	609,435.00	9/20/84	9.54%	
Israel #7	3/12	46,591,368.72	12/15/08	9.247%	
Tunisia #5	3/14	4,698.00	6/1/86	9.48%	
Jordan #3	3/15	5,661.00	12/31/86	9.473%	
Jordan #2	3/15	923,750.00	11/26/85	9.512%	
Korea #8	3/15	220,881.00	12/31/86	9.454%	
Taiwan #8	3/16	382,963.00	7/1/85	9.531%	
Thailand #2	3/16	600,000.00	6/30/83	9.693%	
Cameroon #1	3/16	814,924.00	5/10/84	9.609%	
Peru #3	3/20	39,675.00	4/10/84	9.601%	
Peru #2	3/21	208,998.52	4/1/84	9.606%	
Israel #7	3/26	1,000,000.00	12/15/08	9.247%	
Colombia #2	3/26	435,384.98	9/20/84	9.555%	
Ecuador #2	3/26	560,630.40	8/25/84	9.556%	
Greece #10	3/26	17,632,448.00	2/1/89	9.373%	
Turkey #2	3/26	3,465,714.28	10/1/86	9.46%	
Turkey #4	3/26	1,996,626.60	10/1/87	9.431%	
Turkey #5	3/26	23,300,000.00	12/15/87	9.424%	
Turkey #6	3/26	13,560,410.97	6/3/88	9.405%	
Kenya #5	3/26	2,300,000.00	12/15/87	9.424%	
Thailand #2	3/26	1,091,733.72	6/30/83	9.656%	
Korea #8	3/26	12,843,573.78	12/31/86	9.437%	
Korea #9	3/27	100,000.00	6/30/87	9.404%	
Israel #7	3/28	21,477,061.56	12/15/08	9.231%	
Kenya #6	3/28	999,999.45	10/1/88	9.369%	
Malaysia #3	3/29	159,889.52	3/20/84	9.545%	
Peru #2	3/30	3,843,794.21	4/1/84	9.526%	
Korea #9	3/30	34,200,834.93	6/30/87	9.348%	
Jordan #3	3/30	40,873.60	12/31/86	9.394%	
Tunisia #4	3/30	177,461.40	10/1/85	9.442%	
Farmers Home Administration					
	3/9	545,000,000.00	3/9/84	9.355%	9.574% annually
	3/21	280,000,000.00	3/21/84	9.385%	9.605% annually
Export-Import Bank					
Note #19	3/1	403,000,000.00	3/1/89	9.46%	9.351% quarterly
General Services Administration					
Series K-017	3/6	1,714,809.04	7/15/04	9.280%	
Series M-043	3/13	4,972,265.24	7/31/03	9.238%	
Series L-052	3/16	554,730.63	11/15/04	9.262%	
Health Maintenance Organization (HEW)					
Block #4	3/30	5,211,911.87		9.11%	
Housing & Urban Development Community Block Grant					
Hazelton, Pennsylvania	3/2	6,000.00	6/15/79	9.94%	

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST PAYABLE (other than s/a)
National Railroad Passenger Corp. (Amtrak)					
Note #18	3/5	$ 10,000,000.00	3/30/79	9.904%	
Note #18	3/9	5,000,000.00	3/30/79	9.912%	
Note #18	3/14	10,000,000.00	3/30/79	10.01%	
Note #18	3/15	6,000,000.00	3/30/79	10.021%	
Note #18	3/19	5,000,000.00	3/30/79	10.021%	
Note #18	3/20	5,000,000.00	3/30/79	10.019%	
Note #18	3/27	6,000,000.00	3/30/79	10.019%	
Note #18	3/29	5,000,000.00	3/30/79	9.936%	
Note #18	3/30	66,891,199.00	6/29/79	9.880%	
Rural Electrification Administration					
Arkansas Electric Coop. #97	3/1	4,845,000.00	12/31/13	9.272%	9.167% quarterly
Arizona Electric Power #60	3/1	3,802,000.00	12/31/13	9.272%	9.167% "
Arizona Electric Power #103	3/1	4,092,000.00	12/31/13	9.272%	9.167% "
Cooperative Power #5	3/2	4,000,000.00	3/2/81	10.045%	9.922% "
Cooperative Power #70	3/2	6,978,000.00	3/2/81	10.045%	9.922% "
Cooperative Power #130	3/2	6,022,000.00	3/2/81	10.045%	9.922% "
Minnkota Power #127	3/5	38,608,000.00	3/5/81	10.045%	9.922% "
Tri-State Gen. & Trans. #89	3/5	4,054,000.00	1/31/86	9.375%	9.268% "
Associated Electric #132	3/6	42,750,000.00	3/6/81	10.005%	9.883% "
Wabash Valley Power #104	3/9	2,010,000.00	12/31/13	9.204%	9.100% "
Wolverine Electric #100	3/12	839,000.00	3/12/81	9.965%	9.844% "
Northern Michigan Elect. #101	3/12	1,073,000.00	3/12/82	9.555%	9.444% "
Allegheny Electric #93	3/12	3,141,000.00	3/31/81	9.935%	9.815% "
Golden Valley Electric #81	3/12	344,000.00	3/12/81	9.965%	9.844% "
Minnkota Power #127	3/12	7,175,000.00	3/12/81	9.965%	9.844% "
Golden Valley Electric #81	3/14	389,000.00	3/14/81	9.975%	9.854% "
Western Illinois Power #99	3/14	1,161,000.00	3/14/81	9.975%	9.854% "
Tri-State Gen. & Trans. #89	3/14	967,000.00	2/28/86	9.325%	9.219% "
Associated Electric #132	3/15	21,500,000.00	3/15/81	9.995%	9.873% "
East Kentucky Power #73	3/16	6,344,000.00	3/16/81	9.995%	9.873% "
Sierra Telephone #59	3/16	85,000.00	3/31/81	9.975%	9.854% "
East Ascension Telephone #39	3/20	480,000.00	3/20/81	9.985%	9.863% "
Big River Electric #58	3/20	3,695,000.00	3/20/81	9.985%	9.863% "
Big River Electric #91	3/20	1,462,000.00	3/20/81	9.985%	9.863% "
So. Mississippi Electric #3	3/23	393,000.00	3/26/81	9.945%	9.824% "
So. Mississippi Electric #90	3/23	1,192,000.00	3/26/81	9.945%	9.824% "
Colorado-Ute Electric #78	3/26	2,989,000.00	3/26/81	9.945%	9.824% "
Elmore Coosa Telephone #46	3/26	361,000.00	12/31/13	9.218%	9.114% "
Arizona Electric Power #60	3/27	7,000,000.00	12/31/13	9.22%	9.116% "
Continental Telephone of Texas #119	3/28	1,300,000.00	3/28/81	9.905%	9.785% "
Associated Electric #132	3/28	14,000,000.00	3/28/81	9.905%	9.785% "
Southern Illinois Power #38	3/29	355,000.00	3/29/82	9.495%	9.385% "
Soyland Power #105	3/29	5,753,000.00	3/29/81	9.885%	9.766% "
North Florida Telephone #42	3/29	2,853,000.00	12/31/13	9.185%	9.082% "
Tri-State Gen. & Trans. #37	3/30	100,000.00	2/28/86	9.275%	9.170% "
Oglethorpe Electric Membership #74	3/30	17,290,000.00	4/15/81	9.835%	9.717% "
Wabash Valley Power #104	3/30	1,300,000.00	12/31/13	9.182%	9.079% "
Tri-State Gen. & Trans. #89	3/30	5,625,000.00	2/28/86	9.275%	9.17% "
Arkansas Electric #77	3/30	40,000.00	12/31/13	9.182%	9.079% "
Certificate of Beneficial Ownership	3/31	283,300,000.00	3/31/09	9.195%	
Small Business Investment Companies					
Intercoastal Capital Corp.	3/21	250,000.00	3/1/82	9.575%	
NIS Capital Corp.	3/21	500,000.00	3/1/82	9.575%	
Pioneer Investors Corp.	3/21	1,000,000.00	3/1/84	9.385%	
Dycap, Inc.	3/21	200,000.00	3/1/86	9.335%	
Enterprise Capital Corp.	3/21	650,000.00	3/1/89	9.295%	
First SBIC of Louisiana, Inc.	3/21	150,000.00	3/1/89	9.295%	
Metropolitan Capital Corp.	3/21	300,000.00	3/1/89	9.295%	

FEDERAL FINANCING BANK

March 1979 Activity

BORROWER	DATE	AMOUNT OF ADVANCE	MATURITY	INTEREST RATE	INTEREST PAYABLE (other than s/a)
Student Loan Marketing Association					
Note #186	3/6	$ 90,000,000.00	6/5/79	9.876%	
Note #187	3/13	90,000,000.00	6/12/79	9.994%	
Note #188	3/20	95,000,000.00	6/19/79	10.019%	
Note #189	3/27	100,000,000.00	6/26/79	10.019%	
Tennessee Valley Authority					
Note #95	3/30	970,000,000.00	6/29/79	9.765%	
Department of Transportation Section 511					
Trustee of The Milwaukee Road	3/15	1,931,978.00	11/15/91	9.328%	9.546% annually
Chicago & North Western 511-78-3	3/16	1,313,542.00	11/1/90	9.343%	
Trustee of Chicago, Rock Island	3/21	1,324,637.00	12/10/93	9.354%	9.573% annually
United States Railway Association					
Note #8	3/22	11,015,000.00	4/30/79	10.064%	
Western Union Space Communications, Inc. (NASA)					
	3/1	4,975,000.00	10/1/89	9.443%	9.666% annually
	3/20	9,200,000.00	10/1/89	9.379%	9.599% annually

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

FOR IMMEDIATE RELEASE April 24, 1979

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $2,505 million of $5,501 million of tenders received from the public for the 2-year notes, Series S-1981, auctioned today.

The range of accepted competitive bids was as follows:

Lowest yield	9.75% 1/
Highest yield	9.79%
Average yield	9.78%

The interest rate on the notes will be 9-3/4%. At the 9-3/4% rate, the above yields result in the following prices:

Low-yield price	100.000
High-yield price	99.929
Average-yield price	99.947

The $2,505 million of accepted tenders includes $393 million of noncompetitive tenders and $1,519 million of competitive tenders from private investors, including 27% of the amount of notes bid for at the high yield. It also includes $593 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 $2,505 million of tenders accepted in the auction process, $159 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 April 30, 1979, and $307 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 5 tenders totaling $70,000.

B-1556

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

FOR RELEASE ON DELIVERY
April 25, 1979

STATEMENT OF THE HONORABLE RICHARD J. DAVIS
ASSISTANT SECRETARY OF THE TREASURY
(ENFORCEMENT & OPERATIONS)
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and members of the Subcommittee,

I appreciate the opportunity to testify during these hearings on offshore tax havens. Other witnesses will be detailing for the Subcommittee their views as to the nature and scope of the problems created by the existence of these tax havens. As the Subcommitee suggested, I will discuss various matters relating to the implementation of the Currency and Foreign Transactions Reporting Act, including the Treasury Department's efforts to utilize the reports required under that Act, the GAO report dated April 6, 1979, discussing some aspects of the Act, and the extent to which bank regulatory agencies assist in identifying questionable transactions or in identifying banks where questionable activity is taking place.

Before considering those matters, however, I would like to review some of the background of the Act in order to provide a perspective for the discussion.

The Currency and Foreign Transactions Reporting Act was introduced in 1969 after several law enforcement agencies had expressed concern about the difficulties in investigating and documenting the financial aspects of transnational crimes. The legislation originated in the Committee on Banking and Currency of the House of Representatives as part of H.R. 15073. After extensive hearings in both houses of Congress, it was passed in 1970 as Titles I and II of Public Law 91-508.

B-1557

The Act provides two types of provisions to deal with these problems. It provides, first, for financial recordkeeping requirements for financial institutions. Second, it requires reports by domestic financial institutions and others of certain kinds of financial transactions. Congress recognized that many criminals use legitimate financial institutions to carry on their illegal activities and included the recordkeeping provisions to ensure the maintenance of records required for criminal, tax, and regulatory investigations. The reporting provisions include reports of currency transactions, the international transportation of monetary instruments, and foreign financial accounts.

The reports were intended first to provide leads and intelligence as to possible criminal activity. With this in mind, both the House and the Senate reports on the legislation contain statements indicating that the information in the required reports should be made available to all Federal law enforcement agencies that have a need for them.

The reports, however, were also intended to help overcome investigative and prosecutive difficulties resulting from the tendency for many criminals to use currency and foreign banks in conducting their affairs. As the Senate report on the bill states:

> "Reports are not a foolproof method of preventing organized crime from sending currency out of the country. Obviously, a criminal who is already breaking the law could just as easily ignore the reporting requirement. The significance of requiring reports is that it provides the Justice Department with another means of obtaining a conviction. The mere failure to file a report would constitute a criminal violation much easier to establish compared to proving the funds transported were illegally acquired or were to be used for an illegal purpose. Those who fail to report would be subject to a criminal penalty of a year in prison, a $1,000 fine, or both. If the failure to report was committed in furtherance of the commission of any other violation of Federal law, or as part of a pattern of illegal activity involving transactions exceeding $100,000 a year,

> the person who fails to file a report is subject to a much stiffer criminal penalty - 5 years in jail or a $500,000 fine, or both. Finally, any unreported currency is subject to seizure and forfeiture to the United states and those who fail to make required reports are liable for a civil penalty equal to the amount of currency transported less any amount already seized and forfeited."
>
> "It is believed that these penalties will constitute a significant deterrent to organized crime. At the same time, the Secretary has broad discretionary authority to return seized currency or waive the civil penalties which he could use to prevent ordinary citizens or businessmen from being unduly penalized for an inadvertent violation."

The reporting requirements authorized by the Bank Secrecy Act are interrelated. This is especially true of the requirements that banks report currency transactions and that travellers report the international transportation of currency. They complement one another. If one did not exist, the other could be more easily circumvented. For example, if banks were not required to report currency transactions, there would be little need for criminals to smuggle money into or out of the country. Currency simply could be taken into a bank, and the funds transferred abroad to a secret bank account without disclosing the identities of the persons arranging the transfer or receiving the funds. Conversely, without reports of the import or export of currency, the requirements that banks report large currency transactions would be relatively ineffectual. Criminals could easily travel to a nearby foreign country and convert their currency into a more compact and more profitable form of wealth.

As the Subcommittee may have noted, the Department submitted rather extensive comments to the GAO on a draft of the report prior to the issuance of the final report. In many regards, the final report indicates that the GAO considered our comments in drafting the final version and modified certain statements that appeared in the earlier draft. We are not, however, in complete agreement with the report. We do not believe, for example, that the scope of the audit on which the report was based was broad enough to permit the GAO to reach conclusions regarding the overall value of the reporting requirements.

The record, nevertheless, clearly indicates that we agree with many of the GAO's observations and have in the last eighteen months acted to make necessary changes. Of particular importance is the need to assure that we are using the information we are receiving. To accomplish this, we took action to establish an analysis unit to act as a focal point for the computerization, analysis and dissemination of data obtained from all the reports required to be filed in compliance with the Bank Secrecy Act. That unit has been fully operational since July, 1978. Initially, this unit was located in my office and included Treasury, Customs and IRS personnel. To provide the unit with a permanent home, we have recently transferred it to the Customs Service where it can obtain needed resources, including data processing support. This change is also consistent with the fact that Customs already has important enforcement responsibilities under the Act. An IRS agent is still, however, participating in the unit and my office actively works with it to continue to develop our ability to use this information.

The unit is working with data from the following documents:

-- Currency Transaction Reports (IRS Form 4789), which are filed by banks and certain other financial institutions with respect to unusual currency transactions involving more than $10,000,

-- Reports of the International Transportation of Currency or Monetary Instruments (Customs Form 4790), which are filed by travellers and others who import or export more than $5,000 in currency and other bearer instruments, and

-- Reports of Foreign Bank and Financial Accounts (Treasury Form 90-22.1), which are filed by U.S. persons who are the owner of record, have legal title to, or control over a foreign financial account.

The unit is developing computerized indices for both the currency transaction reports and the reports of foreign financial accounts similar to that already existing for the Customs Form 4790. When they are completed later this year, the Department, for the first time, will be able to readily access the reports and analyze them. We expect that this will enable us to provide the IRS with whatever information from the reports it requires for tax enforcement. It will also greatly improve our ability to service requests from the Congress and Federal law enforcement agencies.

