

ANNUAL REPORT

of the Secretary of the Treasury
on the State of the Finances



FISCAL YEAR 1978

DEPARTMENT OF THE TREASURY

DOCUMENT NO. 3276

Secretary



THE SECRETARY OF THE TREASURY
WASHINGTON

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January 17, 1979

Dear Sirs:

I have the honor to transmit to you
a report on the state of the finances
of the United States Government for the
fiscal year ended September 30, 1978.
This submission is in accordance with
31 U.S.C. 1027.

Sincerely yours,

W. Michael Blumenthal

President of the Senate

Speaker of the House of Representatives

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Secretary, Deputy Secretaries, Under Secretaries, General Counsel, Assistant Secretaries, and Treasurer of the United States serving in the Department of the Treasury from January 21, 1977, through September 30, 1978¹

Term of service		Officials
From	To	
		Secretary of the Treasury:
Jan. 23, 1977		W. Michael Blumenthal, Michigan.
		Deputy Secretaries:
Mar. 3, 1976	Jan. 23, 1977	George H. Dixon, Minnesota.
May 3, 1977		Robert Carswell, New York.
		Under Secretary for Monetary Affairs:
Mar. 30, 1977		Anthony M. Solomon, Virginia.
		Under Secretary (Counselor):
Mar. 30, 1977		Bette B. Anderson, Georgia.
		General Counsel:
Aug. 4, 1977		Robert H. Mundheim, Pennsylvania.
		Assistant Secretaries:
Apr. 11, 1972	Apr. 28, 1977	Warren F. Brecht, Connecticut.
Feb. 28, 1977	Dec. 7, 1977	Laurence N. Woodworth, Maryland.
Mar. 30, 1977		Gene E. Godley, District of Columbia. ²
Mar. 31, 1977		C. Fred Bergsten, New York. ²
Apr. 29, 1977		Roger C. Altman, New York.
Apr. 29, 1977		William J. Beckham, Jr., Michigan.
Apr. 29, 1977		Joseph Laitin, Maryland.
May 16, 1977		Daniel H. Brill, Maryland.
Jan. 30, 1978		Richard J. Davis, New York.
June 26, 1978		Donald C. Lubick, Maryland.
		Fiscal Assistant Secretaries:
July 29, 1975	Dec. 31, 1977	David Mosso, Virginia.
July 5, 1978		Paul H. Taylor, Maryland.
		Treasurer of the United States:
Aug. 3, 1977		Azie T. Morton, Virginia.

¹ For officials from Sept. 11, 1989, to Jan. 20, 1977, see exhibit 62, 1977 Annual Report.

² Act of May 18, 1972, provided for two Deputy Under Secretaries, to be designated Assistant Secretaries by the President as desired.

PRINCIPAL ADMINISTRATIVE AND STAFF OFFICERS OF THE DEPARTMENT OF THE TREASURY AS OF SEPTEMBER 30, 1978

Secretary of the Treasury.....	W. Michael Blumenthal
Deputy Secretary of the Treasury.....	Robert Carswell
Under Secretary for Monetary Affairs.....	Anthony M. Solomon
Under Secretary	Bette B. Anderson
General Counsel.....	Robert H. Mundheim
Office, Secretary of the Treasury:	
Executive Assistant to the Secretary	Curtis A. Hessler
Executive Assistant to the Secretary	Richard W. Fisher
Confidential Assistant to the Secretary	Lisa Astudillo
Office, Deputy Secretary of the Treasury:	
Inspector General	Leon Wigrizer
Executive Assistant to the Deputy Secretary	David W. Heleniak
Executive Secretary.....	(Vacancy)
Deputy Executive Secretary	Steven L. Skancke
Special Assistant to the Secretary (National Security)	J. Foster Collins
Office, Under Secretary for Monetary Affairs:	
Assistant Secretary (International Affairs)	C. Fred Bergsten
Deputy Assistant Secretary for Trade and Investment Policy	Gary C. Hufbauer
Deputy Assistant Secretary for Commodities and Natural Resources.....	Helen B. Junz
Deputy Assistant Secretary for International Monetary Affairs.....	F. Lisle Widman
Deputy Assistant Secretary for Developing Nations	Arnold Nachmanoff
Deputy to the Assistant Secretary for Saudi Arabian Affairs	Lewis W. Bowden
Deputy to the Assistant Secretary and Secretary of IMG (International Monetary Group).....	George H. Willis
Inspector General	Weir M. Brown
Fiscal Assistant Secretary	Paul H. Taylor
Deputy Fiscal Assistant Secretary	(Vacancy)
Assistant Fiscal Assistant Secretary (Banking)	John A. Kilcoyne
Assistant Fiscal Assistant Secretary (Financing).....	Philip J. Fitzpatrick
Assistant Fiscal Assistant Secretary	Lester W. Plumly
Office, Under Secretary:	
Special Assistant to the Under Secretary.....	Faye P. Hewlett
Assistant Secretary (Administration).....	William J. Beckham, Jr.
Deputy Assistant Secretary (Administration)...	Patricia M. Harvey
Director, Office of Administrative Programs ...	Robert R. Fredlund
Director, Office of Audit.....	Wilbur R. DeZerne
Director, Office of Budget and Program Analysis	Arthur D. Kallen
Director, Office of Computer Science	Francis A. McDonough
Director, Office of Equal Opportunity Program	David A. Sawyer
Director, Office of Management and Organization	J. Elton Greenlee
Director, Office of Personnel.....	Morris A. Simms

Assistant Secretary (Enforcement and Operations) ..	Richard J. Davis
Deputy Assistant Secretary (Operations)	William T. Archey
Deputy (Regulatory and Trade Affairs) ...	Stephen M. Creskoff
Director, Office of Operations	John W. Mangels (acting)
Deputy Assistant Secretary (Enforcement)	Arthur Sinai
Director, Foreign Assets Control	Stanley L. Sommerfield (acting)
Director, Interpol (National Central Bureau) ..	Louis B. Sims
Treasurer of the United States	Azie T. Morton
Assistant to the Treasurer of the United States ..	Joan T. Thornell
Office, General Counsel:	
Deputy General Counsel	Henry C. Stockell, Jr.
Assistant General Counsel and Chief Counsel,	
Internal Revenue Service	Stuart E. Seigel
Assistant General Counsel	Wolf Haber
Assistant General Counsel	Russell L. Munk
Assistant General Counsel	Hugo A. Ranta
Counselor to the General Counsel	Forest D. Montgomery
Director of Practice	Leslie S. Shapiro
Deputy to the General Counsel for Tariff Affairs ..	Peter D. Ehrenhaft
Assistant Secretary (Tax Policy)	Donald C. Lubick
Deputy Assistant Secretary (Tax Policy)	Daniel I. Halperin
Deputy Assistant Secretary (Tax Policy) (Tax	
Analysis)	Emil M. Sunley
Associate Director, Office of Tax Analysis	Harvey Galper
Tax Legislative Council	John M. Samuels
International Tax Council	H. David Rosenbloom
Director, Office of Industrial Economics	Karl Ruhe
Assistant Secretary (Legislative Affairs)	Gene E. Godley
Deputy Assistant Secretary (Legislative Affairs)	Lawrence M. Baskir
Deputy Assistant Secretary (Legislative Affairs)	Colbert I. King
Special Assistant to Assistant Secretary	B. Alexander Kress
Special Assistant to Assistant Secretary	Lawrence F. O'Brien III
Special Assistant to Assistant Secretary	Leslie J. Barr
Assistant Secretary (Economic Policy)	Daniel H. Brill
Deputy Assistant Secretary for Domestic Economic	
Analysis	Beatrice N. Vaccara
Director, Office of Financial Analysis	John H. Auten
Deputy Assistant Secretary for International Eco-	
nomomic Analysis	John R. Karlik
Assistant Secretary (Domestic Finance)	Roger C. Altman
Deputy Assistant Secretary for Capital Markets	
Policy	Stephen J. Friedman
Director, Office of Securities Markets Policy ...	(Vacancy)
Director, Office of Capital Markets Legislation ..	Gordon Eastburn
Deputy Assistant Secretary for State and Local	
Finance	Donald H. Haider
Director, Office of Municipal Finance	(Vacancy)
Director, Office of New York Finance	John J. McLaughlin
Deputy Assistant Secretary (Debt Management) ...	Richard M. Kelly
Senior Adviser (Debt Research)	Edward P. Snyder
Director, Office of Government Financing	Francis X. Cavanaugh
Director, Office of Market Analysis and Agency	
Finance	Roland H. Cook
Director, Office of Revenue Sharing	Bernadine N. Denning
Assistant Secretary (Public Affairs)	Joseph Laitin
Deputy Assistant Secretary	Everard Munsey

BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

Director	(Vacancy)
Deputy Director	John G. Krogman
Assistant Director (Administration)	William J. Rhodes
Assistant Director (Criminal Enforcement)	Miles Keathley
Assistant Director (Inspection)	Jarvis L. Brewer
Assistant Director (Regulatory Enforcement)	Stephen E. Higgins
Assistant Director (Technical and Scientific Services)	Michael Hoffman
Chief Counsel	Marvin J. Dessler

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Comptroller of the Currency	John G. Heimann
First Deputy Comptroller	(Vacancy)
Deputy Comptroller for Operations	H. Joe Selby
Deputy Comptroller for Policy Planning	Cantwell Muckenfuss
Deputy Comptroller for Bank Supervision	Paul M. Homan
Deputy Comptroller (Special Surveillance)	(Vacancy)
Deputy Comptroller for Administration	James T. Keefe
Deputy Comptroller for Specialized Examinations	Dean E. Miller
Deputy Comptroller (Research and Economic Programs)	(Vacancy)
Deputy Comptroller for Interagency Coordination	David C. Motter
Chief National Bank Examiner	Charles B. Hall
Special Assistant to the Comptroller	Charles Van Horn
Special Assistant to the Comptroller	Stuart Gordon
Special Assistant to the Comptroller (Congressional Affairs)	Donald A. Melbye
Special Assistant to the Comptroller (Communications)	Samuel Kaplan
Associate Deputy Comptroller—Bank Organization and Structure	(Vacancy)
Associate Deputy Comptroller (Consumer Programs)	Thomas W. Taylor
Director, Customer and Community Programs	Jo Ann Barefoot

BUREAU OF ENGRAVING AND PRINTING

Director	Seymour Berry
Deputy Director	Everett J. Prescott
Assistant Director (Administration)	(Vacancy)
Assistant Director (Operations)	Sadie Mitchell (acting)
Assistant Director (Research and Engineering)	(Vacancy)

FEDERAL LAW ENFORCEMENT TRAINING CENTER

Director	Arthur F. Brandstatter
Deputy Director	(Vacancy)
Associate Director for Administration	David W. McKinley
Associate Director for Training	Dale C. Mitchum
Assistant Director (Criminal Investigator Training Division)	William H. McClarin
Assistant Director (Police Training Division)	Alvin C. Turner
Assistant Director (Special Training Division)	Robert T. Lacey
Assistant Director (Washington Liaison Office)	John C. Doohar

BUREAU OF GOVERNMENT FINANCIAL OPERATIONS

Commissioner	Dario A. Pagliai
Deputy Commissioner	Gerald Murphy
Assistant Commissioner, Administration	George L. McConville
Assistant Commissioner, Banking and Cash Management	Lloyd L. Morgan
Assistant Commissioner, Comptroller	Steve L. Comings
Assistant Commissioner, Disbursements and Claims	Michael D. Serlin
Assistant Commissioner, Government-wide Accounting	John O. Turner

INTERNAL REVENUE SERVICE

Commissioner	Jerome Kurtz
Deputy Commissioner	William E. Williams
Assistant Commissioner (Taxpayer Service and Returns Processing)	James I. Owens
Assistant Commissioner (Resources Management)	Joseph T. Davis
Assistant Commissioner (Compliance)	Singleton B. Wolfe
Assistant Commissioner (Employee Plans and Exempt Organizations)	Sidney A. Winborne
Assistant Commissioner (Inspection)	(Vacancy)
Assistant Commissioner (Planning and Research)	Anita F. Alpern
Assistant Commissioner (Technical)	John L. Withers
Assistant Commissioner (Data Services)	Donald J. Porter
Chief Counsel	Stuart E. Seigel

BUREAU OF THE MINT

Director	Stella B. Hackel
Assistant Director for Administration	Chadwick B. Pierce
Assistant Director for Marketing and Statistical Services ..	Francis B. Frere
Assistant Director for Production	George G. Ambrose
Assistant Director for Technology	Alan J. Goldman
Assistant Director for Personnel	James J. Mulcahy

BUREAU OF THE PUBLIC DEBT

Commissioner	Hubert J. Hintgen
Deputy Commissioner	William M. Gregg
Assistant Commissioner (Washington)	Kenneth W. Rath
Assistant Commissioner (Field)	Martin French
Chief Counsel	Calvin Ninomiya

UNITED STATES CUSTOMS SERVICE

Commissioner of Customs	Robert Chasen
Deputy Commissioner of Customs	G. R. Dickerson
Assistant Commissioner (Operations)	Vernon V. Hann
Assistant Commissioner (Regulations and Rulings)	Leonard Lehman
Assistant Commissioner (Administration)	Jack Lacy
Assistant Commissioner (Investigations)	George C. Corcoran, Jr.
Assistant Commissioner (Internal Affairs)	Perry Martin (acting)
Assistant Commissioner (Enforcement Support)	Alfred R. DeAngelus
Chief Counsel	Thaddeus Rojek

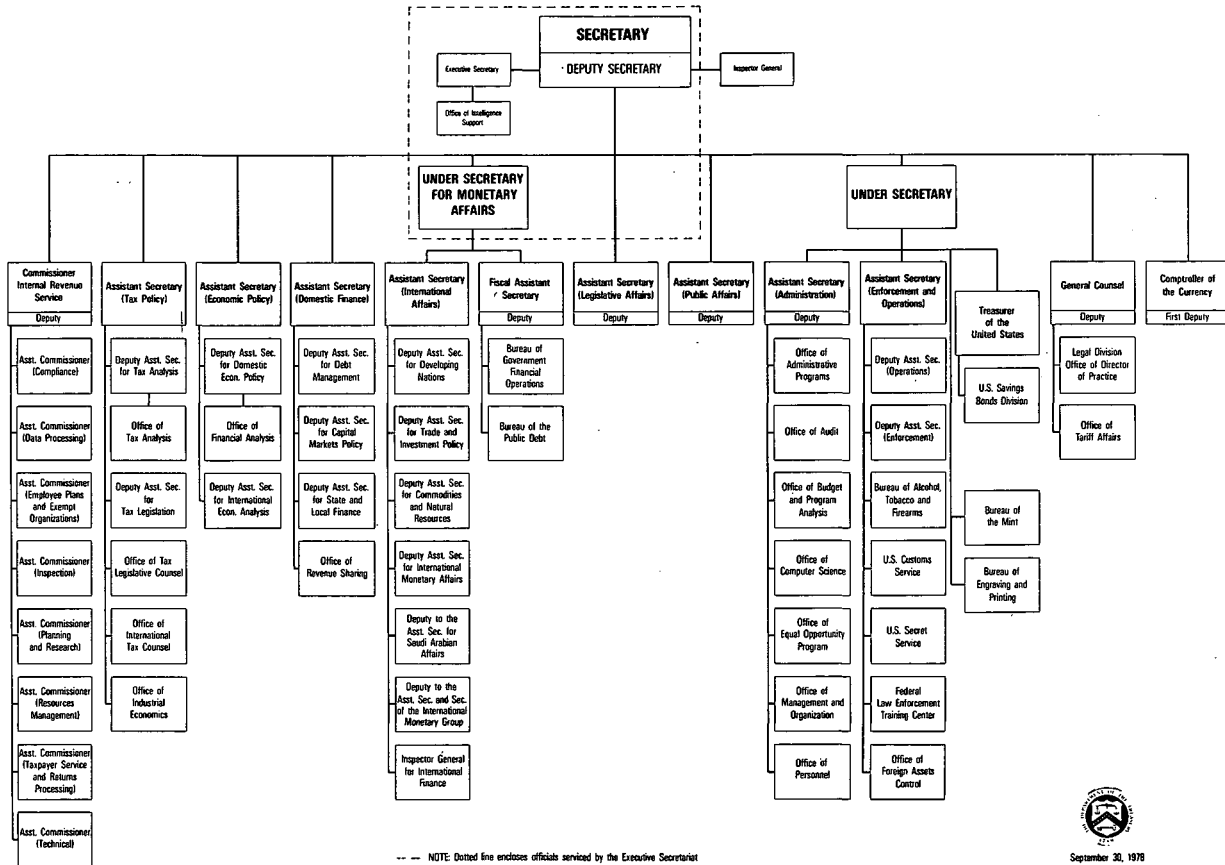
UNITED STATES SAVINGS BONDS DIVISION

National Director	Azie T. Morton
Deputy National Director	Jesse L. Adams, Jr.
Director of Sales	Walter R. Niles
Director of Advertising and Promotion	Louis F. Perrinello

UNITED STATES SECRET SERVICE

Director	H. Stuart Knight
Deputy Director	Lilburn E. Boggs
Assistant Director (Protective Research)	Myron I. Weinstein
Assistant Director (Investigations)	James T. Burke
Assistant Director (Protective Operations)	Robert E. Powis
Assistant Director (Inspection)	Arnold J. Lau
Assistant Director (Administration)	Francis A. Long

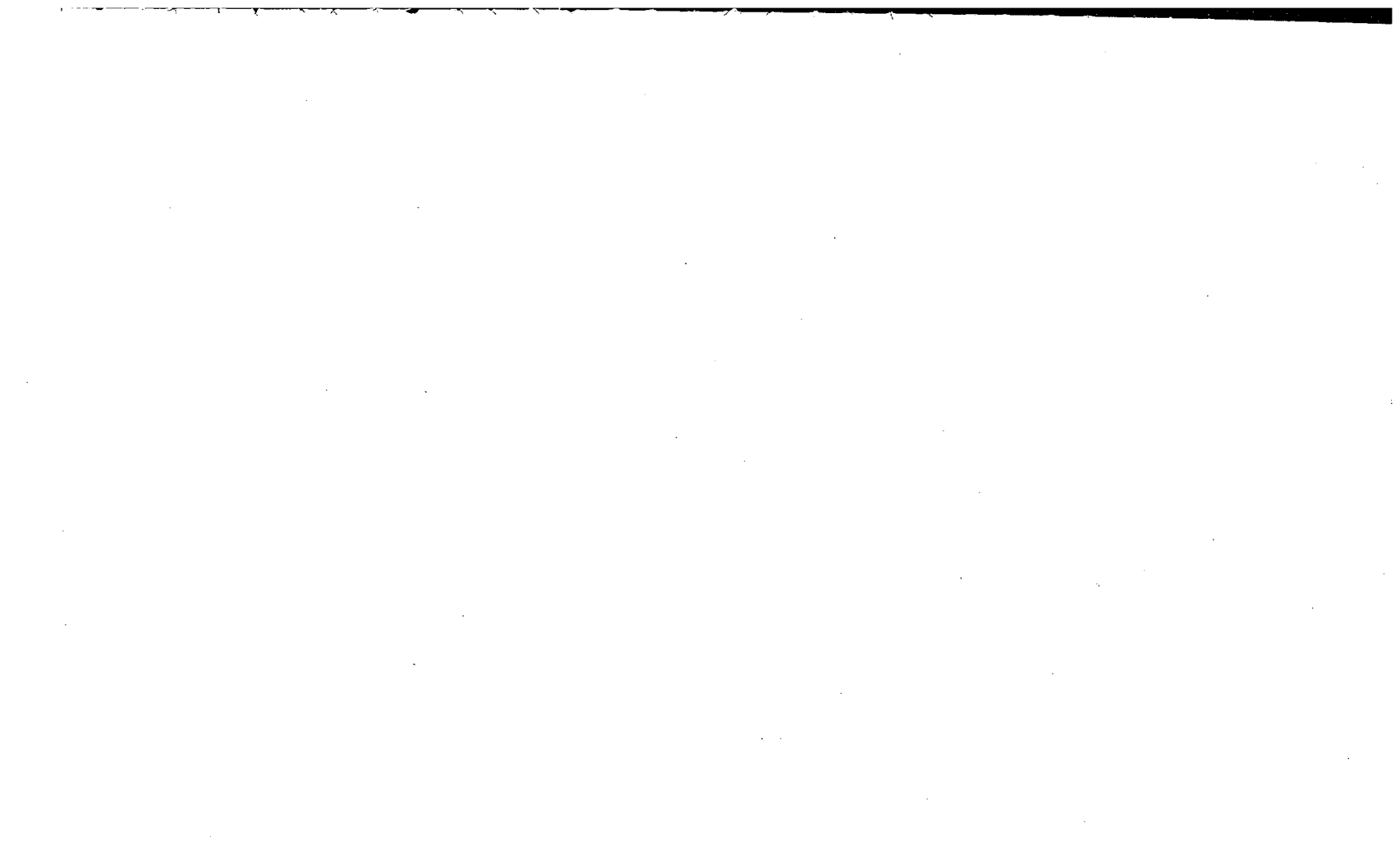
ORGANIZATION OF THE DEPARTMENT OF THE TREASURY



-- NOTE: Dotted line encloses officials serviced by the Executive Secretariat



September 30, 1978



INTRODUCTION

This introduction reviews developments which affected areas of Treasury interest and responsibility during fiscal 1978. Only major domestic and international developments are covered since detailed information on the operating and administrative activities of the Department is provided in the body of the report. Statistical information is presented in the separate Statistical Appendix.

DOMESTIC DEVELOPMENTS

The Economic Expansion

The economic upswing which began at the end of the first quarter of 1975 continued through fiscal 1978. The pace of growth moderated somewhat during the course of the year, and the expansion remained remarkably well balanced although inflationary pressures did intensify. The level of economic activity (measured in terms of real GNP) at the close of fiscal 1978 was up 3.5 percent from a year earlier. A 5.3-percent increase had been recorded during fiscal 1977. During 1978, the pace of growth was interrupted in the first quarter of calendar 1978 by severe winter weather and a lengthy coal strike, but the economy rebounded during the following quarter. In the final quarter of the fiscal year real GNP registered an annual growth rate of 2.6 percent, somewhat below the average growth rate for the year but definitely not a cause for concern. The Department of Commerce estimated that if the strike and weather effects are set aside, real GNP probably would have increased at about a 3½-percent annual rate in each of the three quarters of calendar 1978. This was a remarkably steady and satisfactory pace for such an advanced stage of the economic expansion.

During the course of the fiscal year, economic policy began to shift from the promotion of rapid rates of real growth toward the control of inflation. This resulted in large part from two developments. First, the decline in the rate of unemployment was much more rapid than expected during the first half of the fiscal year and this was combined with a very slow rate of advance in productivity which, in turn, added to cost pressures. Second, the economy began to move into a zone of high utilization within which demand pressures were more easily translated into rising prices. The result was a relatively unsatisfactory price performance which acted adversely on the value of the dollar abroad. By the close of the fiscal year, control of inflation became the primary economic policy objective of the administration in recognition of the fact that accelerating rates of inflation would imperil the continuation of the expansion itself and would further undermine the foreign exchange value of the dollar.

Employment continued to register strong gains during the year which even outpaced the exceptionally large increases in the labor force. Total

employment increased by 3.8 million persons (4.2 percent) from September to September, significantly faster than the increase of 3.2 million persons (3.2 percent) in the labor force. The consequence of this rapid rate was a drop in the unemployment rate from 6.8 percent at the beginning of the fiscal year to 5.9 percent at the end. Most of the improvement in the unemployment rate occurred during the first half of the fiscal year. After April of 1978, the overall rate generally remained in the vicinity of 6.0 percent but did go as low as 5.8 percent for one month (June).

The improvements in the unemployment picture affected all labor force groups more or less equally in fiscal 1978, somewhat in contrast with the previous year. For adult men, the unemployment rate dropped from 4.7 percent to 4.1 percent from September 1977 to September 1978, while the corresponding figure for adult women was a drop from 6.9 to 5.9 percent and for teenagers a drop from 18.3 to 16.3 percent. In the previous fiscal year, adult women had experienced a decline in the unemployment rate only half as large as that for adult males. While the rate for teenagers declined somewhat in fiscal 1978, the absolute number of unemployed teenagers remained relatively constant.

Personal consumption spending was a key element in the economic developments of fiscal 1978. In a pattern reminiscent of the cold-weather-related stop-and-go movements of a year earlier, retail sales sagged during the first quarter of calendar 1978, recovered briskly, and then entered a period of relatively slow growth which continued until fall. The weakness in retail sales at the end of the fiscal year occurred in conjunction with a relatively low personal saving rate (5.2 percent) and some tightening in credit conditions, as reflected primarily in rising interest rates. The latter development was potentially important since it appeared that some consumption spending during the year had been financed by converting equity in existing homes into cash and this source of funds was presumably being made less attractive by rising interest rates. However, there was very little direct evidence that any seriously restraining effect on consumption spending was being exerted through this or other avenues. The ratio of consumer debt repayments to disposable income moved up during the fiscal year, but demographic and other factors have probably been raising the level of what constitutes an acceptable debt ratio for consumers. Therefore, the fiscal year closed without any obvious signs of weakness in the consumer spending picture.

Investment also played a key role in the economic developments which occurred during fiscal 1978. Nonresidential fixed investment in real terms increased at about a 4-percent annual rate in three out of the four quarters of the fiscal year. The second quarter of 1978 was the exception, however, and it witnessed a sharp jump in investment spending, particularly for nonresidential structures. The second quarter 1978 increase contributed substantially to the increase of 8.3 percent recorded for the fiscal year as a whole. Residential investment, on the other hand, stabilized at a

high level but did not provide much further net contribution to real growth, rising by only 1.5 percent for the year as a whole and posting small declines in the first and third quarters of calendar 1978.

The important fact was that the high levels of activity in the home-building industry which had been reached by the end of fiscal 1977 were essentially maintained in fiscal 1978, despite rising interest rates. This was accomplished, in large part, by the regulatory authorities allowing thrift institutions to issue money market certificates with yields geared to the 6-month Treasury bill rate. Inflows into thrift institutions were well maintained and mortgage lending continued at high levels. This was in marked contrast to earlier postwar experience when monetary restraint and high interest rates led to sharp contractions in mortgage lending and residential construction activity.

Business inventories were relatively stable over the course of the fiscal year and reflected the somewhat cautious behavior evident in this area after the inventory corrections of the beginning of fiscal 1977. In manufacturing, inventories came under increasingly tight control as evidenced by the steadily declining inventory-sales ratios for most industries. At the retail level, the only significant aberration was in the early cold-weather-related months and the inventory-sales ratio was little different from a year earlier as fiscal 1978 drew to a close. Wholesale inventories were only slightly tighter at the end of the fiscal year than they were at the beginning and also showed unusual stability during the period. Inventory-sales ratios in some general merchandising levels were relatively high by historical standards at the close of the fiscal year, but this was the exception, with most industries holding very low inventories relative to sales. The absence of inventory imbalance was a favorable development, suggesting that the expansion might well continue, rather than move into a recessionary phase. Indeed, by the close of the fiscal year, there were few signs that the expansion was running into its late stages. Growth had moderated but few of the traditional signs of cyclical imbalance had emerged. The main flaw in economic performance was an excessively high rate of inflation.

Inflation

The need to control inflation became an increasingly urgent task during fiscal 1978. At the beginning of the fiscal year, the Consumer Price Index for all urban workers was increasing at an annual rate slightly under 5 percent, a rate which represented substantial improvement from only 6 months earlier.

Following the fiscal 1977 pattern, however, prices again accelerated until mid-1978, when once again a moderating phase set in. Before the moderation occurred, however, the inflation rate had accelerated to a double-digit pace, reaching 11.4 percent (annual rate) for the 3 months ending in June. In the final quarter of the fiscal year the rate eased to 7.8 percent.

Also in a replay of 1977, the driving forces of the monthly price movements were concentrated in the behavior of food prices, and to a lesser extent in energy and services. Producer prices tended to exhibit somewhat the same pattern for the year except that both the acceleration and deceleration turning points in the index tended to occur a few months in advance of the equivalent movements in the Consumer Price Index. At the producer level, food prices were again the major contributor to the volatility of the quarter-to-quarter changes.

The behavior of industrial prices at the close of the fiscal year suggested that the recently observed moderation in price performance might prove to be short lived. Crude materials prices declined for 2 of the 3 months of the final quarter of fiscal 1978, but the final month recorded a 1.6-percent monthly rate of increase. The disturbing element here was that the earlier declines were largely due to decreasing prices of foodstuffs and feeds while the prices of other crude items continued showing a definite tendency to accelerate, a tendency which had been evident for several months:

Productivity in the private business sector was virtually unchanged in the final quarter of fiscal 1978 from the level which had prevailed a year earlier. Within the year the quarterly pattern was quite erratic, reflecting the influence of severe weather and the coal strike on the economy during the first half of calendar 1978. Increases in compensation per man-hour accelerated from the already rapid pace of fiscal 1977, going up at an annual rate of 9.3 percent for fiscal 1978. The net result of the productivity and compensation movements was a rapid acceleration in unit labor costs, which went up at a worrisome 9.1 percent for the year. Thus inflation which had been a major problem in fiscal 1977 became the most critical economic issue as fiscal 1978 drew to a close. Significant improvement on the price front was imperative to prevent distortions in consumption, saving, and investment patterns. Furthermore, the absence of progress in controlling inflation at home was beginning to undercut the dollar abroad.

The Budget and Fiscal Developments

The budget estimates for fiscal 1978 presented in January 1978 called for outlays of \$462.2 billion and revenues of \$400.4 billion, leaving a deficit of \$61.8 billion. Outlays for the fiscal year actually turned out to be \$450.8 billion and receipts \$402 billion, producing a deficit of \$48.8 billion. The major reason for the difference between the expected and realized budgetary outlays was the continued occurrence of outlay underruns. Much of the shortfall which occurred in the actual outlays figure was evident by the middle of calendar 1978. By that time it was becoming increasingly clear that as a result of accelerating inflationary pressures a shift in fiscal stance was in order and steps were not taken to combat or offset these shortfalls.

The slight addition to budgeted revenues in fiscal 1978 reflected legislative changes and higher receipts under existing tax statutes. Congressional action brought about slightly higher individual and corporate income taxes which were only partly offset by lower excise taxes. These changes accounted for about half of the gain in receipts compared with the January estimates, while higher receipts under existing legislation accounted for the other half.

Off-budget net outlays for fiscal 1978 were also somewhat lower than had been anticipated. In the January budget submission such outlays were expected to amount to \$11.5 billion, including an offset of net revenues amounting to \$78 million from the Exchange Stabilization Fund which, beginning in July, became a budget item (meaning, for comparison purposes, the January off-budget estimate should have been considered to be \$11.6 billion). In the midsession review issued on July 1, off-budget outlays were estimated to amount to \$11 billion. At the conclusion of fiscal 1978, total off-budget outlays were reported to have been \$10.3 billion, with most of the decline from expectations attributable to a shift by the Postal Service from an expected deficit in excess of \$800 million to a net revenue position just slightly below \$500 million.

Domestic Finances

The financing of the record volume of funds raised in the financial markets in fiscal 1978 was facilitated by substantial inflows of funds to depository institutions, assisted by the introduction of the new money market certificates on June 1, 1978. These permitted savings and loan associations, mutual savings banks, and commercial banks to offer higher yields on 6-month certificates based on the yield on 6-month Treasury bills. Some \$37 billion of these certificates were outstanding at the close of the fiscal year. The successful introduction of these certificates helped maintain the flow of funds into mortgage markets and supported a high level of residential construction activity.