The computerization and dissemination of the foreign financial account data was made possible when the report was changed from an IRS form to Treasury Form 90-22.1 in October, 1977. Prior to the change, the reports could be considered to be taxpayer return information because they were filed with income tax returns and disclosure of their existence would also disclose the fact that a tax return had been filed. Now, they are filed on a calendar year basis directly with the Treasury Department.

We also agree with the recommendation in the GAO report that Treasury should try to monitor the use of the various Bank Secrecy Act reports. This is not, however, a simple task. We cannot overlook the practical difficulties in attempting to monitor results. If individual reports are used in tax investigations or in criminal investigations conducted under the authority of a grand jury, the investigating agencies are often subject to disclosure restrictions. These restrictions preclude a meaningful assessment unless the information needed for evaluation is made public during the trial. It is also often difficult to assess the impact of a report, as opposed to other evidence in producing an arrest and prosecution.

While further evaluation is necessary, the experience to date suggests that these reports have been and will be useful for law enforcement purposes. While the Reports Analysis Unit is in its relatively early stages, the Treasury Department has been analyzing data contained on the currency transaction reports for almost two years, and where appropriate, copies of the reports and other data have been furnished to Congressional committees as well as to interested Federal law enforcement agencies.

Since May, 1977, we have provided DEA, alone, with more than 2,800 currency transaction reports totalling more than $370 million. Nearly 1,400 of those currency transaction reports reflecting bank transactions totalling $157.5 million were provided in fiscal year 1978. Numerous reports of international transportation have also been supplied to them. DEA has acknowledged that some major investigations have been initiated, in part, as a result of information provided by the reports. Similarly, these reports have been used in various Congressional and Justice Department investigations.

Although we strongly believe that the reporting requirements have already proven to be very useful, we have been taking various actions to improve our utilization of them. These include:

-- Arrangements have been completed for the dissemination of material to the Department of Justice including the Federal Bureau of Investigation and the Drug Enforcement Administration.

-- Letters have been sent to senior officials of appropriate Federal departments and agencies to make them aware of the data available to them pursuant to the Bank Secrecy Act.

-- Formal guidelines and safeguards for the utilization of report information by user agencies have been established in order to provide appropriate safeguards for the privacy of individuals.

With the renewed emphasis on white collar crime recently announced by the Department of Justice and the creation of inspector general positions in the Federal departments, I am confident that the report information being indexed and analyzed by the unit will become increasingly useful.

Other benefits of the reporting requirements were not addressed by the GAO report. As discussed above, in passing this statute Congress desired to do more than provide evidentiary leads; it sought to provide an additional vehicle to investigate and prosecute organized and white collar criminals and sought to make more difficult the undetected use and transportation of cash and cash type instruments.

The obstacles the reports create are apparent in some of the criminal cases that have been brought to trial. Drug traffickers have bribed bank officials to launder or exchange money or employed experts in laundering money to assist them. Corporations have also been subjected to substantial penalties in connection with the accumulation of slush funds. For example, a civil penalty was asserted against Gulf Oil Corporation in the amount of $229,000. The Control Data Corporation was convicted for violations of 31 U.S.C. 1059 - the criminal fine was $1,001,000 and the civil penalty asserted was $380,000.

The Williams Companies were convicted of a violation of 31 U.S.C. 1059 - the criminal fine was $21,000 and the civil penalty was $177,000.

Drug traffickers have also lost substantial amounts of currency as a result of the requirement to report the international movement of currency. Customs frequently uses the authority in the Act to seize currency carried by drug suspects and other smugglers. In one case, Ashok Solomon, Ramesk Solomon, and Pardeep Chand were convicted for narcotics conspiracy and unreported currency transportation (31 U.S.C. 1059). Based on these convictions they were sentenced to ten years imprisonment and were fined $530,000. A civil penalty of $99,000 was also asserted against Ashok Solomon. Ramesk Solomon received a sentence of eight years imprisonment and a $530,000 fine. Pardeep Chand was sentenced to 5 years imprisonment and was fined $515,000.

The Subcommittee has expressed an interest in the role of the bank regulatory agencies in the enforcement of the Act. Sections 128 and 205 of the Act, which deal with compliance, state that the Secretary of the Treasury shall have the responsibility to assure compliance with the Act and that he may delegate that responsibility to the appropriate bank supervisory or other supervisory agency. The implementing regulations have taken advantage of that provision. The Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board are among the agencies that have been delegated compliance responsibilities. If criminal violations are suspected, the follow-up investigation is conducted by the Internal Revenue Service.

A uniform examiner's compliance checklist was developed in cooperation with the supervisory agencies. In addition, in 1973, guidelines for the disposition of reported violations were also developed. In 1975, when it became apparent that bank examiners had not detected some serious violations of the currency transactions reporting requirement, additional more detailed procedures were developed with the help of the agencies. The number of referrals made to our office, however, has remained very low.

To see if further steps could be taken, in September, 1978, my office met with senior representatives of these supervisory agencies to discuss enforcement of the financial recordkeeping and reporting regulations. At this meeting, we requested copies of the instructions pertaining to 31 CFR 103 that each agency had issued to its examiners in order that we might review them to determine whether or not the scope of the examination should be expanded. We also requested that we be provided with a description of every transaction involved in a violation of the currency transaction reporting requirement which is discovered by the examiners of the aforementioned agencies. Our goal in doing this is to determine whether or not additional steps should be taken to determined the circumstances surrounding the violation and to determine whether or not any additional steps should be taken to ensure compliance.

One area to which we have devoted substantial attention is the compliance of uninsured foreign banks operating in the United States. These are among the most important banks whose compliance should be monitored, yet at one time, because no Federal banking agency had general jurisdiction over them, their activities in this area were not being inspected. To correct this, we made arrangements with the Federal Deposit Insurance Corporation to inspect the uninsured foreign banks operating in the U.S. in order to ensure their complinace with both the reporting and recordkeeping requirements of the Act. In this regard, we recently sent letters to approximately 300 of these institutions informing them that the FDIC will begin inspecting them for compliance with the requirements of the Bank Secrecy Act.

In the past, in some cases, unusual currency transactions not falling within the statute have, on occasion, been reported by banks. Nevertheless, given the terms of the recently passed Right to Financial Privacy Act, we do not expect the bank agencies to report to us anything more than apparent violations of the Bank Secrecy Act or other legal requirements.

Ordinarily, if a bank engages in an unusually large volume of currency transactions, we expect that the Customs unit that is analyzing the reports will be aware of the situation before the bank is examined by a supervisory agency and that the data will be forwarded to the appropriate Federal law enforcement agency.

Mr. Chairman, no single statute itself should ever properly be viewed as the "answer" to the problem of crime, white collar or other. Nevertheless, the Currency and Foreign Transactions Reporting Act has provided a significant tool in the struggle to deal with these problems and we will continue to try to seek ways to enhance its value to the law enforcement community.

I will be happy to answer any questions the Subcommittee might have.

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 2:00 P.M.
THURSDAY, APRIL 26, 1979

STATEMENT OF JOHN R. KARLIK
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL ECONOMIC ANALYSIS
before the
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY AND TRADE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

Mr. Chairman and Members of the Subcommittee:

It is a pleasure for me to testify today regarding the proposed amendment of Section 9 of the International Investment Survey Act of 1976, review Treasury's activities under the Act, and respond to the thoughtful questions raised in your April 5, 1979 letter of invitation.

We are currently conducting a survey of foreigners' portfolio investment in domestic securities and a feasibility study of alternative approaches to surveying U.S. residents' portfolio investment abroad. We anticipate that the same staff will be able to simultaneously complete the study of foreigners' portfolio investment now under way, including analysis of the survey results, and complete the feasibility study for conducting a survey of U.S. portfolio investment abroad.

Therefore, the estimated expenditures for fiscal year 1980, compared to 1979, include no personnel increases, but additional amounts needed for data processing and for expert advice and consultation. A firm estimate of expenditures for fiscal year 1981 cannot be made until the decisions regarding an outward survey are reached.

In order to continue this work during fiscal year 1980, expenditures for these purposes must be authorized and appropriated. We, therefore, request that to fulfill Treasury's responsibilities for conducting portfolio investment surveys, expenditure authorization be granted in the amount of $1.574 million for the fiscal year ending September 30, 1980.

A year ago when I testified before this Subcommittee I explained our plans for fulfilling the requirements mandated by the Act regarding portfolio investment surveys. During the past year we made significant progress. I would now like to briefly summarize this work.

Last year we proposed that a benchmark survey be conducted to collect only information on levels of foreign holdings of domestic securities--stocks and bonds--and to supplement these questionnaire data with information on foreign ownership of other financial instruments collected in the existing monthly and quarterly Treasury International Capital (TIC) surveys. Because of their relative lack of importance in the previous benchmark survey, and to limit reporter burden and public expense, certain equity investments were excluded from the proposed survey--foreign limited partnership interests and fractional interests in oil and gas, crops and other investment property. We believed this approach met the analytic requirements of most potential users of the data, and at the same time resulted in a minimum burden to the public and a significant cost savings.

On August 9, 1978, the Office of Management and Budget approved our survey of foreign portfolio investment in domestic securities. The survey will measure foreigners' holdings as of December 31, 1978. In November we mailed 10,600 survey questionnaires to banks, brokers, and corporations in the United States. We also completed a separate mailing to associations and other interested organizations, so that the survey would receive maximum publicity. We conducted these mailings well in advance of the December "as-of-date" to give prospective respondents an opportunity to organize their data information systems to provide the requested information at a minimum cost.

Firms were asked to return the completed questionnaire by March 31, 1979. To date over 3,500 completed questionnaires and 2,000 valid exemptions have been received. A follow-up letter was mailed to firms who did not respond. We expect the majority of these firms to file completed questionnaires within the next 30 days.

While we were temporarily delayed by the hiring freeze last fall, our staffing for the survey is on schedule. All of the permanent staff and approximately one half of the temporary personnel needed for processing the questionnaires, analyzing them and writing the report to Congress have been hired. Installation of the computer facilites required for entering responses, editing for accuracy and compiling a final data base is complete. With the completion of necessary software forthcoming, we plan to begin data processing in a few weeks.

Twenty six days have elapsed since the deadline for firms to file completed questionnaires. It will take several months to review, process, edit and tabulate the thousands of questionnaires. Therefore, I cannot report to you today on what the survey reveals about current trends or findings in foreign portfolio investment. The survey work is proceding on schedule and we anticipate the report on foreigners' portfolio investment in the United States will be completed by late 1980, as originally planned.

The 1976 Act also requires a survey of U.S. residents' portfolio investment abroad. No such survey has been conducted since 1943. Given changes in the volume and structure of international financial investment flows, there is a lot to learn about conducting an outward survey, and we have initiated an analysis of how to best go about it. Since the Act defines portfolio investment to mean any international investment other than direct investment, this is a most difficult, although challenging, technical task. Therefore, the feasibility analysis must carefully cover all aspects of conducting such a survey--information requirements, existing data collection mechanisms, current data deficiencies, survey coverage and methodology, resource requirements, public reporting burden, and questionnaire design.

The Act requires that a balance between costs, burden to the public, and the need for information must be fully considered before implementing any data collection program. We consider this a sound principle, and each possible approach will fully take into account those considerations. In this regard, diverse and responsible views from qualified persons representing business, labor, academia, and other

Federal user agencies will be actively solicited. We would also appreciate the views of this Subcommitte regarding the uses to which data resulting from a survey of outward portfolio investment would be put. Such knowledge is essential to balancing the costs and benefits of collecting information on U.S. residents' holdings of foreign securities.

Conclusions and recommendations derived from the feasibility study will not be available before late July. Any decision to undertake an outward survey and its particular design will be adopted only after consultation with the Members and staff of this Subcommittee.

Mr. Chairman, in your letter of invitation, you requested that my prepared statement respond to several questions. I have responded to most of these in my review of our activities under the Act and our request for fiscal year 1980 expenditure authorization. However, some questions raised in your letter remain unanswered. I will conclude my testimony today by responding to these questions.

The Department of the Treasury feels that mandatory disclosure by foreign investors would be both unnecessary and undesirable. There are sufficient regulations and data collection programs now in place to provide adequate information for analysis and policy review. The additional reporting burden and cost would, in our view, be unjustified.

The Treasury Department does not explicitly monitor foreign portfolio investment in real estate and energy on a continuing basis. While we do monitor portfolio capital flows, our TIC reporting system does not provide for a breakdown by industry. However, the amount of foreigners' portfolio investment in real estate and energy was reported in the 1974 benchmark survey and foreign holdings of stocks and bonds in these sectors will be updated in the current survey.

Finally, Mr. Chairman, you asked about the time and cost to firms responding to surveys and what comments or criticisms they make about the surveys. In the design of our survey questionnaire we included two voluntary questions on respondent burden. The information obtained from these questions will be used to estimate the dollars and manhours expended by the public in responding to the survey. This analysis will be included in our report. While we have received a few favorable comments regarding questionnaire design and elimination of certain burdensome items included in the previous survey, three main criticisms and concerns have been voiced by firms: one, they question the need for these data and wonder how the information will be used; two, many complain about the cost and time required to furnish the detailed information; and three, several express concern about our ability to keep reported information confidential. With regard to the last concern, while the International Investment Survey Act specifically provides that reported information be kept confidential and be used only for statistical and analytical purposes, firms which are unaware of the strict protections of confidentiality provided by the Act point out that other information furnished to the Government in the past, under legislation containing less stringent safeguards against disclosure, has been disclosed under the Freedom of Information Act.

From our standpoint, both as data collector and user, these criticisms and concerns are particularly worrisome. If firms become over-burdened with information requests and fearful of disclosure, the quality and validity of reported statistics would suffer. It is incumbent upon us in the Federal Government to ensure that the public is required to furnish only essential and relevant information.

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE April 25, 1979

TREASURY MAY QUARTERLY FINANCING

The Treasury will raise about $2,500 million of new cash and refund $1,719 million of securities maturing May 15, 1979, by issuing $2,250 million of 10-year notes and $2,000 million of 30-year bonds.

The $1,719 million of maturing securities are those held by the public, including $123 million held, as of today, 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 $550 million of the maturing securities that may be refunded by issuing additional amounts of new securities. Additional amounts of the new securities may also be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing securities held by them.

Details about each of the new securities are given in the attached "highlights" of the offering and in the official offering circulars.

oOo

Attachment

B-1559 (over)

HIGHLIGHTS OF TREASURY
OFFERINGS TO THE PUBLIC
MAY 1979 FINANCING
TO BE ISSUED MAY 15, 1979

April 25, 1979

Amount Offered:		
To the public	$2,250 million	$2,000 million
Description of Security:		
Term and type of security	10-year notes	30-year bonds
Series and CUSIP designation	Series A-1989 (CUSIP No. 912827 JQ 6)	Bonds of 2004-2009 (CUSIP No. 912810 CG 1)
Maturity date	May 15, 1989	May 15, 2009
Call date	No provision	May 15, 2004
Interest coupon rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction
Interest payment dates	November 15 and May 15	November 15 and May 15
Minimum denomination available	$1,000	$1,000
Terms of Sale:		
Method of sale	Yield Auction	Yield Auction
Accrued interest payable by investor	None	None
Preferred allotment	Noncompetitive bid for $1,000,000 or less	Noncompetitive bid for $1,000,000 or less
Deposit requirement	5% of face amount	5% of face amount
Deposit guarantee by designated institutions	Acceptable	Acceptable
Key Dates:		
Deadline for receipt of tenders	Tuesday, May 1, 1979, by 1:30 p.m., EDST	Wednesday, May 2, 1979, by 1:30 p.m., EDST
Settlement date (final payment due)		
a) cash or Federal funds	Tuesday, May 15, 1979	Tuesday, May 15, 1979
b) check drawn on bank within FRB district where submitted	Thursday, May 10, 1979	Thursday, May 10, 1979
c) check drawn on bank outside FRB district where submitted	Wednesday, May 9, 1979	Wednesday, May 9, 1979
Delivery date for coupon securities	Thursday, May 17, 1979	Thursday, May 17, 1979

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

FOR IMMEDIATE RELEASE
April 26, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT EXTENDS PERIOD OF INVESTIGATION ON CERTAIN FRESH WINTER VEGETABLES FROM MEXICO

The Treasury Department today said that it will extend its antidumping investigation involving imported fresh winter vegetables from Mexico for an additional period not to exceed 90 days.