Total funds raised aggregated some \$453 billion during the fiscal year, up about 19 percent from \$380 billion in fiscal 1977. Business—nonfinancial and financial institutions—moved into first place as the largest borrowing sector. Its borrowings increased by 32 percent, rising from \$129 billion in fiscal 1977 to \$170 billion in fiscal 1978, with the increase accounting for about 56 percent of the higher total borrowings. The nonfinancial corporate portion of the business sector raised about \$91 billion, up from \$71 billion in fiscal 1977, as the margin between corporate capital expenditures and internally generated funds widened. The greater share of the increase in corporate debt—about 57 percent—was funded at long term. Households, which had been the largest borrowing sector in fiscal 1977, raised \$151 billion during fiscal 1978, for an increase of 13½ percent. Home mortgages accounted for nearly two-thirds of household borrowing and consumer credit for nearly one-third, with other borrowings

relatively small. Federal Government (Treasury) borrowings accounted for a slightly smaller percentage (13 percent) than in the year before, but a substantial rise in Federal agency borrowings resulted in a slight increase in the share of the Federal sector (including Federal agencies) in total borrowings. State and local government net borrowing, on the other hand, virtually leveled off, at about \$25 billion.

The large volume of funds was raised in an environment of rising interest rates and some shift toward monetary restraint. Credit became more expensive during the course of the fiscal year but remained readily available. As is typical of periods of strong credit demand, the potential gap between funds raised and supplied was bridged by an increase in direct household purchases of market securities induced by rising interest rates. Thus, even though the ratio of financial intermediation to total funds raised declined from the levels of the previous 2 years, the credit markets functioned smoothly.

Short-term money market rates increased over the 12-month period, with most of the rise occurring in the second half of the year. By late September 1978, private short-term interest rates had climbed by 2 to 2½ percentage points to levels of 8½ to 8¾ percent, not seen in nearly 4 years. The prime lending rate to corporate borrowers at commercial banks rose from 7½ percent to 9¾ percent during the fiscal year. In the capital markets, yields on Treasury coupon issues and on corporate bonds climbed over most of the fiscal year, but dipped slightly towards the end. Intermediate-term issues rose about 1½ points over the fiscal year as a whole, while longer term Treasury and corporate bonds rose about 1 point. Municipal bond yields, on the other hand, advanced only about one-half of a percentage point. Even so, by the end of the fiscal year, all long-term yields were generally high by historical standards.

Federal Reserve policy moved in a restraining direction during fiscal 1978. The discount rate was raised in six steps from 5¾ percent to 8 percent by the end of the fiscal year. Federal funds, which had been trading close to 6 percent at the end of fiscal 1977, rose to the 8½ range by the end of fiscal 1978. Restraint was not as clearly reflected in the behavior of the monetary aggregates. The money supply on a narrow definition, consisting of currency and demand deposits (M-1), rose by 8.4 percent during the fiscal year, up slightly from 8.2 percent in fiscal 1977. On a slightly broader definition, including time deposits at commercial banks other than large certificates of deposit (M-2), the rise was 8.5 percent, down from nearly 11 percent in fiscal 1977.

Federal financing proceeded smoothly during the course of the fiscal year. Treasury net cash borrowing (excluding Government account transactions) totaled \$60.2 billion, up from \$54.8 billion in fiscal 1977. The bulk of Treasury financing was done in the intermediate area, with only a slight expansion over the period in Treasury bills outstanding in the market, following a net paydown of bills in fiscal 1977. A high priority continued to

be placed upon the issuance of longer term notes and bonds. As a result, the average length of the privately held marketable debt was increased from 2 years 11 months at the beginning of the fiscal year to 3 years 3 months at the end.

Of the \$60 billion increase in public debt securities held by the public during the fiscal year, the Federal Reserve banks absorbed \$11.6 billion. (Publicly held securities include nonmarketable issues as well as the market financing discussed above.) Commercial banks reduced their holdings by about \$2.8 billion in the face of strong loan demand—a usual adjustment during a cyclical expansion. Household net purchases equaled \$15.6 billion, of which savings bonds held by individuals accounted for \$4½ billion. State and local holdings rose about \$15 billion, in large part reflecting special nonmarketable issues, and foreign and international issues rose \$26.3 billion. Corporations reduced their holdings by \$6.7 billion, and nonbank financial and other investors increased theirs by \$1 billion.

Taxation Developments

Tax policy developments reflected tax proposals to reduce tax burdens and provide economic stimulus coupled with tax reform to make the tax system fairer. Social security, energy, and urban matters were also reflected in tax policy.

In January 1978, President Carter proposed a \$25 billion net tax reduction program for fiscal 1979. It provided for a gross reduction of \$30.4 billion in fiscal 1979 offset, in part, by tax reform that would have increased tax liabilities by \$5.4 billion.

The proposal also included: (1) Net cut, in individual income tax liabilities of \$18.3 billion, comprising gross cuts of \$22.6 billion and tax-raising reforms of \$4.3 billion; (2) net business income tax cuts of \$5.1 billion, reflecting gross tax cuts of \$6.3 billion combined with \$1.2 billion of reform; and (3) cuts in excise taxes and payroll taxes of \$1.6 billion in fiscal 1979.

In May 1978, the administration trimmed the proposed tax cut from \$25 billion in fiscal 1979 to \$14.3 billion. The administration recognized that economic conditions had changed substantially since January 1978 and there was a need to get a better balance between monetary and fiscal policy. Inflationary pressures were mounting; employment was increasing, the unemployment rate was falling. Under these circumstances, a smaller budget deficit in fiscal 1979 was appropriate.

Congress gave immediate consideration to the President's proposals but had not enacted a tax program by the close of the fiscal year.

In March 1978, the administration proposed several tax incentives related to urban policy: An employment tax credit for the hiring of young and handicapped persons to replace the existing "new jobs" credit and an additional investment credit for certain investments made in distressed areas. "Small issue" industrial development bonds were to be limited to

distressed areas but the dollar limit on an issue increased. No final congressional action had been taken by the end of the fiscal year.

Acting on the President's proposals of May 1977 to resolve both short- and long-term financing problems in the social security system, Congress passed and the President signed on December 20, 1977, the Social Security Amendments of 1977. The amendments included the President's recommendation to correct a serious inflation-indexing flaw and to change the relationship of the self-employment tax rate to the employee rate.

Subsequent to the approval of the 1977 amendments and during congressional consideration of the President's 1978 tax program, various legislative efforts were made to modify or reduce the social security tax increases in the 1977 act. These actions were opposed by the administration, and the Congress did not approve any change.

The Congress continued to consider President Carter's comprehensive long-term national energy program proposed in April 1977 which included a number of tax penalty and tax incentive recommendations. At the close of the fiscal year, congressional consideration of these proposals and alternatives was proceeding with the nature of the eventual legislative outcome in doubt.

INTERNATIONAL DEVELOPMENTS

International Cooperation on Payments Problems

The central feature in the international monetary and payments sphere was the recurrent periods of pressure on dollar exchange rates that were associated with the continuing imbalances in international payments. Overall payments surpluses were especially prominent in Japan, Germany, and Switzerland, while the United States, Canada, and a number of other countries were in deficit. The recurrent periods of strain in the exchange market led to appreciation of the currencies of surplus countries in terms of the dollar. At times the exchange markets became nervous, uncertain, and disorderly, leading to substantial purchases of dollars by foreign central banks.

In the month of October 1978, in particular, very heavy sales of dollars took place, leading to rapid declines in dollar exchange rates against major currencies that were exaggerated by a seriously deteriorating market psychology. This situation was met by an important series of actions culminating in the announcements made by the President, the Treasury, and the Federal Reserve System on November 1, 1978. U.S. monetary policy was tightened, and major foreign exchange resources were arranged to finance participation by U.S. authorities in internationally coordinated market intervention. These announcements were followed by a rise in dollar exchange rates and by more balanced and orderly exchange market conditions.

Faced with the problems presented by these imbalances of payments, the United States and the major industrial nations took action during the year along three broad and interrelated lines of approach.

The first of these three aspects was a series of policy measures of fundamental importance taken by the United States to deal with underlying economic factors that exerted a powerful influence on both the external and internal value of the dollar. In the sphere of energy, the Congress, after long and arduous deliberations, enacted an energy bill, designed to reduce dependence on imports of oil by an amount estimated at up to 500,000 barrels per day from the level otherwise expected, as early as 1979, with further import reductions in later years. These reductions would decrease the anticipated deficit in the current accounts and thus contribute to correcting the imbalance in world payments.

As the year progressed, and output and employment continued to advance closer to the economy's potential, prices began to move upward in the United States, with consumer prices rising at an annual rate of 8.0 percent in July–September 1978, as against 6.7 percent a year earlier. By contrast, in Germany and Japan, consumer prices were rising only about 2½ and 4 percent, respectively, in the third quarter of 1978, and the rate of growth had been declining during the year. Slower growth relative to potential in those countries was considered to be one factor in their divergence from U.S. price behavior, which contributed to the strength of their currencies vis-a-vis the dollar in the exchange market.

To cope with the resurgent inflationary pressures, fiscal policy in the United States was modified during the year, resulting in a budget deficit estimated at \$33.2 billion for fiscal 1979, as compared with \$48.8 billion in fiscal 1978. For fiscal 1980, the President has proposed that the deficit be reduced to \$29 billion. This is roughly 1 percent of gross national product, and it compares with a deficit of \$66 billion in fiscal 1976, which was about 4 percent of gross national product.

Monetary policy also became progressively more restrictive during the year, with the average Federal funds rate rising from 5.82 percent in the third quarter of 1977 to 8.45 percent in September 1978 and later to 9¾ percent or more after the Federal Reserve's discount rate was raised from 8½ to 9½ percent on November 1, 1978. Some reserve requirements were also tightened at that time. The uncovered margin between short-term dollar rates and German and Japanese rates widened markedly, providing an interest incentive to international investors.

In October 1978, the President announced a broad, tough, and determined anti-inflation program designed to slow down the rate of change in wages and prices.

To promote exports, the President also announced on September 26, 1978, a series of measures committing the administration to placing a higher priority on exports. Congress will be asked to increase the loan authorization of the Export-Import Bank; intensified efforts were an-

nounced to reduce domestic governmental barriers to U.S. sales abroad; and the Treasury was directed to negotiate more effective international arrangements to restrain excessive subsidies through export credit procedures.

The second of the three broad approaches to the problem of international imbalance was encouragement of policy measures that would stimulate domestic-led economic growth in the major surplus countries. Responding to international consultations, including meetings of Ministers and heads of government, Germany and Japan adopted programs designed to maintain or expand rates of growth, and thus to reduce their excessively large trade and current account surpluses. Comparing the third quarter of 1978 with the third quarter of 1977, the German rate of real growth had risen from about 2 percent per annum to 4 percent, but the Japanese rate had advanced only from about 5½ percent to nearly 6 percent.

The appreciation of the currencies of these countries, together with their increased growth rates, began to have an impact on physical volumes of exports and imports of Germany, Japan, and Switzerland in 1978. However, dollar prices of exports rose more rapidly than dollar prices for imports, including oil, and this caused the combined current account surpluses of these three countries, in dollar terms, to rise from about \$18 billion in calendar 1977 to an estimated \$30 billion in calendar 1978.

From a longer term perspective, compound annual rates of real economic growth in the decade 1962–72 were substantially higher in other industrial countries than the figure of 3.9 percent for the United States. Corresponding figures were 10.3 percent in Japan, 5.5 percent in Canada, and 4.5 percent in industrial European countries. In 1977, by contrast, foreign growth rates on average were well below the U.S. figure of 4.9 percent. Corresponding figures were 5.3 percent in Japan, 2.7 percent in Canada, and 2.1 percent in European industrial countries in that year. This sizable shift in relative economic progress had affected the U.S. trade position adversely in 1977. The movement towards a narrower divergence in real growth rates that has occurred in 1978, and that is expected to continue in 1979, should over time have a favorable impact on the trade and current account positions.

In the nonoil developing countries, the growth in output was relatively well sustained at about 5 percent in both 1976–77 and 1977–78, a level somewhat higher than in the major industrial countries.

The third major line of approach to international cooperation in correcting imbalances was the response to disturbed and increasingly disorderly market conditions through evolving intervention policies. During the year, U.S. intervention became more forceful as market conditions changed.

At the beginning of the fiscal year, the dollar encountered generalized and continuing selling pressure in increasingly unsettled foreign exchange market conditions. These conditions reflected, in particular, the sharply rising U.S. trade deficit, the delays in completion of U.S. energy legislation, and concerns that growth rates among major industrialized nations

would not soon converge. In January 1978, the Treasury began to use the Exchange Stabilization Fund actively, along with the resources of the Federal Reserve System, in foreign exchange market operations. Treasury operations were financed by drawings of German marks against a swap agreement concluded with the Bundesbank on January 4, 1978.

In March, Secretary Blumenthal and the German Finance Minister reaffirmed that forceful action would be continued to counter disorderly market conditions. In this connection, in order to provide further foreign currency resources if needed, the Treasury announced that arrangements had been made for the sale of SDR 600 million to purchase German marks, that the United States was prepared to draw against its reserve position in the International Monetary Fund, and that the Federal Reserve and Bundesbank had agreed to double the amount of their swap arrangement from \$2 billion to \$4 billion.

In early April, selling pressure on the dollar intensified following the release of U.S. trade figures showing a record \$4.5 billion deficit in February. Later in April the Treasury announced that a series of monthly public auctions of gold would be initiated in May, amounting to 300,000 ounces at each of the first six auctions, which would reduce net imports of gold.

In August, the Treasury announced that the amount of gold offered would be increased to 750,000 ounces beginning with the November auction. At that time, a congressional compromise on the natural gas bill was achieved, paving the way for passage of energy legislation. The Federal Reserve moved to increase U.S. interest rates further and reduced reserve requirements on Eurodollar borrowings by U.S. banks.

Swap indebtedness to the Bundesbank, incurred by the Treasury and Federal Reserve to finance foreign exchange market operations in German marks, reached a peak in early April 1978 of \$2,284 million. However, by the end of the fiscal year, this indebtedness had been reduced to \$1,031 million.

During October, it became evident that the severe and persistent disorder and excessive decline in the dollar were undermining U.S. efforts to control inflation and adversely affecting the climate for continued investment and growth in the United States. The market did not respond favorably to the President's comprehensive anti-inflation program and was failing to take account of the improvements that were being made in the underlying conditions that determine the dollar's value.

Accordingly, on November 1, 1978, the President, the Secretary of the Treasury, and the Chairman of the Board of Governors of the Federal Reserve System announced a series of major corrective actions. The Federal Reserve raised the discount rate from 8½ to 9½ percent and imposed a supplementary reserve requirement on large time deposits. The U.S. authorities joined Germany, Switzerland, and Japan in closely coordinated exchange market intervention. To finance the U.S. participation in the

coordinated market intervention, the United States announced that it would mobilize up to \$30 billion in the currencies of those three countries. These resources were to be obtained by drawings on the IMF, sales of special drawing rights (SDR's) to foreign monetary authorities, increases in Federal Reserve swap lines, and by the issuance abroad by the Treasury of up to \$10 billion in securities denominated in foreign currencies. The Treasury also increased its monthly sales of gold to at least 1½ million ounces per month, starting with the December auction.

The market responded favorably to these measures, dollar exchange rates rose from the October lows, and more orderly conditions resulted.

Changes in Dollar Exchange Rates, Gold Market Prices, and Global Reserves

Persistent large current account surpluses of Japan, Germany, and Switzerland reached a combined total of nearly \$30 billion during the 12 months ending September 30, 1978. These surpluses were not fully offset by outward nonofficial capital movements. The currencies of those countries appreciated by 40, 19, and 50 percent, respectively, in terms of the U.S. dollar, from September 30, 1977, to the end of September 1978. There were also substantial accumulations of reserves by the three countries, amounting to about \$20 billion during fiscal 1978, which absorbed a substantial amount of market pressure on their currencies.

Overall, during the fiscal year, the dollar depreciated by 12.5 percent on a trade-weighted basis, as against the other Organization for Economic Cooperation and Development (OECD) currencies, and by 9.2 percent in terms of the SDR.

Gold market prices rose from about \$155 per ounce at the beginning of the fiscal year to about \$188 per ounce in March 1978. After declining to about \$168 per ounce in the latter part of April, the gold price resumed rising in May. The price was about \$218 per ounce at the end of the fiscal year, representing an increase of about 40 percent during the fiscal year. Under the Treasury's monthly program, sales of gold to the public were conducted by the General Services Administration on a competitive bid basis. Through September 30, 1978, proceeds of the sales totaled nearly \$300 million.

The oil-exporting group of countries, for the first time in several years, reported to the IMF a decline of about SDR 15 billion (nearly \$19 billion) in reserves during the fiscal year, though part of this appears to be accounted for by reclassification of some assets into a nonreserve and unreported category. Other developing countries continued to build up their aggregate reserves at a somewhat faster rate than the industrial country group. For the world as a whole, reported reserves increased to SDR 264 billion (\$338 billion) at the end of September 1978, as compared with SDR 249 billion (\$290 billion) a year earlier, an increase of about 6 percent in SDR terms, and 17 percent measured in dollars.

The International Monetary System and the International Monetary Fund

The entry into force of the second amendment of the IMF Articles of Agreement, on April 1, 1978, represents the most fundamental change in the international monetary order since the Bretton Woods system was established in 1944. The United States had earlier accepted the amendment pursuant to Public Law 94-564, effective October 19, 1976.

The central features of the new international monetary system, as embodied in the amended IMF Articles, are:

- Members are given wide latitude in the choice of exchange rate practices, subject to specific undertakings regarding promotion of orderly underlying economic and financial conditions and avoidance of unfair exchange rate practices. The IMF is given expanded authority for surveillance over exchange rate policies to ensure that members comply with their obligations;
- Concrete steps to reduce the monetary role of gold, including the abolition of the official price of gold, the elimination of gold's function as the "numeraire" of the system and as an important instrument in IMF transactions, and provision for continued disposal of the IMF's gold holdings;
- Changes in the characteristics and expansion of the uses of the SDR, designed to enhance its role in the system;
- Changes in the IMF's operation and organization to modify obsolete provisions, simplify operations, and adopt structural changes.

The increase in IMF quotas agreed in 1976 also became effective on April 1, 1978. Total Fund quotas were raised from SDR 29.2 billion to SDR 39 billion (about \$50 billion). The U.S. quota was increased from SDR 6,700 million to SDR 8,405 million, pursuant to Public Law 94-564.

Legislation required for U.S. participation in the Supplementary Financing Facility was passed by Congress and signed by the President. The facility will temporarily supplement the IMF's resources by credit lines from members of approximately \$11 billion, and should enable it to provide more financing to members experiencing particularly difficult payments problems. The U.S. share in the facility is approximately \$1.8 billion, 17 percent of the total.

At the September 1978 meeting of the IMF's Interim Committee, a consensus was reached in support of two major additional measures to strengthen the International Monetary Fund and the monetary system: A 50-percent increase in IMF quotas and new allocations of SDR's totaling approximately SDR 12 billion, to be issued over 3 years.

The continued uncertainties in the world economy—and the associated wide range of world payments patterns which could develop—argued for a substantial increase in Fund quotas. The 50-percent increase was the result of the seventh periodic review of quotas, and is intended to cover the next 5 years. It is mainly equiproportional; i.e., equal percentage in-

creases for most countries, with only 11 developing countries receiving selective quota increases.

The consensus on SDR allocations reflects the view that SDR allocations should provide a part of the growth of reserves as international transactions continue to expand in value, and that such allocations will help to assure the viability and credibility of the SDR as a reserve asset and will assist the SDR in fulfilling its longrun potential in the international monetary system.

Financial Relations with Non-OPEC Developing Countries

The overall economic situation of the non-OPEC developing countries in 1977-78 was mixed with significant improvements being made in some indicators and less progress in others. Current account deficits for the group, which declined significantly to \$26 billion (excluding official transfers of funds) in calendar 1976 and fell further to \$22 billion in calendar 1977, have been projected to rise in calendar 1978 to about \$28 billion.* This nominal increase is not significantly different from historical averages when world inflation and economic growth are factored in, and it should not pose financing difficulties for the group as a whole.

Total official and private flows to non-OPEC developing countries have been more than adequate to cover the aggregate current account deficits. Official development assistance (grants and loans) from Development Assistance Committee countries and multilateral institutions to less developed countries (LDC's) as a group increased in 1977 to about \$15 billion; concessional and nonconcessional flows from OPEC countries to non-OPEC LDC's were about \$5 billion. Gross foreign exchange reserves of the non-OPEC LDC's increased 29 percent to about \$53 billion by the end of calendar 1977. Data for December 1978 showed slower growth in aggregate reserves although it is estimated that import coverage did not decline.

During 1978, the United States continued its policy of placing increased emphasis on the role of the multilateral development banks in providing financing for sound projects and programs in developing countries. These institutions, including the World Bank group, the Inter-American Development Bank, the Asian Development Bank, and the African Development Fund, provided almost \$12 billion in loans during the year, of which nearly \$4 billion was on concessional terms for the poorest countries.

A paramount objective of U.S. policy in the banks has been to encourage projects which reach poor people in recipient countries and which help meet the basic human needs of these people. For this reason, the United States has favored greater priority in bank lending for the agricultural sector and for those projects which improve health, education, and nutrition. In working toward this objective, the United States has also

*Including official transfers of funds (grants only) to these countries, their deficits were approximately \$17 billion in 1976, \$12 billion in 1977, and are projected at about \$16 billion for 1978.

proposed the channeling of more assistance to small-scale enterprises and the development and use of labor-intensive and capital-saving technologies. During 1978, significant progress was made in reaching the poor through changes in the sectoral composition of lending to meet basic human needs, modifications in the design of projects to pass greater benefit to poorer people, and increased use of aid leverage to encourage policy changes in developing countries.

Improvement of human rights conditions in recipient countries has also been an important policy objective of the United States. Accordingly, during 1978, the United States used its voice and vote on a number of occasions in the multilateral development banks to advance these rights. Other issues within the banks on which substantial progress was made in 1978 included greater availability of information concerning the operations of the banks, improved audit procedures, and reduction of administrative costs including travel and compensation.

The Congress appropriated \$2,514 million for U.S. subscriptions and contributions to the multilateral development banks for fiscal 1979, up from \$1,925.5 million in fiscal 1978. Of this amount, \$1,258 million represented contributions to the International Development Association, including \$800 million for the second installment of the fifth replenishment of resources and \$458 million for the fourth replenishment of resources. Under the same appropriation, \$265 million was made available to the Asian Development Bank; \$763 million to the Inter-American Development Bank; \$163 million to the International Bank for Reconstruction and Development; \$40 million to the International Finance Corporation; and \$25 million to the African Development Fund.

The appropriations legislation enacted by the Congress also included the following provisions: That the U.S. Governors of the banks propose and seek the adoption of amendments to the Articles of Agreement to establish human rights standards to be considered in connection with each application for assistance; that international consultations be initiated to develop a viable standard for allocation of development assistance for production and export of commodities; and that the United States oppose loan proposals for the production for export of surplus commodities which would cause substantial injury to U.S. suppliers of similar or competing commodities.

The IMF/IBRD Development Committee, which was established in 1974 to maintain an overview of the development process especially regarding the transfer of resources to developing countries, continued to provide a forum for discussion of important issues. The United States is represented on the Committee by the Secretary of the Treasury.

The Department of the Treasury participated actively in the formulation of U.S. development assistance policy through its membership in the National Advisory Council on International Monetary and Financial Policies, in the Development Coordination Committee (DCC), and in various other

interagency committees designed to coordinate economic assistance programs. Under the reorganization of the DCC, four new subcommittees were established to treat issues in the specific areas of multilateral assistance, bilateral assistance, food aid, and international organizations. Treasury assumed responsibility for chairing the Subcommittee on Multilateral Assistance.

Treasury continued to follow developments in international indebtedness. In January 1978, Treasury submitted to Congress the administration's fourth annual report on developing countries' external debt and debt relief provided by the United States. The report is comprehensive, containing detailed information on the debt situation of major debtor countries and the means by which the United States and other creditor countries have dealt with debt service programs. During fiscal 1978, the United States participated in multilateral debt reschedulings for Zaire and Turkey.

Trade

Treasury activities in the trade area during the fiscal year centered on continuing efforts to secure significant trade liberalization and reform of the international trading system, as well as on specific trade problems and new efforts to reduce our record trade deficit.

Treasury continued to participate actively in drafting proposals for a subsidy/countervailing duty code within the multilateral trade negotiations in Geneva, as a prerequisite for U.S. adherence to the final package of agreements. The Department also participated actively in the adoption of positions with respect to tariffs, safeguards, customs matters, and special treatment to developing countries. In July 1978, the major trading nations agreed upon a basic "framework of understanding" for these negotiations, which the Bonn economic summit agreed should be completed by December 15.

A number of special import problems also developed during the year, the most important relating to steel imports allegedly dumped in the U.S. market. To assure prompt investigation of potential dumping in the future, an interagency steel task force chaired by Under Secretary Solomon proposed, and the administration adopted, a trigger price mechanism (TPM) for steel imports. The TPM is part of a comprehensive steel program to modernize and improve the competitive position of the U.S. steel industry.

A new International Arrangement on Export Credits was negotiated. This constituted a useful, if limited, instrument of international discipline in the provision of officially supported export credits. The clear need for substantive improvements in the Arrangement caused the Secretary to undertake renewed consultations with major trading nations in the fall of 1978 to strengthen and broaden the Arrangement.

In September 1978, the United States adopted a new national export policy to encourage U.S. exports, as one means of helping to reduce the record U.S. trade deficit. The new program includes efforts to assure fully competitive financing through the Export-Import Bank and to minimize Government disincentives to exports. Export expansion should also assist our broader efforts to maintain confidence in the dollar and stimulate continued domestic economic growth.

The East-West Foreign Trade Board, chaired by the Secretary of the Treasury, continued to monitor trade with the nonmarket economy countries to insure that it remained consistent with the national interests of the United States. Secretary Blumenthal participated in the meeting of the U.S.-U.S.S.R. Trade and Economic Council in Los Angeles on November 14, 1977. In December 1978, Secretary Blumenthal served as Cochairman of the Joint U.S.-U.S.S.R. Commercial Commission during its Seventh Session at Moscow. He also conferred with Chairman Brezhnev and other Soviet leaders, and addressed a meeting of the U.S.-U.S.S.R. Trade and Economic Council. He subsequently visited Bucharest, where he met with President Ceausescu and other Romanian officials.

Investment

In the international investment area the U.S. Government placed special emphasis during the past fiscal year on the problems associated with governments' use of (1) subsidies to induce investors to locate in their territories and (2) other measures to tilt the benefits of such investments their way. Several initiatives, which the Treasury played a key part in developing, were taken in international organizations and on a bilateral basis. In the OECD the Committee on International Investment and Multinational Enterprises (CIME) has agreed, at the suggestion of the United States, to undertake a comprehensive examination of the effects of investment incentives, performance requirements, and other measures on international economic relations. This work will begin after the CIME's review of the 1976 OECD Investment Declaration, a part of which covers investment incentives and disincentives. Bilateral consultations between the U.S. and Canadian Governments were also begun, and will continue in fiscal 1979, on governments' use of investment incentives. These consultations were initiated after the Canadian Government gave a subsidy to an American automobile manufacturer to induce it to locate a new plant in the Province of Ontario.

The incentives issue was also among those relating to the role of foreign investment in development that were pursued in a working group of the IMF/IBRD Development Committee. The group completed its work in December 1978, with the preparation of a report to the Development Committee regarding appropriate policies for developed and developing countries. Discussions are now underway to establish a small task force

consisting of policy-level officials from a few countries to continue and give added emphasis to this work.

Regarding inward investment, the Committee on Foreign Investment in the United States, an interagency group chaired by Treasury, met during the fiscal year to review current trends in and coordinate U.S. policy on such investment. One of the Committee's major concerns was foreign investment in U.S. farmland. It served as a forum for coordinating the positions taken by executive branch agencies in congressional discussions of the issues and legislative proposals relating to it.

The House and Senate committees with legislative responsibility approved plans submitted by Treasury for a survey of foreign residents' portfolio investment in the United States and authorized the funds required to initiate this project. The last such survey conducted by Treasury was in 1974. Questionnaires were to be mailed in November, the reporting or "as of" date being December 31, 1978, and respondents are being requested to file their reports by the end of March 1979. Up to a year will be required to tabulate and check the roughly 10,000 expected responses. Treasury plans to file a report with the Congress by the end of 1980. In addition, the feasibility of surveying U.S. residents' portfolio investment abroad is being studied. If such an outward survey is conducted, its outcome will be reported in 1981.

Energy

In the energy area, the key issues continued to be price, supply, and development of indigenous energy resources in the United States itself and also in the oil importing developing countries. The Bonn economic summit gave major attention to these issues, as well as to the growing dependence of the United States on imported oil. In this regard, President Carter committed the United States to adoption of a comprehensive energy program by the end of the year that would result in oil import savings of 2.5 million barrels per day by 1985.

During the year, the U.S. current account deficit, the national energy program, and oil prices became intimately linked. Our deficit was increasingly a result of excessive oil imports, while the depreciation of the dollar led to renewed pressure within OPEC for an oil price increase.

In their relations with the developing countries, the developed countries took steps to intensify cooperation in energy research and development, with special attention to renewable energy resources and technologies. The United States continued to stress the importance of adequate investment in indigenous energy resources and the role of the multilateral development banks and the private sector in fostering energy development.

The World Bank adopted new policies in July of 1977 which significantly enlarged its participation in the development of energy resources of the developing nations. A Petroleum Projects Division was established to

coordinate this. In 1978, missions were sent to a dozen developing countries to identify and prepare projects aimed at oil and gas production.

Loans have been approved by the World Bank group to India (\$150 million), to Zaire (\$4.1 million), Turkey (\$2.5 million), and Pakistan (\$30 million) for training of technicians and for petroleum development.

In response to the Bonn summit request, the World Bank sent a report to the Board in November of 1978 on the first year of this program, together with proposals to extend the group's activities into energy exploration in the oil-importing LDC's.

Commodity Policy

During fiscal 1978, the United States continued to develop and refine its basic initiatives in commodity policy. In these discussions, the United States has advocated commodity proposals that would work to the mutual benefit of producers and consumers.

Foremost among commodity problems is the sharp fluctuation of prices which is detrimental to stable economic growth in both developed and developing countries, by giving rise to near-term inflationary pressures and by discouraging investment in commodity industries. To remedy the situation in the most volatile markets, the United States has supported, where feasible, the negotiation of international commodity agreements. These agreements, operating to the maximum possible extent through buffer stocks, are aimed at stabilizing prices within a broad range around their long-term trends while at the same time allowing for the play of market forces to promote an efficient allocation of resources. Currently, international commodity agreements are in effect for tin, coffee, and cocoa (though the United States is not a member of the latter); a sugar agreement was negotiated in fiscal 1978, but has not as yet been acted upon by Congress. Discussions which may eventually lead to agreements have been undertaken for wheat, natural rubber, and copper. Proposed negotiation of a tungsten agreement was rejected as technically infeasible by the United States and other industrial countries.

To assist in financing buffer stock activities designed to reduce instability in commodity prices, the United States actively participated in the November 1977 negotiating conference on a common fund. The industrial countries presented a proposal at that session for the consolidation of individual international commodity agreement financial resources in a common fund that would lower the paid-in financial requirements for each agreement. To provide for more equitable sharing of financial responsibility for the agreements, the proposal implicitly assumes participation of consuming and producing countries in their financing. The developing countries presented their own proposal for a common fund which would be financed by mandatory direct government contributions and which would contain a second window to finance non-buffer-stocking measures for commodities and a voting structure which would give developing countries a controlling voice in decisions.

The differences between the two approaches prevented agreement in the November 1977 session. Subsequent informal discussions took place in Geneva in an attempt to narrow the differences. These discussions led to a resumption of the negotiations in November 1978. The resumed negotiations saw some convergence of views, with the developed countries indicating a willingness to accept an element of direct contributions in the financial structure of the fund and some possible activities which the second window might finance. However, developing countries insisted on a larger role for direct government contributions in the financial structure of the fund, and a broader scope for the second window, than developed countries could accept. These differences between the developed and developing countries reflected different conceptions of the nature and role of the fund, and the negotiating session concluded without reaching agreement. Another conference is scheduled for early 1979.

The administration undertook a commitment to contribute tin to the International Tin Agreement buffer stock. Although considerable support for it developed in Congress, legislation faltered late in the session because of Congress's inability to settle policy with respect to disposals from the U.S. strategic stockpiles.

The United States participated in the Third United Nations Conference on the Law of the Sea which met twice in 1978 and will reconvene in the spring of 1979. Much of the discussion at these two sessions centered on the deep seabed mining regime, as serious differences persist between the industrialized and the developing countries on the scope, nature, and organization of this regime.

The Congress considered seabed mining legislation in 1978 which would have authorized the licensing of private firms to begin mining the seabeds. The legislation passed the House of Representatives, but was not acted on by the full Senate. It is expected that such legislation will again be considered at the next session of Congress.

The staffs of the International Monetary Fund and World Bank undertook an examination of the provisions of and possible changes in the compensatory financing facility of the International Monetary Fund. Their analysis showed heavy use of the facility in 1975-76 and indicated the effects of possible changes. Action on the need for any changes will await the results of the full-scale review now scheduled for the spring of 1979.

Major International Meetings and Consultations

During the spring and summer of 1978, the Secretary took part in the meeting of the Interim Committee of Governors of the International Monetary Fund in Mexico at the end of April, the OECD Ministerial meeting in Paris in mid-June, and the Bonn meeting of heads of government of seven industrial countries in July. Through these meetings a consensus was reached on the major policy adaptations needed for achieving further progress toward better balanced growth among major industrial countries.

A meeting of the IMF/IBRD Development Committee in September 1978 was held at the time of the annual meeting of the Boards of Governors of the two institutions. The Committee commented favorably on the Bank's World Development Report, reviewed the Committee's work program, and agreed to establish a Task Force on Foreign Direct Investment.

Secretary Blumenthal visited the Middle East twice over the past 2 years to discuss U.S. economic and financial concerns with the leaders of important countries in that area. In October 1977, he visited Egypt, Israel, Kuwait, Iran, and Saudi Arabia. In November 1978, he met with the leaders of Saudi Arabia, the United Arab Emirates, Iran, and Kuwait.

United States/Saudi Arabian Joint Commission

While in Saudi Arabia, Secretary Blumenthal headed the U.S. delegation and served as Cochairman of the Fourth Session of the Commission, held in Riyadh November 18–19, 1978. Three new technical cooperation agreements were signed, in the areas of transportation, agricultural bank operations, and executive management development.

The Joint Commission now is implementing 20 major projects, with a total ultimate value of over \$850 million.

Funding of the International Affairs Function of Treasury

The Congress, in early October 1978, terminated the financing of administrative expenses by the Exchange Stabilization Fund, to become effective when appropriations become available.

REVIEW OF TREASURY OPERATIONS

FINANCIAL OPERATIONS

Summary

On the unified budget basis the deficit for fiscal 1978 was \$48.8 billion. Net receipts for fiscal 1978 amounted to \$402.0 billion (\$44.2 billion over fiscal 1977), and outlays totaled \$450.8 billion (\$48.0 billion over fiscal 1977).

Fiscal 1978 borrowing from the public amounted to \$59.1 billion as a result of (1) the \$48.8 billion deficit, (2) a \$3.0 billion increase in cash and monetary assets, and (3) a \$7.3 billion decrease in other means of financing.

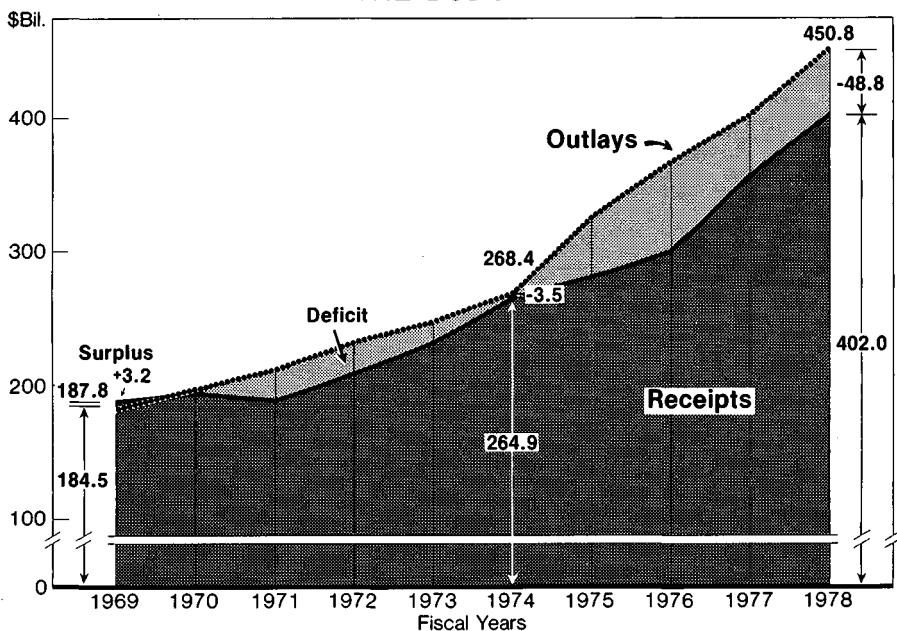
As of September 30, 1978, Federal securities outstanding totaled \$780.4 billion, comprised of \$771.5 billion in public debt securities and \$8.9 billion in agency securities. Of the \$780.4 billion, \$610.9 billion represented borrowing from the public.

The Government's fiscal operations for fiscal years 1977 and 1978 are summarized below. The receipts and outlays figures reflect the reclassification of earned income credit from an income tax refund to a budget outlay.

[In billions of dollars]

	1977	1978
Budget receipts and outlays:		
Receipts	357.8	402.0
Outlays	402.8	450.8
Budget deficit	-45.0	-48.8
Means of financing:		
Borrowing from the public	53.5	59.1
Increase in cash and other monetary assets	-2.2	-3.0
Other means:		
Increment on gold and seigniorage.....	.4	.4
Outlays of off-budget Federal agencies.....	-8.7	-10.3
Other.....	2.0	2.6
Total budget financing	45.0	48.8

THE BUDGET



Receipts

Total budget receipts amounted to \$402.0 billion in fiscal 1978, an increase of \$44.2 billion over fiscal 1977. Net budget receipts by major source for fiscal years 1977 and 1978 are shown below.

[In millions of dollars]

Source	1977	1978
Individual income taxes	157,626	180,988
Corporation income taxes	54,892	59,952
Employment taxes and contributions	92,210	103,893
Unemployment insurance	11,312	13,850
Contributions for other insurance and retirement	5,167	5,668
Excise taxes	17,548	18,376
Estate and gift taxes	7,327	5,285
Customs duties	5,150	6,573
Miscellaneous receipts	6,531	7,413
Total budget receipts	357,762	401,997

Projected estimates of receipts to future years, required of the Secretary of the Treasury, are shown and explained in the President's budget.

Individual income taxes.—Individual income taxes rose to \$181.0 billion in fiscal 1978, an increase of \$23.4 billion. Substantially all of the increase was due to higher personal incomes.

Corporation income taxes.—Corporation income taxes increased by \$5.1 billion over the prior year to reach \$60.0 billion. This modest increase (9 percent) reflects in part unusually high final payments in fiscal 1977 on 1976 liability.

Employment taxes and contributions.—Receipts from this source totaled \$103.9 billion, reflecting in part an increase in the social security taxable earnings base from \$16,500 effective January 1, 1977, to \$17,700 effective January 1, 1978.

Unemployment insurance.—Unemployment insurance receipts increased by 22 percent to reach \$13.8 billion in fiscal 1978. State tax deposits at the Treasury, the largest component in this category, increased by \$1.8 billion, reflecting continued high financing of past unemployment benefits. In addition, the Federal Unemployment Tax Act base was raised from \$4,200 to \$6,000 effective January 1, 1978, and receipts from this source increased from \$1.9 billion in fiscal 1977 to \$2.6 billion in fiscal 1978, a 39-percent increase.

Contributions for other insurance and retirement.—Receipts in this category increased by \$0.5 billion to a total of \$5.7 billion in fiscal 1978.

Excise taxes.—Receipts of excise taxes in fiscal 1978 were \$18.4 billion, an increase of \$0.8 billion over the prior year. These receipts reflect continued phaseout of the telephone excise tax from 5 percent in 1977 to 4 percent in 1978.

Estate and gift taxes.—Receipts in this category declined by \$2.0 billion in fiscal 1978 to reach \$5.3 billion. Much of the decline can be attributed to substantially increased gifts in fiscal 1977 in anticipation of the estate and gift tax provisions of the Tax Reform Act of 1976.

Customs duties.—Customs duties increased by \$1.4 billion in fiscal 1978 to reach \$6.6 billion.

Miscellaneous receipts.—These receipts totaled \$7.4 billion in fiscal 1978, an increase of \$0.9 billion. Deposits by the Federal Reserve System, the largest component of this category, increased by \$0.7 billion to reach \$6.6 billion.

Outlays

Total outlays in fiscal 1978 were \$450.8 billion (compared with \$402.8 billion for 1977). Outlays by major agency for fiscal years 1977 and 1978 are presented in the following table. For details see the Statistical Appendix.

[In millions of dollars]

	1977	1978
Funds appropriated to the President.....	2,487	4,475
Agriculture Department.....	16,738	20,368
Defense Department.....	97,930	105,677
Energy Department ¹	5,252	6,430
Health, Education, and Welfare Department.....	147,455	162,809
Housing and Urban Development Department.....	5,838	7,761
Labor Department.....	22,374	22,902
Transportation Department.....	12,514	13,452
Treasury Department.....	50,461	56,309
National Aeronautics and Space Administration.....	3,944	3,980
Veterans Administration.....	18,019	18,962
Other.....	34,843	43,405
Undistributed offsetting receipts.....	-15,053	-15,773
Total outlays.....	402,802	450,758

¹ Created Oct. 1, 1977.

Cash and monetary assets

On September 30, 1978, cash and monetary assets amounted to \$31.9 billion. The balance consisted of U.S. Treasury operating cash of \$22.4 billion (\$3.3 billion more than September 30, 1977); \$1.6 billion held in special drawing rights (\$0.4 billion more than September 30, 1977); a net \$3.5 billion with the International Monetary Fund (\$0.6 billion less than September 30, 1977); \$0.7 billion in loans to International Monetary Fund (a slight increase over September 30, 1977); and \$3.6 billion of other cash and monetary assets (\$0.1 billion less than September 30, 1977).

For a discussion of the assets and liabilities in the Treasury's account, see page 173. Transactions affecting the account in fiscal 1978 are shown in the following table:

Transactions affecting the account of the U.S. Treasury, fiscal 1978
[In millions of dollars]

Operating balance Sept. 30, 1977		19,104
Excess of deposits or withdrawals (-), budget, trust, and other accounts:		
Deposits	465,672	
Withdrawals (-)	506,526	-40,854
Excess of deposits or withdrawals (-), public debt accounts:		
Increase in gross public debt	72,704	
Deduct:		
Net discounts on new issues	11,603	
Interest increment on savings and retirement plan securities	4,136	
Net public debt transactions included in budget, trust, and other Government accounts	12,764	
Net deductions	28,503	44,201
Operating balance Sept. 30, 1978		22,444

Corporations and other business-type activities of the Federal Government

The business-type programs which Government corporations and agencies administer are financed by various means: Appropriations (made available directly or in exchange for capital stock), borrowings from either the U.S. Treasury or the public, or by revenues derived from their own operations. Various agencies have been borrowing from the Federal Financing Bank; which began operations in May 1974. The bank is authorized to purchase and sell securities issued, sold, or guaranteed by Federal agencies. Many Federal agencies finance programs through this bank that would otherwise involve the sale or issuance of credit market instruments, including agency securities, guaranteed obligations, participation agreements, and sales of assets.

Corporations or agencies having legislative authority to borrow from the Treasury issue their formal securities to the Secretary of the Treasury. Outstanding borrowings are reported as liabilities in the periodic financial statements of the Government corporations and agencies. In fiscal 1978 borrowings from the Treasury, exclusive of refinancing transactions, totaled

\$32.5 billion, repayments were \$13.2 million, and outstanding loans on September 30, 1978, totaled \$85.7 billion.

Agencies having legislative authority to borrow from the public must either consult with the Secretary of the Treasury regarding the proposed offering, or have the terms of the securities to be offered approved by the Secretary.

The Federal Financing Bank makes funds available in accordance with program requirements to agencies having authority to borrow from the bank. Interest rates shall not be less than rates determined by the Secretary of the Treasury taking into consideration current average yields on outstanding Government or bank securities of comparable maturity. The bank may charge fees to provide for expenses and reserves. During fiscal 1978, all funds loaned by the bank have been borrowed from the Treasury.

During fiscal 1978, Congress granted new authority to borrow from the Treasury in the total amount of \$14.4 billion, adjustments increased borrowing authority by \$1.8 billion, making a total increase of \$16.2 billion. The status of borrowings and borrowing authority and the amount of corporation and agency securities outstanding as of September 30, 1978, are shown in the Statistical Appendix.

Unless otherwise specifically fixed by law, the Treasury determines interest rates on its loans to agencies by considering the Government's cost for its borrowings in the current market, as reflected by prevailing market yields on Government securities which have maturities comparable with the Treasury loans to the agencies. A description of the Federal agency securities held by the Treasury on September 30, 1978, is shown in the Statistical Appendix.

During fiscal 1978, the Treasury received \$4.4 billion from agencies which consisted of dividends, interest, and similar payments. (See the Statistical Appendix.)

As required by Department Circular No. 966, Revised, semiannual statements of financial condition, and income and retained earnings are submitted to the Treasury by Government corporations and business-type agencies (all other activities report on an annual basis). Quarterly statements showing direct and guaranteed loans, and annual statements of commitments and contingencies are also submitted. These statements are the basis for the combined financial statements compiled by the Treasury which, together with individual statements, are published periodically in the Treasury Bulletin. Summary statements of the financial condition of Government corporations and other business-type activities, as of September 30, 1978, are shown in the Statistical Appendix.

Government-wide financial management

Joint Financial Management Improvement Program.—During fiscal 1978, JFMIP continued to concentrate on Government-wide improvements in accounting, auditing, cash management, and financial management. A study

on various aspects of auditing federally assisted programs was made and tentative findings and recommendations were released in an exposure draft. Draft statements were developed on the objectives of Federal agency financial statements. A project was initiated to prepare a financial and administrative checklist for new agencies to assure that all necessary actions in financial management matters are properly performed within a timely manner. A project on accounting for ADP costs and charging users for computer services was also initiated.

As a continuing process, JFMIP engaged in sharing information on new techniques and new technology with Federal, State, and local governments through liaison meetings and various publications. In addition, JFMIP sponsored cash management workshops on letters of credit, in Washington, D.C., and in Boston. The seventh annual Financial Management Conference was held in February 1978, on the "Impact of New Initiatives on Financial Management."

DOMESTIC FINANCE

Federal Debt Management

In fiscal 1978, Treasury debt management operations continued to have a major impact on the Nation's credit markets as the Treasury refunded its maturing debt and raised a large amount of new cash. The bulk of this financing was accomplished in a period of rising prices and interest rates as inflation dominated the economic and financial scene during fiscal 1978. An added depressing factor was the decline of the dollar in foreign exchange markets.

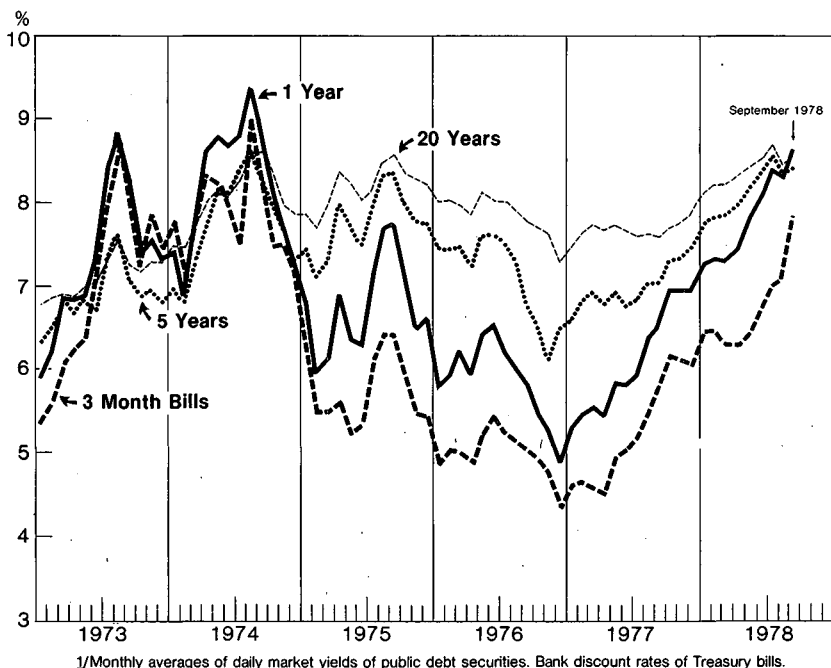
Over the course of the fiscal year both the Producer Price Index and the Consumer Price Index rose more than 8 percent. Likewise, both short and long interest rates moved steadily upward. In addition, the Federal Reserve, in tightening monetary policy in order to strengthen the international position of the dollar and to slow the growth in the money supply, increased the discount rate 6 times in fiscal 1978, while commercial banks increased the prime rate 10 times.

In conducting its debt management operations, the Treasury had to make sure (1) that the extensive fundraising was done in the most efficient manner possible; (2) that the borrowings were done in such a way that fosters, rather than inhibits, economic stability and sustained growth of the economy; and (3) that new issues were geared toward creating a more balanced maturity structure, which in turn would facilitate the orderly managing of the debt in future years. Consistent with these principles, the Treasury's financing requirements were met primarily by auctions of regularized coupon securities.

The auction technique allowed the price of the new securities to be determined by competitive bidding and thereby minimized the Treasury's financing costs and the underwriting pressures on primary dealer organizations. The regularized offerings of cycle notes and bonds provided the Treasury with regular access to the various maturity sectors of the market and, at the same time, allowed investors to plan on these expected offerings for their investment needs because of the reduction in market uncertainty concerning Treasury financing plans.

Excluding bills, total Treasury financing amounted to \$99.3 billion. This included nearly \$43.2 billion to refund privately held maturing securities and \$13.2 billion of new issues allotted to Federal Reserve banks and Government accounts. Total new cash raised from marketable and nonmarketable issues amounted to \$63 billion, which was \$10 billion more than in fiscal 1977. About \$17 billion of the \$63 billion in new cash was from nonmarketable issues with State and local government series sales providing a record \$12.8 billion and E and H savings bonds another \$4.4 billion. Other nonmarketable securities declined \$0.2 billion.

MARKET YIELDS AT CONSTANT MATURITIES 1973-1978^{1/}



Federal debt and Government-sponsored agency debt
[In billions of dollars]

Class of debt	Sept. 30, 1976	Sept. 30, 1977	Sept. 30, 1978	Increase, or decrease (-)
Public debt securities:				
Marketable public issues by maturity class:				
Within 1 year.....	206.1	217.9	225.4	7.5
1 to 5 years.....	131.1	148.4	168.5	20.1
5 to 20 years.....	57.3	58.9	65.9	7.0
Over 20 years.....	13.2	18.3	25.4	7.1
Total marketable issues.....	407.7	443.5	485.2	41.7
Nonmarketable public issues:				
Series E and H savings bonds.....	70.8	75.4	79.8	4.4
U.S. savings notes ¹.....	.4	.4	.4	.....
Investment series bonds.....	2.3	2.2	2.2	.....
Foreign government series:				
Dollar denominated.....	19.2	20.5	20.9	.4
Foreign currency denominated.....	1.6	1.3	.8	-.5
State and local government series.....	2.9	11.4	24.2	12.8
Other nonmarketable debt.....	.1	2.8	.1	-2.7
Total nonmarketable public issues.....	97.3	114.0	128.4	14.4
Government account series (nonmarketable).....	128.6	140.1	153.3	13.2
Non-interest-bearing debt.....	1.1	1.2	4.6	3.4
Total gross public debt.....	634.7	698.8	771.5	72.7
Federal agency securities:				
Government National Mortgage Association.....	4.1	3.8	3.2	-.6
Export-Import Bank of the United States.....	3.6	2.9	2.1	-.8
Tennessee Valley Authority.....	2.0	1.8	1.8	.....
Defense family housing.....	1.1	1.0	.9	-.1
Other.....	.8	.8	.9	.1
Total Federal agency debt.....	11.7	10.3	8.9	-1.4
Total Federal debt.....	646.4	709.1	780.4	71.3
Government-sponsored agency securities:				
Federal home loan banks.....	19.1	19.2	27.4	8.2
Federal National Mortgage Association.....	30.7	31.5	38.4	6.9
Federal land banks.....	16.6	18.7	20.2	1.5
Federal intermediate credit banks.....	10.8	11.7	11.6	-.1
Banks for cooperatives.....	3.9	4.1	4.3	.2
Farm Credit discount notes.....	.7	1.0	2.8	1.8
Farm Credit consolidated bonds.....	.....	1.0	2.3	1.3
Government-sponsored agency debt.....	81.8	87.2	107.0	19.8

¹ U.S. savings notes first offered in May 1967; sales discontinued after June 30, 1970.

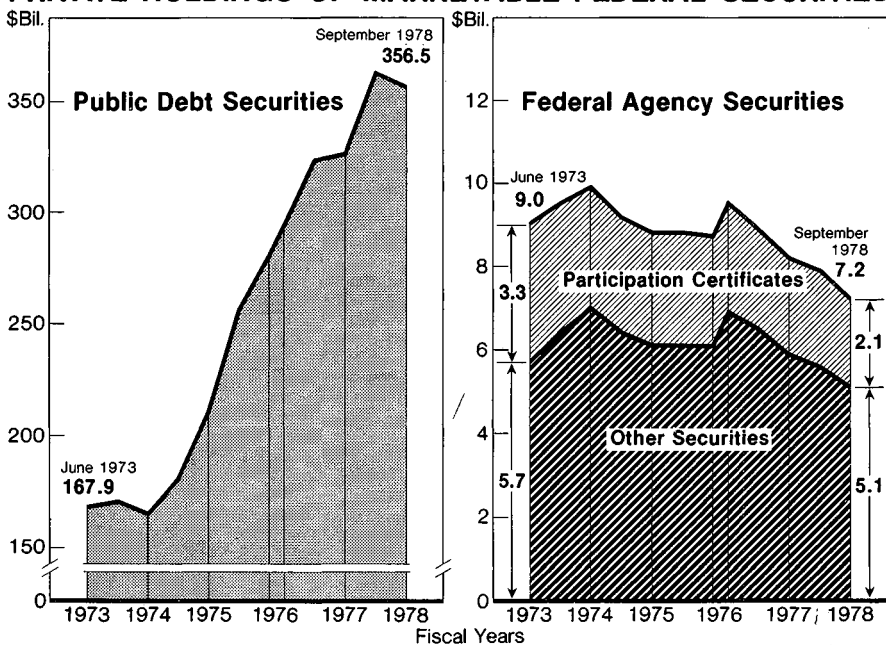
Changes in Federal securities

The public debt issues of the Treasury, both marketable and nonmarketable, as well as the obligations issued by those Federal agencies in which there is an element of Federal ownership are known as Federal securities. The Federal agency securities included are the participation certificates of the Government National Mortgage Association, the debt issues of the Export-Import Bank of the United States and the Tennessee Valley Authority, Postal Service bonds, Defense family housing mortgages, and various guaranteed issues of the Federal Housing Administration.

At the close of fiscal 1978 there were \$780.4 billion of Federal securities outstanding, compared with \$709.1 billion a year ago. The public debt issues of the Treasury amounted to \$771.5 billion, an increase of \$72.7 billion for the fiscal year. Outstanding Federal agency securities totaling \$8.9 billion were down \$1.4 billion from the end of fiscal 1977. Treasury marketable securities outstanding amounted to \$485.2 billion, an increase of \$41.7 billion for the fiscal year, compared with the \$35.8 billion increase in fiscal 1977. Treasury nonmarketable public issues rose by \$14.4 billion to a level of \$128.4 billion. The increase in fiscal 1978 was \$2.3 billion less than in fiscal 1977. Special nonmarketable securities issued to State and local governments increased \$12.8 billion, or 111 percent, while special nonmarketables issued to foreign official accounts declined \$0.1 billion, or less than 1 percent. Savings bonds and notes increased \$4.4 billion, compared with \$4.6 billion a year earlier. The Government account series, or special nonmarketables issued only to Government accounts and trust funds such as the Federal old-age and survivors insurance trust fund, increased \$13.2 billion, or 9 percent. Total nonmarketable Treasury securities increased \$27.7 billion to a level of \$281.8 billion at the end of fiscal 1978.

In fiscal 1978, the securities issued by Government-sponsored agencies increased by \$19.8 billion to a level of \$107 billion. The \$8.2 billion increase

PRIVATE HOLDINGS OF MARKETABLE FEDERAL SECURITIES



in Federal Home Loan Bank securities and the \$6.9 billion rise in Federal National Mortgage Association issues accounted for 76 percent of the increase in sponsored agencies' issues outstanding.

The securities issued by Government-sponsored agencies are not included in Federal securities since these agencies are not owned in whole or in part by the Government. However, these privately owned and managed agencies are subject to some degree of Federal supervision. At the end of fiscal 1978 private investors held \$99 billion of Government-sponsored agency securities. This accounted for \$18.8 billion, or 95 percent, of the \$19.8 billion increase in these agencies' outstanding issues. Holdings by the Federal Reserve System increased by \$1 billion to a level of \$8 billion. Nearly \$46 billion in new cash was raised through marketable issues. Excluding the \$20.5 billion of cash management bills issued and redeemed in the fiscal year, over \$4.8 billion of the new cash was raised with Treasury bill issues. Regular issues of 13- and 26-week bills accounted for \$2 billion and 52-week bill issues raised \$2.8 billion, close to \$1.5 billion of which was foreign add-ons. Coupon securities provided \$41.1 billion of new cash, including a record \$9.4 billion of foreign add-ons. Eleven 2-year cycle notes accounted for \$12.5 billion while the four 4-year cycle notes brought in \$11.4 billion. Two 5-year cycle note issues raised \$5.3 billion and two issues of 15-year bonds raised almost \$3.3 billion of the new cash. The quarterly refundings accounted for the remaining \$8.6 billion of new money.

In fiscal 1978, the Treasury took advantage of two increases in its "bond authority" to sell \$8.8 billion of new bonds to the public. The bond authority applies to the limit on the amount of marketable Treasury bonds with coupon rates exceeding 4 1/4 percent held by private investors. Congress raised the ceiling from \$17 to \$27 billion in October 1977 and to \$32 billion in August 1978. By the end of the fiscal year, the amount of bonds held by private investors rose by only \$7.9 billion because of market purchases by the Federal Reserve of issues originally sold to the public. The increase in bond authority gave the Treasury more flexibility in its financing options and was a factor in the Treasury's successful efforts to lengthen the average maturity of the Treasury marketable debt held by private investors, which had increased by over 3 months to a level of 3 years 3 months by the end of the fiscal year.

Estimated ownership

Private investors held \$495.5 billion of the \$780.4 billion of Federal securities outstanding at the end of fiscal 1978. The remaining \$285 billion was held by the Federal Reserve banks and Government accounts. Borrowings from the public, which includes the Federal Reserve as well as foreign and international investors, amounted to a net \$59.1 billion, compared with \$53.3 billion in fiscal 1977. Private investors accounted for \$48.7 billion, or 82 percent, of the \$59.1 billion borrowed from the public while the Federal Reserve System absorbed the remaining \$10.4 billion, or 18 percent.

Individuals.—Public debt securities held by individuals increased by \$5.5 billion in fiscal 1978, compared with \$4.2 billion in fiscal 1977. Savings bonds accounted for \$4.4 billion of the increase while marketable holdings rose \$1.1 billion. On September 30, 1978, individuals held \$109.3 billion of public debt securities, of which \$79.9 billion were savings bonds and notes and \$29.4 billion were marketable and other Treasury securities. Individuals' holdings of Federal agency securities totaling \$0.4 billion remained unchanged.

Estimated ownership of public debt securities on selected dates 1976-78
[Dollar amounts in billions]

	June 30, 1976	Sept. 30, 1976	Sept. 30, 1977	Sept. 30, 1978	Change during fiscal 1978
Estimated ownership by:					
Private nonbank investors:					
Individuals:¹					
Series E and H savings bonds	\$69.2	\$70.5	\$75.2	\$79.5	\$4.4
U.S. savings notes ² .....	.4	.4	.4	.4	(-*)
Other securities	26.8	28.8	28.3	29.4	1.1
Total individuals	96.4	99.7	103.9	109.3	5.5
Insurance companies	10.6	11.7	14.3	15.1	.8
Mutual savings banks	5.4	5.7	6.2	5.4	-.8
Savings and loan associations	8.0	8.3	9.7	8.2	-1.5
State and local governments	39.3	38.7	53.0	67.8	14.8
Foreign and international	69.8	74.6	95.5	121.0	25.4
Corporations	24.3	25.3	23.3	21.5	-1.8
Miscellaneous investors ³	30.0	32.8	32.9	44.7	11.8
Total private nonbank investors	283.8	296.9	338.8	393.0	54.2
Commercial banks	92.5	95.2	99.8	95.3	-4.5
Federal Reserve banks	94.4	96.4	104.7	115.3	10.6
Government accounts	149.6	146.1	155.5	168.0	12.5
Total gross debt outstanding	620.4	634.7	698.8	771.5	72.7
Percent owned by:					
	<i>Percent</i>				
Individuals	16	16	15	14	.....
Foreign and international	11	12	14	16	.....
Other private nonbank investors	19	19	20	21	.....
Commercial banks	15	15	14	12	.....
Federal Reserve banks	15	15	15	15	.....
Government accounts	24	23	22	22	.....
Total gross debt outstanding	100	100	100	100	.....

r Revised.

* Less than \$50 million.

¹ Including partnerships and personal trust accounts.

² U.S. savings notes first offered in May 1967; sales discontinued after June 30, 1970.

³ Includes nonprofit institutions, corporate pension trust funds, nonbank Government security dealers, certain Government deposit accounts, and Government-sponsored agencies.

Insurance companies.—Insurance companies' holdings of public debt securities increased by \$0.8 billion in fiscal 1978. This compares with a \$2.7 billion increase in fiscal 1977. At the end of the fiscal year insurance companies held \$15.1 billion of public debt securities. Federal agency securities held by insurance companies decreased \$0.2 billion to a level of \$0.3 billion.

Savings institutions.—In fiscal 1978, savings and loan associations liquidated \$1.5 billion of public debt securities, compared with a \$1.5 billion increase in holdings in fiscal 1977. Holdings of Federal agency securities increased \$0.2 billion. On September 30, savings and loan associations held \$8.2 billion of public debt securities and \$0.4 billion of Federal agency securities.