The decision was made because more time was needed to analyze the data provided before determining whether this merchandise is being sold in the United States at "less than fair value." (Sales at less than fair value generally occur when the price of merchandise sold 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. If Treasury determines that sales at less than fair value occur, the case is referred to the U. S. International Trade Commission for an injury determination. An affirmative ITC decision would require dumping duties.)

Notice of this action will appear in the Federal Register of April 30, 1979.

Imports of fresh winter vegetables from Mexico in 1978 were valued at about $200 million.

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B-1560

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

FOR IMMEDIATE RELEASE
April 26, 1979

Contact: Alvin M. Hattal
202/566-8381

TREASURY DEPARTMENT TO START ANTIDUMPING INVESTIGATION OF SUGARS AND SYRUPS FROM CANADA

The Treasury Department today said it will start an antidumping investigation of imports of sugar and syrups from Canada.

Treasury's announcement followed summary investigations conducted by the U. S. Customs Service after receipt of a petition filed by the Amstar Corporation alleging that firms in Canada are dumping this merchandise in the United States.

The petition alleges that the imports are 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.) The Customs Service will investigate the matter and make a tentative determination by October 30, 1979.

If sales at less than fair value are determined by Treasury, the U. S. International Trade Commission will subsequently decide whether they are injuring or likely to injure 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 in the United States.)

Notice of the start of this investigation will appear in the Federal Register of April 30, 1979.

Imports of sugars and syrups from Canada in 1978 were valued at $28 million.

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

FOR IMMEDIATE RELEASE April 25, 1979

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $3,022 million of 52-week Treasury bills to be dated May 1, 1979, and to mature April 29, 1980, 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 -	90.698	9.200%	10.06%
Low -	90.652	9.245%	10.11%
Average -	90.662	9.235%	10.10%

Tenders at the low price were allotted 99%.

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

Location	Received	Accepted
Boston	$ 29,985,000	$ 9,985,000
New York	5,323,980,000	2,487,680,000
Philadelphia	51,490,000	11,390,000
Cleveland	35,360,000	5,360,000
Richmond	41,980,000	32,980,000
Atlanta	11,110,000	11,110,000
Chicago	449,030,000	208,930,000
St. Louis	42,565,000	20,565,000
Minneapolis	25,035,000	25,035,000
Kansas City	18,615,000	10,615,000
Dallas	2,255,000	2,255,000
San Francisco	464,610,000	179,510,000
Treasury	16,320,000	16,320,000
TOTAL	$6,512,335,000	$3,021,735,000

The $3,022 million of accepted tenders includes $119 million of noncompetitive tenders from the public and $1,242 million of tenders from Federal Reserve Banks for themselves and as agents of foreign and international monetary authorities accepted at the average price.

B-1562

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

FOR IMMEDIATE RELEASE
EXPECTED AT 10:00 A.M., EST
WEDNESDAY, APRIL 25, 1979

STATEMENT OF THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
HOUSE OF REPRESENTATIVES

INTRODUCTION

Mr. Chairman, it is a pleasure to be back with you and the committee again. On our part we have benefited from the dialogue on the multilateral development banks which took place during the three previous days of oversight hearings. In the three weeks since we last met together, we have had time to study the Investigators' Report further, review the transcripts and to reflect on the comments and questions which were raised during the hearings.

Mr. Chairman, in the concluding minutes of the last day of hearings you asked us to assess "what benefit you feel the report has been to the Executive Branch." In particular, you asked us to address ten areas of specific concern highlighted in the Report. In my prepared statement and in the discussion following, my colleagues and I will address these concerns and will comment on a number of related points as well.

B-1563

<u>THE ROLE OF THE EXECUTIVE DIRECTORS AND THE PROJECT REVIEW PROCESS</u>

Mr. Chairman, four of the areas of concern raised in your list of ten are related and I propose to treat them together: Executive Directors' awareness of and access to MDB documents, Executive Directors' input into and role in the loan review process, general project review procedures, and the need for more timely project review and feedback.

As I indicated in some detail in my statement of March 27, member governments set the policies to be followed by the banks. The Executive Directors ensure that the banks are managed in conformity with these policies. To carry out this responsibility, the <u>Executive Directors determine what information they require</u>. That information is then provided by the management.

That is how the system works. ~~That~~ is how the system should work. Mr. Fried and Mr. Dungan testified earlier that they had access to, could obtain and do obtain any document they need.

Mr. Fried also testified why some documents were not routinely made available to the Board. The principle adhered to in determining which documents not to distribute routinely was that documents should not be distributed which could put Executive Directors into a conflict of interest situation and which could lead to political logrolling in place of the present professionalism that guides the allocation of the funds.

That is a principle which promotes better-run banks and harmonious member-country relationships. as we have stated earlier, however, even these documents are available to the United States Executive Director should he determine that he needs them to meet his responsibilities.

Finally, Directors do not receive copies of internal working documents prepared by staff for managements' day-to-day operation of the banks. These documents are raw material and as such are of little relevance to the role the Executive Directors perform. Should a question arise requiring examination of detailed background material, however, any Executive Director does have access to these papers.

In discussing the project review process and the role of the Executive Directors in that process, let me reiterate that the Executive Directors acting in concert with the officials of member governments set the broad policies of the banks. The policy framework so established is not formed solely in the Board rooms of the MDBs. It is importantly the product of formal and informal meetings of the Governors, in addition to numerous bilateral and multilateral meetings at every level. The policy framework is also the product of the periodic replenishment negotiations, during which important policy issues are often resolved.

As I mentioned in my earlier testimony, the amount of influence exercised by the United States in determining broad based policy for the Banks is considerable. In that earlier testimony, I gave six pages of examples of U.S. influence on on policy issues. In short, the member governments, in large part tthrough their Executive Directors, provide the policy framework for the Banks.

Once these policies are established, it is then up to the Executive Directors to insure that the banks operate in conformity with them. They do this by taking an active part in the loan review process.

Let me briefly review that process (a more detailed review will be submitted for the record). Once having done that, I will discuss the Executive Directors involvement in that process.

Every loan project financed by an MDB follows a six-stage cycle: identification, preparation, appraisal, negotiation, implementation and supervision and evaluation. At each stage our Executive Directors, supported by the Treasury and the other agencies of the National Advisory Council and the Development Coordination Committee, can and frequently do, make inputs to the process.

At the identification stage, the selection of projects will reflect the sectoral priorities, such as agriculture or energy, that have been established based on member country views. Preparation and appraisal deal with such matters as appropriate technology, reaching the poor and economic rate of return estimates. For example, our Executive Director inquires of bank staff as to the alternative technologies being considered in a road construction project, and requests evidence of the analysis used in selecting alternatives, and inquires into the intended beneficiaries of an irrigation project.

At the negotiation stage our Executive Director can influence the types of loan covenants or side letters which are attached to the loan contract. For example, in a rural development loan planned for an Asian country, the United States urged the management of the ADB to include in a side letter a pledge on the part of the Government involved to eliminate poppy production in the project area. Loan covenants typically cover agreements undertaken by the borrower to institute specific pricing policies to insure the financial viability of the project.

At the implementation and supervision stage our Executive Director might seek information which documented that the banks' international competitive bidding procedures were conformed with or information on why a project was being delayed. Finally, during the project evaluation stage, our Executive Director will be most concerned with whether or not the project actually realized the intended goals, and what lessons were learned from this project for future bank activity. The World Bank's system of project performance audit reviews (PPAR), which are computerized and available for easy retrieval, can be used by the Executive Director in his analysis of similar projects under consideration.

With this as background the project review procedures employed by the United States Government can be better appreciated.

The concerns the U.S. Government may have with a particular loan proposal being prepared by the MDBs are categorized into two major groups: policy and economic/financial concerns. The policy concerns include reaching the poor, commodities, appropriate technology, alternative financing, human rights, graduation of higher income countries, and loans to particular countries. The economic/financial concerns include the appropriateness of the borrower's macro-economic policies, including efforts to mobilize domestic resources, and specific concerns regarding the particular project, e.g., rate spreads, rate of return and cost recovery and government practices affecting producer prices.

The procedures call for the DCC Working Group on Multilateral Assistance (WGMA) to review proposals at all stages of their preparation.

The first step in the review procedure is the WGMA's review each month of the list of new projects in each Bank's MOS. Each new listing is reviewed in light of the broad range of U.S. concerns. This is the first time a proposal is analyzed in the loan review process and the first time a "problem" project can be identified and listed in the "early warning system" (EWS). The identification of new problems is the long range part of the EWS, i.e., those projects not likely to come before the Board for a year or more.

The results of the WGMA's review are passed to the U.S. Director and, as appropriate, to Bank staff to alert them to the U.S. concerns with the project and to seek clarification and possible changes to deal with the problems which have beem raised.

The loan review procedure then provides for a thorough analysis of the loan documents by the WGMA prior to consideration by the Board. The emphasis during this step of the procedures is to review whether concerns raised at the early stage of the project were resolved and to assess the project as a whole for feedback into the selection and design of future projects. The U.S. Director's comments at the Board -- or with the staff as appropriate before the project comes to the Board -- provide the means for accomplishing this objective.

Finally a word about timeliness of feedback into new projects -- lessons learned from ongoing or completed projects. The World Bank's Project Performance Audit Reports provide feedback from completed projects. Indeed, the documents on a new project going to the Board must show, where this is relevant, how problems uncovered in performance audits have been addressed in earlier projects.

There are two further sources of project review and feedback that ensure that problems are recognized and corrected on current projects and that lessons learned are applied in future projects. These two sources are supervision missions and evaluations.

Supervision: The Articles of Agreement require the banks to supervise the use of the proceeds of its loans. During the life of a loan, the Bank maintains continuous contact with its borrowers. One of the main purposes of this supervision is to help ensure that bank-financed projects achieve their objectives by having bank staff work with the borrower to identify and solve implementation problems. The experience gained in the course of supervising projects is also used to improve project preparation and appraisal in the future. Thus, supervision is part of a continuous process, in which the bank's activities in helping a project achieve its objectives in turn lead to improvements in future projects.

Evaluation: Two Steps

Project Completion Reports: Following the final disbursement of a loan, the Bank staff prepares a Project Completion Report, usually within six months of the completion of loan/ credit disbursements. The primary objective of the PCR system is to improve the Bank's operations and the effectiveness the borrowers' development efforts. Specifically, it is intended to reinforce self-evaluation by the operating departments and the borrowers; to facilitate dissemination of the lessons learned in the borrowing countries and within the bank; and to help meet the need for accountability to the bank's member countries. The PCR assesses the strengths and weaknesses of the project shortly after completion in light of the objective specified at appraisal, and draws whatever lessons may be relevant for this and other bank projects.

Post-Project Evaluations or Audits: These go under different names and their coverage varies. In the World Bank they are called Project Performance Audit Reports (PPARs); in the others, simply "evaluations". Their purpose is to assess the extent to which the project achieved -- or failed to achieve -- its economic and other purposes and whether it did so within planned costs and time schedules. In the process, the reasons for shortfalls are brought to light and the lessons learned conveyed to staff for application to future projects. Our EDs use these evaluations in assessing the prospects of loans being presented to the Board for approval. It should be noted that the establishment of independent evaluation units, in each of the banks results in large part from the adoption by them of recommendations embodied in legislation adopted by the U.S. Congress.

Evaluations are based to a large extent on project completion reports and other documentation produced during project preparation and implementation. This material is carefully assessed and independent judgments are applied as to its accuracy. Where it appears to be wanting, further reviews, including on-site inspections, are conducted.

Practices differ in each of the banks. In the World Bank, a PPAR is issued about one year after the closing date of each project. In addition, more searching evaluations are conducted of groups of projects in selected sectors, which go beyond the performance of the individual project and aim to assess the results of the banks' and the borrowers' efforts in furthering the country's economic development. Both the IDB and the ADB evaluate individual projects on a selective basis. The ADB is unique in calling for private outside contractors to do evaluations on some of its individual projects.

MDB AUDIT SYSTEMS

The Report states that none of the MDBs has a central point within the institution to which cases of suspected irregularities, conflicts of interest, employee violations of internal regulations on other misconduct can be referred and investigated. It states that any such cases arising are now dealt with by the department of the employee concerned or by the legal staff of the bank. As that central point, the Report recommends that an Inspector General be appointed and given sufficient investigatory responsibility to carry out these functions. The Report concludes that were this post to be created, detached from operating responsibility, it would improve the banks' "accountability as well as their image."

There appears to be some disagreement on this question. The Inter-American Development Bank, in its response to the committee's invitation to submit comment, believes that "it has several such points." The World Bank believes that its practice of referring all allegations of fraud, corruption, conflict of interest or other improper behavior to its legal staff meets the requirement adequately since the legal department is "detached from operating responsibility . . ." in the sense recommended in the Report. I might add that in the entire history of the World Bank allegations of corruption and improper behavior have been negligible. Each such allegation has been investigated by the Bank's legal department and in not a single case was the allegation substantiated.

Nonetheless Treasury will explore with the Banks the adequacy of existing investigatory systems and the possibility of establishing an IG function.

With respect to the overall audit systems employed by the Banks, I would like to make a number of general comments. The audit procedures of all the MDBs are well established.

The Banks employ a combination of financial and operational audits. The operational audits are both program and project audits. These can be defined as follows:

A) Operational Audits -- These can be of two types -- Program or project.

A program audit is a review of all or a segment of an institution's organization and procedures to assess the effectiveness of its controls over its operations. It can be performed either internally or by external auditors.

A project audit is a review of the implementation of a project including the proper expenditure of funds, and of the effectiveness of the supervision applied to it. It covers much the same ground as the detailed operational aspects of project supervision.

Program Audits-Internal

Each bank has an internal audit department which reports directly to top management to ensure independence from the operational departments.

Typically, the internal auditors review and determine the soundness, adequacy and application of systems, procedures and related internal controls. They review and determine the extent of compliance with various governing agreements or instruments and related decisions, regulations, policies, plans and procedures of the Board of Governors, Executive Directors and management. They also determine the extent to which each Bank's assets are accounted for and safeguarded from losses of all kinds and review the reliability and validity of significant accounting, financial and other data used by management.

Thus a typical work program for an internal auditing program includes reviews of cash management; controls over investments; reviews of systems, procedures and related internal controls over the supervision of loans and related accounting practices; review of operations of field missions; review systems and controls over the selection and evaluation of consultants; and review of the auditing standards of selected independent auditors appointed by borrowers to determine their adequacy.

It should be noted that, in the case of the World Bank, the investigators found the IAD's reports "to be of good quality". It should especially be noted that the Report states that:

> "One copy of each IAD audit report is given to the external auditors for their use in reviewing and commenting upon the internal audit function."

<u>Program Audit of Borrowers and their Projects</u>

The Banks do not carry out independent audits directly to supplement their own implementation and supervision practices. It would add greatly, and in our view unnecessarily, to administrative cost to have a staff to do so. This function is seen as the responsibility of the borrower. Each bank, therefore, basically requires independent audits of (a) the borrowing or executing agency and (b) the individual project. In the case of the IDB and ADB, all projects are subjected to independent audits. In the case of the IBRD, the requirement for a project audit depends on the nature of the project. For example, for a project to strengthen the distribution network of an electricity authority or for a dam or highway, an audit of the agency or enterprise concerned is generally adequate. For rural development projects, on the other hand, involving a number of agencies, numerous small local expenditures, small dispersed civil works and numerous sub-borrowers, audits by external auditors are required. The auditors -- either a private independent auditor or a government auditing agency -- must be approved by the bank concerned. One aspect of the technical assistance provided by the banks is to encourage the development of such auditing capabilities in all borrowing countries.

The audits supplied cover principally:

a) The financial situation of borrowers and/or executing agencies and projects; the borrower's capacity to handle debt servicing;
b) Use of loan resources and local contributions;
c) Availability of local contributions; financial capacity of the institutions involved to continue

punctual payment of local contribution;

d) Evidence of compliance with clauses of an accounting and financial nature set forth in the loan contract;

e) Measures recommended by the auditors to correct any shortcomings found in the administrative and accounting controls of institutions and of projects.

f) For project audits:

   i) statement of cash received and disbursement made broken down into (a) funds loaned by the MDB,

      (b) contributions of the borrower and/or executor and

      (c) other contributions.

   ii) statement of investment in the project.

   iii) review of the quality of the accounting records and administrative procedures used to produce the financial information that the Bank requires including the records to control bidding, contracts, disbursements, installations, or constructions, etc.

   iv) report on implementation of recommendations previously made or lack thereof.