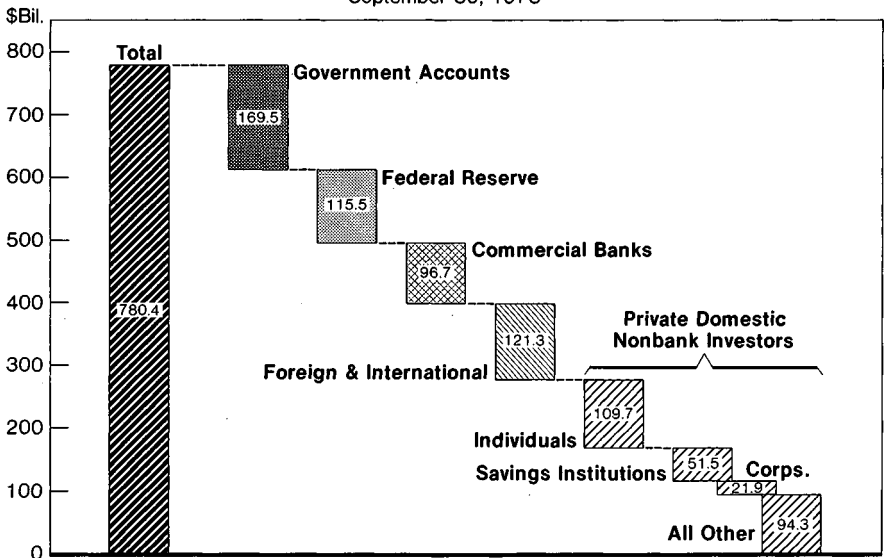
Mutual savings banks also decreased their holdings of public debt securities as they liquidated \$0.8 billion in fiscal 1978, compared with a \$0.5 billion increase in fiscal 1977. Holdings of Federal agency securities amounted to \$0.5 billion, an increase of \$0.1 billion for the year.

State and local governments.—Public debt securities held by State and local governments increased by \$14.8 billion in fiscal 1978. This was \$0.5 billion more than the increase in fiscal 1977. Most of the increase was concentrated in their holdings of special nonmarketable issues designed especially for these governmental units to invest the proceeds from the sale of lower coupon issues that are to be used to “advance refund” higher coupon securities. Holdings of these special issues increased by a record \$12.8 billion as State and local units stepped up their “advance refunding” issues to beat the September 1 deadline when new Treasury regulations restricting arbitrage opportunities would go into effect. Holdings of Federal agency issues fell by \$0.9 billion to a level of \$2.1 billion. Over \$0.4 billion of the decline was in Government National Mortgage Association participation certificates.

Foreign and international.—Foreign investors increased their holdings of public debt securities by a record \$25.4 billion after posting a \$20.5 billion increase a year earlier. The increase in holdings was all due to acquisitions of marketable securities, \$10.8 billion of which was from foreign add-ons.

OWNERSHIP OF FEDERAL SECURITIES

September 30, 1978



Foreign add-ons represent additional amounts of publicly offered marketable securities sold to foreign official accounts at the average price.

Actually, over the first half of the fiscal year foreign and international investors acquired \$29 billion of public debt securities, part of which was acquired in foreign central bank support operations of the dollar. Holdings peaked in March at \$124.5 billion and since then have declined to \$121 billion by the end of fiscal 1978. At that level foreign and international investors became the largest holders of public debt securities among private investors. Federal agency securities held by foreign investors declined by \$0.2 billion to a level of \$0.4 billion.

Nonfinancial corporations.—Corporations continued to liquidate public debt securities in fiscal 1978 and reduced their holdings by \$1.8 billion, compared with a reduction of \$2 billion in fiscal 1977. On September 30, 1978, corporations held \$21.5 billion of public debt securities. Federal agency securities held by corporations amounted to \$0.4 billion after a decline of \$0.2 billion in fiscal 1978.

Other private nonbank investors.—Public debt securities held by other private nonbank investors increased by \$11.8 billion in fiscal 1978, compared with an increase of \$0.1 billion in fiscal 1977. By contrast, holdings of Federal agency issues increased by \$0.4 billion to an end of fiscal year level of \$1.4 billion.

Commercial banks.—Unlike fiscal 1977, when bank loan demand was low and banks had an incentive to take longer maturities, commercial banks liquidated \$4.5 billion of public debt securities to help meet the high loan demand from business and consumers. By contrast, in fiscal 1977 commercial banks added \$4.6 billion of public debt securities. On September 30, 1978, commercial banks held \$95.3 billion of public debt securities. Federal agency securities held by commercial banks fell by \$0.3 billion to a level of \$1.4 billion at the end of fiscal 1978.

Federal Reserve System.—The Federal Reserve System increased its holdings of public debt securities \$10.6 billion in fiscal 1978, compared with \$8.3 billion in fiscal 1977. Holdings of Federal agency securities declined \$0.1 billion. On September 30, 1978, the System held \$115.3 billion of public debt securities and \$0.2 billion of Federal agency securities.

Government accounts.—Holdings of public debt securities by Government accounts increased \$12.5 billion in fiscal 1978, compared with an increase of \$9.4 billion in fiscal 1977. Special nonmarketable securities (Government account series) held by these accounts increased \$13.2 billion while holdings of marketable securities decreased \$0.7 billion. Federal agency securities held by Government accounts declined \$0.3 billion. At the end of fiscal 1978, Government accounts held \$168 billion of public debt securities and \$1.5 billion of Federal agency securities.

Financing operations

On September 30, 1977, the temporary debt limit of \$700 billion expired, leaving the Treasury without the authority to issue new debt obligations. In the absence of new debt legislation, the debt ceiling reverted to its "permanent" statutory limit of \$400 billion until October 4, when Congress passed legislation increasing the temporary debt limit to \$752 billion through March 31, 1978.¹ During the interim, the Treasury was able to handle its short-term cash needs without difficulty because of the large \$19.1 billion operating cash balance at the end of fiscal 1977.

The economy looked strong at the start of fiscal 1978. Early October reports of a decline in unemployment and an increase in the index of leading economic indicators for September provided evidence of a vigorous economy. In addition, industrial production and housing continued to move along at a brisk pace. Nevertheless, inflation and recent large increases in the money supply were the major worries of market participants.

On September 27 the Treasury announced plans to sell a 5-year 1-month note to raise \$2.5 billion of new cash. The October 5 auction drew over \$3.7 billion of tenders from the public including \$0.2 billion submitted on a noncompetitive basis. Foreign add-ons of \$0.2 billion increased the issue size to \$2.7 billion and made it the largest amount of 5-year notes sold since the Treasury instituted this cycle at the beginning of 1976. Commercial banks received \$1 billion, or 37 percent, of the notes and dealers received \$0.8 billion, or 30 percent. A slightly higher than expected 7.18-percent average yield led to the assignment of a 7 1/8 percent coupon. The issue declined in price in the secondary market and by the time the notes were issued on October 17, they were bid at a price yielding 7.33 percent.

Meanwhile, on October 12, the Treasury announced it would sell \$3.5 billion of 2-year notes to refund \$2.9 billion of privately held notes due October 31 and raise \$0.6 billion of new cash. The issue was well received at the auction on October 18. Almost \$0.6 billion of noncompetitive tenders were included in the \$6.2 billion of tenders received from the public and \$0.6 billion of foreign add-ons brought the issue size up to \$4.1 billion and new cash to \$1.2 billion. Commercial banks took \$1.8 billion, or 44 percent, of the issue while dealers took \$0.8 billion, or 20 percent. The average yield of 7.27 percent was 53 basis points above the yield at the previous 2-year note sale and resulted in a 7 1/4 percent coupon. The new notes moved to a premium in when-issued trading activity.

Both short- and long-term rates moved higher during October. The effective Federal funds rate rose about 35 basis points to almost 6 1/2 percent as the Federal Reserve attempted to slow monetary growth. The prime rate was increased twice in October, first to 7 1/2 percent and then to 7 3/4 percent; and in late October, the Federal Reserve raised the discount rate 1/4 percent

¹ See exhibit 6.

to the 6-percent level. In the Treasury bill market, 3-month bill rates rose above 6 percent to reach their highest levels since late 1975. In the coupon market, intermediate and long Treasury rates rose from about 15 to 40 basis points in terms of monthly averages, with the larger increases recorded for the shorter maturities causing a flattening of the yield curve. Corporate and municipal bond rates climbed about 10 basis points during the month.

Data released covering the month of October revealed the basically healthy performance of the economy. Personal income rose by a large \$20.2 billion seasonally adjusted annual rate, while industrial production rose 0.3 percent seasonally adjusted. Housing starts posted a healthy rise along with retail sales. Employment was up but unemployment rose as well. However, inflationary pressures persisted as wholesale prices rose a rather high 0.8 percent, seasonally adjusted, while consumer prices rose by a moderate 0.3 percent. The large increase in business loans by commercial banks was indicative of the strength of credit demands.

Within this framework of strong economic activity, on October 21, a slightly larger than expected quarterly refunding package of three securities totaling \$6.5 billion was announced by the Treasury. The new securities offered were: \$3 1/4 billion of 3-year notes, \$2.0 billion of 10-year notes, and \$1 1/4 billion of 30-year bonds. The Treasury sought to raise \$4.1 billion in new cash while refunding \$2.4 billion of privately held notes due November 15. The 10-year note represented the first time such an issue was sold in a yield auction. The two previous 10-year note issues were sold at fixed prices by the subscription method in the May and August 1976 quarterly refunding operations.

The 3-year note auction on October 28 attracted strong bidding interest. About \$8.6 billion of tenders were submitted by the public including over \$1.1 billion of noncompetitive tenders. The issue size grew to almost \$4 billion when \$0.7 billion of add-ons were sold to foreign accounts. The average yield was 7.24 percent and the Treasury assigned a 7 1/8 percent coupon to the issue. Commercial banks took \$1.9 billion, or 47 percent, of the notes; dealers received \$0.7 billion, or 18 percent; and individual investors received \$0.3 billion, or 7 percent.

Since the Federal Reserve usually remains neutral during a refunding, some confusion and apprehension existed over the Federal Reserve's apparent tightening maneuvers at the time of the refunding. Nevertheless, the 10-year notes auctioned on November 1 attracted strong bidding interest. This was the Treasury's first use of this maturity length since August 1976. About \$4.3 billion of tenders from the public were received for the \$2 billion of notes, including \$0.3 billion of noncompetitive tenders. A 7 5/8 percent coupon was set on the basis of an average yield of 7.69 percent for the notes. Dealers received \$0.8 billion, or 39 percent, of the issue; commercial banks were allotted \$0.6 billion, or 32 percent; and State and local pension and retirement funds took \$0.2 billion, or 10 percent.

The 30-year bond auction on November 2 also attracted a good level of interest with tenders totaling \$2.9 billion received from the public. Of the almost \$1.3 billion accepted, \$0.1 billion were noncompetitive tenders. The average yield was 7.94 percent which resulted in setting a 7 7/8 percent coupon on the issue. Dealers and commercial banks each received \$0.5 billion which accounted for 82 percent of the bonds. In all, over \$7.2 billion of new securities were sold to the public in this quarterly financing. Of this total, almost \$4.9 billion represented new cash.

The Treasury's announcement, on November 3, of an 8-day issue of cash management bills was expected by the market as the Treasury had announced earlier that it anticipated an offering of cash management bills to get by a low cash point in early November. Moreover, the Treasury also announced that it might raise new cash by additions to the regular bills. About \$2.5 billion of cash management bills were issued on November 7 as an addition to 52-week bills maturing November 15. The minimum acceptable tender was \$10 million. With good demand, evidenced by the \$6.4 billion of tenders received at the November 4 auction, an average rate of 6.39 percent evolved.

Around midmonth an offering of \$3 3/4 billion of 2-year notes to refund \$2.5 billion of privately held notes due November 30 and raise \$1 1/4 billion of new money was announced by the Treasury on November 14. This was the largest 2-year note offering since the cycle was started in late 1972. Although the amount of new cash was above market expectations, the November 22 auction encountered good bidding interest. Almost \$3.8 billion of the \$8.7 billion of tenders from the public was accepted including \$0.7 billion tendered noncompetitively. In addition, official foreign and international accounts were allotted an unprecedented \$0.9 billion of add-ons, raising the size of the issue to \$4.7 billion and the new cash figure to \$2.2 billion. Commercial banks were allotted \$1.8 billion, or 39 percent, of the notes while dealers took \$1.1 billion, or 23 percent. A 7.13-percent average auction yield led the Treasury to assign a 7 1/8 percent coupon rate to the issue.

November 23 brought the expected announcement of the offering of \$3 billion in 139-day Treasury bills to be issued as an addition to the outstanding 26-week bills due April 20, 1978. The minimum acceptable tender was \$10,000 for the bills which were auctioned on November 29. About \$7.4 billion of tenders were received and \$3 billion were accepted including \$14 million of noncompetitive bids. Good demand for the bills resulted in an average discount rate of 6.27 percent, just below the bid rate on the outstanding 26-week bills of the same maturity.

As a result of the financing operations during November, the average length of the privately held portion of the marketable Treasury debt rose by nearly 2 months to a level of 3 years by the end of the month.

On November 30, the Treasury auctioned \$2 3/4 billion of 4-year 1-month notes, to be dated December 7. This was the largest offering for a 4-year cycle

note to date. The auction attracted \$5.4 billion of tenders from the public, of which \$2.8 billion was accepted including \$0.4 billion of noncompetitive tenders. Almost \$0.7 billion of foreign add-ons, also a historic high for a 4-year cycle note, were accepted and this brought total new cash raised to almost \$3.5 billion. Commercial banks received \$1.4 billion, or 41 percent, of the issue while dealers accounted for \$0.6 billion, or 18 percent. A 7.31-percent average yield, almost 50 basis points above the previous 4-year note auctioned in August 1977, led to a 7 1/4 percent coupon rate.

The new cash raised with this latest 4-year cycle note brought the total raised by the Treasury in the coupon sector to \$14.4 billion for the first quarter of fiscal 1978. About \$3.3 billion was from 2-year cycle notes, while \$6.2 billion was from 4- and 5-year cycle notes. In addition, \$4.9 billion of new cash was raised in the quarterly refunding. Over the course of the quarter, \$7.8 billion of maturing coupons were refunded.

Offerings of marketable Treasury securities excluding refunding of regular bills, fiscal 1978
[In millions of dollars]

Date	Description	Allotted to private investors		Allotted to Federal Reserve and Government accounts	Total	Average auction yield (percent)
		For cash	For refunding			
1977						
NOTES AND BONDS						
Oct. 1.....	1 1/2 percent note, Oct. 1, 1982 ¹		2		2	
Oct. 17.....	7 1/8 percent note, Nov. 15, 1982.....	2,737			2,737	7.18
Oct. 31.....	7 1/4 percent note, Oct. 31, 1979.....	1,178	2,938	218	4,334	7.27
Nov. 15.....	7 1/8 percent note, Nov. 15, 1980.....	2,664	1,311	625	4,600	7.24
Nov. 15.....	7 5/8 percent note, Nov. 15, 1987.....	1,350	664	373	2,387	7.69
Nov. 15.....	7 7/8 percent bond, Nov. 15, 2002-2007.....	841	414	240	1,495	7.94
Nov. 30.....	7 1/8 percent note, Nov. 30, 1979.....	2,163	2,516	112	4,791	7.13
Dec. 7.....	7 1/4 percent note, Dec. 31, 1981.....	3,452			3,452	7.31
1978						
Jan. 3.....	7 1/8 percent note, Dec. 31, 1979.....	1,164	2,428	328	3,920	7.20
Jan. 6.....	7 7/8 percent bond, Feb. 15, 1993.....	1,501			1,501	7.95
Jan. 31.....	7 1/2 percent note, Jan. 31, 1980.....	1,364	2,239	272	3,875	7.55
Feb. 15.....	7 1/2 percent note, May 15, 1981.....	857	2,036	1,000	3,893	7.53
Feb. 15.....	8 percent note, Feb. 15, 1985.....	890	2,113	1,200	4,203	7.88
Feb. 15.....	8 1/4 percent bond, May 15, 2000-2005.....	372	882	771	2,025	8.23
Feb. 28.....	7 5/8 percent note, Feb. 29, 1980.....	1,705	2,062	53	3,820	7.70
Mar. 6.....	7 7/8 percent note, Mar. 31, 1982.....	2,853			2,853	7.89
Mar. 31.....	7 1/2 percent note, Mar. 31, 1980.....	845	2,850	312	4,007	7.56
Apr. 1.....	1 1/2 percent note, Apr. 1, 1983 ¹		(^c)		(^c)	
Apr. 5.....	7 7/8 percent note, May 15, 1983.....	2,573			2,573	7.94
May 1.....	7 3/4 percent note, Apr. 30, 1980.....	606	2,146	428	3,180	7.80
May 15.....	8 1/4 percent note, May 15, 1988.....		2,548	1,600	4,148	8.29
May 15.....	8 3/8 percent bond, Aug. 15, 1995-2000.....		1,502	895	2,397	8.47
May 31.....	8 percent note, May 31, 1980.....	532	2,390	177	3,099	8.09
June 7.....	8 1/4 percent note, June 30, 1982.....	2,594			2,594	8.27
June 30.....	8 1/4 percent note, June 30, 1980.....	1,076	2,537	794	4,407	8.32
July 11.....	8 5/8 percent bond, Aug. 15, 1993.....	1,768			1,768	8.63
July 31.....	8 1/2 percent note, July 31, 1980.....	1,309	2,480	375	4,164	8.61
Aug. 15.....	8 3/8 percent note, Aug. 15, 1981.....	1,280	1,630	1,200	4,110	8.46
Aug. 15.....	8 1/4 percent note, Aug. 15, 1985.....	1,496	1,908	1,434	4,838	8.36
Aug. 15.....	8 3/8 percent bond, Aug. 15, 2003-2008.....	661	842	600	2,103	8.43
Aug. 31.....	8 3/8 percent note, Aug. 31, 1980.....	595	2,749	200	3,544	8.38
Sept. 6.....	8 3/8 percent note, Sept. 30, 1982.....	2,501			2,501	8.41
Total notes and bonds.....		42,927	43,187	13,207	99,321	

Offerings of marketable Treasury securities excluding refunding of regular bills, fiscal 1978 — Con.
 [In millions of dollars]

		Allotted to private investors		Allotted to Federal Reserve and Government accounts	Total	Average auction yield (percent)
Date	Description	For cash	For refunding			
BILLS (MATURITY VALUE)						
Change in offerings of regular bills:						
1977						
	October-December	1,986	.....	.....	1,986	.....
1978						
	January-March	1,567	.....	.....	1,567	.....
	April-June.....	113	.....	.....	113	.....
	July-September	1,179	.....	.....	1,179	.....
	Total change in regular bills.....	4,845	.....	.....	4,845	.....
Other bill offerings:						
1977						
Nov. 7	6.390 percent, 8-day, maturing Nov. 15, 1977	2,505	.....	.....	2,505	.....
Dec. 2	6.273 percent, 139-day, maturing Apr. 20, 1978	3,004	.....	.....	3,004	.....
1978						
Mar. 8	6.346 percent, 43-day, maturing Apr. 20, 1978	3,004	.....	.....	3,004	.....
Apr. 3	6.645 percent, 24-day, maturing Apr. 27, 1978	6,006	.....	.....	6,006	.....
June 6	7.110 percent, 20-day, maturing June 22, 1978	6,005	.....	.....	6,005	.....
	Total other bill offerings	20,524	.....	.....	20,524	.....
	Total offerings	68,296	43,187	13,207	124,690	.....

¹ Issued in exchange for 2 3/4 percent Treasury bonds, investment series B-1975-80.

* Less than \$500,000.

In the bill market, the Treasury raised \$5 billion of net new cash during the first quarter of fiscal 1978; \$3 billion from 139-day bills and \$0.6 billion from three 52-week bill auctions, all of which was from foreign add-ons. Finally, \$1.4 billion of new cash was raised from regular weekly 13- and 26-week bill auctions. The November 5 issues of 13- and 26-week bills marked the first time since March 1976 that the Treasury had used the weekly bill auctions as a source of new cash.

The total amount of net new money, \$19.4 billion, raised from marketable securities during the October–December quarter was the highest since the January–March 1976 quarter when the Treasury raised \$22.8 billion. Included in the \$19.4 billion of new cash for the quarter was \$3.7 billion of foreign add-ons, \$3.1 billion of which was the most ever raised from coupon issues.

From nonmarketable sources, about \$4.1 billion of additional new cash was raised during the quarter, nearly \$2.4 billion was from State and local series, while foreign nonmarketables provided \$0.5 billion and savings bonds \$1.2 billion.

The signs of economic strength exhibited in October continued to improve during November and December. The seasonally adjusted unemployment rate fell in both months and stood at 6.4 percent by yearend—the lowest level in 3 years. Consumer spending provided a boost throughout the quarter as personal income posted large gains. Residential construction continued to be another source of strength, and demand for credit was high in almost all areas including commercial bank loans.

Most short-term rates rose only slightly during November and December. Intermediate- and long-term rates eased slightly lower in November but rose in December. Intermediate and long Treasury security yields ended the calendar year about 20 basis points higher than late October levels. Corporate bond rates also rose 20 basis points during the period while municipal bond rates climbed by 5 to 10 basis points. Rates on new conventional mortgages edged higher also.

The first two coupon issues in January had been announced and sold during December. On December 13, the Treasury had announced an offering of \$3 billion of 2-year notes to be dated January 3, 1978, to refund \$2.4 billion of privately held maturing notes and raise \$0.6 billion of new cash. Expectations of higher rates ahead contributed to the weakness of bidding interest at the December 21 auction as only \$4.2 billion of tenders from the public were received. About \$3 billion was accepted including \$0.5 billion in noncompetitive tenders. A 7 1/8 percent coupon was assigned to the notes following the 7.20-percent average yield result in the auction. New cash totaled almost \$1.2 billion with the addition of \$0.6 billion of foreign add-ons. Commercial banks were allotted \$1.4 billion, or 39 percent, of the notes and dealers took \$0.9 billion, or 26 percent.

Market uncertainty as to whether the Treasury would use a 5-year or 15-year issue to fill the early January slot was resolved in favor of the latter with the announcement on December 19 of an offering of 15-year 1-month bonds to raise \$1.5 billion of new cash. Market reaction was mild and a cautious market atmosphere prevailed up to the December 27 auction in anticipation of further interest rate increases, the appointment of a new Chairman of the Federal Reserve Board, and uncertainty concerning the yield needed to attract investors to this maturity area which was seldom used by the Treasury. However, a good interest did surface for the auction as \$3 billion of tenders were received from the public including \$0.1 billion submitted noncompetitively. Dealers were awarded \$0.6 billion, or 40 percent, of the bonds while commercial banks took another \$0.6 billion, or 37 percent. Corporations took \$0.3 billion, or 18 percent. This was about three times what they received in the June 1977 15-year bond auction. The average yield was 7.95 percent and a 7 7/8 percent coupon was assigned to the issue compared with a 7.29 percent

coupon on an issue identical in size and maturity auctioned 6 months earlier.

Later, on January 12, the Treasury announced a \$3 1/4 billion 2-year note to refund \$2.2 billion of similar notes privately held and to raise new cash. The note was to be dated January 31. A good bidding interest developed at the January 18 auction as \$6.7 billion of tenders from the public were submitted and \$3.3 billion were accepted including \$0.7 billion of noncompetitive tenders. About \$0.3 billion of foreign add-ons increased the issue to \$3.6 billion and net new money to \$1.4 billion. Commercial banks received \$1.7 billion, or 48 percent, of the notes and dealers took \$0.9 billion, or 24 percent. The 7.55-percent average yield was the highest for a 2-year note since the October 16, 1975, auction which produced an identical yield. The notes were assigned a 7 1/2 percent coupon.

One of the biggest concerns at the start of the new year was the decline of the dollar in foreign exchange markets caused mainly by the large trade and current account deficits posted by the United States in recent months. So, early in January the Treasury and Federal Reserve jointly announced that the Treasury's Exchange Stabilization Fund and a \$20 billion currency swap network of agreements among the Federal Reserve and other central banks would be utilized to keep the foreign exchange markets orderly. Market participants reacted favorably to this news.

Also in early January the Federal Reserve raised the discount rate 1/2 percent to 6 1/2 percent, a move motivated in part by the disorders in the foreign exchange markets. Other short-term rates moved up as well, as the Federal funds rate rose to 6 3/4 percent and the prime rate increased to 8 percent. Also, rates on commercial paper due in 90 to 119 days rose about 15 basis points in January while 3-month Treasury bill rates climbed about 40 basis points. In the coupon area, intermediate- and long-term Treasury rates rose 20 to 30 basis points above the levels prevailing at the end of 1977. Municipal bond yields edged slightly higher while new Aa corporate bonds yielded about 20 basis points higher in late January than the month before.

Meanwhile, the economy had slowed up slightly in January due, in part, to the severe winter weather. Residential construction and industrial production fell but the drop in unemployment indicated underlying strength in the economy. The major economic problems were the renewed weakness of the dollar in foreign exchange markets and the outlook of increased inflation.

Nevertheless, the January 25 announcement of the Treasury's quarterly refunding package was received quite favorably. The amount of new cash to be raised, \$1.7 billion, was modest and \$5 billion of privately held maturing notes were to be refunded. The inclusion of a \$2.5 billion, 3 1/4-year note represented a departure from the usual 3-year length as the short note issue. This was done because of the sizable amount of notes already maturing on February 15, 1981. The intermediate issue was \$3 billion of 8 percent 7-year notes to be sold at a price auction, the first of this kind since November 1974. The Treasury opted for this auction technique to elicit broader investor interest to what was considered a slightly larger intermediate issue than usual.

This was the first time since August 1976 that the intermediate-term note issue size was larger than the short anchor issue in a quarterly refunding. Finally, the 8 1/4 percent bonds of May 15, 2000–05 were to be reopened in the amount of \$1 1/4 billion, also in a price auction. The objective in enlarging this issue was to improve its currently limited tradability. Only about \$0.9 billion of the bonds were in private hands.

Market participants were optimistic approaching the auctions due to the market's good technical position and the relative stability of interest rates and Federal Reserve System policy at the time. The 7.53-percent average in the 3 1/4-year note auction was a little below yields available on some outstanding issues in this maturity range. A 7 1/2 percent coupon was set in the January 31 yield auction. About \$2.6 billion of the \$5.1 billion of public tenders was accepted, including \$1.2 billion of noncompetitive tenders. Foreign add-ons totaling \$0.3 billion increased the issue size to \$2.9 billion. Investor classes taking the largest portions of the notes were commercial banks with \$1.4 billion, or 50 percent; dealers with \$0.5 billion, or 16 percent; and individuals with \$0.3 billion, or 10 percent.

Bidding interest at the February 1 price auction of 8 percent notes was routine. Of the \$4.9 billion of tenders submitted by the public, \$3 billion was accepted including \$1.1 billion of noncompetitive tenders. Commercial banks were allotted \$1.3 billion, or 42 percent, of the notes and dealers received \$0.9 billion, or 31 percent. In addition, individuals, apparently attracted by the 8 percent coupon, took \$0.5 billion, or 16 percent, of the issue. The average auction price of 100 21/32 corresponded to a yield of 7.88 percent.

The 8 1/4 percent bonds of 2000–05 sold at the February 2 price auction at an average yield of 8.23 percent, close to the yield available on this issue in the secondary market. Almost \$1.3 billion of the \$3.4 billion of public tenders was accepted including less than \$0.2 billion of noncompetitive tenders. Dealers took \$0.7 billion, or 57 percent, of the bonds while commercial banks took \$0.2 billion, or 19 percent, and State and local pension funds took \$0.1 billion, or 8 percent. Including the \$0.3 billion of foreign add-ons to the 3 1/4-year note, over \$2.1 billion of new cash was raised in the quarterly refunding. The prices of all three new issues moved to a discount in when-issued trading as investor demand for the issues proved less than anticipated by some and caution surfaced over the possibility of a firmer policy stance by the Federal Reserve System.

February 10 brought the expected announcement of a 3 1/4 billion, 2-year note offering to be issued February 28. The notes were to refund \$2.1 billion of maturing privately held 2-year notes and raise \$1.2 billion of new cash. The February 16 auction drew \$5.2 billion of tenders of which \$3.3 billion was accepted including \$0.5 billion of noncompetitive tenders. About \$0.5 billion of foreign add-ons increased the issue size to \$3.8 billion and the new cash figure to \$1.7 billion. Commercial banks received \$1.6 billion, or 42 percent, of the issue while dealers were allotted \$0.8 billion, or 21 percent. A 7.70-percent average yield, 15 basis points above the yield in January's 2-year note

auction, led to the assignment of a 7 5/8 percent coupon. Demand was good for the notes, so in when-issued trading the notes sold at a premium.

Earlier, on February 15, the Treasury had announced its regular 4-year cycle note auction which was to be dated March 31, 1982. The February 22 auction for \$2.5 billion of new cash drew good bidding interest with over \$5.8 billion of tenders submitted by the public including \$0.3 billion of noncompetitive tenders. An additional \$0.3 billion of foreign add-ons increased the size of the issue to nearly \$2.9 billion. Commercial banks took \$1.3 billion, or 46 percent, of the notes and dealers picked up \$0.8 billion, or 29 percent, in the auction. The 7.89-percent average yield was almost 60 basis points higher than the yield at the most recent 4-year cycle note auction 3 months back. A 7 7/8 percent coupon was set on the issue, which immediately traded at higher price levels in when-issued trading.

Disposition of marketable Treasury securities excluding regular bills, fiscal 1978
[In millions of dollars]

Date of retirement	Securities		Redeemed for cash or carried to matured debt	Exchanged for new issue at maturity	Total
	Description and maturing date	Issue date			
1977					
NOTES AND BONDS					
Oct. 1.....	1 1/2 percent note, Oct. 1, 1977.....	Oct. 1, 1972.....	17	.....	17
Oct. 31.....	7 1/2 percent note, Oct. 31, 1977.....	Oct. 31, 1975.....	2,938	218	3,156
Nov. 15.....	7 3/4 percent note, Nov. 15, 1977.....	Nov. 15, 1974.....	2,392	1,238	3,630
Nov. 30.....	6 5/8 percent note, Nov. 30, 1977.....	Mar. 3, 1976.....	2,516	112	2,628
Dec. 31.....	7 1/4 percent note, Dec. 31, 1977.....	Dec. 31, 1975.....	2,437	328	2,765
1978					
Jan. 31.....	6 3/8 percent note, Jan. 31, 1978.....	Feb. 2, 1976.....	2,239	272	2,511
Feb. 15.....	6 1/4 percent note, Feb. 15, 1978.....	Feb. 15, 1971.....	5,418	2,971	8,389
Feb. 28.....	8 percent note, Feb. 28, 1978.....	Oct. 7, 1975.....	2,062	53	2,115
Mar. 31.....	6 3/4 percent note, Mar. 31, 1978.....	Mar. 31, 1976.....	2,850	312	3,162
Apr. 1.....	1 1/2 percent note, Apr. 1, 1978.....	Apr. 1, 1973.....	15	.....	15
Apr. 30.....	6 1/2 percent note, Apr. 30, 1978.....	May 17, 1976.....	2,146	428	2,574
May 15.....	7 1/8 percent note, May 15, 1978.....	Feb. 18, 1975.....	3,006	954	3,960
May 15.....	7 7/8 percent note, May 15, 1978.....	Aug. 15, 1975.....	2,882	1,541	4,423
May 31.....	7 1/8 percent note, May 31, 1978.....	June 1, 1976.....	2,390	177	2,567
June 30.....	6 7/8 percent note, June 30, 1978.....	June 30, 1976.....	2,537	794	3,331
July 31.....	6 7/8 percent note, July 31, 1978.....	July 30, 1976.....	2,480	375	2,855
Aug. 15.....	8 3/4 percent note, Aug. 15, 1978.....	May 15, 1974.....	1,825	637	2,462
Aug. 15.....	7 5/8 percent note, Aug. 15, 1978.....	May 15, 1975.....	2,558	2,597	5,155
Aug. 31.....	6 5/8 percent note, Aug. 31, 1978.....	Aug. 31, 1976.....	2,749	200	2,949
Sept. 30.....	6 1/4 percent note, Sept. 30, 1978.....	Sept. 30, 1976.....	2,684	511	3,195
Total coupon securities.....			48,141	13,718	61,859
BILLS					
1977 Other:					
Nov. 15.....	6.390 percent (8-day).....	Nov. 7, 1977.....	2,505	.....	2,505
1978					
Apr. 20.....	6.273 percent (139-day).....	Dec. 2, 1977.....	3,004	.....	3,004
Apr. 20.....	6.346 percent (43-day).....	Mar. 8, 1978.....	3,004	.....	3,004
Apr. 27.....	6.645 percent (24-day).....	Apr. 3, 1978.....	6,006	.....	6,006
June 22.....	7.110 percent (20-day).....	June 2, 1978.....	6,005	.....	6,005
Total other bills.....			20,524	.....	20,524
Total securities.....			68,665	13,718	82,383

The harsh winter weather continued into February but its impact on the economy did not appear too drastic. Industrial production showed a small increase, but was not enough to offset January's decline. The seasonally adjusted annual rate of housing starts was also higher than the January rate but was much lower than the rates of other recent months. The same was true with retail sales. However, credit demands continued high as commercial bank loans and consumer installment credit posted increases. The unemployment rate fell to 6.1 percent despite the long coal miners strike. Probably the worst news for the month of February was the record \$5.5 billion U.S. balance of trade deficit.

To help meet its seasonal cash needs, the Treasury announced the offering of a 43-day cash management bill of \$3 billion. There was very little market reaction to the March 1 announcement. The bills were to be issued March 8 as an addition to the outstanding bills maturing on April 20. This raised the total amount of bills maturing on that date to \$11.7 billion. Only competitive tenders totaling \$3 billion in minimum amounts of \$1 million were accepted from the \$7.3 billion of public tenders received in the March 3 auction. A 6.35-percent average discount rate resulted in the auction.

Subsequently, on March 15, the Treasury announced a \$3 billion issue of 2-year notes to refund \$2.8 billion of privately held notes due March 31 and raise \$0.2 billion of new cash. Of the \$6.1 billion of tenders from the public, \$3 billion was accepted including \$0.7 billion of noncompetitive tenders. Another \$0.7 billion of foreign add-ons increased the size of the issue to \$3.7 billion. Commercial banks were allotted \$1.9 billion, or 51 percent, of the notes. Dealers took only \$0.3 billion, or 8 percent, while individuals and corporations each received \$0.2 billion, or 6 percent. The good bidding interest in the March 22 auction resulted in a 7.56-percent average yield, 14 basis points below the last 2-year note auction. A 7 1/2 percent coupon was set. Since this coupon was identical to that of an outstanding 4-year note issue also maturing on March 31, 1980, the new issue was considered an addition to the 4-year notes. The Treasury had anticipated this possibility and had indicated in the original announcement that the two issues would be consolidated effective March 31, 1978, if a 7 1/2 percent coupon resulted in the auction. The auction of this 7 1/2 percent 2-year note was the last coupon issued in the first quarter of 1978.

For the quarter as a whole, the Treasury raised \$11.6 billion of new cash with coupons, \$5.1 billion of which came from four 2-year cycle notes issued during the quarter. The quarterly 4-year cycle note raised \$2.9 billion while the 15-year bond issue accounted for \$1.5 billion. The quarterly refunding issues raised an additional \$2.1 billion of new cash. The total of foreign add-ons included in the notes and bonds issued during the quarter amounted to \$2.7 billion.

Looking at the bill market in the January-March quarter, \$4.6 billion of new cash was raised including \$3 billion from the March 1, 43-day cash management bill. About \$1.2 billion was raised from regular 13- and 26-week

issues during the second half of February and the month of March. Foreign add-ons to 52-week bills accounted for \$0.4 billion of new cash during the quarter.

In all, the Treasury raised \$16.1 billion from marketable issues during this period compared with \$19.4 billion in the previous quarter. In addition, about \$14.6 billion of privately held coupon maturities was refunded during the quarter.

New cash raised in the nonmarketable sector in the January–March quarter amounted to \$5.1 billion, \$2.5 billion of which was in the State and local government series, while \$1.4 billion was received from the foreign government series. Series E and H savings bonds accounted for another \$1.2 billion.

After their initial rise in January, most short-term interest rates fluctuated within fairly narrow ranges during February and March. The Federal funds rate continued to hover around 6 3/4 percent, its level since mid-January. Rates on commercial paper due in 90 to 119 days also remained at the level of 6 3/4 percent. However, short-term Treasury bill rates actually declined since January, reflecting in part the strong demand by foreign investors seeking to halt the appreciation of their currencies against the U.S. dollar. Intermediate- and long-term Treasury rates posted net increases of from 10 to 15 basis points between late January and the end of March. These rates rose through most of February and then declined in early and mid-March, only to begin climbing again in late March. Corporate and municipal bonds ended March trading at about the same price levels as in late January, but mortgage rates continued to climb steadily during the January–March period.

Around the end of the month, on March 28, the Treasury auctioned a 5-year 1-month note that had been announced on March 21. This announcement to raise \$2.5 billion of new cash had been expected. About \$2.5 billion of the notes, which were to be dated April 5, was accepted from the \$5.6 billion of public tenders. Nearly \$0.4 billion was noncompetitive tenders. Foreign add-ons of \$50 million increased the issue size to almost \$2.6 billion. Commercial banks took \$1.3 billion, or 49 percent, of the issue while dealers' allotments totaled \$0.6 billion, or 25 percent. Routine bidding interest resulted in an average yield of 7.94 percent and a 7 7/8 percent coupon rate was assigned to the notes. Both the average yield and the coupon were the highest since the Treasury began selling 5-year cycle notes early in 1976. The issue traded at about the same price levels as the auction average in when-issued activity.

On March 28, the Treasury announced a slightly larger than expected issue of 24-day cash management bills to raise \$6 billion in new cash. The bills, available only by competitive tender in \$1 million minimums, were to be dated April 3 and due April 27. About \$5.7 billion of outstanding 13- and 26-week bills were also maturing on April 27. Almost \$10.9 billion of tenders were received from the public for the \$6 billion of bills and an average discount rate of 6.64 percent resulted in the auction on March 30.

March economic data showed that the adverse effects of the harsh winter were not lingering. Industrial production, sales, employment, and both

commercial and residential construction rose. At the same time, however, inflationary fears were fueled by further large increases in the Consumer Price Index and the Producer Price Index, formerly known as the Wholesale Price Index. Commercial bank lending also continued to expand in March, and the United States continued to run a balance of trade deficit.

The Treasury's offering of its regular monthly 2-year note was announced on April 12. This cycle note was to refund \$2.2 billion of notes maturing April 30, with a new 2-year note dated May 1. The auction was held on April 19, 1978. About \$2.2 billion of the \$5.3 billion of tenders from the public was accepted including \$0.4 billion of noncompetitive tenders. Foreign add-ons totaling nearly \$0.6 billion increased the issue size to \$2.8 billion. Commercial banks received \$1.3 billion, or 48 percent, of the notes while dealers received \$0.6 billion, or 22 percent. Despite good demand for the notes, the 7.80-percent average yield was higher than expected and almost 25 basis points above the most recent 2-year note auction in March. A 7 3/4 percent coupon was placed on the issue.

As the quarterly refunding approached, a cautious atmosphere developed in the market due mainly to fears of accelerating inflationary pressures. Nevertheless, a favorable reaction greeted the Treasury's April 26 announcement concerning the May quarterly refunding. The refunding package included a paydown of \$1.9 billion to be achieved by issuing \$2.5 billion of 10-year notes and \$1.5 billion of 22 1/4-year bonds to partially refund \$5.9 billion of privately held notes due May 15. The bond issue represented a reopening of the outstanding 8 3/8 percent bonds maturing in August 2000. The 10-year note issue was the fourth since March of 1976, when the Treasury was granted authority to sell notes up to 10 years in length instead of the previous 7-year maximum.

The 10-year notes were well received at the auction on May 2 as slightly more than \$2.5 billion of tenders were accepted from the \$5 billion submitted by the public, including a higher than expected \$0.6 billion of noncompetitive tenders. Dealers received \$1 billion, or 40 percent, of the notes while commercial banks took \$0.8 billion, or 32 percent; and allotments to nonfinancial corporations totaled almost \$0.3 billion, or 11 percent. The average auction yield was 8.29 percent, and an 8 1/4 percent coupon was placed on the issue.

The May 3 price auction for the \$1.5 billion of reopened 8 3/8 percent bonds attracted \$3.1 billion of tenders from the public. Noncompetitive tenders totaled almost \$0.2 billion. This reopening raised the amount of these bonds in the hands of the public to \$2.7 billion. Dealers took \$0.6 billion, or 40 percent, of the bonds while commercial banks were awarded \$0.4 billion, or 27 percent. State and local governments accounted for \$0.3 billion, or 20 percent, of the issue including \$0.2 billion, or 12 percent, taken by the general funds. Routine interest in the auction resulted in an 8.47-percent average yield which was a bit higher than anticipated.

The paydown resulting from the refunding was over \$1.8 billion but slightly less than originally announced. Due mainly to the refunding, the average length of the marketable debt held by private investors reached 3 years 1 month at the end of May, representing a gain of about 1 1/2 months over the April figure.

Concern over disintermediation was heightened in May when savings flows figures in thrift institutions for April showed a sharp decline in savings. Subsequently, a joint statement by the Federal Reserve Board, Federal Deposit Insurance Corporation, and Federal Home Loan Bank Board announced the authorization of two new types of time certificates designed to boost savings inflows. The first was a 6-month money market certificate with a ceiling interest rate tied to the average auction yield for the most recently auctioned 6-month Treasury bill. Thrift institutions could pay 1/4 percent above the Treasury bill rate while commercial banks could pay a rate equal to that on the Treasury bill. The second instrument was a certificate maturing in 8 years or more on which thrift institutions would pay 8 percent and commercial banks 7 3/4 percent. The 6-month issues had a \$10,000 minimum, and the long-term certificates had a \$1,000 minimum. Both new instruments were to be offered beginning on June 1.

At the time the Treasury announced its intention to refund \$2.4 billion of privately held notes due May 31 by selling an identical amount of 2-year notes, there were several factors contributing to the gloomy market atmosphere that prevailed. There was evidence of a strong economy with high inflationary pressures and, also, the fear of a tightening in Federal Reserve monetary policy. This was enough to overshadow the good technical position of the market. In the auction, \$2.5 billion of the \$5.8 billion of tenders from the public was accepted including \$1 billion of noncompetitive tenders. The amount of noncompetitive tenders was the highest in a 2-year cycle note sale since September 1975. The size of the issue was increased to \$2.9 billion with the addition of almost \$0.5 billion of foreign add-ons. Commercial banks received \$0.8 billion, or 27 percent, of the notes and dealers received \$0.6 billion, or 20 percent, while individuals took \$0.3 billion, or 11 percent. The 8.09-percent average yield in the May 23 auction marked the first time since September 1975 that a 2-year cycle note was auctioned at a yield above 8 percent. The coupon rate was set at 8 percent.

Later in the month, on May 22, the Treasury announced plans to auction \$2 1/4 billion of 4-year 1-month notes for new cash on the last day of the month. Almost \$2.3 billion of tenders was accepted from the \$5 billion submitted by the public including \$0.5 billion of noncompetitive tenders. The \$0.3 billion of foreign add-ons increased the size of the issue to \$2.6 billion. Commercial banks took \$1.2 billion, or 47 percent, of the total and dealers took \$0.6 billion, or 25 percent. Routine interest in the auction led to an 8.27-percent average yield, almost 40 basis points higher than the previous quarter's 4-year cycle note issue. The assignment of an 8 1/4 percent coupon followed. By the time of issue date, the notes were selling at a premium.

Meanwhile, some Treasury bill yields increased in reaction to the Treasury's May 26 announcement of a larger than expected \$6 billion issue of 20-day cash management bills. The bills were sold June 1, and were to mature on the same day as the \$5.6 billion of 13- and 26-week bills. Only competitive bids in minimum amounts of \$1 million were accepted. About \$6 billion of the \$12.3 billion of public tenders was accepted at an average discount rate of 7.11 percent.

The regular monthly 2-year cycle note offering was announced on June 14, when the Treasury invited tenders for \$3 billion of notes to refund \$2.5 billion of privately held maturing notes and raise \$0.5 billion of new cash. Almost \$3.1 billion of the \$4.9 billion of public tenders was accepted in the June 20 auction, including \$0.7 billion of noncompetitive tenders. Foreign add-ons of \$0.6 billion brought the new cash figure for this issue up to \$1.1 billion. Allotments to commercial banks totaled \$1.5 billion, or 41 percent, of the notes while dealers were allotted \$0.9 billion, or 24 percent. The average auction yield of 8.32 percent was 23 basis points above the May 2-year cycle note. The coupon set on the issue was 8 1/4 percent.

Unlike the previous two quarters, a net paydown of \$0.3 billion was achieved through issues of marketable Treasury securities to private investors during the April-June quarter. The paydown in Treasury bills was \$5.9 billion, excluding \$6 billion each of April and June cash management bills issued and redeemed during the quarter. Marketable coupon issues provided \$5.5 billion of new cash including \$1.9 billion of foreign add-ons. The new cash consisted of \$2.2 billion from 2-year cycle notes, \$2.6 billion each from the 4- and 5-year cycle notes and a paydown of \$1.8 billion in the quarterly refunding. In addition to the new cash raised, \$13 billion of maturing coupons were refunded.

In the nonmarketable area, a record \$4.2 billion of new cash was raised with State and local government series issues. This was partially offset by a more than \$2.1 billion paydown of foreign government series securities; however, E and H bonds provided \$1.2 billion in new money which raised the total to a net \$3.2 billion.

During the quarter, interest rates rose rather sharply. Federal funds moved up by 1/4 percent to a 2.7-percent trading level in late April and then to 7 1/4 percent in early May. For most of June, funds traded at 7 1/2 percent but, by the end of the month, a further 1/4-percent boost to 7 3/4 percent took place. Commercial paper rates tended to lag behind the rising Federal funds rate for most of the quarter, but by late June a 7 3/4-percent rate also prevailed on these 90 to 119 day money market instruments. Three-month Treasury bill rates actually declined in April and did not begin rising until late May. In the last weekly auction in June, the average yields on both 13- and 26-week bills were the highest since December 1974. A 6.97-percent yield was realized on 13-week bills, and the companion 26-week bill yielded 7.40 percent in the June 26 auction. Commercial banks raised their prime lending rate three times between early May and late June, bringing the level from 8 percent to 8 3/4

percent. In early May, the Federal Reserve raised the discount rate 1/2 percent to a 7-percent level.

Likewise, the intermediate- and long-term interest rates rose consistently during the April-June period. Rates on Treasury securities maturing in 1 year rose almost a full percentage point to about 8.30 percent on the basis of weekly averages. Rates on Treasury issues due in 7 to 10 years increased by about 1/2 percent to 8 1/2 percent or higher while longer term issues rose by 35 to 40 basis points. Aa-rated corporate bond rates rose by 1/2 percent to almost 9.20 percent while long-term municipal bond yields rose at a steady clip from about 5.70 percent at the end of March to 6.30 percent at the end of June. Mortgage rates also continued their steady climb during the quarter.

Most economic data reported for the April-June quarter indicated underlying strength. Industrial production, for example, increased during all 3 months. Residential and commercial construction activity were robust throughout the period. In June, seasonally adjusted employment increased by over 700,000, pushing unemployment down to 5.7 percent. This was the first time this rate had fallen below 6 percent since October 1974. Personal income continued to gain while at the same time consumer borrowing was on the rise, as evidenced by the strong increases in consumer installment credit. Commercial bank lending was also brisk. Inflation worries continued to be justified as the Producer Price Index posted successive large increases. The rise in April was about 12 percent on a seasonally adjusted annual basis due in large part to food price increases. Consumer prices rose at a double-digit pace throughout the quarter led by very sharp increases in food prices and, more specifically, in meat prices. While the U.S. trade and current account deficits were smaller than the previous quarter, the deficits were still very large.

When the time came for the Treasury's regular 5-year cycle offering for the first month after the quarter, the market expected the Treasury's June 19 announcement of \$1 3/4 billion of 15-year 1-month bonds for new cash; however, the amount was higher than some anticipated. This marked the third time, beginning with July 1977, that the Treasury substituted a 15-year bond in the previously established 5-year note cycle slot. About \$1.8 billion of the \$4.1 billion of public tenders for the new bonds due in August 1993 was accepted, including \$0.4 billion of noncompetitive tenders. Commercial banks and dealers combined to take \$1.4 billion, or 80 percent, of the bonds with the latter group accounting for \$0.8 billion, or 47 percent. The good bidding interest in the June 28 auction resulted in an average yield of 8.63 percent. This represented an increase of almost 70 basis points over the similar maturity sold 6 months earlier. The 8 5/8 percent coupon placed on the new security was a record for a Treasury bond. The bonds traded at a discount and were bid at a yield of 8.70 percent when issued on July 11.

The next day after the settlement day for the 15-year 1-month bond, the Treasury announced a \$3 1/4 billion 2-year note to be dated July 31 to refund \$2.5 billion of privately held maturing notes and raise \$0.8 billion of new cash.

Almost \$5 billion of tenders were received from the public in the July 20 auction, including \$0.8 billion of noncompetitive tenders. A total of \$3.3 billion of tenders was accepted and foreign add-ons of \$0.5 billion increased the issue size to \$3.8 billion. Commercial banks received \$1.5 billion, or 39 percent, of the notes and dealers were allotted \$1.2 billion, or 31 percent. Routine bidding interest resulted in an 8.61-percent average yield, 29 basis points higher than the previous 2-year note auction for June and the highest yield for this maturity length since the May 1974 auction. An 8 1/2 percent coupon was assigned to this new issue which traded at a premium throughout the when-issued period.

Most short-term rates rose slightly in July. Federal funds, for example, rose from 7 3/4 percent to about 7 7/8 percent. Treasury bill rates rose in early and mid-July but fell later in the month, as the market rallied. On balance, only a small 5 to 10 basis point increase was realized during July. Ninety-119-day commercial paper rates posted an increase of about 1/8 percent and reached the 7 7/8-percent level. During the first week of July, the Federal Reserve raised its discount rate 1/4 percent to 7 1/4 percent, and banks raised their prime rate 1/4 percent to 9 percent. Rates on most intermediate and long Treasury issues increased about 5 basis points from the end of June to late July. Corporate bond yields rose by about the same amount while rates on long-term municipal issues declined slightly.

On July 26, the Treasury announced the terms of its August quarterly refunding in which \$4.4 billion of privately held notes maturing August 15 were to be refunded, and \$2.6 billion of new cash was to be raised. The refunding package consisted of offerings of \$2.5 billion of 3-year notes, \$3 billion of 7-year notes, and \$1.5 billion of 30-year bonds. Market reaction to the announcement was favorable, as the amounts of the new securities were considered quite manageable given the market's good technical position.

The 3-year notes attracted \$5.4 billion of public tenders at the August 1 auction. Almost \$2.6 billion was accepted, including \$1.1 billion of noncompetitive tenders. Over \$0.3 billion of foreign add-ons increased the issue size to \$2.9 billion. Commercial banks received \$0.8 billion, or 30 percent, of the notes and dealers took \$1.2 billion, or 46 percent. Strong bidding interest resulted in an 8.46-percent average yield and an 8 3/8 percent coupon.

Nearly \$3.1 billion of the \$4.1 billion of public tenders was accepted at the August 2 auction of 7-year notes, including \$0.7 billion of noncompetitive tenders. The \$0.3 billion of foreign add-ons, a new high for an issue of this length, brought the issue size up to \$3.4 billion. Commercial banks' allotments totaled \$0.7 billion, or 22 percent, of the notes and dealers received \$1.9 billion, or 1.3 percent. An 8.36-percent average auction yield led to the placement of an 8 1/4 percent coupon.

The 30-year bond auction on August 3 attracted \$2.6 billion of tenders, and of the \$1.5 billion accepted, over \$0.1 billion was noncompetitive. Dealers took \$0.8 billion, or 56 percent, of the bonds while commercial banks received

\$0.4 billion, or 29 percent. An average auction yield of 8.43 percent, lower than anticipated, led to the setting of an 8 3/8-percent coupon rate. In when-issued trading, the 3-year notes, which were fairly widely distributed, were selling at a premium while the two longer issues moved to a discount by the August 15 issue date. All three auctions resulted in record average yields for the specific maturities sold. Including add-ons, a total of \$3.4 billion of new cash was raised in this quarterly refunding. Largely due to the three new issues, the average length of the privately held marketable debt rose to 3 years 3 months by the end of August, its highest level in almost 6 years.

Following its successful August refunding, the Treasury announced, on August 17, the sale of \$3 billion of 2-year notes to refund \$2.7 billion of notes maturing on August 31 and raise \$0.3 billion of new cash. About \$6.1 billion of tenders were submitted by the public and \$0.6 billion of the nearly \$3.1 billion of accepted tenders were noncompetitive. Including \$0.3 billion of foreign add-ons, \$0.6 billion of new cash was raised. Investor groups receiving the largest amounts of the new notes were commercial banks with \$1.3 billion, or 44 percent, and dealers who took \$0.7 billion, or 22 percent. A favorable reception to the auction led to an 8.38-percent average yield, 23 basis points below the 2-year sale 1 month earlier. An 8 3/8 percent coupon was set on the new notes which traded below the average auction price during when-issued trading.

The market rally which began in late July lasted, approximately, through the first half of August. It was fueled by a good technical position and favorable reception to the Treasury's August refunding package, as well as a favorable report that farm prices had dropped in July for the first time in 10 months. However, in late August the market began to view the situation less optimistically. The Federal funds rate jumped from about 7 7/8 percent in early August to 8 1/8 percent and then to 8 1/4 percent. At midmonth, 90-119-day commercial paper rates had declined to 7 3/4 percent but late in the month rates rose to about 8 percent. Also in late August the Federal Reserve increased the discount rate by 1/2 percent to 7 3/4 percent. Three-month Treasury bills were bid up to about 7.35 percent in the last week of August compared with about 6.75 percent earlier in the month.

Intermediate-term Treasury rates near the shorter end of the maturity spectrum also fell in the early part of the month and then climbed later on. Longer term rates moved within a narrow range over the month, showing a decline on balance. As a result, by late August, the Treasury yield curve was almost perfectly flat from 1 to 20 years at a level of about 8.40 percent. A-rated corporate bond yields declined by about 1/4 percent in August, while municipal bond rates fell slightly. New conventional mortgage rates remained at their July level of 7.80 percent.

Meanwhile, the introduction of the two new savings certificates back in June had helped to improve the flow of savings to thrift institutions, and thus mitigate worries concerning disintermediation. As the popularity of the 6-

month certificates grew, however, many in the thrift industry expressed concern over the high cost of these funds and the resulting squeeze on profit margins, as interest rates on the 6-month Treasury bills to which the 6-month certificates were tied, continued to climb.

Interest rates continued to advance in September and approached their 1974 highs. Short-term rates posted significant increases as the Federal funds rate rose steadily from about 8 1/4 percent to an average of 8 5/8 percent during the final week, while 90–119-day commercial paper rates climbed about 1/2 percent to 8 1/2 percent and commercial banks increased their prime lending rate in three successive 1/4-percent steps to 9 3/4 percent, the highest since early 1974. In mid-September, the Federal Reserve raised its discount rate to 8 percent from 7 3/4 percent. This equaled the previous high reached during 1974. Three-month Treasury bills rose by over 40 basis points to a bid-yield above 8 percent. In the last bill auctions in fiscal 1978, the 13-, 26-, and 52-week bills recorded the highest average yields since September 1974. Larger increases in short- and intermediate-term Treasury coupon issues relative to longer maturities gave the Treasury yield curve a negative slope as 1-year maturities yielded about 8.80 percent by the end of September while 20-year maturities yielded about 8.50 percent. Aa-rated corporate bonds ended the month yielding almost 9 percent representing a 1/4-percent increase over the month while municipal bond and mortgage rates remained relatively unchanged during September.

The last coupon security issued in fiscal 1978 was a 4-year cycle note that had been announced on August 22 and was to be issued on September 6, 1978. The smaller than expected \$2 1/4 billion issue of 4-year 1-month notes for new cash was well received. Due to a mistake in recording competitive tenders, less than \$2.2 billion was accepted from the \$3.9 billion of tenders submitted by the public in the August 29 auction. With foreign add-ons of slightly over \$0.3 billion the issue size was increased to \$2.5 billion. About \$0.4 billion of noncompetitive tenders was accepted. Commercial banks were allotted \$1.1 billion, or 53 percent, of the notes while dealers' allotments totaled \$0.5 billion, or 23 percent. The 8.41-percent average auction yield was the highest in 3 years for a similar maturity and an 8 3/8 percent coupon was assigned to the notes. Though the issue began trading at a discount it moved to a slight premium by the September 6 issue date.

In the last quarter of fiscal 1978, the Treasury raised \$10.8 billion of new cash through issues of marketable securities to private investors. Slightly more than \$9.6 billion of new cash was raised in the coupon sector and an identical amount of maturing notes held by private investors was also refunded. The new cash raised was as follows: \$1.9 billion from the two 2-year cycle notes; \$2.5 billion in the 4-year cycle note sale; \$1.8 billion from the 15-year bond; and \$3.4 billion in the August quarterly financing. Foreign add-ons to coupon issues included in the above figures totaled more than \$1.7 billion. All of the new money from Treasury bills came from the 52-week bills. The net bill issues was \$1.2 billion, \$0.4 billion of which was foreign add-ons.

In the nonmarketable area \$4.6 billion of new cash was raised in the final quarter. Over \$3.6 billion was from State and local government series issues, of which \$3.4 billion was raised in August alone as many State and local governments invested the proceeds from advance refunded issues in Treasury State and local series as they rushed to beat the September 1 deadline, when new Treasury regulations would restrict arbitrage opportunities created by investing in higher yielding taxable securities through sinking funds set up for this purpose. Another \$0.2 billion of new cash was raised through sales of the foreign government series securities while the \$0.8 billion raised through sales of E and H savings bonds was the smallest amount for this category in almost 4 years.

Most economic measures continued to give off strong signals during the last quarter of fiscal 1978, although some indicated a slower pace than in the previous quarter. The unemployment rate fluctuated up and down during the period and stood at 6 percent in September, representing a 0.3-percent increase since June but still a rather low rate for recent years. Industrial production posted steady increases though not as large as during the previous quarter. The housing market was just slightly below the booming April-June quarter. Credit demands appeared to be undaunted by rising interest rates as commercial bank loans rose, reflecting a rise in business loans and the very strong demand for real estate and consumer loans. The extension of consumer installment credit remained at a high rate. Inflation still loomed as a major problem although the pace of both producer and consumer price increases had slowed from the previous quarter. The U.S. merchandise trade balance continued to show large monthly deficits and the dollar was still moving to new lows against some foreign currencies at the end of the fourth quarter of fiscal 1978.

Federal Financing Bank

The Federal Financing Bank (FFB), a corporate instrumentality of the U.S. Government managed and operated by Treasury employees, ended fiscal 1978 with holdings of \$48.08 billion in U.S. agency and U.S. agency-guaranteed obligations, an increase of \$12.66 billion over the year. Net income for fiscal 1978 totaled \$86.3 million; there were no operating losses, and administrative expenses were \$403,273. Accumulated surplus reached \$117.4 million on September 30, 1978; a motion to transfer this surplus, less an operating reserve, to the Treasury will be considered at the next FFB Board of Directors meeting.

The FFB was established by the Federal Financing Bank Act of 1973 to reduce the costs of Federal and federally assisted borrowing programs, and to finance these programs in a manner least disruptive of private financial markets and institutions. The act authorizes the FFB to purchase obligations issued, sold, or guaranteed by a Federal agency, and to finance these purchases by borrowing either directly in the private market or through the Secretary of

the Treasury. Since it began operations in 1974, the FFB has become the vehicle for most Federal agency financing; major eligible programs still not financed by the FFB are: Department of Commerce guaranteed ship mortgage bonds, Department of Housing and Urban Development guaranteed tax-exempt housing and urban renewal notes and bonds, and Government National Mortgage Association guaranteed passthrough securities. Currently, the FFB finances each of its loans by a borrowing from the Treasury with identical terms other than the interest rate; currently the FFB lends at one-eighth percent above its borrowing rate, which is Treasury's cost of money. This one-eighth-percent spread, and the FFB's investment of cash surplus in Treasury market-based short-term special issues, produce the FFB's income.

Fiscal 1978 was a period of FFB growth through existing, rather than new, lending programs, and of increased congressional interest in the FFB role in foreign military sales financing and in Federal credit assistance generally.

During fiscal 1978, for example, holdings of Farmers Home Administration certificates of beneficial ownership in pools of insured loans increased by \$7.66 billion; loans to electric and telephone systems guaranteed by the Rural Electrification Administration increased by \$1.8 billion; and holdings of the Tennessee Valley Authority notes and bonds increased by \$1.34 billion. The FFB began the year holding New York City revenue anticipation notes having a book value of \$1.16 billion purchased with recourse from the Secretary of the Treasury pursuant to the New York City Seasonal Financing Act of 1975. These notes, plus \$0.73 billion in additional notes purchased in 1978, were repaid by June 30, 1978, when the Secretary's lending authority under this act expired. The FFB will have no role in the new assistance legislation: the New York City Financial Assistance Act of 1978.

FFB loans to foreign governments guaranteed by the Department of Defense pursuant to the Arms Export Control Act grew by \$1.46 billion in fiscal 1978. This program was the subject of an oversight hearing on January 30, 1978, by the Senate Banking Committee with Roger Altman, Assistant Secretary of the Treasury and Vice President of the FFB, testifying on behalf of Treasury and the FFB. After this hearing, Senator Proxmire introduced S. 2545, which would prohibit the FFB from any further foreign military sales financing. No action was taken on the bill during the 95th Congress.

In an attempt to control the overall level of Federal loan guarantees, several bills were introduced in the 95th Congress (e.g., H.R. 10416, H.R. 7416) which would utilize the FFB as the instrument for control. Generally, the bills would (1) place the FFB on budget, (2) limit annual FFB lending to an amount approved in appropriations acts, and (3) require guarantee programs of the marketable-security type to be financed through the FFB. In commenting on these proposals, Treasury agreed that greater congressional control is needed, that loan guarantee programs should be subject to appropriation process review and that if the FFB is included in the budget, a requirement that certain

guarantee programs be financed through the FFB was necessary to counter budgetary pressures for returning these programs to market financing. Treasury also promised to work with the Congress to clarify the technical issues raised by the bills. None of these bills was enacted; however, an administration proposal on Federal credit program control is being prepared.

Capital Markets Policy

The Office of the Deputy Assistant Secretary for Capital Markets Policy includes the Office of Capital Markets Legislation (which is responsible for the development of administration policy on legislation affecting banks and other financial institutions) and the Office of Securities Markets Policy (which is primarily concerned with the corporate securities markets and with equity capital formation).

In the area of capital markets legislation, the Office played an important role for the administration in shaping the Financial Institutions Regulatory Act of 1978, the first major piece of banking legislation since 1970. It was also responsible for the development of the administration's views on proposed legislation to stem the attrition in membership in the Federal Reserve System, to regulate the rights of consumers of banking services in the area of electronic funds transfer, and to establish a central liquidity facility for credit unions. It continued to advance the Treasury's work as lead member of the Interagency Task Force on Regulation Q and other aspects of deposit interest rate controls.

In the securities markets area, the Office has continued its review of proposed changes in the restrictions governing the securities activities of commercial banks, commenced an investigation of the effects on the capital-raising process of structural changes in the securities markets and the securities industry, and initiated a broad-ranging inquiry into problems experienced by small and medium-sized enterprises in raising equity capital. The Office of Securities Markets Policy has also undertaken part of the Treasury's responsibility for the Industrial Innovation Domestic Policy Review.

Finally, the Office has continued to represent the Treasury in performing the Secretary's statutory role as a Director of the U.S. Railway Association and the Pension Benefit Guaranty Corporation. In the former capacity, the Office has been the lead negotiator of the terms of an additional \$1.3 billion investment in the Consolidated Rail Corporation (ConRail) authorized by the 95th Congress.

State and Local Finance

The Office of the Deputy Assistant Secretary for State and Local Finance serves as the point of coordination for the Offices of New York Finance, Urban and Regional Economics, and Municipal Finance.