B) Financial Finally each MDB is subject to an annual overall financial audit performed by an internationally-known public accounting firm. These audits are performed using generally accepted accounting standards, and are published in each institution's annual report, available to the public. The external auditors attest to the financial practices, document procedures and control systems employed by the Banks. I have submitted statements made by the external auditors of both the World Bank and the IDB for the record.

REACHING THE POOR

Mr. Chairman, the MDBs, led by the World Bank, have since 1974 made significant progess in directing their lending efforts to benefit the poorest of the poor. This change in the orientation of the banks has not happened overnight nor has it been easy. In a number of areas, the banks' policies and procedures have had to be altered considerably. Nonetheless, real progress has been made and an important base has been laid for the future.

I would like to highlight some of the elements of this re-orientation, and discuss further steps which the U.S. Government can take in advancing this effort.

The composition of the reaching-the-poor shift in MDB orientation is made up of essentially six components: changes in the sectoral allocation of bank lending, redesigning the more traditional projects to impact more directly on the poor, shifting a larger percentage of bank lending to the lowest income countries, changes in bank methodology to better reach the poor, changes in monitoring and evaluation systems and changes in the institutional structure of the banks. I will touch briefly on each of these components.

Sectoral Allocation of Bank Lending

The banks have, as a first step, shifted the sectoral composition of their lending activity in favor of those sectors which prima facie are likely to have greater impact on the poor. In recognition of the fact that an estimated 80 percent of the world's poor live in rural areas, this has resulted in greater lending to the agricultural and rural development sector. For example, during the current IDA replenishment period, nearly half of IDA lending is devoted to agriculture compared to 38 percent for IDA IV and an average of 28 percent for the previous three replenishments. In the case of the Asian Development Fund, the soft loan window of the Asian Development Bank, lending for agriculture in 1978 exceeded 53 percent of total lending. Combined World Bank and IDA lending for agriculture and rural development has increased from 22 percent of total lending in 1975 to 39 percent in 1978.

Redesigning Traditional Projects

Another important change underway in the MDBs as part of their reaching-the-poor orientation is that of project design. It is clear that the vast majority of projects, even more traditional infrastructure projects, can be designed in such a way that specific poverty-oriented components can be designed into a project. For example, in water supply, electrification, and road projects, benefits accruing to the poorer groups in the general population have been expanded by redesign.

The World Bank recently held a staff training seminar entitled Urban Poverty Analysis and Targeting for Water Supply Projects. The seminar brought together the Bank staff responsible for water supply project identification and appraisal with the bank's recently created urban-poverty task force- the Urban Operations Review and Support Unit (UORSU). Project engineers, economists and financial analysts were familiarized with the basic ingredients of "urban poverty analysis" and its use. A number of case studies of earlier water supply projects were analyzed to determine in which cases urban poverty analysis was used to increase the percentage of project benefits accruing to the urban poor, and in which cases it was not. Lessons learned from this analysis are intended to improve the design of future water supply projects so as to increase their urban poverty impact. Similar seminars are planned for other sectors as well.

An additional part of the World Bank's project design program is to identify the cost of creating a job in a particular country. This becomes the capital-per-job threshold, reflecting the country's available capital resource and the size of the workforce to be employed. For a project to be defined as an urban poverty project it must create employment at less than the national average amount of capital available per work place. This type of target is intended to increase the labor intensiveness of urban projects by altering projects at the design stage.

Changes in Country Allocation

The banks have taken steps to increase the percentage of their total lending to the lowest income countries. In the Asian Development Bank's soft loan window, the Asian Development Fund, approximately 85 percent of recent lending was directed toward the low income countries of South Asia (excluding India, which voluntarily seeks no ADF lending because of its heavy share of the IDA program). In addition, as part of the recently concluded ADF replenishment negotiations, resources were mobilized so as to allow ADF lending to increase from the approximately 30 percent of total ADB lending for ADF II to approximately 40 percent for ADF III (1979-1982).

In the recently concluded IDB replenishment, agreement was reached to shift the lending from the FSO toward the lowest income countries in Latin America. Indirectly the IDBs commitment to channel 50 percent of its total lending to low income groups will also promote this country shift as well. For IDA, the percentage of lending going to countries with per capita GNP less than $280 (1976 dollars) was 88 percent for FY78.

Methodology

To reach the poor, they must first be identified. The World Bank has been at the forefront in the effort to establish effective poverty criteria, to identify target groups of beneficiaries in terms of these criteria, and to implement projects the benefits of which impact on the poverty target groups.

Absolute poverty is defined by the World Bank as an income level which will not meet minimal daily nutritional requirements, will not allow for minimal clothing and shelter nor access to safe water, decent sanitation, basic health facilities and primary education. Absolute poverty levels are computed by Bank staff for each borrowing country. These country-by-country poverty levels are computed by costing a local, nutritionally adequate (around 2200 calories) food "basket". To the cost of such a basket is added an additional component ranging from 30 to 40 percent to cover all non-nutritional needs. A measure of relative poverty, reflecting extreme income differentials within a country is also compiled -- it is the income level equivalent to one-third of the per capita total personal income of the country.

These two poverty estimates are refined and revised yearly by World Bank staff, and are used by each project appraisal mission in estimating the economic characteristics of the project's target group of beneficiaries. Recently the World Bank has begun to include in each loan document the estimated absolute poverty income level, the estimated relative poverty level, and the estimated population below the poverty income level. These estimates are included in the loan document's social indicators data sheet and are computed on both a rural and urban basis.

The poverty criteria are then used by the World Bank's project identification and appraisal missions in their estimates of a project's intended beneficiaries. Each appraisal report and each loan document contains a section on the intended beneficiaries of the particular project.

The final step in the chain is to ascertain if the majority of project benefits, defined as <u>direct</u> benefits which <u>permanently and significantly</u> raise the income of beneficiaries, accrue to people earning less than either the absolute or relative poverty income level. That is the test which must be met before a project can be classified as a reaching-the-poor project. For example, over the past five years, the World Bank/IDA has approved 358 projects which have the rural poor as their main beneficiaries. Estimates on a project-by-project basis indicate that around 60 million of the 100 million people who are expected to be direct beneficiaries of these projects have incomes below the poverty levels in their respective countries. For 1978 alone, of the $3.3 billion loaned by IBRD/IDA for agricultural and rural development projects, it is estimated that some 7.2 million rural _families_ are expected to benefit directly. Of these families 67 percent are estimated to have incomes below the absolute or relative poverty level.

Monitoring and Evaluation

The reaching-the-poor orientation of the MDBs over the last few years has involved the banks in many so-called "new style" projects which are innovative, often involve multi-sector coordination and multi-target groups of beneficiaries. Because these projects put both the banks and the borrowing countries on new terrain, careful design, implementation control and accurate assessment are all critical to the success of these and future projects. Therefore, the need for effective built-in monitoring and evaluation systems is of greater importance than in the case of more traditional projects.

The World Bank has again taken the lead in designing and implementing monitoring and evaluation systems. However, considerable work in this area has also been started in the agricultural and rural development projects of the Asian Development Bank as well.

The aims of monitoring and evaluation are to implement projects more efficiently, to review their progress more closely, and to ensure more effectively that the projects meet their development objectives, and to gather more systematically the lessons of accumulating experience.

An important part of these M and E systems is a base line data survey. Such surveys establish the existing data base from which the progress associated with project benefits can be measured. The survey results give evidence of the existing economic and social status of the population within the project area. These initial survey results become the benchmark from which the progress of the project's beneficiaries can be measured. The monitoring aspect involves insuring that the benefits of a project under implementation are being achieved as projected in the appraisal report. Finally, the evaluation is an examination of what has actually taken place.

The practice of including monitoring and evaluation units in World Bank agricultural and rural development projects has increased significantly from 48 percent in FY73 to 75 percent in FY78. In addition, the World Bank has sponsored monitoring and evaluation seminars for country project offices in Brazil and Kenya. Additional seminars are scheduled for the coming months.

Institutional Changes

The Banks have also instituted specific institutional changes to facilitate their reaching-the-poor orientation. At the World Bank, a Rural Operations Review and Support Unit (RORSU) and an Urban Operations Review and Support Unit (UORSU) have been established to develop poverty impact methodology and to oversee its implementation in the project formulation activities of the Bank. In the Inter-American Development Bank, a methodological unit is being established to monitor the Bank's lending program in light of the coming replenishment goal of lending 50 percent to low income groups. The Asian Development Bank is expanding its Office of Post-Evaluation so as to facilitate increased base-line data surveys and benefit monitoring responsibilities.

Other recent changes instituted in bank procedures include the regular inclusion in each World Bank appraisal report of the absolute and relative poverty estimates and the percentage of the population falling below those lines. The IDB loan documents now regularly include a section on project beneficiaries. At the World Bank, each country programming paper now includes a full discussion of the poverty issue in the country from the macro-economic standpoint, together with a section on the relevant country and Bank policies designed to alleviate such poverty. In addition, the pipe-lines of upcoming loans will indicate what percentage of each loan meets poverty criteria.

A Caveat

A final caveat is in order. The MDBs have developed over their history a widely recognized comparative advantage in successfully undertaking traditional infrastructure projects. It is vital to the developing world, and indeed to the world economy at large, that this comparative advantage not be lost. In many of the poorest countries of Africa and Asia, the rural poor cannot be reached at all unless the infrastructure of these countries is improved. We believe, therefore, that a continued MDB effort in infrastructure projects is not only consistent with an overall reaching-the-poor orientation, but necessary to its achievement.

Treasury Follow-Up

Treasury, operating in conjuction with the other NAC and DCC agencies, will take the following steps to enhance the reaching-the-poor efforts of the Banks:

1. Explore the establishment of specific units within each regional bank charged with the responsibility to oversee the reaching-the-poor activities. These units might be modeled after the RORSU and UORSU in the World Bank.
2. Assess the feasibility of the Banks to prepare an annual "reaching-the-poor report" on its yearly lending in which the benefits of each project are divided according to the income status of the beneficiaries.

3. Urge the establishment of an inter-MDB clearing system for sharing each bank's findings on reaching-the-poor methodology and poverty oriented project design.

OTHER CONCERNS

During the previous hearings a number of other concerns were raised which you asked us to address.

We share the Committees' concern that a rational overall growth strategy for all the MDBs is both desirable and necessary. In the past, they grew faster than the LDCs. In the future, we believe that MDB lending should normally grow at roughly the same rate as the developing countries are growing, for several reasons. As I discussed at length in my statement submitted at the opening session of these hearings, "the main contribution of the banks lies in the catalytic effect of their operations on the flow of capital from other sources, and in the manifold ways in which they encourage efficient economic policies in the borrowing countries . . ." Growth in lending significantly below the 3-5 percent range would seriously reduce the MDBs' effectiveness in this important area of promoting the growth of the world economy.

On the other hand, growth in lending in line with LDC growth rates will enable the banks to avoid absorptive capacity problems in the borrowing countries, as well as minimize the disbursement lag problems.

We do believe, however, that such an overall MDB growth strategy needs to be followed intelligently and flexibly. In particular, we believe the needs of the African developing countries call for lending growth in excess of the overall range. In addition, the recent replenishment of the Asian Development Fund resulted in a resource mobilization which will allow a growth in lending to the poorest countries and peoples of Asia in excess of the range cited above. At the same time, the recent replenishment of the IDB/FSO calls for an absolute reduction in lending levels because the remarkable development progress of most Latin American countries means that they need less concessional lending of this type. The different conditions prevailing throughout the developing world consequently argue against a too rigid and doctrinaire application of any overall growth strategy for the MDBs.

I might add that the higher rates of growth of MDB lending in the early and mid-seventies were felt to be necessary because the structural adjustments required in the wake of the oil crisis. MDB lending has rightly been given credit for facilitating the adjustment of the developing countries to these altered conditions. Should similar disturbances occur, the Banks might again be called on to temporarily step up lending to facilitate structural adjustment of the world economy.

In this regard, you also raised the issue of <u>disbursement lags</u>. There are several reasons for the "disbursement lag". As just noted, MDB lending grew dramatically from 1974 in response to the oil crisis. Disbursements from a particular loan do not peak until 4-6 years after commitment, so disbursements have not yet had a chance to catch up with this jump in commitments. In addition, the increased debt levels assumed by many developing countries to get through the height of the crisis period required them subsequently to slow their economies by tightening their budgets, thereby stretching out the flow of local currency needed to complement the MDB supply of foreign exchange. In addition, the composition of MDB lending by sector has shifted to agriculture and other areas where disbursements are slower than in sectors such as power and communications. Furthermore, fast-disbursing program lending has declined. In 1975, IBRD and IDA program lending reached nearly 9 percent of total lending. By 1978, program lending had declined to less than 2 percent. And the World Bank especially has increased the fraction of its lending going to its lower income borrowers, countries which are likelier to have implementation problems than better developed borrowers. Nevertheless, the banks are responding to the growing disbursement lag by increasing technical assistance and other activities intended to reduce implementation problems. These measures, combined with the decreases in lending growth in the next few years, should ease the disbursement backlog.

In fact, the disbursement record of the World Bank Group in the 1970s as compared with the 1960s does show a substantial improvement, in that the growth of commitments will exceed the growth of disbursements by only 2 percent. This compares to a difference of 4.1 percent during the 1960s. On the whole the disbursement experience of the World Bank has closely matched the growth of commitments. The disbursement performance during the 1970s is all the more impressive in the light of the shifts that have occurred in World Bank lending policies.

The issue of aid <u>coordination</u> is a subject to which we have devoted considerable attention. Perfect coordination, as is true for all programs, can never be achieved. However, it is a goal for which we must continuously strive. Coordination is required at all levels from the broad country strategy worked out in a consultative group down to the individual project level involving coordination in the field. At each level, the requirements of effective coordination vary.

The Report itself found that coordination by the MDBs with other public or private donors through the "co-financing" of projects was "excellent." This is especially gratifying to us in that we have continuously urged all the MDBs to do more co-financing in their roles as catalysts for increased capital flows.

The Report also found that coordination at the country level, where development potential is assessed and priority needs established, is relatively good. This was found particularly true where consultative groups are in operation. There are now twenty-one active consultative groups, all organized and chaired by the World Bank. The Bank prepares and circulates, in advance of the consultative group meetings, the background materials and economic analysis of the country's prospects and problems, as an important contribution to better coordination.

Inter-bank coordination is an area which, as the Report correctly points out, may require some additional measures. We will ask each MDB to review the present coordination machinery and assess its adequacy. Although the regional banks participate in the relevent consultative group meetings, a formal country-by-country review mechanism established jointly by the MDBs may turn out to be necessary. We will pursue this with the banks as one possibility for improved coordination.

It is at the project and sector level that the Report calls coordination efforts least effective. The Report sees this to be less of a problem in Latin America, where the IDB has resident missions, than in Asia where the ADB does not. In light of this distinction, we have asked the ADB to examine the case for establishing resident missions, perhaps on a selective basis.

We have also taken steps to involve U.S. AID missions more directly in project and sector coordination. Embassies and AID missions in Africa, Asia and Latin America are asked to comment on upcoming African Development Fund, Asian Bank or Inter-American Bank loans. Their comments have become useful inputs into the project review process. We are implementing a similar system for World Bank loans as well.

At the World Bank and IDB, our Executive Directors have had more regular meetings with AID mission directors, to improve coordination and to review lending priorities. In addition, ad hoc meetings are held with AID mission directors with World Bank and regional bank staff arranged by the U.S. Executive Directors over specific issues. The creation of IDCA and the new reorganization should further improve coordination.

A major issue that has been of concern to both the Congress and the Administration is that of salaries, benefits, and administrative costs within the multilateral development banks. Of these issues, the predominant one has been staff salaries. With the strong support of the United States, the EDs of the World Bank and the IMF formed a Joint Committee of Executive Directors on Compensation Issues. This Committee was given responsibility to study the compensation situation of all IMF/IBRD employees and to make appropriate recommendations to the Executive Boards of the two institutions. The Committee met on numerous occasions throughout 1977 and 1978, employed professional compensation firms to obtain necessary data for comparative purposes and finished its work in late December. Its final report has been printed, and copies were sent to the Congress in early February.

This report and its recommendations provide the framework for an objective determination of salaries based on public and private salary levels in member countries. It advances three basic recommendations:

- - salaries in the main professional grades should be determined as the average of those in the U.S. private sector and the U.S. Civil Service, plus a premium of ten percent to adjust for regional differences of pay within the United States and to make salaries competitive on an international as well as an East Coast basis.