This Office provides policy guidance within Treasury and without on financial and economic matters relating to State and local finance. It works closely with the Office of Revenue Sharing, a separate agency within Treasury,

in reviewing various policy options with respect to general revenue sharing, a major Federal assistance program to State and local governments which expires September 30, 1980. This Office will continue its close relationship with the Office of Revenue Sharing during 1979-80 as the administration's position on the program is developed and transmitted to the Congress.

Further, the Office serves as the Department's liaison to several interagency groups designed to coordinate administration policies and programs directed at the State and local sector including the Assistant Secretaries' Working Group for Rural Development and the Interagency Coordinating Council. The latter was established as part of the President's urban program announced in March 1978. The Office also deals with State and local governments directly or through their interest groups in Washington.

Office of New York Finance

During fiscal 1978, the Department had oversight responsibility for the loan program to New York City pursuant to the provisions of the New York City Seasonal Financing Act of 1975 (Public Law 94-143). That act authorized the Secretary to extend up to \$2.3 billion in annual seasonal financing to New York City until the end of the city's 1978 fiscal year. It expired on June 30, 1978.

The Federal Government provided \$725 million in loans to New York City in fiscal 1978. This amount, along with another \$1.15 billion it had lent the city in Federal fiscal 1977, was repaid in the April-June 1978 quarter. These were the final loans authorized under the act. While Public Law 94-143 was in existence, the Department lent the city a total of \$5.2 billion (\$1.26 billion in city FY 1976, \$2.1 billion in FY 1977, and \$1.875 billion in FY 1978). All loans were repayed on time or ahead of schedule with interest. The Department estimates it returned some \$30 million less administrative expenses to the general Treasury as a result of the 1-percent fee charged to the city above the Treasury cost of borrowed funds.

The seasonal financing legislation was intended to assist the city's successful return to the credit markets. The city attempted a sale of notes in the public markets in November 1977, as required under section 6.11 of the Department's credit agreement with the city. However, this offering failed. It became clear that the city would not be able to regain market access in fiscal 1979 either for its short-term or long-term needs.

Consequently, the administration introduced legislation in 1977 to assist the city in fulfilling its financing needs. The bill was adopted on August 8, 1978, as the New York City Loan Guarantee Act of 1978 (Public Law 95-339). It authorizes the Secretary to guarantee up to \$1.65 billion in long-term city debt as a means of assembling financing necessary to carry the city through fiscal 1982. During this period, the city is required to achieve a balanced budget in accordance with generally accepted accounting principles and to complete other budget and financial reforms. These actions should enable the city to regain access to conventional borrowing sources so that, by the end of the

period (fiscal 1982), it will be able to meet its short- and long-term financing needs in the public credit markets.

Under the terms of the Loan Guarantee Act, the Secretary of the Treasury may make guarantees only if there is a reasonable prospect of repayment of the city indebtedness and if the city is unable to obtain credit in the public markets or elsewhere. Accordingly, the Office of New York Finance has major responsibilities and functions under this act for overseeing the city's finances and in assisting the Secretary of the Treasury in making the findings pursuant to extension of Federal loan guarantees.

Office of Municipal Finance

In fiscal 1978, the Office established a comprehensive data base which proved to be useful in evaluating the fiscal effects of the administration's economic stimulus programs on 48 large city governments. A final report was released in January 1978 and will be updated periodically. Early in 1978 this data base was again drawn upon for assessing the antirecession fiscal assistance (ARFA) program scheduled for expiration on September 30, 1978.

Based upon research and evaluation provided by this Office, the administration proposed a supplementary fiscal assistance program to replace the existing ARFA program. The major feature of the proposed legislation was a formula which targeted funds to economically distressed areas, excluding States. [Although a compromise proposal was passed by the Senate, the House failed to pass the proposal and Congress adjourned sine die October 15, 1978, without passing on the legislation.]

The Office continues in its duties to review developments and proposals in the field of fiscal management and financial administration of State and local governments. It will give particular attention to State-local government budgetary and accounting practices. In addition, the Office will be reviewing impact of newly imposed tax and/or expenditure controls on State and local governments.

The Office also is giving significant attention to current issues which may affect the municipal credit market, in particular those issues relating to governmental accounting principles, the development of uniform financial disclosure in the sale of State and local securities, the impact on credit markets of new Federal bankruptcy laws for municipalities, and related issues.

Office of Urban and Regional Economics

The Office of Urban and Regional Economics was established to evaluate local and regional economic trends and their impact on the financial condition of State and local governments. In addition, it will assess the impact of Federal economic policies on local economies.

In 1978, the Office assumed the lead role in drafting and introducing to Congress the President's proposal to establish the National Development Bank.¹ The bank would provide a package of long-term financing incentives

¹ See exhibit 13.

to influence private businesses to invest in economically distressed communities. Related to the bank legislation, this Office reviewed the impact of existing Federal economic development programs on rural and urban areas and has worked closely with the Office of Management and Budget in developing the administration's policies in the economic development area.

ECONOMIC POLICY

The Office of the Assistant Secretary for Economic Policy (OASEP) is responsible for advising and informing the Secretary and other senior policy officials of the Department on current and prospective economic developments, and for assisting in the development of appropriate domestic economic policies.¹ The Office of Economic Policy also has responsibility for macroeconomic analyses relevant to the formulation of international economic policies, including analyses of the longer term effects of policies—both U.S. and foreign—on U.S. domestic activity and foreign trade and capital flows. The office participates in the interagency group that produces the official domestic economic projections which serve as the basis for budgetary planning and for choices among alternative courses of economic policy. The staff support for these activities is provided by the Office of Financial Analysis and the Office of Special Studies.

A series of biweekly briefings for the Secretary and other senior policy officials were initiated in 1977 and continued during 1978. These briefings present analyses of important economic and financial developments, both domestic and international, on a timely basis designed to supplement the flow of information provided through other channels.

In addition, OASEP participated with the Council of Economic Advisers, Office of Management and Budget, Domestic Policy Staff, and various other agencies in the analysis and formulation of a number of specific policy initiatives. The work included a review of the trustees report on the social security system, including an analysis of proposals for changes in the financing and benefit structure; an analysis of the economic aspects of the national health insurance proposals; monitoring and evaluating the economic impact of the coal strike; participation in the work of the Regulatory Analysis Review Group; work on the interagency task force on industrial innovation; review of energy issues and of alternative measures for reducing oil imports; evaluations of the economic aspects of the capital gains taxes; and the general revenue sharing program. Other, more general projects undertaken during the year centered on the President's programs for controlling and reducing inflation, analysis related to the budget, and the development of policies directed at youth employment.

¹ See exhibit 15.

Office of Special Studies

The Office of Special Studies provided a number of analyses and evaluations of economic issues. A sample of some of the major policy issues that this office was concerned with are as follows:

Social security.—The Social Security Amendments of 1977 restored the financial soundness of the cash benefit program throughout the remainder of this century and into the early years of the next one. The tax increases mandated under the amendments have important economic implications, including their impact on inflation and the tax burden of employers and employees. Treasury undertook analyses of proposals for changes in the financing and benefit structure and their impact on the economy. In addition, Treasury staff participated in the review of the economic assumptions and estimates underlying the trustees annual report on the social security system.

Health insurance.—The President announced his national health insurance (NHI) principles on June 30, 1978, following several months of intensive staff work within the administration. The Secretary of the Treasury is a key adviser to the President on NHI as this issue has important implications for the Nation's economic and budget policies. The Office of Special Studies participated in interdepartmental work groups on various aspects of NHI and economic analyses that included examinations of cost estimates for various NHI program options.

Capital gains tax treatment.—The tax treatment of capital gains came under considerable discussion and debate prior to passage of the Revenue Act of 1978 and the reduction in capital gains taxation. The Office of Special Studies analyzed the impact of capital gains tax reductions upon the stock market and the U.S. economy in general. This study was prepared in connection with the testimony of the Assistant Secretary for Economic Policy before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee in June 1978.

Coal strike.—In late 1977 and early 1978, a prolonged strike of coal miners threatened to impose a serious economic hardship and burden on the U.S. economy. Treasury participated in an interagency task force established to monitor and analyze the economic impact of the strike and to evaluate the potential threat to the Nation's health and security. The strike was eventually settled before serious damage was inflicted on the economy.

Government regulations.—Government regulations impose a sizable cost burden on business, taxpayers, and consumers and contribute directly to raising prices. Under Executive Order 12044, President Carter established a high-level interagency committee—the Regulatory Analysis Review Group (RARG)—to review the economic effects of major regulations. The RARG, which includes Treasury as well as other economic and regulatory agencies, seeks to assure that the costs of each regulation have been carefully considered and that all alternatives have been explored so that the least costly means of achieving the regulatory objectives are applied. Several Government regula-

tions were reviewed, including the Occupational Safety and Health Administration's (OSHA) generic carcinogen regulations, the Department of Transportation's proposed regulations to prevent discrimination on the basis of handicap, and OSHA's proposed standards for acrylonitrile.

Industrial innovation.—There has been a generally perceived decline in industrial innovation in the United States, both in spending on pure research and development and in the translation of such research and development findings into commercially feasible and profitable products or processes. This decline appears to have had an impact on capital formation, productivity, and inflation.² The Department of Commerce is coordinating an interagency Domestic Policy Review of Industrial Innovation, and Treasury is chairing and coordinating an interagency task force investigating the impact of economic and trade policies on industrial innovation. This task force, along with several others, is preparing for the President's consideration policy options that will stimulate increased innovation. Some of the areas of concern are tax policy, availability of venture capital, the impact of Government regulations, the role of research and development, and the impact of foreign trade policies on industrial innovation.

Anti-inflation.—Inflation is recognized as the Nation's top priority economic problem.³ After decelerating substantially in 1976, the Consumer Price Index started to rise more rapidly in 1977 and by 1978 was accelerating at a disturbing pace. During the first 10 months of 1978, consumer prices increased 9.5 percent at an annual rate. Treasury, along with economists from the other economic agencies, analyzed and evaluated intensively many alternatives for controlling and reducing inflation.

General revenue sharing.—Title I of the State and Local Fiscal Assistance Act of 1972 provides for the distribution of general revenue sharing funds to approximately 40,000 State and local governments. The authorizing legislation for the general revenue sharing program expires at the end of fiscal 1980. As part of an overall assessment and evaluation of the existing program, Treasury staff undertook a review of the research conducted to date on the macroeconomic and aggregate fiscal effects of revenue sharing; analyzed the estimated impact of general revenue sharing on aggregate State and local expenditures, revenues, and surpluses; and evaluated its effects on the gross national product and on public and private employment. In addition, the macroeconomic effects of general revenue sharing were compared with the effects of alternative uses of Federal resources such as increased Federal purchases, transfer payments, categorical grants-in-aid, and Federal tax cuts.

Employment tax credits.—The Tax Reduction and Simplification Act of 1977 contained the new jobs tax credit for calendar year 1977 and 1978. The Office of Special Studies provided analyses for the interagency task force evaluating the effect of that credit. The Revenue Act of 1978 allowed the new

² See exhibit 18.

³ See exhibit 16.

jobs tax credit to expire and replaced it with a targeted employment tax credit that the administration had proposed to the Congress. The Office of Special Studies staff participated in the interdepartmental task force that designed the new targeted credit.

Private sector employment initiative.—The fiscal 1979 budget includes a major effort to increase the orientation of training and employment programs toward preparing and placing disadvantaged and unemployed persons in private sector jobs. Treasury played a major role in designing this initiative and provided the economic analyses upon which many of the interdepartmental discussions were based.

Energy issues.—Treasury staff participated in the analytical work on the energy proposals submitted to the Congress by the administration. The Office of Special Studies collaborated with other U.S. Government agencies in assessing the impact of these proposals on U.S. energy use, energy prices, and economic activity. The office devoted a substantial effort to develop an understanding of the economic impacts of U.S. crude oil price regulations, especially as these regulations affected the level of domestic crude oil production and import requirements. The office evaluated adjustments in the regulations which could increase the production of domestic crude oil and thus reduce import requirements.

This office also monitored movements in domestic energy markets. During 1978, this office made projections of short- and long-term levels of U.S. energy consumption and production, and projected movements in the mix of fuels consumed. One output of these exercises, a forecast of the quantity and cost of U.S. oil imports, was regularly used by the Treasury Office of Balance of Payments in its short- and long-term forecasts.

Office of Financial Analysis

The Assistant Secretary for Economic Policy represents Treasury on an interagency group charged with developing the official economic forecasts on which the administration's budgetary and economic policy decisions are based. Other agencies represented on this group are the Council of Economic Advisers, OMB, and the Departments of Commerce and Labor. Staff of the Office of Financial Analysis provided support for the Assistant Secretary in this role and regularly attended meetings of the forecasting group.

An essential element in the formulation of economic policy is the compilation and evaluation of current economic data and information. In order to support the Department's economic policy function, the office prepares an Economic Briefing Book for use by the Secretary of the Treasury and other high-level Treasury officials. The briefing material covers the data for all the major economic statistics and provides historical perspective on these series. Memoranda prepared for the Briefing Book on latest economic developments circulate throughout Treasury and provide a vehicle for keeping Treasury officials informed of current economic developments.

Supplementing the Briefing Book, the office prepares a weekly Summary of Economic Developments, which gives an overview of current economic performance and evaluates prospects for the future course of the economy. In addition, the office has primary responsibility for a biweekly economic and financial briefing for top Treasury officials.

As a principal participant in the formulation of economic policy, Treasury is requested by congressional committees to explain and elaborate upon the economic goals and objectives of the administration. In support of this function, the office prepares briefing and background material for the Secretary and Assistant Secretary for Economic Policy to use in testimony before the Joint Economic Committee, congressional budget committees, and other committees concerned with economic and financial policies.

Public awareness of economic developments and acceptance of Government policies are important for achieving stated goals and objectives. The Office of Financial Analysis conducts periodic briefings for private groups and organizations on the current economic performance and the economic outlook.

Officials of Treasury serve as attaches in the embassies and missions to several foreign nations. In order to keep these officials, as well as members of the Treasury staff in this country, well informed about current economic developments, the office prepares a periodic review of economic and financial developments.

Office of Trade Research

The Office of Trade Research is responsible for performing substantive economic analysis of issues confronting the Department of the Treasury related to international trade and U.S. commercial policies. Thus, the Office of Trade Research could be requested to analyze the effects on U.S. trade, or on the U.S. economy as a whole, of various developments in international markets for traded goods such as U.S. or foreign measures to protect domestic industries and their workers from foreign competition, changes of exchange rates, and new international agreements to reduce tariffs and other barriers to trade, or to establish multilateral buffer stocks for commodity price stabilization.

During fiscal 1978, the Office of Trade Research undertook and completed a number of research projects and activities. To aid U.S. negotiators at international forums, one important analysis sought to identify factors contributing to successful outcomes at previous multilateral negotiations to liberalize trade among countries, while another study developed and proposed operating rules for internationally held commodity buffer stocks. Contributions by this office to interagency task forces included an analysis of the impact on U.S. exports of the 1977-78 decline of the U.S. dollar in world money markets, and the development of procedures by which the U.S. Export-Import Bank might judge the competitiveness of U.S. commercial jet aircraft as

opposed to foreign-produced planes. This analysis was designed to help the Eximbank determine whether or not its financing was critical to obtaining an export sale for a U.S. manufacturer.

The office also responded directly to needs for economic research within Treasury. To aid the Inspector General's Office, an index was developed for measuring the advancement of basic human needs in developing countries. Since these countries borrow from institutions such as the World Bank, whose operations Treasury must monitor according to the instructions of the Congress, an evaluation of human needs performance is required. For the Office of International Monetary Affairs, an analysis of the economic foundations and relative performance of different effective exchange rate measures was also completed. To support congressional testimony by the Assistant Secretary of the Treasury for International Affairs that favored the extension of the U.S. Export-Import Bank Charter, an empirical analysis was prepared of the effectiveness of major Eximbank programs. The success of that institution in overcoming imperfections in private capital markets was evaluated, along with a comparison of Eximbank programs relative to the activities of similar foreign official lending institutions.

In addition to its normal research activities, the Office of Trade Research assisted in the calculation of trigger prices for U.S. imports of steel mill products until a full-time staff could be assembled to administer this new Treasury program protecting domestic steel manufacturers from dumping by foreign steel producers. As a part of this effort, the inflationary effect on the U.S. economy of the trigger price mechanism and the magnitude of the fall in aggregate demand that would be necessary to offset the inflationary effect were estimated.

Office of Monetary Research

The primary function of the Office of Monetary Research is to conduct technical analyses of various aspects of international financial and monetary relations, especially in terms of their consequences for the United States. A variety of quantitative techniques are used to evaluate and predict the performance of major foreign economies as they affect the U.S. economy.

The day-to-day activities of the Office of Monetary Research are geared towards providing: (a) Background analyses on particular issues faced by senior Treasury officials in their conduct of international economic policy, (b) quantitative assessments of effects of unexpected developments abroad, and (c) specific forecasts of various foreign economic variables.

Major projects undertaken by the Office of Monetary Research included: (a) Development of a framework for investigating the global distribution of current-account payments surpluses and deficits among the United States, Organization of Petroleum Exporting Countries (OPEC), and the rest of the world; (b) construction of a model of German economy; (c) analysis of the effects of new accounting standards for U.S. corporations on foreign exchange

markets; (d) setting up a large computerized data bank containing basic economic information on all less developed countries; (e) developing a methodology for comparing domestic and export prices of major product categories in other industrial countries.

Office of International Energy Research

The Office of International Energy Research provides two kinds of analysis—general reports covering energy developments throughout the world, and those specialized studies that focus on particular issues.

The office analyzed the relationship between energy demand and economic growth to help formulate alternative options for U.S. energy policy. Also examined in detail was the question of energy prices and their effect on exports. Further issues examined included OPEC financial holdings and the future international coal market factors influencing the foreign exchange value of the dollar. Treasury officials were given advice on the impact that the export of energy and other technology could have on tax revenues and economic development abroad.

Oil imports and oil pricing policy have been a continuous subject of attention. Various options for curbing oil imports were examined. This office also provided Treasury officials with nuclear and Sino-Soviet energy expertise; these studies were frequently consulted by other agencies. The office participated in a White House review of solar energy and pointed out the need for an initial international market analysis, a thorough survey of existing Federal programs, and budgetary restraint.

Office of Balance of Payments

The Office of Balance of Payments has staff responsibility for briefing and advising the Secretary and other policy officials on the current situation and outlook for our international payments, including the merchandise trade balance, other current account transactions, and official and private international capital flows. This office also represents the Treasury in technical meetings of various interagency groups and international organizations such as the International Monetary Fund and the Organization for Economic Cooperation and Development.

During the fiscal year the merchandise trade balance suffered a substantial further deterioration in the first half, followed by a sharp improvement in the second. Starting from a \$28 billion seasonally adjusted annual rate in the second (April–September) half of fiscal 1977, the trade deficit rose to a \$43 billion annual rate in the first (October 1977–March 1978) half of fiscal 1978 before declining again to a \$32 billion rate in the second half.

This worsening of the trade balance in the first half of the fiscal year reflected a nearly 34-percent annual rate increase in nonpetroleum imports over the preceding half year, compounded by a 5-percent decline in nonagricultural exports. In the second (April–September) half, however, that adverse pattern

was reversed—with nonagricultural exports rising at a 37-percent annual rate from the previous half, while nonpetroleum imports slowed to an 18-percent growth rate.

Agricultural exports in fiscal 1978 totaled about \$3 1/2 billion more, and petroleum imports about \$1 1/2 billion less, than in fiscal 1977.

The current account deficit in the first (October–March) half of the fiscal year rose to a \$28 billion annual rate—more than double the \$11 billion rate in the second half of fiscal 1977—before declining sharply again in the second half to a \$14 billion annual rate. Also in the first half of fiscal 1978, the recorded net outflow on private capital transactions rose to a \$43 billion annual rate (not seasonally adjusted) from a \$10 billion rate in the previous half year.

The main source of financing for these very large deficits, on both current account and private capital transactions, in the first half of the fiscal year was an annual rate inflow of more than \$60 billion (not seasonally adjusted) of foreign official capital, predominantly from other industrial countries.

In the second (April–September) half of the fiscal year, official assets declined at an annual rate of \$1.6 billion. Since only \$1.6 billion of private capital inflow could be identified in this period, an unusually large (not seasonally adjusted) statistical discrepancy resulted, amounting to almost \$23 billion.

U.S. current account transactions, October 1977–September 1978
[Seasonally adjusted; \$ billion]

	Fiscal 1977 (quarterly averages)	Fiscal 1978*			
		Oct.–Dec. 1977	Jan.–Mar. 1978	Apr.–June 1978	July–Sept. 1978
Exports.....	30.2	29.5	30.7	35.1	36.9
Agriculture	6.2	5.7	6.5	8.0	7.9
Other	24.0	23.8	24.2	27.1	29.0
Imports.....	-36.3	-39.7	-41.9	-42.9	-45.0
Petroleum and products.....	-10.9	-10.6	-9.9	-10.8	-10.8
Other (including other fuels).....	-25.4	-29.1	-31.9	-32.1	-34.2
Trade balance	-6.1	-10.2	-11.2	-7.8	-8.0
Net services and remittances.....	4.8	3.8	5.1	5.5	5.0
Government economic grants	-.7	-.6	-.8	-.8	-.8
Net invisibles.....	4.1	3.2	4.3	4.7	4.2
Balance on current account	-2.0	-7.0	-6.9	-3.1	-3.8

* Due to seasonal adjustment on calendar-year basis, quarterly data will not add precisely to fiscal year totals.

Source: Survey of Current Business, June and December 1978, published by U.S. Department of Commerce, Bureau of Economic Analysis.

*Financing of U.S. current account balances, October 1977–September 1978**
 [Inflows (+) and outflows (–); \$ billion]

	Fiscal 1977 (quarterly averages)	Fiscal 1978			
		Oct.–Dec. 1977	Jan.–Mar. 1978	Apr.–June 1978	July–Sept. 1978
Current account balance*	–2.2	–5.2	–6.4	–2.7	–6.3
U.S. reserve assets (increase (–))			.2	.3	.2
Other U.S. Government assets*	–1.0	–.7	–1.1	–1.2	–1.4
Foreign official assets	7.2	15.5	15.8	–5.7	4.9
Industrial countries	5.0	13.9	13.2	–2.2	6.4
OPEC members	1.7	1.0	2.0	–2.8	–1.6
Other countries	.5	.6	.6	–.7	.1
U.S. banks, net	–1.0	–5.6	–6.6	1.3	.9
Claims	–3.1	–8.7	–6.3	–.5	–7.1
Liabilities ²	2.1	3.1	–.3	1.8	8.0
Securities, net	–1.0	–.2	.4	1.1	–1.1
Foreign securities	–1.7	–.7	–.9	–1.1	–.5
U.S. securities ^a	.7	.5	1.3	2.2	–.6
Direct investment, net	–2.0	–2.3	–4.3	–2.5	–.5
U.S. investment abroad*	–2.9	–2.8	–5.1	–4.4	–2.3
Foreign investment in United States*	.9	.4	.8	1.9	1.8
Other U.S. corporate capital, net	–.5	–.8	–1.7	.5	.8
Claims	–.4	–1.2	–2.2	.3	.3
Liabilities	–.1	.4	.5	.2	.5
Statistical discrepancy*	.4	–.7	3.6	8.8	2.6

* All data are seasonally unadjusted, because capital flows except U.S. Government lending and reinvested earnings component of direct investment income are not available on seasonally adjusted basis.

^a Excluding foreign official assets.

Source: Survey of Current Business, June and December 1978, published by U.S. Department of Commerce, Bureau of Economic Analysis.

Office of Statistical Reports

The Office of Statistical Reports manages two international financial statistics collection systems—the Treasury international capital (TIC) reporting system, and the Treasury foreign currency (TFC) reporting system.

The TIC system collects weekly, monthly, quarterly, and semiannual data on U.S. banks' foreign assets and liabilities (the TIC/B subsystem); U.S. commercial firms' claims on and liabilities to unaffiliated foreigners (the TIC/C subsystem); and securities transactions with foreign residents (the TIC/S subsystem). These data provide information on all movements of capital between the United States and foreign countries other than direct investment flows and Government transfers. During fiscal 1978, the TIC staff produced a dozen brief analyses of monthly flows of U.S. bank credits to foreign residents, in addition to supplying the capital movement data for monthly publication in the Treasury Bulletin, the Federal Reserve Bulletin, and quarterly in the Department of Commerce's Survey of Current Business.

The TFC system collects weekly, monthly, and quarterly data on the foreign currency positions of U.S. banks and commercial firms, publishing these data in the Treasury Bulletin monthly; these data provide the Government's only information on foreign exchange market positions, and are collected under title II of the Par Value Modification Act of 1973. During fiscal 1978, the TFC staff produced seven analyses of the banks' weekly data for internal Treasury use.

Office of Data Services

The Office of Data Services provides computer and data processing facilities for the international affairs areas within the Office of the Secretary. Data Services also maintains and operates a computerized system for the collection and reporting of information on U.S. Government loans to foreigners.

This office furnishes computer programming and technical advice services to other offices to enable them to efficiently process and analyse the large volumes of information associated with research in such areas as international capital flows, balance of payments forecasting, trade and international economic competition, and aid to the less developed countries.

Foreign portfolio investment survey project

The foreign portfolio investment survey project is responsible for the collection and analysis of data relating to international portfolio investment and its effect upon the national security, commerce, employment, inflation, general welfare, and foreign policy of the United States. The Secretary of the Treasury was designated by the President as the Federal executive responsible for collecting these data pursuant to the International Survey Act of 1976 (Public Law 94-472). The act requires comprehensive surveys of both foreign portfolio investment in the United States and U.S. portfolio investment abroad.¹

On August 9, 1978, the Office of Management and Budget approved a survey of foreign portfolio investment in domestic securities as of December 31, 1978. A report is required to be filed by every U.S. issuer of securities which, as of the latest available closing data of its accounting records, had total consolidated assets of \$50 million if a nonbanking enterprise, or \$100 million if a bank. However, a firm falling below these asset levels, but with assets of \$2 million or more, is required to report if there is evidence of foreign ownership of its securities. Firms with assets less than \$2 million are exempt from filing a report. In addition, a report is required from every U.S. entity acting as a holder of record of domestic securities on behalf of foreign persons if the combined market value of these securities, held for all foreign accounts, exceeded \$50,000 as of December 31, 1978.

¹ See exhibit 17.

Completed survey forms are required to be filed on or before March 31, 1979. Approximately 10,000 U.S. businesses are expected to meet the reporting requirements. The data collection, processing, and analyses are scheduled to be completed in the fall of 1980 with the submission of a report to the Congress.

OFFICE OF THE GENERAL COUNSEL

The General Counsel, appointed by the President by and with the advice and consent of the Senate, is the chief law officer of the Department of the Treasury. As the chief law officer, the General Counsel administers the Legal Division, composed of all attorneys performing legal services in the Department and all nonprofessional employees providing support to the attorneys, and is responsible for all of the legal activities of the Department. This includes the legal staffs of all subordinate offices, bureaus, and agencies.

The primary role of the General Counsel is to serve as the senior legal and policy adviser to the Secretary of the Treasury and other senior Treasury officials. As such, he reviews the legal considerations relating to policy decisions affecting the management of the public debt, administration of the revenue and customs laws, international economic, monetary, and financial affairs, law enforcement, and other activities. Other responsibilities include providing general legal advice wherever needed, coordinating Treasury litigation, preparing the Department's legislative program and comments to the Congress on pending legislation, reviewing the Department's regulations for legal sufficiency, and counseling the Department on conflict of interest and ethical matters. The General Counsel also is responsible for hearing appeals to the Secretary of the Treasury from administrative decisions of bureau heads or other officials.

In addition, the Office of Director of Practice (which regulates practice before the Internal Revenue Service) and the Office of Tariff Affairs (which administers the U.S. antidumping and countervailing duty laws) are under the supervision of the General Counsel.

The General Counsel manages the Legal Division through the Deputy General Counsel, the Assistant General Counsel for the Department, and the Chief Counsel and Legal Counsel of the various bureaus.

Legislation

During fiscal 1978, the General Counsel provided the Department's views to the Congress and the Office of Management and Budget on more than 1,000 bills on non-tax-related matters pending before the Congress. In addition, the Legal Division participated in drafting a number of legislative proposals during this period. Among the more significant were:

On October 3, 1978, President Carter signed into law the Customs Procedural Reform and Simplification Act of 1978. This law permits Customs to establish more efficient and flexible procedures for handling documents and the financial aspects of import transactions; revises the Customs penalty provision dealing with the false entry of merchandise so that the penalty is limited to the culpability of the violator; and modifies numerous customs procedures to expedite the processing of goods and travelers while reducing administrative costs.

On December 28, 1977, the President signed Public Law 95-223, revising certain wartime and emergency powers of the President. The act confines the powers of section 5(b) of the Trading with the Enemy Act to wartime use and recodifies the emergency powers in a new International Emergency Economic Powers Act subject to new procedural restrictions on the use of emergency authority. However, the act permits the continued use of section 5(b) authorities with respect to all countries subject to regulations administered by the Office of Foreign Assets Control as of July 1, 1977. These emergency authorities were to expire on September 14, 1978, in accordance with the National Emergencies Act unless the President made a determination (which he did on September 8, 1978) that an extension for 1 year was in the national interest. The act authorizes additional 1-year extensions.

The Legal Division also participated in drafting the following major legislation:

1. Financial Institutions Regulatory and Interest Rate Control Act of 1978 (Public Law 95-630).
2. Authority for Treasury to invest for cash management purposes (public funds deposited in banks will draw interest under this legislation, Public Law 95-147).
3. Providing for increased U.S. participation in multilateral development banks (Public Law 95-118).
4. Amendment to Bretton Woods Agreements Act authorizing U.S. participation in the Supplementary Financing Facility of the International Monetary Fund (Public Law 95-435).
5. Susan B. Anthony Dollar Coin Act of 1978 (Public Law 95-447).

Litigation

The Legal Division is responsible for formulating the Department's position on litigation involving Treasury activities and for working with the Department of Justice in the preparation of litigation reports, pleadings, trial and appellate briefs, and assisting in trying all cases in which the Department is involved.

There are many thousand individual cases pending in the Customs Court, the Tax Court, and other Federal courts pertaining to Treasury functions.

In *Zenith Radio Corporation v. United States*, the Supreme Court affirmed the U.S. Court of Customs and Patent Appeals and sustained the longstanding

Treasury position that the nonexcessive remission upon export of an excise tax was not a bounty or grant as a matter of law and did not require that countervailing duties be levied.

In *Davis Walker v. Blumenthal*, an independent producer of wire and wire products challenged the legality of the Department's trigger price mechanism (TPM) for monitoring imports of steel mill products under the Antidumping Act. The plaintiff claimed that the TPM was beyond the Secretary's authority under the Antidumping Act, was adopted without following the procedures of the Administrative Procedures Act, and was arbitrary and capricious in its effect on independent producers of wire and wire products. On the Government's motion for summary judgment, the U.S. District Court for the District of Columbia ruled for the Government on all three elements of the complaint. Plaintiff's motion for an injunction pending appeal was denied by the Court of Appeals and subsequently the appeal was withdrawn.

Regulations

During the fiscal year, the Chief Counsel for the Office of Foreign Assets Control prepared final regulations authorizing persons in the United States to send periodic support remittances to close relatives in Cuba and Vietnam. Additional one-time remittances were authorized to assist relatives in emigrating to the United States. Regulations were also promulgated which authorize transactions ordinarily incident to travel to, from, and within the United States by Cuban nationals holding U.S. visas.

The Chief Counsel of the Customs Service prepared a final regulation amending the Customs Regulations relating to antidumping investigations which involve merchandise from state-controlled-economy countries. The new regulation provides that when the foreign market value of merchandise from a state-controlled-economy country is based upon the price or constructed value of like merchandise in a free-market-economy country, the free-market-economy country selected for comparison purposes should be at a level of economic development comparable to that of the state-controlled-economy country.