- - salaries in the management levels will be determined by setting a moderate differential for each successive grade over the preceeding grade, to arrive at a rational management structure.

- - tax reimbursements to American staff will be calculated from net salaries, using the average deduction for that income level rather than the standard deduction as heretofore.

The net effect of these recommendations would be to bring Bank and Fund salaries more closely into line with comparable public and private sector salaries, as directed in Section 704 of Public Law 95-118. We will be working with other countries to restructure the compensation system along these lines and to monitor the system on a regular basis in the future.

Mr. Chairman you have also asked us to consider the question of greater participation by the Executive Directors in the formulation and administration of the operating budgets of the MDBs. We have, and we believe the facts reveal that their involvement is both meaningful and constructive.

The administrative budgets of the MDBs are closely controlled by the Executive Directors. Not only are the budgets themselves approved by the Boards, but all the significant items in the budget reflect administrative practices approved by the Boards. In the World Bank Group, for instance, personal services (compensation) comprise 65 percent of the total budget, operational travel a further 10.2 percent, leaving less than 25 percent to cover the remainder (consultants and contractual services 9.8 percent, other travel 3.9 percent, general overhead costs 11.1 percent).

When viewed in this light it is clear that, if one wants to affect the budget, attention should be focussed where the leverage is greatest -- viz compensation (65 percent) and travel (14.1 percent). These are precisely the areas where we have concentrated in the past.

There are two parts to determining the total wage-bill for compensation: salary levels and the number of staff. Both aspects are important and have received our careful attention in exercising budget restraint.

Consequently, Mr. Chairman, we conclude that the Executive Directors have major influence over the level of expenditures through exercise of their responsibility to set and re-examine <u>every</u> policy of the MDBs.

CONCLUSION

Mr. Chairman, let me sum up. We believe these hearings have been useful. They have helped us explore in depth some of the operations of the multilateral development banks. We have been made more aware of the concerns of the Congress as they relate to the MDBs, and we hope the Committee is more aware of the operations of the banks. The constructive dialogue which we have shared together is a positive example of the close and productive consultation which this Administration has sought to establish with this Committee. We look forward to its continuation in the coming months. In three months we will submit a report to you on progress made in the areas we have discussed.

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

FOR IMMEDIATE RELEASE
EXPECTED AT 10:00 A.M., EST
TUESDAY, APRIL 24, 1979

STATEMENT OF THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE
COMMITTEE ON BANKING
FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

Introduction

The Report on the International Financial Institutions prepared for the House Appropriations Committee by the Committee's Surveys and Investigative Staff has been thoroughly reviewed by the Treasury. We welcome this and other such reports as contributions to the better understanding of the operations of the multilateral development banks (MDB) and as ingredients in the ongoing process of improving these critical agents of world economic development. These are the ends to which the Administration and the Congress are jointly committed. In this regard we welcome the opportunity to appear before you today, Mr. Chairman, and to continue the close consultation with the Congress to which this Administration has given the highest priority. My colleagues and I will be happy to answer any questions which the Committee may have regarding the Report, or any other subject concerning the banks.

B-1564

An Overview of the Report

Let me begin by summarizing our general view of the Report. Of its seven substantive chapters (II-VIII), the first ("Operational Mechanisms and Interrelationships of the International Finance Institutions") is a summary of how the banks function. In terms of attention and concern, the heart of the Report is contained in Chapters III-V: Oversight Procedures of the U.S. Executive Branch, Accountability of the International Financial Institutions, and Administrative Practices, Staffing and Remuneration. These three chapters account for over two-thirds of the analytical material in the Report. Chapters VI-VIII represent the other concerns spelled out in the Committee's directive to the investigators: Commodities, Human Rights and Reaching the Poor.

Virtually the entire Report is thus devoted to an examination of MDB processes rather than results. Process is important. But the Report does not address the question of whether the poorer countries have been successful in achieving development, or whether the banks have been successful in promoting development or whether supporting the banks represents an effective way to pursue the U.S. national interest in development. <u>In assessing the Report, we should not lose sight of the fact that in no way does it question the fundamental contribution which the multilateral banks have made to development and improved living conditions in the poor countries of the world</u>.

In addition, the Report does not question the cost-effectiveness of providing U.S. foreign assistance through the MDBs: that every dollar we put into the banks is matched by three dollars from other donor countries, and that the World Bank over its lifetime has made $50 of loans for every $1 we have paid into it. Nor does the Report question that the banks bring clear economic benefits to the United States: that over the years 1972-1977, every dollar we paid into the banks generated $2.40-$3.40 of additional real U.S. GNP, that MDB economic activities created between 57 thousand and 103 thousand jobs annually, and that over the lifetimes of the banks, U.S. balance of payments has gained about $2.4 billion as a direct result of MDB programs. In short, the Report deals with an important but narrow set of issues -- but fails to address some of the most central features of the banks and of U.S. policy toward them.

In addressing the process of the MDBs, the Report records a number of positive conclusions about the banks -- around fifty -- and a number of criticisms. Of the former, let me cite two key statements contained in the Report.

> Multilateral institutions enjoy a political assistance (sic) frequently more effective, staffs trained in a variety of disciplines to provide technical assistance, leverage of capital with borrowing in private markets, equitable burden-sharing among donors, and freedom to employ infrastructure and industrial development which generate employment that are outside the scope of USAID. (p.45) and

> Multilateral lending embraces a subtle influence throughout the Third World of encouragement of beneficial adherence to economic patterns of the Free World rather than embracing the communist patterns of development with the assistance offered by the IFIs being insulated from policy variations of any one member country. (p.45).

These statements are unfortunately not included in the Report's Summary and Conclusion section; they should be. They lend support to the widely accepted view, both in the United States and throughout the world, that the Banks have become the most efficient and cost-effective international instruments to encourage economic and social progress in the world.

This is not meant to imply that the Report is uncritical of the Banks. It is. But of the criticisms or shortcomings contained in the Report, the majority have been identified by the banks themselves and were contained in the internal bank documents which were made available to the Investigators by the Banks. In most cases these self-criticisms of Bank operations have already produced corrective action.

However, some of the criticisms contained in the report do call for additional responses. In my testimony in March before the Subcommittee on Foreign Operations, I enumerated a number of steps which we are and will be pursuing in the banks to improve certain procedures -- steps which I will note shortly.

There are also criticisms in the report which we believe are based on simple misunderstanding of either procedures currently used by the banks or of the roles played by management and the Executive Directors of the member countries. In the remaining section of this statement, let me concentrate on the two areas which are the primary focus of the report and which, unfortunately, reflect this confusion:

1) Auditing and Evaluation Procedures

2) Decision making and the Role of the Executive Directors

I will address both these issues in summary form in this statement and submit for the record more detailed descriptions in the form of annexes.

Audits and Evaluations

A major theme of the Report is that the MDBs should do a much better job in auditing and evaluating their own activities. The Report (p.70) addresses the confusing and interchangeable use of the words "audit" and "evaluation" and comes to essentially the right conclusion: "In this Report, traditional definitions are adhered to in that audit refers to the methodical review and verification of records of account, and evaluation refers to the study and appraisal of the worth of a function or of its product." I would add to the latter "..... and the achievement of the aims originally intended within cost and time factors originally set forth."

Within this general area it is the adequacy of Bank audit procedures which receive the major attention. I believe the Investigators failed to distinguish among the various review and/or audit procedures in the IFI's, and therefore have presented a somewhat incomplete and misleading picture of the system. Annex I is a full description of the program supervision and auditing procedures of the banks including several charts. Let me summarize those procedures.

First, the MDB's exercise control over the use of project funds through requiring international competitive bidding for procurement. The bidding process ensures not only that goods and works are procured in the most efficient and economical manner, but also that procurement is subject to public review and that any controversy concerning a proposed bid award is called immediately to the Bank's attention.

Secondly, disbursement of project funds is made only against documentation of goods received or work completed. Staff members of the Controllers Department regularly take part in supervision missions specifically to review work completed and equipment installed, and to test documentation of statements of expenditure. With the exception of some non-revenue earning projects the Banks also requires the appointment of independent auditors acceptable to them, and the submission of audit reports of reasonable scope and detail.

Quite apart from the control over uses of project funds are the Banks' own internal audit procedures. Each Bank has an internal audit department whose function is to review and determine the soundness, adequacy, and application of systems, procedures, and related internal controls.

Third, all of the Banks are subject to an annual audit performed by an internationally known accounting firm in accordance with generally accepted accounting standards.

Another separate and distinct part of the review process is project supervision. This is the process whereby the IFI staffs review with the borrower the development of design, procurement, costs, finance, staffing, training, and other key aspects of the project. Supervision is a cooperative exercise in problem solving and is part of a continuous process whereby the Banks' activities in helping a project achieve its objectives in turn lead to improvements in future projects.

The final procedure in the review process is that in which the Banks serve the unique function of compiling information on a range of projects in a variety of countries -- the evaluation process. Evaluation consists not only of evaluation of each project, but also of a review of these evaluations to determine the comprehensiveness, internal consistency, and objectivity of the project evaluations.

A review of the World Bank audit procedures conducted by the Congressional Research Service in July 1978 concluded:

> "This paper has discussed the World Bank loan supervision system and the process the international agency uses to oversee its loans. While the World Bank does not perform a comprehensive expenditure audit on all its completed projects, it does use a series of financial and operational controls to supervise its loans. If the system works as described, it would seem the World Bank has an adequate system for monitoring its projects and seeing that its loan funds are used for the purposes intended. Comparisons in this paper indicate that the World Bank procedures are equally or more extensive than those standard for certain U.S. Government loan programs."

Nonetheless, further improvements can be made. In this regard, a number of suggestions made in the Investigators' Report will be quite useful, and we will pursue them.

Specifically, we share the Investigators' opinion that, to the maximum feasible extent, the Banks' auditing systems should be independent and detached from the operational side of the institution. Therefore we support, and will promote, suggestions that:

1. The World Bank's Internal Audit Department should report directly to the President (p.79).
2. In the IDB, the Auditor General should not report to an official with operating responsibilities (p.89).

We also agree with the Investigators' recommendation that regular monitoring of all internal Bank functions should be instituted by the auditing arms of the respective Banks. No internal management system is fault-free; all can be improved.

We, therefore, also support the following recommendations and will press for their adoption within the MDBs:

3. The ADB's evaluation unit should not limit itself to project evaluations; it should also evaluate Bank operations (p.98).

4. The World Bank's Operations Evaluations Department should devote more time and resources to broad review of how well management performs its responsibilities (p.83).

5. The IDB should establish an Audit Committee composed of Executive Directors similar to the ones in the World Bank and the ADB (p.89).

6. The IDB Group of Controllers should evaluate the work of the Auditor General's office (p.89).

7. The IDB Operations Evaluations Office reports should be made available to the EDs (p.90).

Role of Executive Directors

The Report also devotes considerable attention to the question of "who runs the Banks". The Report claims that contrary to what the MDB charters provide the Executive Directors "are more led by management than directing it". To support this charge the Report suggests that the Executive Directors play a limited role in the project review process.

We emphatically believe that the Investigators have misunderstood the proper division of responsibility between the management and member governments. The policy framework for the Banks is set by formal and informal meetings of the Governors of the banks, through numerous bilateral and multilateral meetings at every level, and importantly through the periodic replenishment negotiations -- all conducted by the member governments. The Executive Directors as the permanent representatives of the member governments, then define in detail, set and review all MDB policies. They insure that the banks are managed in conformity with the policies set by the governments, and determine what information and procedures are required to discharge these obligations.

My statement before the Subcommittee on Foreign Operations contained six pages of examples of U.S. policy influence on the MDBs, ranging from appropriate technology and reaching poor to lending for energy development. I would like to supply that list for the record. It demonstrates conclusively that the member governments run the banks, and that the United States has a very great weight in that entire process.

Assuming that the Executive Directors should be involved in a pre-audit of project objectives, including design and conditions to be negotiated, completely misconstrues the complementary but functionally distinct roles of the Executive Directors and management, which has existed since the establishment of the banks with the full understanding and approval of the member governments. Similarly, it is the proper job of Management to plan, negotiate and implement individual projects within the policy framework set by the member governments.

With respect to the project review process the Report similarly misrepresents the role of member governments and Executive Directors in that process. In Annex II i have attached a detailed description of the project review process conducted by the United States including the role of our Executive Directors. It shows clearly that our reviews are thorough in covering all aspects of concern both to the Administration and to the Congress.

Conclusion

In conclusion, I would note again that the Report does not challenge the fundamental premises of U.S. participation in the development banks: that the development of the poorer countries is a U.S. national objective of high priority, that the banks are an extremely cost-effective way through which we can pursue that objective and that United States policy goals are effectively advanced via these institutions.

As I also noted at the outset, the Report -- unlike its summary -- also notes the steps which are being taken by the Bank and the United States to address some of the problems identified in the report. In my statement I have highlighted additional measures which have been taken or planned by the MDBs. Many of the findings in this Report are based upon assessments and evaluations made by Bank managements precisely for the purpose of improving the effectiveness of their loans and operations.

In addition, the Report points the way toward further strengthening of the banks in several areas, most notably the audit and evaluation functions and the flow of information. We have profited from the work of the Surveys and Investigation staff in these areas, and we are initiating additional steps to implement several of their recommendations in the near future.

Finally, let me reiterate the conclusion of my testimony before this Subcommittee on March 21st that we urge you, and the entire Congress, to support the three multiyear replenishments contained in the authorizing legislation before you. We strongly believe that they advance important U.S. foreign policy and economic objectives.

These replenishments were negotiated in full congnizance of the need for budget austerity. The proposed replenishment of the IDB -- which accounts for 85 percent of the funding included in the bill -- calls for lower U.S. payments into the Bank during each of the next four years than the payments called for under the previous four year replenishment. As we look out through FY83, we expect no rise in total U.S. payments into the MDBs from the current (and, indeed, FY78) level. The entire growth in these programs will be funded through the use of callable capital, which has never required a single dollar of U.S. budget outlay and which is virtually certain never to do so in the future.

Department of the TREASURY NEWS

WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR IMMEDIATE RELEASE
April 26, 1979

Contact: Robert E. Nipp
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GOLD MEDALLIONS TO BE SOLD BY DIRECT MAIL ORDER

The Treasury announced today that it expects to use a direct mail order system to market the gold medallions to be produced and sold under the American Arts Medallion Act.

Final planning for the production and sale of the medallions will be completed and production begun only after Congress appropriates the necessary funds. Requests for appropriations are under consideration by the Office of Management and Budget. The Treasury expects to be able to initiate sales within nine months after funds become available for expenditure.

If funds are provided this year, the Treasury will offer in 1980 one million medallions each containing a half ounce of gold and bearing the image of singer Marian Anderson and 500,000 medallions containing one ounce of gold and having the image of artist Grant Wood. The reverse side of each medallion will have the inscription "American Arts Commemorative Series," the words giving the amount of gold in the medallion and a design representing the achievement of these artists. Under the Act, medallions containing one million ounces of fine gold and honoring other American artists are to be offered for sale in each of the four ensuing years.

The direct mail order system has been selected as providing the best and least costly method of enabling individuals to obtain medallions at the market value of the gold content of the medallions plus production and distribution costs. In order to assure the maximum opportunity for individual ownership, the number of medallions which any individual would be eligible to buy would be limited. Corporations, including gold dealers and banks, would be subject to the same limitation.

Further information will be provided once funds have been made available and plans can be made final.

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B-1565

Department of the TREASURY NEWS
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FOR IMMEDIATE RELEASE
April 27, 1979

Contact: George G. Ross
202/566-8381

TREASURY ANNOUNCES PUBLIC MEETING TO DISCUSS
USA/ARGENTINA TAX TREATY ISSUES, ON MAY 31, 1979

The Treasury Department today announced that it will hold a public meeting on Thursday, May 31, 1979, to solicit the views of interested persons on issues being considered in negotiations of a prospective income tax treaty between the United States and Argentina.

The public meeting will be held at the Treasury Department, at 2:00 p.m., in room 4121. Persons interested in attending are requested to give notice in writing by May 25, 1979, of their intention to attend. Notices should be addressed to H. David Rosenbloom, International Tax Counsel, Department of the Treasury, Washington, D. C. 20220.

Today's announcement of the May public meeting follows the recent conclusion of a second round of negotiations between representatives of the United States and Argentina to develop an income tax treaty for the avoidance of double taxation and the prevention of tax evasion. There is no income tax treaty now in effect between the two countries.

In the course of the recent negotiations, many subjects of mutual concern were identified and discussed. Among the issues being considered are: the taxes to be covered (and credited); the definition of a "permanent establishment"; the withholding rates at source on dividends, interest, and royalties; the taxation of capital gains; and the taxation of personal property rentals, payments for technical assistance, director's fees, annuities and the profits of shipping and aircraft companies.

The Treasury seeks the views of interested persons in regard to these issues, as well as on other matters relevant to the negotiation of an income tax treaty between the United States and Argentina. The May 31 public meeting is being held to provide an opportunity for an exchange of views, as well as for the purpose of discussing the United States position in regard to the issues presented in the negotiations.

This announcement will appear in the Federal Register of Wednesday, May 2, 1979.

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B-1566

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

FOR IMMEDIATE RELEASE
April 27, 1979

Contact: George G. Ross
202/566-2356

TREASURY ANNOUNCES PUBLIC MEETING TO DISCUSS USA/NORWAY TAX TREATY ISSUES, ON MAY 30, 1979

The Treasury Department today announced that it will hold a public meeting on Wednesday, May 30, 1979, to solicit the views of interested persons on issues being considered in negotiations to amend the income tax treaty between the United States and Norway.

The public meeting will be held at the Treasury Department, at 2:00 p.m., in room 4121. Persons interested in attending are requested to give notice in writing by May 25, 1979, of their intention to attend. Notices should be addressed to H. David Rosenbloom, International Tax Counsel, Department of the Treasury, Washington, D.C. 20220.

Today's announcement of the May public meeting follows the recent conclusion of a second round of negotiations between representatives of the United States and Norway on amendments to the income tax treaty for the avoidance of double taxation and the prevention of tax evasion which has been in effect since 1971.

In the course of the recent negotiations, several subjects of mutual concern were identified and discussed. Among the issues being considered are: Norwegian taxation of income from petroleum resources and other offshore activities; Norwegian reserve requirements for branches of U.S. corporations; withholding rates at source on dividends and interest; the taxation of capital gains; and exchange of information.

The Treasury seeks the views of interested persons in regard to these issues, as well as other matters relevant to the income tax treaty between the United States and Norway. The May 30 public meeting is being held to provide an opportunity for an exchange of views, as well as for the purpose of discussing the United States position in regard to the issues presented in the negotiations.

This announcement will appear in the Federal Register of Wednesday, May 2, 1979.

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

EXPECTED AT 2:30 P.M.
APRIL 26, 1979

PAPER PRESENTED BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY FOR
INTERNATIONAL AFFAIRS
BEFORE THE
AMERICAN SOCIETY OF INTERNATIONAL LAW
WASHINGTON, D.C.

A FRAMEWORK FOR TRADE POLICY IN THE 1980's: THE NEW SUBSIDY/COUNTERVAILING DUTY CODE

Subsidies have become an increasingly important tool of national economic policy in all nations. While they have long been considered critical to development in the LDCs, virtually all industrial nations in recent years have turned to fiscal and other incentives in an effort to help maintain employment, improve industrial efficiency, spur exports and stimulate research and development. In many ways such programs buffer the domestic economy from short-run fluctuations in supply and demand and help ease the long-run adjustment to changes in production and trade. Unfortunately, governments are often also under great pressure to grant subsidies to do just the opposite -- to protect domestic industry from the need to adjust to changing global trade patterns.

The increasing reliance on government support has already distorted trade in many major products, and threatens to become even more prevalent in the next decade. This underscored the importance of strengthening the international rules on subsidies and made an Agreement on Subsidies and Countervailing Measures one of our top priorities in the MTN.

The objective of the MTN Subsidies Code was not to eliminate subsidies entirely, but to set guidelines for the use of subsidies which adversely impact on international trade. International rules needed to be clarified to ensure that countries would not be able to export their domestic economic problems to other countries via export or domestic subsidies. As in Article XVI of the GATT, no distinction was made whether such subsidies were explicit aids to exports or directed in the first instance to domestic production.

On the other side of the coin, new international rules were needed to clarify the kinds of countermeasures that were appropriate in response to subsidized competition. It was recognized that by their nature CVDs are both a tool of economic policy and a political response to the economic programs of other countries. Expanding upon provisions in GATT Articles VI and XXIII, the MTN Code focused on whether the subsidized products caused or threatened injury to foreign producers or seriously prejudiced the reasonable expectations of foreign exporters regarding access to domestic markets.

The Trade Act of 1974, the Congressional mandate for U.S. participation in the Multilateral Trade Negotiations, urged the President to "take all appropriate and feasible steps within his power (including the full exercise of the rights of the United States under international agreements) to harmonize, reduce, or eliminate barriers to (and other distortions of) international trade". The term distortion specifically includes the use of subsidies (Section 102 a and g). The Act also requested the President to update current international agreements making "any revisions necessary to define the forms of subsidy to industries producing products for export and the forms of subsidy to attract foreign investment which are consistent with an open, nondiscriminatory, and fair system of international trade." (Section 121).

We have substantially met these requirements of the Trade Act through the new code. The new code includes the following major components:

-- A reinforcement of the commitment already accepted by most industrial countries not to use export subsidies for industrial products, plus staged expansion of that commitment to LDCs.

-- New international discipline to guard against the disguised protection of domestic markets through internal or production subsidies.

-- Improved discipline over subsidized competition in agricultural products in third markets.

-- Concomitant guidelines on the use of countervailing duties, which would recognize that such duties should be applied only when a subsidy threatens or causes injury to a domestic industry.

-- Prompt recourse to other countermeasures if specific commitments regarding the use of subsidies have not been fulfilled.

-- Effective implementation of rules on both subsidies and countervailing duties, and strengthened provisions on dispute resolution.

-- Acceptance by advanced developing countries of increased obligations on subsidies as their industries become internationally competitive.

The MTN Subsidy/Countervail Code

The code spells out specific rights and obligations for all signatories on both subsidies and CVDs along a basic two-track mechanism:

I. Countervailing Duties

The principal right under Track I of the code is the right to countervail any foreign subsidized export which causes injury to a domestic industry. This includes both domestic and export subsidies, on both agricultural and industrial products, from industrial and developing nations alike. Action by the importing nation, after a determination of injury, is simple and direct. It is completely under the control of the importing nation, with no international review required before action can be taken.

The heart of this part of the Code is the new injury test. The new injury test is a major improvement over similar standards in domestic and international law. For the first time, industries seeking relief will have a clear idea of the standards to be applied and the specific criteria that will be examined in making determinations. The code spells out in detail the procedures to be followed by domestic authorities, but allows a great deal of flexibility to weigh only the particular factors that are affecting the industry under review. It's not a tougher or easier standard than we have applied in dumping cases -- in almost all respects it is completely consistent with the practice of the ITC in its injury determinations under the Trade Act of 1974.

If the subsidized imports are depressing prices, or preventing sales, profits or full employment in our industry, we will consider the industry "injured." But we will not attribute to the imports other factors that may be causing injury as well, such as changes in consumer taste, obsolete facilities or unsubsidized competition.

Furthermore for agricultural products, the new injury test ensures that subsidies of any kind which interfere with domestic support programs may be countervailable.

If U.S. industries are hurt, an injury test will trigger a just response. And, for the first time, we will have the ability to impose provisional measures to protect an industry against subsidized competition even while investigations are still underway.

The introduction of an injury test in U.S. law was the major objective of our trading partners during the negotiations. We have been able to impose CVDs solely on the basis of an existing foreign government bounty or grant. The United States is the only major industrial nation which imposes CVDs without such an injury requirement.

Though it has been strongly resisted by some in the United States who like the automaticity of existing procedures, it has been clear that the fact that the U.S. was not in conformity with the international rules in this area was costing us much more than was justified by the economic protection provided by our "automatic" CVDs. In strict trade terms, our unwillingness to adopt an injury test simply made others unwilling to adopt meaningful limits on their use of subsidies and other trade-distorting practices. Moreover, as long as our production, employment and trade interest are not adversely affected, we should not object if foreign nations undertake to subsidize U.S. consumers through <u>their</u> government budget -- why should we countervail and rob our consumers of this benefit?

II. Other Countermeasures.

Under Track II of the Code, nations have the right to retaliate against any proscribed export subsidies without a finding of injury when specific code obligations have been violated. This both reinforces the discipline of the code itself against such subsidies, and assures effective U.S. reaction whenever the rules are breached.

Nations also have the right to retaliate against domestic subsidies which adversely affect their trade through import substitution. This is particularly important because such domestic subsidies can be used to impair GATT tariff bindings for which we have negotiated reciprocal concessions, and can become an alternative to tariff protection to restrict access to domestic markets. Again, injury does not have to be shown where basic GATT commitments have been violated.

Counteraction can be in the form of increased import duties (CVDs) on the product concerned, or can involve alternative measures in third market or import substitution cases. This provision greatly strengthens international procedures and specifically sanctions for the first time countermeasures against subsidized competition to third markets.

If, for example, a nation grants export subsidies on steel or automobiles sold in a third market which adversely affect U.S. sales in that market, the imposition of countervailing duties on U.S. imports may not be relevant. Instead, the United States would be justified in seeking international approval for countermeasures against imports from the offending nation into the United States.

Similarly, if domestic production subsidies are used in a manner which impairs a GATT tariff binding, retaliatory action is warranted on imports of other goods from the offending nation. If, for example, the European Community were to subsidize the production of soybeans (on which we have a zero-duty tariff binding in the EC), we could request international review and authorization for U.S. retaliatory action against a like amount of EC exports to the United States.

In sum, in cases where injury is shown, the importing country can act against imports unilaterally -- no international mandate is needed. Where commitments are violated, countermeasures can be taken without showing injury after sanction by an international body.

III. Rules on Subsidies

The principal obligation under the new code is a commitment not to use export subsidies on industrial or mineral products. Although most industrial nations have accepted a commitment not to use industrial export subsidies in the past, the addition of mineral products is new, as is the acceptance of commensurate obligations by signatory developing nations. The Code also deals with the problem of the archaic dual-price criterion in the GATT (Article XVI:4) as a prerequisite for action against export subsidies. We have developed an updated list of export subsidy practices which are prohibited per se. As a result, in our view there will be no need to demonstrate dual-pricing for any item on the new, updated list.

Domestic subsidies have been explicitly recognized as subject to the discipline of the new international rules, In using such subsidies to eliminate industrial, economic, and social disadvantages in specific regions, to facilitate the restructuring of certain sectors, to sustain employment and encourage retraining and change in employment, or to encourage research and development programs, nations have agreed to seek to avoid causing serious prejudice to other nations and to consider possible adverse effects on trade and existing conditions of world trade, production, and supply in the product concerned.

With regard to agricultural export subsidies we have achieved a major step toward resolving the main problems in our important agricultural export markets. The new code will prohibit the use of agricultural export subsidies which (a) displace the exports of other or (b) involve material price undercutting in a particular market. These are tighter criteria than the existing GATT Article XVI provision that agricultural export subsidies should not result in a country gaining "more than an equitable share of world trade".

The current Section 301 complaint by Great Plains Wheat, Inc. against EC export subsidies on wheat to Brazil, Poland, the Peoples Republic of China, and other markets where the United States has strong export interests provides a good example of the way in which this new code provision would operate. Great Plains claims that the EC export subsidies result in both a loss of U.S. traditional exports to particular markets and a reduction in world wheat prices.

Either result could serve as the basis for an international review and determination of whether countermeasures are justified. The code thus provides an important international sanction for action which we might want to take under domestic law, but which would violate present international commitments if we just took action unilaterally.

Developing countries which join the code can fulfill the general obligation to refrain from the use of industrial and mineral export subsidies by assuming obligations regarding the use of these subsidies commensurate with their competitive needs. Article 14 of the Code specifically recognizes that export subsidies are an integral part of many development programs, but that they become less necessary as nations develop. The requirement is designed to encourage the phase-out of export subsidies as nations become more advanced, and hence have less need for such practices. Nations which accept these responsibilities under the code receive an assurance that, as their subsidies are phased out, their exports will not be countervailed unless injury is shown.

Brazil, for example, has already announced the phase-out of its major export subsidies over a period of approximately four and half years within the context of the code. Reductions in its export incentives began in January, and will continue at quarterly intervals. This is a significant contribution to improved discipline in the subsidies area, since Brazil has for some years maintained perhaps the largest subsidy program of any major trading country. It is particularly significant for the United States, since Brazil is our eighth largest trading partner.

Beyond Brazil, we expect other advanced developing nations to undertake similar phase-out commitments, tailored to their own situation, and negotiations are actively underway with a number of them. These phase-out commitments become an obligation under the code. Violation of the obligation permits countermeasures under Track II, following international review and agreement, without a finding of injury.

It should be noted that nations which do not accept the obligations of the code, whether industrial or developing, will not receive its benefits. In particular, the United States does not intend to apply the injury test to subsidized exports from those nations that fail to sign the code and assume appropriate obligations. In the absence of such obligations, we would countervail subsidized imports without an injury determination as in the past. It is extremely important to get as broad participation as possible in the MTN code -- and we believe the benefit of recourse to an injury test in the U.S. is a real incentive for accession to it.

DISPUTE SETTLEMENT

International dispute resolution provisions have been tightened considerably under the code. One of the major accomplishments of the subsidies code is in fact the development of dispute settlement provisions with sufficient teeth to ensure that the new rules translate into effective international discipline. The Code provides for prompt and expeditious review of international disputes. Cases will be heard and acted upon in a matter of months, not years as with some recent GATT cases. Disputes should normally be resolved within 180 days.

As in all international disputes, bilateral resolution should be first sought through conciliation procedures. If the matter is not resolved within 30 days, however, the Code recognizes the right of any signatory to have a panel of objective experts review the case. Such panels would be charged with reporting to the Committee of Signatories its findings concerning the rights and obligations of the signatories party to to the dispute. The Committee (by its nature a more political body than a panel) would then review the findings, issue recommendations, and authorize counter-measures as appropriate.

What particularly distinguishes these procedures from past GATT practice is the elimination of procedural roadblocks which often have hamstrung international actions. No longer will months go by arguing whether it is appropriate to call a panel to review a dispute, and many more months selecting its members. The Chairman of the Committee shall have 30 days to constitute a panel, and once constituted that panel will have to produce its report within 60 days. The Committee in turn will have only 30 days to review the panel findings and make its recommendations.

I know there are some who will argue that no matter how good the new international rules are, they will not be effectively implemented in domestic law. They cite years of frustration with domestic procedures.

Probably the most basis concern in the past was that CVD cases dragged on with no effective remedies available when they were really needed. The Trade Act of 1974 made significant strides in setting deadlines for preliminary and final determinations, and providing judicial review of all such decisions. U.S. procedures now provide unparalleled opportunities for private parties to initiate and participate in proceedings leading to the imposition of CVDs and to obtain judicial review of administrative decisions.

As a result of implementing the MTN Code, we will adopt the first genuine overhaul of our countervailing duty law in 80 years. This process is now well underway. Consistent with our international commitments we should now have a law that provides, first, for prompt consideration of the twin tests of subsidy and injury; second, for provisional measures within a few months of the filing of a petition -- cutting significantly the time now usually taken before the law "bites;" third, an expanded and much more transparent procedure allowing all interested parties to participate and review information collected; fourth, assured periodic review to update the basis on which CVDS are collected; and, fifth, a system under which we can quickly accept undertakings from foreign governments or exporters to end the injurious effects of subsidies to achieve the aims of the law quickly and effectively.

In particular, much tighter deadlines for the conclusion of investigations will be incorporated in U.S. law. All cases will be resolved in less than the one-year period now prescribed in the Trade Act. Conclusion of CVD investigations will be facilitated by the improved notification and consultation procedures in the code. Information on subsidy practices will be more readily available from foreign goverments, who will have an incentive to supply all relevant data at the start of a case lest their exports be subject to provisional measures while the investigation continues. Information will also be available to interested private parties to ensure the transparency of procedures and the accuracy of the data supplied. Standards for claims of confidentiality will be tightened and non-confidential summaries will be required if confidential information is used.