Other matters

The General Counsel's Office held primary staff responsibility for the Emergency Loan Guarantee Board, which was established by Congress in 1971. The Board administered the Government guarantee of private bank loans of up to \$250 million to Lockheed Aircraft Corp. The guarantee was terminated by the mutual agreement of the parties on October 14, 1977, and the Board transferred all residual authority and responsibility for matters related to the program to the General Counsel on January 31, 1978.

The Office participated in the negotiations concerning the settlement of the Government's claims against the bankrupt Penn Central Railroad, and advised the Secretary on the legal and financial aspects thereof.

ENFORCEMENT AND OPERATIONS

At the beginning of fiscal 1978, four operating bureaus of the Department of the Treasury were organized under a Chief Deputy to the Under Secretary (Enforcement and Operations), who was assisted by two deputies and two staff offices. The bureaus were U.S. Customs Service, U.S. Secret Service, Federal Law Enforcement Training Center, and the Bureau of Alcohol, Tobacco and Firearms. The policies and operations of the Office of Foreign Assets Control were also under the purview of the Chief Deputy to the Under Secretary.

On January 20, 1978, by Executive Order 12035, the position of Assistant Secretary, disestablished during the fiscal 1977 reorganization, was reestablished in the Office of Enforcement and Operations.

The Office of Operations, in conjunction with other Office of the Secretary staff offices, established an objective adjunct to the zero-base budget system (zero-base budget objectives). The zero-base budget objectives link desired goals for the current year to available resources with interim progress measured at quarterly review sessions. This has been a useful tool in the review and support of bureau activities. The Office of Operations continued to be concerned with cost-effective execution of programs, productivity improvements, equal employment opportunities, and various policy issues regarding the bureaus. The Office of Operations continues to provide staff support to the Under Secretary in the supervision of the Bureaus of the Mint and Engraving and Printing. This is done through the Deputy Assistant Secretary (Operations).

The Office of Law Enforcement continued its oversight and coordination of Treasury's law enforcement policies and programs, and initiated programs to maximize their effectiveness. The staff of the Deputy Assistant Secretary (Enforcement) has begun a review of particular policies and standards under which Treasury law enforcement personnel perform their duties. The Office reviewed legislation affecting the enforcement bureaus and strongly supported the enactment of Public Law 95-575, which relates to trafficking in contraband cigarettes. The Office was abolished at the end of the fiscal year, and the staff report directly to the Deputy Assistant Secretary (Enforcement).

Reorganization studies were continued in the U.S. Customs Service and the Bureau of Alcohol, Tobacco and Firearms.

The activities of each of the bureaus are recorded in the "Administrative Reports" section of this volume.

Alcohol

A comprehensive review of legislation and regulations for the alcoholic beverage industry was conducted in fiscal 1978.¹ As a result, some significant policy changes were implemented. These include more involvement by trained criminal enforcement agents in Federal Alcohol Administration Act cases;

¹ See exhibit 22.

new procedures for referring criminal cases to the Department of Justice and for processing offers-in-compromise within the Bureau of Alcohol, Tobacco and Firearms; review of trade practice regulations, largely unchanged since 1935, with a view toward modernization; and closer scrutiny and review of important regulatory changes, particularly in wine labeling. A partial ingredient labeling proposal has also been developed in collaboration with the Federal Drug Administration, and three expert consultants were hired to review research and scientific materials relating to possible labels on liquor bottles, warning pregnant women of possible harm drinking can cause to unborn children.²

Arson

Treasury in the past year has sought to develop new and more effective strategies within the Department to deal with arson for profit.³ The Office of Enforcement coordinated the activities of the Bureau of Alcohol, Tobacco and Firearms (ATF) in conjunction with the Organized Crime and Racketeering Section of the Department of Justice in establishing arson task forces in certain strike force locations. Specific investigative standards and guidelines were developed to determine when an arson-related organized crime or white collar crime should be investigated.

ATF made arrangements to assume teaching duties at the National Fire Academy in order to assist in the training of State and local law enforcement and firefighting personnel in the detection and investigation of arson.

Contraband cigarettes

Evidence submitted to Congress established that the States are now losing an estimated \$400 million per year in evaded State cigarette taxes, and that cigarette bootlegging has become a major source of income for organized crime. Treasury strongly supported the enactment of Public Law 95-575 concerning the trafficking in contraband cigarettes. The new law is designed to enable the Treasury and Justice Departments to assist the States in combating the practice of purchasing large quantities of cigarettes in low-tax States and transporting them to high-tax States for resale without payment of the second State's tax. The Bureau of Alcohol, Tobacco and Firearms has been delegated the authority to administer the provisions of 18 U.S.C. 114.

Counterterrorism ⁴

The continuing involvement of the Department of the Treasury in U.S. planning for combating terrorism was intensified under the new interagency structure established by President Carter. The Assistant Secretary (Enforce-

² See exhibit 20.

³ See exhibit 28.

⁴ See exhibit 21.

ment and Operations) and his staff actively participate on the Executive Committee and the Working Group on Terrorism of the National Security Council's Special Coordination Committee. Under this guidance, Treasury's principal enforcement agencies—ATF, Customs, and Secret Service—also participate in the topical committees of the Working Group on Terrorism seeking to solve various problems caused by the threat of terrorism. One of these topical committees is chaired by the Assistant Secretary's staff officer for terrorism matters.

Financial recordkeeping and reporting

Treasury regulations (31 CFR 103) issued under the authority of the (Foreign) Bank Secrecy Act provide financial recordkeeping and reporting requirements for the general public, as well as for financial institutions.⁵ The regulations require banks and other financial institutions to keep certain basic records that have a high degree of usefulness in the investigation of tax, regulatory, or criminal matters. They also contain the following reporting requirements:

(1) Financial institutions must report to the IRS any unusual domestic currency transaction in excess of \$10,000. (IRS form 4789)

(2) Travelers and others must report to the Customs Service the international transportation of currency and certain other monetary instruments in excess of \$5,000. (Customs form 4790)

(3) U.S. firms and individuals must report their financial interest in or their control over foreign bank and other financial accounts. (Treasury form 90-22.1)

The Federal bank supervisory agencies, the National Credit Union Administration, the Securities and Exchange Commission, the Internal Revenue Service, and the Customs Service have all been given specific compliance responsibilities under the regulations. In addition, Treasury has the overall responsibility for administering the act and coordinating the activities of the compliance agencies.

The Department has taken additional actions this year to implement the recommendations of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations as reflected in House Report 95-246, dated May 5, 1977. First, IRS Form 4683 (Report of Foreign Bank, Securities, or Other Financial Accounts) was converted to Treasury Department Form 90-22.1, now required to be filed directly with the Office of the Secretary rather than with the IRS as an attachment to an income tax return. This change has made it possible for Treasury to provide information from these reports to other Federal agencies when they have a legitimate need for it.

⁵ See exhibit 27.

Then, on July 1, 1978, the Reports Analysis Unit was established, operating at the Customs Service, under the direction of the Deputy Assistant Secretary (Enforcement), to analyze and disseminate information from the reports filed on forms 4789, 4790, and 90-22.1, already described. The Customs Service and the IRS have made major contributions of manpower and other resources to the Unit, which at the fiscal yearend had a staff of 13 persons.

In order to reduce the reporting burden on the public and eliminate paperwork of marginal value to the Department, the Under Secretary modified the requirement to report foreign financial accounts. Employees of banks subject to Federal supervision are no longer required to report accounts they have signature authority over if they have no financial interest in them. A similar exemption was also granted to employees of certain corporations if the corporation reports the account. In addition, corporations were permitted to file a consolidated report covering all of their subsidiaries, as well as the parent corporation.

The bank supervisory agencies are continuing to check the compliance of every financial institution that is normally subject to Federal supervision. While all violations are reported periodically to the Department in statistical reports, the supervisory agencies have been asked to provide the names of institutions that have failed to comply with the reporting requirements. In fiscal 1978, Treasury began requesting the bank supervisory agencies to provide information concerning the violations when there appears to have been repeated violations at a bank.

The IRS, in cooperation with U.S. attorneys in various judicial districts, has undertaken a number of investigations of alleged criminal violations of the requirement that financial institutions report large currency transactions. The majority of the investigations appear to be related to the efforts of drug traffickers to "launder" their money.

During fiscal 1978, Treasury transmitted to the Drug Enforcement Administration 1,394 reports pertaining to \$157.5 million in currency transactions and 83 reports pertaining to the international transportation of \$6.5 million in currency and other monetary instruments that appeared to be related to drug activity. A large number of reports were also provided to other offices within the Department of Justice, as well as to certain congressional committees.

The Customs Service, with the establishment of the Currency Investigations Division in its Office of Investigations, has continued to increase its efforts to enforce the requirement to report the international transportation of monetary instruments. During the fiscal year, Customs made 639 seizures totaling more than \$12.9 million. The related criminal investigations resulted in 36 convictions.

Firearms

Proposed regulations were published which would amend regulations of the Gun Control Act of 1968 to require new reports of dispositions of firearms to licensees, reports of guns stolen from licensees, and placing unique serial numbers on all guns manufactured or imported into the United States.⁶ Over 340,000 written comments were received and analyzed by ATF, and a decision on the final rules is pending.

This Office also worked with the Bureau to develop new strategies to more effectively enforce the Gun Control Act. More emphasis is being placed on those illegal activities which, because of their interstate nature, ATF has a greater capability to successfully investigate than State and local law enforcement agencies such as illegal interstate firearms traffic, and interdiction of major illegal sources of weapons. In addition, this Office worked with the Bureau of Alcohol, Tobacco and Firearms to eliminate unannounced routine compliance inspections of firearms licensees, and to limit its investigations of gun shows to those instances where there are specific allegations that significant violations have occurred or will occur.

Narcotics

The Assistant Secretary chaired a subgroup of the President's Strategy Council on Drug Abuse which examined the subject of economic assistance for narcotics-producing regions. The final report recommended an inter-agency agreement to institutionalize a formal Justice-State-Treasury reporting system to assure that all agencies are aware of narcotics-growing regions, developmental projects which might be relevant to reducing narcotics cultivation, and the actions being taken by each agency.

Regulatory policy and trade affairs

During the year there was an increased focus on regulatory policy and trade affairs. Executive Order 12044 (March 23, 1978) and the Treasury plan implementing that order established new procedures for agency rulemaking, and mandated that regulations be as simple and clear as possible, that they achieve legislative goals effectively and efficiently, and not impose unnecessary burdens on the economy, on individuals, or private or public sector organizations. The Office of the Assistant Secretary (Enforcement and Operations) worked with the bureaus supervised to implement these new procedures and policy directives.

Substantively, major regulatory activity included the review of regulations implementing the Customs Procedural Reform and Simplification Act of 1978 (Public Law 95-410, October 3, 1978), and major revisions to the Bureau of Alcohol, Tobacco and Firearms' wine-labeling regulations. All Customs and ATF regulatory proposals, as well as major civil penalty cases, were reviewed for consistency with established policies.

⁶See exhibit 23.

TAX POLICY

Legislation

During fiscal 1978, the Carter administration proposed extensive tax reform to make the tax system efficient, equitable, and simple. The administration also recommended substantial tax reductions to stimulate economic activity and to reduce tax burdens of individuals and businesses. In addition, tax incentives were proposed related to urban policy. The administration also continued to pursue enactment of tax aspects of the President's energy program related to gas pricing, utility rates, and energy conservation and continued to pursue social security tax changes directed at solving short- and long-term financing problems.

Tax cuts, incentives, and reforms

President's proposals.—On January 21, 1978, the President proposed major tax reform to make the tax system more efficient, tax burdens more equitable, and tax rules simpler.¹ In addition, tax reductions were proposed to sustain purchasing power and to provide business with incentives to invest in more and better facilities and to create jobs.

The President's recommendations were in a balanced tax program. Recommendations for tax cuts and incentives were designed in conjunction with tax reform. The Congress was informed that enactment of proposed tax cuts and incentives by themselves would be unacceptable. The revenue drain would be too great and tax burdens would be misallocated among the income groups.

Under the program, net tax liabilities would be reduced by \$24.5 billion net for calendar 1979. Gross reductions would be \$33.9 billion. Tax reform, however, would raise tax liabilities by \$9.4 billion.

Net individual income tax liabilities would be cut by \$16.8 billion, comprising gross cuts of \$23.5 billion and tax-raising reforms of \$6.8 billion.

Net business income tax cuts would be \$5.7 billion, reflecting gross tax cuts of \$8.3 billion combined with \$2.6 billion of tax increases resulting from various reforms.

Cuts in excise taxes and payroll taxes would be \$2 billion.

The tax cut proposals are summarized as follows:

Individuals.—Tax rates would be reduced from the present range of 14 to 70 percent to a range of 12 to 68 percent. In each bracket, there would be a cut of up to 5 percentage points on joint returns, and up to 7 percentage points on returns of single people.

The existing \$750 personal exemption and the general tax credit (which equals the greater of \$35 per exemption or 2 percent of the first \$9,000 of taxable income) would be replaced by a \$240 tax credit for each personal exemption.

¹ See exhibit 29.

The above tax cuts would take effect on October 1, 1978. For calendar 1978, there would be a tax cut approximately one-fourth the size of the full year cuts. The tax cut would be reflected in withholding rates in the last 3 months of 1978.

Businesses.—The present corporate income tax rate schedule would be reduced as follows:

Taxable income	Proposed rates	New rates
		<i>Percent</i>
0 to \$25,000.....	20	18
\$25,000 to \$50,000.....	22	20
Above \$50,000.....	48	44

However, the rate on income in excess of \$50,000 would be reduced initially to 45 percent and to 44 percent beginning in 1980.

Other.—The telephone excise tax, scheduled under present law to be phased out by January 1, 1982, would be repealed as of October 1, 1978.

The Federal unemployment insurance tax, which applies to the first \$6,000 of earnings, would be reduced from 0.7 percent to 0.5 percent as of January 1, 1979.

Tax incentive and reform proposals related to individuals are summarized as follows:

Itemized deductions.—Deductions for nonbusiness State and local sales taxes, gasoline taxes, personal property taxes, and State levies for disability insurance would be repealed.

Deductions for up to \$100 of political contributions (or \$200 on a joint return) would be repealed. The credit for 50 percent of the first \$50 of contributions (or \$100 on a joint return) would be retained.

Medical expenses and casualty losses would be deductible only to the extent that, combined, they exceed 10 percent of adjusted gross income. Medical insurance premiums would be treated in the same manner as other medical expenses. The rule limiting deductible casualty losses to the extent that each loss individually exceeds \$100 would be retained.

Capital gains.—The 25-percent alternative tax ceiling on the first \$50,000 of an individual's capital gains would be repealed. Capital gains of individuals would continue to be taxed at one-half the regular tax rates.

Fringe benefits.—The present employee tax exemption for premiums paid and benefits received under employer health, accident, disability, and group life insurance plans would be limited to those plans which do not discriminate in favor of shareholders, officers, and higher paid employees.

The \$5,000 employee death benefit exclusion would be repealed. A limit would be imposed on the extent to which qualified pension plans may be integrated with social security. Generally, there would have to be at least 1 percent in contributions or benefits on compensation below the social security wage base for every 1.8 percent in contributions or benefits provided on compensation above the wage base.

Employer contributions under a nondiscriminatory "cafeteria plan" would be taxable to participants only to the extent the contributions are used to provide an otherwise taxable benefit.

Transfer payments.—The current exclusion for unemployment compensation benefits would be phased out for income above \$20,000 for single persons and \$25,000 for married couples.

Tax shelters.—The deduction under the minimum tax for one-half of an individual's regular income tax liability would be eliminated. Capital gains on the sale of a home would be exempt from the minimum tax.

The "at-risk" provision, which denies the deduction of a taxpayer's losses in an investment except to the extent the taxpayer is personally liable, would be extended to cover all activities other than real estate and to cover closely held corporations (controlled by five or fewer shareholders).

The current method of determining useful lives of buildings for depreciation, which is based on the facts and circumstances of the individual cases, would be replaced by a system of guideline lives based on the average lives now used by all taxpayers. The method of depreciation for buildings would generally be limited to straight-line depreciation, instead of the accelerated depreciation methods used under current law. However, new multifamily housing would be able to be depreciated using the 150-percent declining balance depreciation (instead of the present law 200-percent declining balance method) through 1982. Also low-income housing would continue to be depreciated using the 200-percent declining balance method of depreciation through 1982. After 1982, only new low-income housing would be eligible for accelerated depreciation methods, and the maximum allowable depreciation would be based upon the 150-percent declining balance method.

New limited partnerships with more than 15 limited partners would be taxed as corporations so that they could not pass through their losses to the partners. Residential real estate partnerships would be exempt through 1982, and low-income housing would continue exempted as long as 150 percent declining balance depreciation was allowed.

The IRS would be authorized to conduct audits at the partnership level and apply any adjustments to returns of individual partners.

Taxes would be imposed currently on the earnings of most deferred annuities not purchased under qualified retirement plans.

All farming syndicates and all farm corporations, except nurseries, subchapter S corporations, and those with receipts of \$1 million or less would be required to use accrual accounting and to capitalize preproductive period expenses.

Tax-exempt bonds.—State and local governments would have the option of issuing subsidized taxable bonds. The subsidy rate would be 35 percent of interest costs for bonds issued in 1979 and 1980 and 40 percent for bonds issued thereafter.

Interest on industrial development bonds for pollution control facilities, industrial parks, and hospital construction would no longer be tax exempt unless, in the case of hospitals, there is a certification by the State that those new hospitals are needed.

The \$5 million small issue exemption for industrial development bonds would be eliminated except for economically depressed areas, for which the limit would be increased to \$10 million. This proposal was modified in the administration's urban policy proposals made in March 1978. (See below.)

Tax incentive and reform proposals related to business are summarized as follows:

Investment credit and depreciation.—The 10-percent investment credit would be made permanent. The credit, which now applies only to equipment and certain special purposes structures, would be extended to all new industrial buildings and to investment made to rehabilitate existing buildings for construction costs incurred after 1977. Investment credits would be allowed to offset up to 90 percent of tax liability, instead of 100 percent of the first \$25,000 of tax liability and 50 percent of tax liability in excess of \$25,000 as under present law. The full 10-percent investment credit (instead of 5 percent) would be extended to pollution control equipment qualifying for 5-year amortization which is placed in service after 1977.

Tax administrators would be given legislative authority to issue new asset depreciation range (ADR) regulations to simplify and revise the present regulations for all electing businesses.

Small business.—Subchapter S provisions, which generally allow electing small business corporations to be taxed in a manner similar to partnerships, would be expanded and simplified.

The provision in present law which allows losses from stock in a small business corporation as a deduction against ordinary income would be broadened by allowing business to double (to \$1 million) the amount of their stock issues which may qualify, increasing the aggregate amount of losses which may be claimed on individual tax returns to \$50,000 (\$100,000 on a joint return) and by eliminating some restrictions on the use of the provision.

Business deductions.—Deductions would be disallowed for entertainment facilities such as yachts, hunting lodges, and club dues, as well as for such entertainment activities as tickets to theater and sporting events.

Deductions would be disallowed for one-half of the cost of meals which otherwise would be deductible. However, meals consumed while traveling on business away from home overnight would continue to be deductible fully.

Expenses incurred to attend foreign conventions would be disallowed unless it is as reasonable for the meeting to be held outside as within the United States.

Deductions for first-class airfare would be disallowed to the extent they exceed coach fare for similar flights.

Financial institutions.—The excess additions to the bad debt reserves of commercial banks, now being phased out through 1987, would be disallowed.

as of 1979, at which time banks would compute their bad debt reserves based on actual experience.

The excess additions to the bad debt reserves of savings and loan associations and mutual savings banks would be phased down from 40 percent of taxable income to 30 percent of net income over a 5-year period.

The tax exemption for credit unions would be phased out over a 4-year period, and after 1982, they would be taxed on the same basis as savings and loan associations.

On May 12, 1978, the administration decided to trim the proposed \$24.5 billion tax cut to \$19.5 billion and to postpone the effective date 3 months to January 1, 1979. The administration recognized that economic conditions had changed substantially since January 1978 and there was a need to get a better balance between monetary and fiscal policy. Inflationary pressures were mounting. Employment was increasing. Under these circumstances, a smaller budget deficit in fiscal 1979 would be highly desirable.

Congressional consideration.—The Congress gave immediate consideration to the President's proposals. However, by the end of the fiscal year, Congress had not taken final action.

The House Ways and Means Committee began hearings on January 30 and reported its bill, H.R. 13511 (the Revenue Act of 1978), on August 4. The House approved H.R. 13511 on August 10.

The House-approved bill would provide a \$15.6 billion cut in calendar 1979 tax liabilities. The cut would include \$10.5 billion in personal tax cuts, \$4 billion in business tax cuts, and \$1.1 billion in capital gains tax reductions.

The House bill, however, excluded a number of the President's proposed tax reforms and directed a larger share of tax cut benefits to people in the middle and upper income ranges, rather than to people lower down the income scale, as recommended by the President. In addition, the House bill contained capital gains tax reductions directed largely at wealthy individuals.

The administration sought Senate modification when the Senate Finance Committee began hearings on the House-approved bill on August 17. While accepting the size of the House tax cut, the administration recommended that the personal tax cut be focused more toward lower and middle income groups. In addition, the administration objected to the large capital gains tax cuts which would be less than in the House bill and opposed the House's weakening of the minimum tax. The administration also continued to seek proposed reforms which the House had failed to approve.²

The Senate Finance Committee reported an amended H.R. 13511 on September 28. The calendar 1979 cut in tax liabilities would be considerably larger than the \$15.6 billion cut in the House bill which included a \$2.5 billion revenue gain from repeal of the general jobs credit and the \$19.5 billion in the administration's proposals revised in May 1978.

²See exhibit 34.

Most notably, the Finance Committee's bill enlarged the tax cuts for individuals, businesses, and capital gains. Individual income tax cuts in the House were enlarged primarily to benefit individuals within the \$10,000 to \$50,000 income range. The committee also added business tax cuts to the House-approved reduction in corporate income tax rates, most notably more rapid writeoffs for new plant and equipment. In addition, the committee expanded the capital gains tax reduction in the House bill and provided a new alternative minimum tax to replace the add-on minimum tax.

While indicating that in some respects the Finance Committee's bill improved the House version, the administration still had serious objections to the Finance Committee's decisions. The size of the tax cuts in the committee bill would be excessive not only for calendar 1979 but also for 1980, 1981, and beyond. Such tax cuts would be inflationary and would compromise the flexibility and discretion of the Government to reduce the budget deficit currently and in the future. Moreover, while the committee's distribution of personal tax cuts would be an improvement over the House version, the committee's tax cut share going to middle incomes would be inadequate. The committee's skewing of cuts to upper income individuals was attributable primarily to objectionable capital gains tax cuts. Further, the committee's bill would encourage excessive tax sheltering. The bill would permit very high-income taxpayers to shelter more of their income than they do under present law. Finally, the administration found that not only did the committee's action ignore many of the President's reform proposals but would add inappropriately new and inequitable tax preferences.

At the end of the fiscal year, the Finance Committee's bill was awaiting Senate floor action.

Overseas taxation.—The President proposed in his 1978 tax package a 3-year phaseout of the domestic international sales corporation (DISC) provision. DISC's were typically wholly owned subsidiaries of large manufacturing corporations through which export profits could be channeled. Tax on one-half of a DISC's profits attributable to "incremental" exports was indefinitely deferred so long as the profits were invested in export-related assets. The primary purpose of DISC was to stimulate exports. But analysis indicated that DISC was more costly and less effective than expected.³ The administration preferred more cost-effective and fairer means of stimulating exports than DISC. Moreover, DISC was enacted in 1971, when exchange rates were fixed. But subsequent adoption of flexible exchange rates provided a more direct method of compensating for changes in the U.S. trade balance.

The President also proposed as part of the tax reform program the termination over 3 years of the deferral of U.S. tax on the unremitted income of controlled foreign corporations. Under current law, a U.S. parent corporation typically did not pay tax on the earnings of its foreign subsidiaries unless, and until, those earnings were repatriated. When the earnings were repatri-

³ See Treasury's 5th annual report to Congress, "The Operation and Effect of the DISC Legislation," Apr. 14, 1978.

ated, a credit was allowed against U.S. tax for foreign taxes paid on the earnings. The excess of the U.S. tax over foreign taxes on unremitted earnings of foreign subsidiaries was therefore indefinitely deferred. This deferral created an incentive for U.S. companies to invest overseas in low-tax countries rather than in the United States, and to shift artificially profits from their U.S. to their low-tax foreign subsidiary operations. Consequently, deferral rested entirely on the artifact of a foreign corporate charter interposed between the U.S. parent company and its foreign operations. In addition, terminating deferral would permit the rationalization and simplification of U.S. taxation of foreign income, and would promote competition between large multinational companies and their smaller, more domestic, competitors operating only in domestic markets.

The administration also proposed to amend the taxation of income earned by Americans working overseas. The proposal would have postponed the amendments already enacted in the Tax Reform Act of 1976 until 1978 and would then replace the exclusion of a fixed amount of foreign earned income with a series of special deductions for added costs of housing, education, and home leave travel incurred by Americans working overseas, plus more generous rules for deducting expenses of foreign moves.

The Senate Finance Committee had already introduced a bill with essentially these provisions which was subsequently approved by the full Senate.

The House approved a more generous system of special deductions plus, in the case of Americans living abroad other than in Canada or Western Europe, an additional \$20,000 or \$25,000 exclusion. The House bill also provided an extension of pre-1976 law through 1977.

The matter was in House-Senate conference at the close of the fiscal year.

Urban tax policy.—In March 1978, the administration proposed an employment tax credit for employers of young persons aged 18 to 24 from low-income households and handicapped individuals referred by vocational rehabilitation programs. The credit would replace the current law "new jobs" credit scheduled to expire on December 31, 1978. The credit would be equal to one-third of each employee's wages up to a maximum of \$2,000 the first year and equal to one-fourth of each employee's wages up to a maximum of \$1,500 the second year. The credit would be limited to 20 percent of the total Federal Unemployment Tax Act (FUTA) wage base for any employer and could not exceed more than 90 percent of tax liability in any year.

The administration also proposed to limit tax-exempt "small issue" industrial development bonds (IDB's) solely to the acquisition or construction of land or depreciable property in "distressed" areas but to increase the size of projects that may be financed with tax-exempt IDB's from a maximum of \$5 million to \$20 million.

The administration also proposed an additional investment credit of 5 percent beyond the current 10-percent credit if certain investments are made

in "distressed" areas. The additional credit would be allowed only for those investments or portions of investments for which the Department of Commerce has issued a certificate of necessity.

Social security taxation.—On December 20, 1977, President Carter approved and signed Public Law 95-216, the Social Security Amendments of 1977. The law is primarily directed at counteracting short- and long-term financing problems in the social security system. In recent years, the combination of inflation and recession had raised benefits and reduced tax receipts, respectively, and created excessive drains on trust fund reserves. Also the projected reduction in worker-to-beneficiaries ratio in the population in the next century and the existence of a flaw in a benefit adjustment formula to compensate for inflation endangered long-term solvency of the trust fund.

On May 9, 1977, the President had proposed to the Congress revision of the social security laws to solve these financing problems. The President called for higher payroll taxes into the 1980's, supplemented by general revenues in times of high unemployment. Higher payroll taxes would come from proposed increases in the taxable wage base ceiling. Tax rates would not be increased. However, to provide relatively lower burdens for workers, the President recommended a higher taxable wage base for the employers' tax than for the employees' tax. In addition, he recommended that the tax rate for the self-employed be raised to 1 1/2 times the tax rate for employees, returning to the relationship which existed in 1972 and earlier years. Correction of the inflation indexing flaw was also proposed.

The 1977 act included the administration's recommendation to correct the indexing flaw and to change the relationship of the self-employment tax rate. However, the act featured higher payroll taxes than recommended by the President because the act did not make any provision for general revenue financing of social security. Also, differential wage base ceilings for employees and employers proposed by the administration were not accepted.

The 1977 act provided annual increases beginning in 1979 in both tax rates and wage base ceilings. By 1982, employees and employers will each pay a tax of 6.70 percent on earnings up to \$31,000. In 1977, the tax on each was 5.85 percent on earnings up to \$16,000. After 1982, the law provides that the wage base ceiling keep pace with inflation by automatic annual adjustment.

Miscellaneous tax provisions in the act dealt with contributions by employers of workers receiving tip incomes, exclusion from social security coverage of certain income of limited partnerships, tax treatment if an individual is employed simultaneously by related companies, and options for nonprofit organizations to pay payroll taxes.

Subsequent to the approval of Public Law 95-216 and during congressional consideration of the President's 1978 tax program, various legislative efforts were made to modify or reduce the social security tax increases in the 1977 act. The actions were opposed by the administration and the Congress did not approve any change.

Energy taxation.—President Carter had proposed a comprehensive long-term national energy program on April 20, 1977, which included a number of tax penalty and tax incentive recommendations. Briefly they were: A graduated excise tax on new “gas guzzling” automobiles; a standby tax on gasoline consumption if an annual conservation target were not met; an equalization tax on domestic crude oil based on the difference between the controlled domestic price and the world price of oil; a natural gas and petroleum usage tax in trade or business; an increase in excise tax on fuel for general aviation; an additional 10-percent credit for additional investment in “business energy property”; a tax deduction for intangible geothermal drilling costs comparable to intangible drilling costs available in oil and gas drilling; a tax credit for installation of residential solar energy equipment; a tax credit for the installation of insulation and other energy conservation items in residences; and others. Also recommended were: Rebate of the gas-guzzler tax to buyers of gas-efficient motor vehicles; rebate of the gasoline consumption tax to income taxpayers on a per capita basis (with direct payments to nontaxpayers); and rebate of the crude oil equalization tax to home heating oil retailers if passed through to consumers in the form of lower prices.⁴

The energy legislation became the principal work of the Congress in 1977 and 1978. By the end of fiscal 1978, two versions of an energy program were before the House-Senate conferees. The House had passed an omnibus energy program (H.R. 8444) on August 5, 1977. H.R. 8444 contained a gas-guzzler tax but no rebate. The bill provided for a tax on crude oil and a tax on utility and industrial use of oil and natural gas. The bill provided also for a tax credit for home insulation. The bill, however, did not have a standby gasoline consumption tax.

The Senate had not considered an omnibus bill but had broken the package into six separate bills. By October 31, 1977, the Senate had passed each bill, much of which differed from the President’s proposals and the House-passed H.R. 8444. The Senate rejected a gas-guzzler tax and preferred a ban on production of gas guzzlers instead. The Senate also did not pass the gasoline consumption tax and the crude oil equalization tax. It approved, however, a tax credit for home insulation and a tax on utility and industrial use of oil and natural gas.

Other legislation.—Additional tax legislation was enacted during fiscal 1978.

Public Law 95-147, approved October 28, 1977, expands authorized tax depositaries.

Public Law 95-170, approved November 12, 1977, provides an extension of transitional rules postponing the applicability of private foundation self-dealing rules for certain pre-October 9, 1969, leases.

Public Law 95-171, also approved November 12, 1977, provides an extension for certain child care programs and affects the WIN credit and withholding by employment agencies placing companion sitters; extends

⁴For more details on the President’s program, see 1977 Annual Report of the Secretary of the Treasury, pp. 48-50.

amortization of low-income housing rehabilitation expenses; and extends the exclusion for Armed Forces Health Professional Scholarships.

Public Law 95-172, again approved November 12, 1977, provides for the deletion of amounts paid as State and local sales or excise taxes from the Federal excise tax base related to communications services.

Public Law 95-176, approved November 14, 1977, made technical amendments to provisions of the tax on distilled spirits relating to withdrawals for export, storage procedures, production of gin, etc.

Public Law 95-210, approved December 13, 1977, provides for the disclosure of tax return information to the National Institute for Occupational Safety and Health for the purpose of locating individuals exposed to an occupational hazard.

Public Law 95-227, approved February 10, 1978, provides for an excise tax on coal to finance black lung benefit programs, exempt self-insurance trust funds, and allow business deductions for contributions to such funds.