In addition we will expand upon existing procedures to provide detailed and comprehensive determinations of the nature and amount of foreign subsidy practices. Administrative rules will be developed on the calculation of margins of net subsidies, including the use of offsets. Foreign undertakings to offset the adverse effects of subsidies will be primarily limited to agreements among governments so they can be enforced and properly monitored. We believe such undertakings can provide a valuable channel for quick relief for domestic industries, and it is important that the Administration maintain the discretion to enter into such arrangements. Retroactive countermeasures will be available to ensure that such undertakings are not violated. All in all, the new procedures will provide for the open and expeditious resolution of subsidy complaints.

There has also been concern about what practices were considered bounties or grants under our CVD law. The new code clarifies this matter and plainly recognizes that all subsidies, both export and domestic, are liable to CVD action, depending on the effects of the subsidized goods on international trade.

Finally, a word about the past waiver of CVDs. The Congress included authority in the Trade Act to waive CVDs under three strict conditions to facilitate negotiation of the MTN subsidies code while still guarding the interests of affected domestic industries.

We believe that the waiver has served it purpose:

-- In almost every case, we have gotten substantial reductions in the amount of the subsidy.

-- The waiver has allowed the MTN negotiations to continue on agriculture, enabling us to gain new and important concessions for U.S. agricultural exports.

-- The waiver has provided a bridge to facilitate acceptance by several developing countries of increased responsibilities in the world trading sytem. For example, the Brazilian commitment to phase out its major export subsidies completely was clearly promoted by our unwillingness to waive on several specific products early in this Administration and our willingness to do so, under proper conditions, in the textile case last November. Uruguay, in return for a waiver on particular products, likewise agreed to phase out all of its export subsidies over a four-year period.

CONTINUING PROBLEMS

The new subsidy/countervailing duties code will not solve all of the international problems regarding the use of subsidies. Export credits and investment incentives are two major areas which the new code does not address firmly. The United States is seriously concerned about the potential for friction in both of these areas in the future, if positive steps toward improved cooperation are not achieved soon. These issues are being dealt with in other fora.

We had hoped that the International Arrangement on Official Export Credits, which was concluded by 22 countries plus the European Community in early 1978, would form the basis for cooperation among the major trading nations to curb excessive competition in the use of official export credits. It is a significant agreement, but further action is necessary to restrain aggressive government financing practices and reduce the element of subsidy in official export credit financing.

At the direction of both the President and the Congress, we negotiated throughout the latter part of last year in an effort to expand the scope and tighten the terms of the Arrangement. We have seen no real progress to date, however, and now find the only realistic alternative is to meet foreign official export credit financing through aggressive action by our own Export-Import Bank. While we hope there will be improved international cooperation in this crucial area, we cannot and will not permit unfair financing of exports by foreign official export credit agencies to deprive U.S. exporters of sales.

Problems in the investment area are becoming more serious as well. There is no system of international rules for investment similar to those for trade in the GATT, as now enhanced by the subsidy/CVD code. We have been addressing investment problems in a number of international fora and will continue to pursue the resolution of especially difficult problems both multilaterally and bilaterally.

We have had particular problems with government intervention in the investment process. This takes many forms, but it usually combines two basic features: incentives to attract the investment in the first place and performance requirements, including offset requirements, to assure that the U.S. firm contributes to the priority economic and social goals of the host government. These performance requirements typically focus upon local job creation, minimum local value-added, and technology transfer.

In recent years, offset requirements have been most common in the area of defense procurement but they are quickly spreading to the non-defense area as well. Foreign governments frequently require that, for a U.S. firm to do business with the government, it must agree to transfer technology to the nation by means of licensing or co-production agreements. Although inconsistent with the spirit of the GATT and the concept of an open multilateral trade and payments system, these requirements are rapidly becoming a pervasive feature of the world economy.

A major objective of U.S. policy must be to achieve multilateral discipline on such incentives and other interventions, both to maintain an open investment environment and to avoid our being forced into the adoption of emulative countermeasures. With offshore output by multinational firms now approaching a value of $1 trillion, it is anomalous that no such discipline now apply to the international investment process.

CONCLUSION

The subsidy/CVD code has therefore not solved all the problems of defining and assuring "fair international trade." But it marks a major step in the direction of doing so.

In particular, the new code provides new guidelines regarding the use of subsidies in the following areas:

(1) We have a much stronger prohibition of industrial export subsidies, complemented by an updated list of prohibited export subsidy practices. This new list includes such practices as export inflation insurance, exchange risk guarantees, and duty drawbacks in addition to items carried over from the previous GATT list.

(2) There is an explicit recognition that countries must accept responsibility for the trade effects of their

domestic subsidy programs, and express commitments that they will avoid granting such subsidies that adversely affect the trade interests of other countries.

(3) Domestic subsidies which impair GATT tariff bindings through import substitution are subject to contermeasures as a violation of GATT commitments. Such subsidies may include, but are not limited to, regional development grants, research and development grants, government provision of infrastructure services, and government financing of commercial enterprises, including provision of loans and guarantees on non-commercial terms.

(4) Export subsidies on industrial products to third markets are subject to countermeasures, as are export subsidies on agricultural products which displace the exports of others or involve material price undercutting in a particular market.

(5) The code permits for the first time the use of provisional measures before the application of countervailing duties. Provisional measures may be applied after a preliminary subsidy determination, for a period of up to four months.

(6) Developing countries for the first time are agreeing to phase out the use of export subsidies as part of their obligations, commensurate with their competitive needs, under the new code.

(7) We have an improved framework for conducting domestic countervailing duty investigations. Domestic industries will have a clearer idea of what is required to prove injury, more transparent proceedings, and consistency in the application of the injury test.

(8) Finally, tight deadlines (a maximum of 180 days) on the dispute resolution process assure prompt international review of subsidies which violate code or other GATT commitments.

The code provides a much more effective basis for the resolution of international subsidy problems then has existed in the past, or could possibly exist in the future without the code. It is an essential component of the package of agreements we have achieved as part of the Multilateral Trade Negotiations to deal with the major trade problems of the 1980s.

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

FOR IMMEDIATE RELEASE
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TREASURY ANNOUNCES DEPRECIATION CHANGES FOR TWO TYPES OF PROPERTY

The Treasury Department today announced revisions in the classification, asset guideline periods, asset depreciation ranges and annual repair allowance percentages relating to two types of property--industrial steam plants, and waste reduction and resource recovery plants.

The changes, incorporated in a new Revenue Procedure (Rev. Proc. 79-26) to be published in the Internal Revenue Bulletin 18 of April 30, 1979, are to be effective for property first placed in service in taxable years beginning after December 31, 1978, for taxpayers electing the Class Life Asset Depreciation Range System of depreciation.

The changes apply to:

-- privately owned steam or power plants used in industrial processes, and

-- waste reduction and resource recovery plants that produce steam and electricity by burning garbage.

In both cases, the changes have the effect of speeding up depreciation for federal income tax purposes. The changes are the result of a continuing program of study and updating of the classes and depreciation guidelines under the CLADR System. The CLADR System classes affected by these changes are attached.

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Asset Guideline Class	Description of Assets Included	Asset Depreciation Range (in years) Lower Limit	Asset Guideline Period	Upper Limit	Annual Asset Guideline Repair Allowance Percentage
49.5	Waste Reduction and Resource Recovery Plants:				
	Includes assets used in the conversion of refuse or other solid waste or biomass to heat or to a solid, liquid, or gaseous fuel. Also includes all process plant equipment and structures at the site used to receive, handle, collect, and process refuse or other solid waste or biomass to a solid, liquid, or gaseous fuel or to handle and burn refuse or other solid waste or biomass in a waterwall combustion system, oil or gas pyrolysis system, or refuse derived fuel system to create hot water, gas, steam and electricity. Includes material recovery and support assets used in refuse or solid refuse or solid waste receiving, collecting, handling, sorting, shredding, classifying, and separation systems. Does not include any package boilers, or electric generators and related assets such as electricity, hot water, steam and manufactured gas production plants classified in classes 00.4, 49.13, 49.221, and 49.4. Does include, however, all other utilities such as water supply and treatment facilities, ash handling and other related land improvements of a waste reduction and resource recovery plant..	8	10	12	15

Asset Guide-line Class	Description of Assets Included	Asset Depreciation Range (in years) Lower Limit	Asset Guide-line Period	Upper Limit	Annual Asset Guideline Repair Allowance Percentage
00.4	Industrial Steam and Electric Generation and/or Distribution Systems: Includes assets, whether such assets are section 1245 property or 1250 property, providing such assets are depreciable, used in the production and/or distribution of electricity with rated total capacity in excess of 500 Kilowatts and/or assets used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in his industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in section 1.48-1(e) of the regulations. Assets used to generate and/or distribute electricity or steam of the type described above but of lesser rated capacity are not included, but are included in the appropriate manufacturing equipment classes elsewhere specified. Also includes electric generating and steam distribution assets, which may utilize steam produced by a waste reduction and resource recovery plant, used by the taxpayer in his industrial manufacturing process or plant activity. Steam and chemical recovery boiler systems used for the recovery and regeneration of chemicals used in manufacturing, with rated capacity in excess of that described above, with specifically related distribution and return systems are not included but are included in appropriate manufacturing equipment classes elsewhere specified. An example of an excluded steam and chemical recovery boiler system is that used in the pulp and paper manufacturing industry..................................	17.5	22	26.5	2.5

Asset Guide-line Class	Description of Assets Included	Asset Depreciation Range (in years) Lower Limit	Asset Guide-line Period	Upper Limit	Annual Asset Guideline Repair Allowance Percentag[e]
49.13	Electric Utility Steam Production Plant: Includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle with a conventional steam unit and related land improvements. Also includes package boilers, electric generators and related assets such as electricity and steam distribution systems as used by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others....................	22.5	28	33.5	5
49.221	Gas Utility Manufactured Gas Production Plants: Includes assets used in the manufacture of gas having chemical and/or physical properties which do not permit complete interchangeability with domestic natural gas. Does not include gas producing systems and related systems used in waste reduction and resource recovery plants which are elsewhere classified.........................	24	30	36	2
49.4	Central Steam Utility Production and Distribution: Includes assets used in the production and distribution of steam for sale. Does not include assets used in waste reduction and resource recovery plants which are elsewhere classified...	22.5	28	33.5	2.5

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REMARKS BY THE HONORABLE C. FRED BERGSTEN
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
PENNSYLVANIA INTERNATIONAL TRADE CONFERENCE
HERSHEY PARK, PENNSYLVANIA

The New U.S. Export Policy

Both the U.S. Government and U.S. business as a whole are finally recognizing that exports are essential. They are essential to the overall strength of the U.S. economy. They generate a substantial number of jobs. And they are a significant element in determining the strength of the U.S. dollar.

Exports are clearly critical to both the U.S. private sector and to Federal Government economic policies:

-- Until a few years ago, the U.S. economy accounted for over 50 percent of the world economy; now, the market in the rest of the world is bigger than the U.S. market for virtually every industry.

B-1570

-- <u>Exports have been one of the fastest growing sectors of the U.S. economy</u>. Between 1972 and 1976 total U.S. production of manufactured goods grew by 57 percent, while our exports of manufactured goods grew more than twice as fast. Agricultural exports during this period nearly tripled, as compared to a growth of about 70 percent for domestic agricultural production as a whole.

-- <u>One out of every eight manufacturing jobs in this country produces for export</u>. That's more than 2 million manufacturing jobs in the economy as a whole which depend on exports. For example, in 1976 exports accounted for:

- 63 percent of total U.S. production of oilfield machinery;
- 43 percent of U.S. production of construction machinery;
- 35 percent of U.S. aircraft production;
- 32 percent of U.S. production of turbines and turbine generators;
- 26 percent of all computers and related equipment we produce;
- 24 percent of U.S. pumps and compressors; and
- 18 percent of U.S. farm machinery.

-- <u>One out of every three acres of American farm land produces for export</u>. In fiscal year 1977 we exported:

- 60 percent of our soybeans and soybean products;
- 58 percent of our cattle hides;
- 58 percent of our almonds;
- 55 percent of our rice;
- 45 percent of our cotton;
- 40 percent of our wheat; and
- 30 percent of our tobacco.

-- Many jobs in the coal mining and mineral industries, as well as a considerable number in the fishing industry, are dependent on overseas sales. Exports also support employment in the trucking, rail transport, insurance, and other service industries.

-- Almost one out of every three dollars of U.S. corporate profits now derives from the international activities of U.S. firms, including their foreign investments as well as their exports.

-- Pennsylvania, in particular, depends upon exports for more than $4.7 billion in sales of manufactured goods, $135 million in agricultural goods, and $345 million in mineral goods (all figures are for 1976 or FY 1977). This state is the nation's seventh largest exporter of manufactured goods. More than 150,000 jobs in Pennsylvania are dependent upon exports of manufactured goods, about one of every nine manufacturing jobs in the state. Non-electric machinery, electric equipment, and transportation equipment are Pennsylvania's largest exports, accounting for $2.6 billion in overseas sales in 1976. The state's manufactured exports doubled between 1972 and 1976, with about three-fifths of the increase in electric equipment production and a third of the rise in production of nonelectric machinery and transportation equipment due to exports. One of every fourteen dollars in Pennsylvania farm sales also comes from exports.

In 1970 combined U.S. exports and imports accounted for 8-1/2 percent of our Gross National Product (GNP). By 1978 the share of total trade in our GNP had nearly doubled to 15 percent -- with a bit more than a 6-1/2 percent share for exports and nearly 8-1/2 percent for imports. This difference of almost 2 percent in our import and export shares accounts for our 1978 trade deficit of $34 billion. Although we don't need to eliminate this gap -- which is paid for in large part by net exports of services ($23 billion in 1978) -- we <u>should</u> reduce it substantially.

<u>A healthy and expanding export sector is essential for the long-run stability of our external accounts and thus of the dollar</u>. Indeed, increased U.S. exports are by far the most constructive response to our trade balance and dollar problems.

We have already seen significant improvement in our trade balance as export growth has increased. Over the past year, our trade deficit has been reduced by almost 40 percent. Indeed, between the first quarter and fourth quarters of 1978, the physical volume of U.S. exports grew at a 22 percent annual rate while the volume of imports rose at only a one percent rate.

During the third quarter of 1978, the U.S. share of world export markets for manufactured goods rose to 17.3 percent on a seasonally adjusted basis. This is more than a full percentage point above the first quarter trough of 16.2 percent. It was the second straight quarter of improvement, and confirms that a reversal has taken place in the U.S. market position, which had been deteriorating since 1976.

Still more however, needs to be done to increase U.S. exports -- both to pay for our oil and non-oil imports and to benefit our economy as a whole.

Increasing U.S. Exports

In recognition of the importance of exports to the U.S. economy, last year this Conference urged the President to encourage the growth of U.S. exports through an active Export-Import Bank program, tax incentives similar to DISC, Commerce and State Department promotion programs, and the Tokyo Round of Multilateral Trade Negotiations. You also called for reduced impediments to U.S. exports in such areas as the overseas application of anti-trust laws, taxes on private sector employees based abroad, the prohibition of Eximbank credits for many markets, taxation of foreign manufacturing facilities owned by Americans, and embargos on U.S. trade with selected countries.

Your proposals were given full consideration, along with suggestions from other U.S. industrial and trade groups, Congressmen, and others, in preparing the new U.S. export policy announced by President Carter in September 1978. At that time the President announced a number of new measures designed to stimulate increased exports. He expressed his commitment to this effort as a matter of high national priority.

The new U.S. export policy aims to:

(1) provide increased direct assistance to U.S. exporters;

(2) reduce domestic barriers to exports; and

(3) reduce foreign barriers to our exports and secure a fairer international trading system for all exporters.

The U.S. Government has taken a number of steps to further these goals, and I would like to summarize these for you shortly.

We fully recognize, however, that exports cannot be increased in a vacuum, without regard to the broader macroeconomic situation in the U.S. economy and in the world as a whole. If domestic inflation is too high, relative to inflation overseas, U.S. products will be priced out of foreign markets. If the productivity of

U.S. industries is stagnating, while productivity abroad is increasing rapidly, we will not be able to maintain our competitive edge, either at home or abroad. If exchange rates are distorted and act to increase the effective cost of buying U.S. goods, we cannot expect to sell as much as we should be able to. If foreign nations are growing more slowly than the United States -- and the differential is significant -- U.S. imports will continue to increase at a faster pace than our exports.

Efforts to increase U.S. exports through active encouragement by the U.S. Government and increased involvement by the U.S. business community in foreign markets must be complemented by general economic policies which will foster improved U.S. price stability, better U.S. productivity, realistic exchange rates, and increased growth overseas. We have been working hard in all of these areas, with success in some, but much more to do in others. The international community's reliance on more flexible exchange rates, concerted efforts to counter speculative distortions of rates when they are well out of line with underlying realities, and the narrowing of U.S. and foreign growth differentials should all help to create an environment which is more conducive to U.S. exports.

Inflation, however, remains our number one national problem and must be reduced.

We must also overcome our low rate of productivity growth. U.S. output per manhour in the manufacturing industries increased only slightly more than 25 percent between 1970 and 1976, while Japanese productivity grew by more than 50 percent, and German, French and Italian productivity grew by more than 35 percent. Last year, American manufacturing productivity grew by an abysmal 0.8 percent. One of the most important factors behind this slow growth has been the virtual halt in capital accumulation since 1974. A stronger dollar should enhance the environment for portfolio investment. Our anti-inflation program will help restore after-tax real profits. And the recently enacted tax program should assist investment through a cut in the corporate rate, a reduction in capital gains taxation, and an improved investment tax credit. U.S. industry must also place greater emphasis on investment and new research and development to keep pace with changing market tastes and demands, particularly in those areas in which we can be most competitive both at home and abroad.

The U.S. Government has also taken a number of steps to spur export growth in particular. New measures which the President announced in September 1978 include:

-- A proposed $500 million increase in the Eximbank's direct loan authority to a record $4.1 billion for FY 1980 to help improve the Bank's competitiveness and flexibility in terms of interest rates, length of loans, and percentage of transaction financed. This is in keeping with strong Administration support for steady, sharp increases in the Bank's activities since FY 1977, when actual financing dropped to a recent low of $700 million.

-- Loan guarantees of up to $100 million by the Small Business Administration to help small exporters.

-- An additional $20 million for Commerce and State export development programs.

-- Careful review by Executive departments and independent regulatory agencies of the possible adverse effects on our exports of major adminstrative and regulatory actions, including the use of export controls for foreign policy purposes.

As the President noted in his export policy message, "Increasing U.S. exports is a major challenge -- for business, for labor, and for government. Better export performance by the United States would spur growth in the economy. It would create jobs. It would strengthen the dollar and fight inflation.

There are no short-term, easy solutions. But the actions I am announcing today reflect my Administration's determination to give the United States trade deficit the high-level, sustained attention it deserves. They are the first step in a long-term effort to strengthen this Nation's export position in world trade."

Actions Since September, 1978

To implement this new policy, a number of specific measures have been adopted since September:

-- Eximbank has instituted useful new programs to encourage smaller exporters, agricultural commodity sales, and engineering and construction services. It has also undertaken major efforts to meet foreign competition by matching foreign terms for direct loans and other measures.

-- Commerce has begun work on a computerized information system which will provide exporters with prompt access to international marketing opportunities abroad and will expose American products to foreign buyers.

-- State plans to increase the number of commercial officers in the key Near East market.

-- A comprehensive interagency study of direct Federal export disincentives is underway, with a final report due in June.

-- OMB has directed regulatory agencies to undertake a detailed analysis of how the U.S. foreign trade position would be affected by any significant regulations which they propose.

-- The Commerce Department has developed new procedures to assure that export consequences are taken fully into account when considering export control regulations and to give weight to foreign availability in the administration of export controls for foreign policy purposes.

-- Commerce and Justice are preparing written guidance for the business community on the scope and meaning of the Foreign Corrupt Practices Act to help reduce some of the uncertainty about the application of this statute.

-- A Business Advisory Council has been created to advise the National Commission for the Review of Antitrust Laws and Procedures and has offered recommendations which have been adopted by the Commission in its report to the President.

-- The Justice Department has instituted new procedures to reduce the time required for processing requests for guidance on export-related issues under its business review procedure.

-- President Carter has issued an Executive Order which exempts export licenses from environmental reviews and reduces uncertainties about environmental requirements for other exports.

The Federal Government has also made decisions in a number of cases since September which reflect the Administration's commitment to increase exports and to carefully weigh the impact on U.S. trade of potential controls on exports for foreign policy reasons. A number of these decisions involved both foreign policy and economic considerations of some importance, and might not have resulted in U.S. export sales under previous Administration guidelines.

-- The Commerce Department has authorized the export of $280 million of flat-bed trucks and commercial aircraft to Libya on the basis of a determination that these would not be used for military purposes.

-- Over $200 million in technical data and equipment for exploration and production of petroleum and natural gas in the Soviet Union have been authorized for export since the imposition of special controls in August 1978.

-- The Administration has decided to permit the sale of a $6.8 million American computer system to the Soviet Union's official press agency, Tass, to help in its handling of the 1980 Olympics. This decision was based on modifications in the original application and a decision that national security would not be compromised by the sale.

-- Eximbank has also issued a letter of interest in financing $270 million worth of hydroturbines to Argentina.

In each of these cases the decisions have been difficult and have had to weigh a number of factors. National security, human rights, or environmental and safety considerations must be taken into account in final export control decisions. But it is evident from these recent cases that the Administration is making a real effort to tilt toward exports when borderline cases might otherwise result in denial of export licenses.

The recent defeat of Congressional amendments which would have denied the provision of export credits by Eximbank to certain countries for reasons of human rights seems to indicate that Congress is tilting in this direction as well, while maintaining our overall commitment to improve human rights in the most effective manner.

Benefits From the MTN

Our export strategy has been essentially two-fold: (1) preferably, to get others to cease or reduce government intervention in international trade or (2) to match their intervention or retaliate ourselves where necessary to assure U.S. export and import-competing industries alike a fair shake in international trade. We believe strongly in the free market system as the most efficient way to allocate scarce resources both at home and abroad. Further reducing international barriers to trade should benefit all nations. But we must also reduce and regulate the use of government subsidies which distort normal trade and investment patterns.

The recently concluded Multilateral Trade Negotiations have provided a major step forward in reducing both traditional tariff barriers and regulating government intervention in such areas as subsidies, government procurement and safeguards.

Under the new agreements, the United States will be a major beneficiary of tariff cuts averaging 30 percent or more on $100 billion of imports of manufactures by the other industrial nations. One agreement alone, that providing for duty-free treatment on trade in civil aircraft, will affect several billion dollars in U.S. exports. The United States also has obtained concessions covering more than $4 billion in annual U.S. agricultural exports. These figures will be augumented by industrial and agricultural trade agreements still being worked out with a number of developing countries.

As for the non-tariff measure codes, that on government procurement alone will open up $20 billion in present procurement by foreign nations, compared to some $12 billion in U.S. procurement which will be opened to foreign bidding. The codes on customs valuation, licensing and standards cannot be easily quantified, but restrictive practices in all three areas can have an even more distortive effect on trade than tariff barriers; we expect significant benefits to U.S. exporters from their adoption. Moreover, all the codes include provisions for publishing rules and procedures and for resolution of disputes, which will enable redress when they are the targets of discriminatory treatment.

We are especially pleased with the new subsidy/countervailing duty code, which addresses one of the most contentious issues in international trade in recent years: the increasing tendency for governments to intervene in both domestic and international markets to stimulate exports or increase domestic production in a manner that distorts the trade of other nations.

The United States made the conclusion of such a code our number one priority in the Multilateral Trade Negotiations, as an essential element of future trade cooperation.

The new code provides much stronger guidelines to regulate the use of subsidies and countervailing duties, improved enforcement against unfair subsidy practices, and much better dispute resolution procedures. The United States has been particularly encouraged by the decision of Brazil to formally join the new code and to agree to phase out its use of export subsidies in the years ahead. Other developing nations, including Mexico and India, have given strong indications that they will join as well.

These are major steps which should benefit U.S. exports. The benefits, however, cannot be realized overnight. Some of the new Administration programs will take time to develop and implement. Commerce's new computer information system, for example, will not be in operation until at least 1980. Response of small businesses to new loans offered by the Small Business Administration has been slow. Other measures to reduce Government disincentives to export are still under review. The new U.S. export policy necessarily looks toward the future, but can't promise results tomorrow.

Calls for Even Greater Efforts

More may well be needed. The National Governors Association, representing the Governors of all of the American states, has called for further efforts to reduce delays in processing export license applications; decisions in export control cases which place greater emphasis on the effectiveness of U.S. controls in achieving policy objectives and on foreign availability; and advance notice for new export controls.

The Senate Subcommittee on International Finance has proposed the reorganization of the Executive Branch to support exports; revision of anti-trust regulations to permit collaboration of industrial and agricultural firms for export (including trading companies on the Japanese and Korean models); further expansion of export promotion programs with greater attention to exports of services and to small businesses or firms new to exporting; tax incentives for research and development and exports; the tripling of Eximbank FY 1980 lending authority (to $12 billion), provision of mixed credits and joint financing, and Eximbank participation in trade with <u>all</u> countries; and further reduction of government disincentives to exports.

The Administration will give these suggestions full consideration in its continuing efforts to improve U.S. exports. More must be done by U.S. business, as well, to improve the business community's awareness of the importance of exports, to take advantage of export opportunities overseas, to produce specifically for the export market, and to concentrate production and research and development efforts in those areas in which the United States can be most competitive both at home and abroad.

Small and medium-size businesses in particular need to become more involved in exporting. It's clear that most of our corporate resources now lie untapped and that the bulk of U.S. exports come from the largest U.S. corporations traditionally involved in international trade. While many have been suppliers to large exporting firms, smaller firms have found it much more difficult to keep abreast of foreign market opportunities or to meet the initial costs of entering foreign markets and establishing distribution networks.

A number of new Eximbank and Commerce programs will be tailored toward helping small and medium-size businesses overcome present obstacles to exporting through improved information systems, special loans, and assistance to firms and industries with high export potential aimed at promising markets. We welcome further ideas from your membership on programs which would be helpful to assure that small and medium-size businesses can make full use of their flexibility in adapting products to specific markets as part of our overall export effort.

Export Credits

I would like to say a few words in closing about one final area where the U.S. Government has been playing an active role in seeking to reduce foreign government intervention in trade and to meet foreign competition in the use of official export credits. Here again, we are using the two-track strategy of getting other governments to limit their predatory intervention in official export credits, or, if that fails, matching these practices ourselves in some cases.

The competition in this area has been increasingly aggressive over the past year. It includes such practices as subsidized interest rates on official export credits and mixing aid packages with trade to make the credit terms more attractive. We tried to meet this competition through cooperation and negotiation as required by the amended Export-Import Bank Act. We had hoped international negotiations would resolve some of the issues posed by the predatory financing programs of other countries. We were less than wholly successful.

After an extensive series of discussions and meetings, the negotiations were terminated. The gap between what we were willing to accept, and what the others, mainly the Europeans, were willing to offer was simply too broad.

As a result, we are using our own resources much more aggressively to meet the competition. I've already talked about one quantitative aspect of that new, more aggressive posture, the additional $500 million for Exim-bank. Now let me talk about the qualitative aspects.

(1) We are willing to offer long-term loans at interest rates not only well below commercial credit rates but even below Treasury's cost of money, to ensure -- as much as we can -- that U.S. exporters are not disadvantaged in competing with foreign producers supported by concessional export credits abroad.

Some cases in point include exports of a railway control system to Zambia, tractors to Mexico and a thermal electric plant to Korea.

(2) Foreign governments also offer aid mixed with trade, a practice we have termed "mixed credits". Where we have encountered this practice, we have attempted to persuade the foreign government to desist. In some cases, when the foreign government has refused to withdraw the mixed credit, we have matched the terms.

In Cyprus, for example, U.S. exporters of communications equipment were faced with unfair competition from the French. The French Government had mixed aid financing with trade financing, so that the overall interest rate of the package was lower than what our exporters could reasonably match. Eximbank stepped in with some assistance, and our exporters won the contract.

(3) Eximbank is also willing to cover more of the export value than it has in the past to provide long-term, fixed interest rate financing competitive with official credit offered by Europe and Japan. Aircraft exports are a case in point.

The European Airbus has been routinely supported by European official export credit agencies for up to 90 percent of the value of the plane. To match this financing posture, we have moved the Eximbank-supported portion of U.S. aircraft exports up to 90 percent in instances of head-to-head competition with Airbus. We did this recently in the case of Finnair, and the U.S. exporter won the contract.

(4) We also are expanding the range of Eximbank services. Let me give you an example of what I mean. Several European nations offer official export credit support, particularly guarantees of private export credits, denominated in the currencies of other nations, especially the U.S. dollar. This practice allows the Europeans and Japanese more flexibility in meeting the demands of importers who may prefer one currency of repayment, say the dollar, to another currency, say the Japanese yen.

In those areas where the dollar has been used, it means that other nations have been able to use the dollar capital markets to finance their goods. The ability of the exporter to accept either currency in repayment means additional exports for his country, since the buyer can finance his purchases more easily in a currency of his choice.

Eximbank is now willing to offer a comparable service to U.S. exporters. While the Bank does not offer direct credits in a foreign currency, it will now guarantee loans denominated in foreign currencies. This should redress the advantages that other foreign export credit agencies have given their exporters.

It will allow an American exporter to tap foreign currency markets to finance his goods and have the Eximbank guarantee that transaction. This additional service by Eximbank will mean that importers of American goods may consider a wider range of financing sources in paying for that U.S. export, and that should mean an increase in the sales of American exports.

Another example of an expanded service that Eximbank offers concerns guarantees and insurance for construction and service projects in other countries. These guarantees will cover contractors against risks of confiscation, currency inconvertibility, war or the failure of a government owner to settle disputes. It will greatly broaden the financial protection that we offer U.S. exporters of services.

Both the foreign currency and construction guarantee programs are indications of how we intend to meet competition from abroad in the field of export credits. They are tangible proof that we can play an equally aggressive export game against our competitors, especially if we have your help and support.

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

FOR IMMEDIATE RELEASE

April 30, 1979

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $3,004 million of 13-week Treasury bills and for $3,100 million of 26-week Treasury bills, both series to be issued on May 3, 1979, were accepted at the Federal Reserve Banks and Treasury today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 2, 1979			26-week bills maturing November 1, 1979		
	Price	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/
High	97.601	9.491%	9.89%	95.171	9.552%	10.20%
Low	97.597	9.506%	9.90%	95.158	9.578%	10.23%
Average	97.599	9.498%	9.89%	95.162	9.570%	10.22%

Tenders at the low price for the 13-week bills were allotted 53%.
Tenders at the low price for the 26-week bills were allotted 79%.

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

Location	Received	Accepted	Received	Accepted
Boston	$ 52,865,000	$ 31,440,000	$ 45,680,000	$ 25,680,000
New York	5,656,505,000	2,638,510,000	5,175,095,000	2,604,725,000
Philadelphia	43,510,000	24,505,000	8,315,000	8,315,000
Cleveland	49,390,000	29,975,000	28,700,000	25,700,000
Richmond	31,120,000	22,365,000	26,810,000	26,810,000
Atlanta	46,535,000	38,595,000	31,370,000	27,215,000
Chicago	343,210,000	36,220,000	303,810,000	171,510,000
St. Louis	77,490,000	51,190,000	49,065,000	19,065,000
Minneapolis	46,215,000	4,215,000	31,595,000	31,595,000
Kansas City	40,190,000	34,545,000	26,860,000	26,860,000
Dallas	12,810,000	12,810,000	13,335,000	8,335,000
San Francisco	370,145,000	61,945,000	297,200,000	102,190,000
Treasury	17,995,000	17,995,000	22,025,000	22,025,000
TOTALS	$6,787,980,000	$3,004,310,000a/	$6,059,860,000	$3,100,025,000b/

a/Includes $450,515,000 noncompetitive tenders from the public.
b/Includes $276,725,000 noncompetitive tenders from the public.
1/Equivalent coupon-issue yield.

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

FOR IMMEDIATE RELEASE
April 30, 1979

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TREASURY ENDS STAINLESS STEEL
ROUND WIRE INVESTIGATION

The Treasury Department today said it is terminating its antidumping investigation of stainless steel round wire from Japan. This action follows the withdrawal by petitioners of their complaint.

This investigation began on July 29, 1978, after receipt of an antidumping petition from legal counsel representing 17 domestic producers of stainless steel round wire. In February 1979, the investigatory period was extended for three months, and a tentative determination was due by late April 1979.

Stainless steel round wire is covered by the Treasury's "trigger price mechanism," thus allowing the Department to carefully monitor imports of this product.

This termination in no way precludes any party from filing an antidumping petition in the future concerning the same product.

Notice of this action will appear in the Federal Register of May 3, 1979.

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