Public Law 95-258, approved April 7, 1978, provides for the inclusion of certain disaster crop payments received in 1978, but attributable to 1977, in the 1977 income of cash basis taxpayers and extends for 1 year the existing treatment of State legislators' travel expenses away from home.

Public Law 95-339, approved August 8, 1978, authorizes the Secretary of the Treasury to provide financial assistance for the city of New York and provides for the taxability of certain federally guaranteed obligations.

Public Law 95-345, approved August 15, 1978, permits exempt organizations and mutual funds to loan their portfolio securities to brokers without harmful tax effects.

Public Law 95-372, approved September 18, 1978, established in the Treasury an offshore oil spill pollution compensation fund to be financed by a fee per barrel on oil obtained from the Outer Continental Shelf and to be collected by the Treasury.

Administration, interpretation, and clarification of tax laws

During fiscal 1978, 46 final Treasury decisions, 11 temporary Treasury decisions, and 53 Treasury notices of proposed rulemaking were published in the Federal Register. A substantial number of these publications implemented provisions of the Tax Reform Act of 1976, including regulations relating to the investment tax credit for movie films; public inspection of IRS determinations; requirements to obtain a ruling from the IRS under Code section 367 and information regarding carryover basis property acquired from a decedent.

In addition, regulations implementing the Employee Retirement Income Security Act of 1974 and the Tax Reduction and Simplification Act of 1977 were published.

Guidelines were issued to govern the arbitrage profit allowable on the refunding of certain tax-exempt bonds.

Tax reports

High-income taxpayers.—Pursuant to the Tax Reform Act of 1976, the Treasury published in August 1978 its second annual report, "High Income Tax Returns—1975–1976." The 1976 act requires the annual publication of a report containing data on high-income taxpayers including the number of taxpayers who do not pay any taxes and the importance of various tax provisions which permit individuals to be nontaxable.

Domestic international sales corporation (DISC).—Pursuant to the Revenue Act of 1971, the Treasury submitted to the Congress on April 14, 1978, its fifth annual report, "The Operation and Effect of the DISC Legislation." The report covered DISC year 1976 (essentially calendar 1975).

Americans working overseas.—The Treasury issued a report in February 1978 on the taxation of Americans working overseas including law and legislative proposals, general characteristics of such taxpayers, and the impact of the tax rules. The report covered calendar 1977.

Taxation of U.S. corporations.—Pursuant to the request of the chairman of the Joint Economic Committee and the Senate Select Committee on Small Business, the Treasury issued a report to the Congress in May 1978 on the estimated effective income tax rates paid by U.S. corporations in 1972.

Possessions corporation system of taxation.—Pursuant to the Tax Reform Act of 1976, the Treasury submitted to the Congress on June 29, 1978, the first annual report, entitled "The Operation and Effect of the Possessions Corporation System of Taxation." The report covered calendar 1976.

Tax research.—The Treasury published in "The 1978 Compendium of Tax Research" a series of studies sponsored by the Office of Tax Policy on the effects of the tax system on the economy.

Tax treaties

Negotiations and technical discussions on income tax treaties were continued with Bangladesh, Canada, Cyprus, India, and Jamaica. The tax treaty with the United Kingdom was approved by the Senate with a reservation on article 9(4) dealing with State taxation of multinational corporations. Further discussions were held with the British on how to proceed, following the Senate reservation. The Senate Foreign Relations Committee reported out favorably the tax treaty with Korea, which was not approved by the Senate. The Foreign Relations Committee also considered, but has not yet acted on, the tax treaty with the Philippines. The income tax treaty with Morocco was submitted to the Senate for its advice and consent.

The estate and gift tax treaty with the United Kingdom was prepared for signature. Negotiations for an estate and gift tax treaty were continued with Germany and Denmark. Discussions also continued with France, and a treaty draft was revised to include taxes on gifts as well as estates.

Participation in international organizations

Treasury representatives participated in the work of the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD), including membership on a number of working parties of the Committee. Treasury representatives also attended meetings of the Inter-American Center of Tax Administrators (CIAT), the UNESCO conference on the taxation of copyright royalties, and the U.N. Group of Experts on Tax Treaties between Developed and Developing Countries.

INTERNATIONAL AFFAIRS**Trade and Investment Policy****Trade negotiations**

During fiscal 1978, primary efforts in the trade area were directed at the achievement of substantive progress in the multilateral trade negotiations (MTN), in support of further trade liberalization and the reform of the international trading rules,¹ aiming toward the creation of a new international trading framework which will address a wide variety of major problems: Injurious import competition, government subsidization, government procurement, the use of export controls, the role of the developing countries, and methods of dispute settlement.

By July 1978, we were able to achieve a "framework of understanding" on most major issues in the negotiations.² This should enable a final political level agreement by December 15, 1978, the deadline set by the Bonn summit participants for conclusion of detailed negotiations.

Major progress was achieved especially in the negotiation of a code on subsidies and countervailing duties, one of the most difficult issues in the MTN and a matter of special interest to Treasury. The United States indicated its willingness to accept inclusion of an injury test in our countervailing duty law as part of a comprehensive agreement which brings needed additional discipline to this area. This has been an issue of major importance to our trading partners and clearly demonstrates our great interest in avoiding trade disputes in this area in the future.

Current Treasury authority to waive the imposition of countervailing duties expires in January 1979. Although this factor has complicated the negotiations, the administration has indicated its confidence that it can secure an extension of the waiver authority from the new Congress, which convenes in January 1979, or take other measures which would equally mitigate the possible adverse effects of the expiration of this authority.

¹ See exhibit 43.

² See exhibit 45.

Trade issues

During the fiscal year, the Department was also actively involved in a number of issues relating to imports. In a major test case in June 1978, the Supreme Court in *Zenith Radio Corporation v. United States* unanimously upheld the Treasury decision that the Japanese rebate or remission of its commodity tax on consumer electronics exports is not a countervailable "bounty or grant" under section 303 of the Tariff Act of 1930. Had Treasury lost the case, billions of dollars of imports from virtually every major trading nation could potentially have been affected.

In December 1977, the interagency steel task force chaired by Treasury Under Secretary Solomon proposed a comprehensive steel program to help meet the industry's problems in competing with foreign imports and modernizing the industry.³ As part of this program, the administration adopted a "trigger price mechanism" (TPM) for steel imports to facilitate prompt Treasury investigation of potential cases of steel dumping in the U.S. market and to help prevent destructive, unfair price-cutting competition. The TPM became fully operational in May 1978.

Through bilateral and multilateral discussions, the United States and other major steel trading nations made significant progress during the fiscal year in reaching a cooperative international approach to steel problems. The Ad Hoc Steel Group of the Organization for Economic Cooperation and Development (OECD) agreed to establish a standing steel committee of the OECD to act as a monitoring and consultative body to address future problems in steel trade before they become crises.

Export policy

Finally, in an effort to help reduce the U.S. trade deficit, which reached a record \$31 billion in calendar 1977,⁴ the President in September 1978 announced the adoption of a new national export policy to encourage exports. The program includes a number of measures to increase Government assistance to exports, through expanded budget support for the Export-Import Bank of the United States (Eximbank), loan guarantees by the Small Business Administration to help small exporters, increased export development programs, and other measures to reduce unnecessary government regulations which adversely affect U.S. exports.

East-West trade

U.S. trade with Communist countries decreased in 1977 to \$3.83 billion, down from \$4.70 billion in 1976. This reflected a decline in U.S. exports of agricultural goods, as a result of better harvests in the Soviet Union and other countries, to \$1.6 billion, from \$2.4 billion in 1976. The United States had a

³ See exhibit 38.

⁴ See exhibits 36 and 39.

positive balance of trade with these countries of \$1.58 billion in 1977, down from \$2.56 billion in 1976.

Trade trended up again in 1978, totaling \$4.39 billion for the first 8 months, of which \$2.44 billion represented U.S. agricultural commodities.

Secretary Blumenthal, an honorary Director of the U.S.-U.S.S.R. Trade and Economic Council, addressed a session of the Council in Los Angeles on November 14, 1977.⁵

On April 7, 1978, President Carter issued a waiver of the application of subsections (a) and (c) of section 402 of the Trade Act of 1974 with respect to Hungary. This prepared the way for the exchange on July 7, 1978, of notes which brought into effect the agreement on trade relations between the United States and Hungary.

On June 2, 1978, President Carter recommended to the Congress extension of the waiver authority as provided in section 402 of the Trade Act of 1974, allowing the United States-Romanian trade agreement to remain in force for another year.⁶ By not voting in either House against extension, Congress permitted the agreement to remain in force until at least July 1979.

Export credits

Treasury led a U.S. effort to negotiate the International Arrangement on Export Credits, which became effective April 1, 1978. Secretary Blumenthal, in a subsequent effort to strengthen and improve that agreement, called for new negotiations during the OECD Ministerial meeting in June and met with Ministers of participating countries in September 1978 to emphasize the U.S. view. A series of sessions were held at the official level in the continuing effort to place effective limits on subsidized financing of exports. The dangers of competitive official export financing have become particularly acute in connection with aircraft sales—a subject on which Deputy Assistant Secretary Hufbauer testified before a House subcommittee July 14, 1978.⁷

Assistant Secretary Bergsten testified March 13 and 20 before congressional committees in support of a 5-year extension and expansion of authority of the Export-Import Bank, which has become highly useful in meeting foreign official competition in the financing of exports.⁸ Treasury advises Eximbank on a variety of matters pertaining to U.S. international financial and economic policy. President Carter's program to expand exports will require an increase of Eximbank's budget by \$500 million in fiscal 1980.

Treasury also continued to review the export program of the Commodity Credit Corporation (CCC), providing advice to the Agriculture Department both directly and through the National Advisory Council on International Monetary and Financial Policies. The CCC budget for assisting in the financing of agricultural exports was \$1.7 billion in fiscal 1978.

⁵ See exhibit 37.

⁶ See exhibit 67.

⁷ See exhibit 44.

⁸ See exhibits 67 and 40.

Treasury was active on the Arms Export Control Board which was concerned with the foreign security assistance program. Treasury concern was directed primarily toward ensuring that U.S. Government financing of foreign military sales was offered under terms and conditions which were consistent with other U.S. Government financial policies. Agreements extending more than \$2.1 billion in foreign military sales credit were signed during fiscal 1978, of which some \$1.5 billion was placed by the Federal Financing Bank with 22 different countries.

United States-Saudi Arabian Joint Commission on Economic Cooperation

Since Secretary Blumenthal's visit to Saudi Arabia in October 1977, three additional project agreements, for technical cooperation in the areas of auditing, customs, and central procurement, have been signed. The Joint Commission now is implementing 16 major projects with a total ultimate value of over \$800 million.⁹ [Additional agreements signed on November 18, 1978, at the conclusion of the Fourth Session of the Commission, bring the number of projects to 20 and the total ultimate value to over \$850 million.]

There are presently over 135 American specialists working in Saudi Arabia under the auspices of the Joint Commission. This number is expected to increase during the coming year.

Overseas Private Investment Corporation (OPIC)

In mobilizing and facilitating the participation of U.S. private capital and skills in the economic and social progress of friendly less developed countries (LDC's) as a complement to our development assistance to these countries, OPIC gives preferential consideration to investment projects in LDC's that have per capita incomes of \$520 or less in 1975 U.S. dollars, and restricts its activities in LDC's that have per capita incomes of \$1,000 or more in 1975 U.S. dollars.

Maximum insured amounts as of September 30, 1978, were (1) \$3.3 billion for expropriation; (2) \$2.8 billion for inconvertibility; and (3) \$2.8 billion for war, revolution, and insurrection.

As of September 30, 1978, outstanding commitments under the investment guarantee program were \$134.4 million and outstanding commitments under the direct loan program were \$31.7 million.

Although OPIC's authority to write insurance lapsed for a 4-month period beginning in January, OPIC wrote as much insurance in fiscal 1978 as in fiscal 1977. Thus dollar volume (maximum insured amount) remained constant at approximately \$700 million.

On April 24, 1978, the President signed the Overseas Private Investment Corporation Amendments Act of 1978. This act extends OPIC's insurance and guarantee authority, which lapsed at the end of December, until September

⁹ See exhibit 35.

30, 1981. Key amendments strengthened OPIC's development mandate by requiring, inter alia, that it refocus its efforts on the poorer countries which have the greatest difficulty in attracting adequate flows of public and private development resources; dropped the mandatory privatization targets under which OPIC would have had to transfer its insurance underwriting to the private sector by 1981; and strengthened OPIC's small business mandate by requiring OPIC to seek to increase the number of projects sponsored by or significantly involving small businesses to at least 30 percent of all projects insured, guaranteed, or reinsured by OPIC. The legislative history supports development by OPIC of innovative, risk-reducing coverage for investments in energy and raw materials.

Expropriations

Beginning in January and February 1975, when the Ethiopian Provisional Military Government (EPMG) announced widespread nationalizations, the EPMG nationalized the property of 22 U.S. citizens and firms. In November 1976 and October 1977, the EPMG invited the U.S. firms to file claims, which they did on both occasions.

In October 1977, the United States abstained on an African Development Fund loan to Ethiopia because of the lack of progress toward settlement of the outstanding expropriation claims. Although the Executive Director's statement and Embassy discussions with the EPMG made clear that the U.S. Government hoped and expected that the announced willingness of the Compensation Commission to discuss the claims by telephone would produce meaningful negotiations toward settlements in the near future, no such negotiations have taken place. Thus, on April 4, 1978, the United States abstained on an International Development Association (IDA) loan, advising both IDA and the EPMG that it would vote "no" the next time a loan to Ethiopia was brought forward in a multilateral development bank, unless significant progress has been made toward settlement.

International Center for the Settlement of Investment Disputes (ICSID)

During its annual meeting on September 27, 1978, the Administrative Council of ICSID, with strong support from the United States, represented by Treasury, created an additional facility within the ICSID Secretariat for certain categories of proceedings for conciliation, arbitration, and factfinding which had not been governed by the convention establishing ICSID. The additional facility will allow states which are not members of ICSID and their nationals the opportunity to make use of the services of the Secretariat and will allow the Secretariat to help settle certain types of noninvestment disputes which fall outside the jurisdiction of the convention itself.

UNCTAD discussions on restrictive business practices

The Ad Hoc Group of Experts on Restrictive Business Practices met in March and July 1978 in a continuing effort to reach agreement on principles and rules for controlling restrictive business practices. No agreement on principles was reached, in large part because the LDC's sought a set of legally binding principles while the United States and some other developed countries took the view that any set of principles should be voluntary for both corporations and governments. Nevertheless, there was substantial progress in the areas of information exchanges and technical assistance. The group will meet again in March 1979 for a further attempt to agree on a set of multilaterally agreed principles and rules on restrictive business practices and to discuss the text of the model law that was drafted by the United Nations Conference on Trade and Development (UNCTAD) Secretariat.

Commodities and Natural Resources Policy**U.S. commodity policy**

During fiscal 1978, the United States continued to develop and refine its basic initiatives in commodity policy. Over the past 2 years of North-South dialog, commodity issues have been high on the agenda in exchanges between developed and developing countries, and in these discussions, the United States has advocated a commodity policy that would work to the benefit of both producers and consumers. The U.S. approach has been—

- To promote commodity price stability through the creation of international commodity agreements;
- To support the stabilization of export earnings for producing countries through the compensatory financing facility of the International Monetary Fund;
- To remove existing barriers to investment and trade in commodities, and discourage imposition of new ones, to assure efficient and secure sources of supply.¹⁰

Foremost among commodity problems in recent years has been the sharp fluctuation of prices, which has been caused by changes in worldwide economic activity or changes in crop production. The high rate of growth in the world economy during 1973–74 drove commodity prices sharply higher, only to be followed by the deep recession of 1975–76 which resulted in a decline in most prices. In 1977 commodity prices were mixed, but by mid-1978 prices, both industrial and food, had established a new uptrend. While some fluctuation in prices must be expected, extreme fluctuations are detrimental to stable economic growth in both developed and developing countries as they give rise to near-term inflationary pressures and discourage investment in commodity industries.

¹⁰ See exhibit 47.

To remedy the situation in the most volatile markets, the United States has supported, where feasible, the negotiation of international commodity agreements (ICA's). These agreements, operating preferably through buffer stocks, are aimed at stabilizing prices within a broad band around their longrun trend. Properly designed, commodity agreements can moderate price fluctuations while at the same time allowing for an efficient allocation of resources. This stability contributes to an easing of inflation, greater stability in economic growth, a smoother pattern of investment in raw materials industries, and more reliable income to producers. At the same time, such agreements provide for closer coordination between producers and consumers in maintaining acceptable supply-demand balances. Currently, international commodity agreements are in effect for tin, coffee, and cocoa (though the United States is not a member); a sugar agreement was negotiated in 1977 but has not yet received final ratification. Discussions which may eventually lead to negotiations have been undertaken for wheat, natural rubber, and copper. The administration made a commitment to contribute tin to the buffer stock of the International Tin Agreement, but Congress failed to complete action on legislation.

After considerable study, the Government has concluded that agreements are not feasible for some commodities. Lack of an acceptable reference price, stability problems, nonhomogeneous grades, lack of interest, and chronically depressed markets will likely preclude ICA's for tungsten, jute, manganese, and several other commodities originally proposed by developing countries.

Common fund.—To assist ICA's in financing buffer stock activities, the United States has supported the Group B (mainly OECD countries) proposal for a common fund (CF) presented at the negotiating conference in November 1977. It calls for a consolidation of individual ICA financial resources in a common fund which would lower the paid-in financial requirements for each agreement. If the paid-in resources are exhausted, the CF would supplement the deposits with commercial market borrowings secured by negotiable warehouse receipts (stock warrants) of the ICA's and by the remaining capital assets of the ICA's (callable capital or government guarantees). To provide for more equitable sharing of financial responsibility for agreements, the proposal implicitly assumes participation of consuming and producing countries in the financing of ICA's.

Developing countries continued to insist on a common fund which relies heavily on direct mandatory contributions which would be used to finance buffer stocks. Their common fund would also include a second window to finance a wide range of non-buffer-stock measures for commodities, a provision which the United States was unable to support.

Wide differences between the Group B proposal and the common fund proposal by the G-77 prevented successful conclusion of negotiations at the November conference. During much of 1978 both Group B and Group of 77 sought to narrow their differences so as to raise the prospects of a successful

negotiation of the common fund. The administration, particularly the Departments of Treasury and State, participated in numerous consultations with Congress and other countries—both developed and developing. The developed countries maintained that direct governmental contributions would undermine the autonomy of ICA's and that a second window, as proposed by the developing countries, would essentially duplicate activities of the multilateral development banks. A third negotiating conference is scheduled for November 1978.

Commodity developments

Sugar.—Delay in ratification of the International Sugar Agreement (ISA) was caused by the failure of Congress to enact new domestic sugar legislation, which also contained necessary ISA implementing legislation. A new domestic sugar program is expected to be signed into law early in 1979, after which the Senate is expected to ratify the ISA. The administration believes U.S. sugar policy should be compatible with and built on an effective ISA; together these sugar programs will help stabilize both international and U.S. sugar markets. During the year, the ISA imposed, on a provisional basis, export quotas and most exporters indicated they would abide by them, thus helping to strengthen prices. Nevertheless, there is some concern that in the absence of early U.S. ratification, some exporters may abandon any commitment to restrict exports, causing increased sugar supplies and lower prices. With the expected U.S. ratification, however, the ISA should function effectively, thereby raising market prices to the agreement's 11-cent floor.

Cotton.—During fiscal 1978, world cotton production increased to 64 million bales, the highest level in 3 years. However, cotton prices rose steadily throughout the year because of an expansion in demand. The Cotton Outlook Index for strict middling 1 1/6-inch quality, CIF North Europe, climbed from around 55 cents a pound early in fiscal 1978 to close to 75 cents at year's end.

In early spring, a second preparatory meeting on cotton was held under the auspices of UNCTAD. While the discussions were constructively directed toward the problems in cotton markets, no conclusive evidence was presented to support the need for international stabilization. Two studies prepared by the UNCTAD Secretariat on the marketing and distribution of cotton and on the fluctuations in cotton prices in world markets will be presented at the next preparatory meeting scheduled for early November 1978.

Cocoa.—The United States attended, as an observer, an ad hoc meeting on renegotiation of the International Cocoa Agreement in June 1978. In July, the Cocoa Council tentatively scheduled a negotiating conference for January 1979 as well as two more preparatory meetings in late 1978. The United States plans to participate actively in the preparatory meetings and the negotiating conference.

Coffee.—Prices of coffee continued to fluctuate in fiscal 1978, first dropping from about \$2.00 per pound in August 1977 to \$1.35 in January 1978, then

rising to \$1.53 in March, dropping off again in the summer, and rising sharply once more to around \$1.60 at the end of the fiscal year. Sharp changes in supply in 1977 together with gyrating demand from U.S. crushers were the chief reasons for the price changes. As required by provisions of the 1975 International Coffee Agreement, the International Coffee Council met in September to review the agreement's price triggers for implementing export quotas and to consider a possible revision. The maximum price at which quotas can currently be triggered under the agreement is 77 U.S. cents. The Council was unable to agree upon a revision of the triggers, but it did agree that the Executive Board would meet to consider possible action if prices should change substantially in the coming months.

Wheat.—Progress toward a new International Wheat Agreement (IWA) was achieved, though it was slow in coming. The United States effected a major shift in its position by supporting price-triggered stocking actions with respect to the proposed wheat reserve to be included in a new IWA. Following three preparatory conferences in 1977 and 1978, an UNCTAD-sponsored negotiating conference was convened in Geneva in March. The participants were unable to reach consensus on a new agreement because of differences over several major issues including: (1) The actions to be taken when triggers are tripped; (2) the level of the price triggers; (3) the shape of a coarse grains agreement; (4) supply and purchase commitments in critical market situations; and (5) financing of LDC reserves. Considerable progress was made subsequently in a series of three Interim Committee meetings. Although some major issues—supply and purchase commitments, size of reserve, and LDC financing—have yet to be settled, agreement has essentially been reached on several other issues.

Grain sales to U.S.S.R.—Sales of U.S. grain to the U.S.S.R. totaled 14.8 million metric tons during fiscal 1978, the second full year of the U.S.-U.S.S.R. grain agreement. This amount virtually equaled the amount offered without further consultations by the United States during regular bilateral consultations in the fall of 1977 and included 3.5 million tons of wheat (just over the minimum commitment) and 11.3 million tons of corn. Soviet purchases jumped from 6.1 million tons in the previous year because of a shortfall in 1977 grain production. In addition to the wide fluctuations in annual purchases, a major concern of the United States has been the "bunched" purchases of grain by the Soviets. In the October 1977–September 1978 period, U.S.S.R. purchases occurred in all but one month. This pattern was an improvement over that for the previous year, but the month-to-month variations were still somewhat greater than the United States believes necessary.

Tin.—Tin prices reached an alltime high in October at \$7.00 per pound, well above the fifth International Tin Agreement's (ITA) ceiling price of \$5.90 per pound. The ITA has had little success in the 1970's in moderating tin price increases, partly because its buffer stock is too small and partly because of variable production and export taxes in producing countries which have

discouraged investment and production. An administration request for congressional authorization for a voluntary contribution of nearly 5,000 tons of tin from the United States to the ITA buffer stock was passed by the House, but not the Senate. Moreover, the Congress also failed to authorize disposal of 30,000 tons of tin from the surplus in the strategic stockpile. The administration is expected to request authorizations again in 1979 which would enable the Federal Government to benefit from sales of tin at favorable prices and, at the same time, provide much-needed tin to the international market.

Copper.—Intergovernmental discussions on copper under the UNCTAD Integrated Program for Commodities reached an impasse in July over the establishment of an independent producer-consumer forum (PCF) for copper to examine various possible arrangements for stabilizing the copper market and to decide whether to move to negotiation of an ICA for copper. In October 1978, therefore, the governments participating in the discussions agreed to lay aside the PCF issue at least temporarily and to return to a series of intergovernmental meetings under UNCTAD auspices to consider stabilization measures. The governments must meet again, probably in January 1979, to spell out their work program on such measures, including any new proposals.

Rubber.—In February 1978, the major natural rubber producing and consuming countries, meeting under UNCTAD auspices, agreed to negotiate a buffer stock arrangement to stabilize prices in the international market. Their decision was based on intensive, technical work during 1977 which indicated that measures to stabilize natural rubber prices were feasible and in the interests of both groups. In preparation for the negotiations, consuming countries held further technical discussions with producers in May, then met among themselves in June and July to design a consumer proposal. In September, both groups drafted a text which will serve as a basis for negotiations under UNCTAD auspices in November. An appropriately designed agreement could benefit the United States by bringing forth additional supplies of natural rubber by the mid-1980's, when a tight market is widely forecast.

Tungsten.—In February, an expert group of the UNCTAD Committee on Tungsten (COT) reached a stalemate over the issue of whether to negotiate an international commodity agreement for tungsten or establish an institutionally autonomous producer-consumer forum (PCF) to discuss problems in the tungsten market and alternative procedures for solving them. Australia and Bolivia, on behalf of the producers, tabled a proposal for an ICA; the United States and four other major consumers of tungsten backed the PCF concept. The issue was referred to the April session of the UNCTAD Trade and Development Board, but was not resolved there. Consequently it was remanded to a special preparatory working group of the COT which met in June. This group did not resolve the issue but did agree to meet again, probably

in April 1979. The consuming countries opposed negotiations of an ICA because they believe the structure of the market and the heterogeneity of tungsten-containing raw materials would likely make any price-stabilizing agreement unworkable.

Energy policy

The administration has given high priority to development, adoption, and implementation of a national energy program. Key aspects of this program are embodied in the National Energy Act, passed by the Congress on October 15, 1978. Treasury's interests in the program center on its tax, financial, and economic implications. It is estimated that the Energy Act will result in oil import savings of 2.5 million barrels per day over what they would have been otherwise in 1985.

During the year, Treasury staff participated in the evaluation of various issues affecting domestic and international energy policy. Among these, Treasury gave particular attention to the effects of Organization of Petroleum Exporting Countries (OPEC)-pricing decisions on the U.S. and the world economy and to policy options which would encourage the development of indigenous resources in oil-importing developing countries.¹¹ In addition, Treasury officials responded to numerous inquiries and invitations by the Congress and the public to speak on a wide range of energy issues, energy-related legislation, and energy regulatory policy.

Oil prices

Oil import costs were a major burden on the U.S. trade and current account balances, even though the volume of U.S. oil imports was somewhat below that of the previous year. As a result, the U.S. current account deficit, national energy program, and oil prices became intimately linked—although official oil prices remained stable during the year. Our deficit continued to be attributed in large part to excessive oil imports, while the declining value of the dollar led to renewed pressure within OPEC for an immediate oil price increase that would have further exacerbated our trade problem, by adding roughly \$0.4 billion to our import costs for each 1-percent increase. This pressure, however, was successfully resisted by Saudi Arabia and Iran throughout fiscal 1978.

LDC energy development

In its relations with the developing countries, the United States was guided by the belief that reducing the dependence of developing countries on expensive oil imports would both further their development and improve the world energy balance. As a result, the United States took further steps to assist these countries in developing their own energy resources, such as:

- The Agency for International Development and Department of

¹¹ See exhibit 46.

Energy adopted new programs to assist the LDC's to develop renewable energy technologies.

- We proposed and gained a Bonn summit commitment to coordinate national efforts to bring renewable energy technologies into use in the developing countries. The scope and details of the effort will be worked out over the next year.

- We endorsed the effort already underway within the World Bank (responding to proposals by the previous summit in London) to expand the financing of LDC energy development and agreed to the suggestion that it examine whether new approaches would be useful, particularly in the exploration area.

- OPIC introduced a program to develop coverage for new types of energy investments—joint ventures, service contracts, and the like.

International Energy Agency (IEA)

As a result of the 1973 Arab oil embargo, 19 industrialized oil-consuming countries established the IEA to help coordinate their international energy policies. The goal is to reduce dependence upon imported oil through conservation, accelerated development of indigenous resources, and shared research and development. In addition, the IEA has developed methods to restrain demand and share existing supplies equitably so as to meet supply emergencies. Treasury participated in meetings of the Governing Board and its several subordinate bodies.

Standing Group on Emergency Questions (SEQ).—The Standing Group has developed a program which establishes procedures to implement the sharing of fuel assets in emergencies. This program is embodied in an Emergency Management Manual, which includes basic decisions, goals, and procedures for emergency operations in the event of an oil embargo. A successful test of the emergency oil allocation system was conducted during the spring of 1978.

Standing Group on Long-Term Cooperation (SLT).—Largely as the result of Standing Group action, IEA participants agreed in an October 1977 Ministerial session to a 1985 objective for group dependence on imported oil of 26 mmb/d (millions of barrels per day) and pledged individual country action on energy policies designed to achieve this goal. The SLT also makes an annual assessment of the energy programs of IEA member countries.

Standing Group on Oil Markets (SOM).—Treasury has participated mainly in the SOM's Ad Hoc Group on Capital Investment and Financial Structure. This group is attempting to forecast energy industry capital requirements for OECD countries and to assess the ability of the industry to finance such capital investments.

Ad Hoc Group on International Energy Relations.—This group is concerned with energy relations with the oil-importing developing countries and the OPEC countries. It has been considering activity in the area of energy resource

development in the developing countries, including energy balances, supply requirements, investment needs, and the adequacy of existing programs. Its Secretariat maintains contacts with OPEC spokesmen.

Oceans policy

Treasury continued to play an important role in two major areas of oceans policy in 1978: (1) The seabed mining negotiations within the U.N. Law of the Sea Conference,¹² and (2) the economic provisions in ocean mining legislation. Legislation only narrowly missed passage by the Congress in the rush to adjournment. Limited progress was made in specific areas at the Law of the Sea Conference, but wide gaps still separate the United States from other countries on a number of issues.

Ocean mining legislation.—The House (H.R. 3350) and Senate (S. 2053) bills were primarily aimed at setting up a Federal administrative structure which would give guidelines to prospective ocean mining firms as they make their investment and development decisions. The Department of Commerce and/or Interior are expected to play the lead role in administering the domestic ocean mining regime. Treasury was most interested in the provisions to protect industry investment in the transition from a national deep seabed mining regime to an international regime. During the legislative process, the protection mechanism was changed from one of investment guarantees and insurance by the Federal Government to one of seeking grandfather rights for operating seabed miners in the Law of the Sea treaty.

A second major issue of interest to Treasury and other agencies was establishment of an escrow "revenue sharing" fund and the tax treatment of payments by firms to the fund. This fund could be used later to meet certain obligations the United States might agree to in a final Law of the Sea treaty. The Department sought to have these payments treated as a business deduction, while industry representatives initially asked for them to be treated as tax credits. In the final versions of the bill, the industry and Federal agencies supported a small payment on the mining activities in the seabed which would be a business deduction.

Other issues of interest to Treasury included: U.S. flag requirements for the construction and operation of mining and transportation vessels (the administration favors no flag requirements except for the operation of mining vessels to facilitate law enforcement in the event of criminal actions); requirements to locate plants to process seabed minerals in the United States (the administration opposed any such requirements); a Treasury-sponsored provision to avoid any impact of the law on existing tax and tariff regulations.

Treasury, working with other agencies, will develop legislation describing tax treatment of ocean mining income. Under present law, such income would be ineligible for benefits such as investment tax credits, rapid depreciation, expensing of exploration costs, and perhaps depletion allowances. Also, the

¹² See exhibit 48.

treatment of any payments by seabed mining firms to an "international revenue sharing fund," under a Law of the Sea treaty, will need to be decided by the administration.

Law of the Sea Conference.—The seventh session of the third U.N. Conference on the Law of the Sea met in Geneva from March 28 to May 19, 1978, and resumed in New York from August 21 to September 15, 1978. Discussions and redrafting of texts were undertaken on a number of issues including: Transfer of technology to the Enterprise, the seabed mining organization of the Authority; a limitation on production from the seabed area according to a formula which would allocate a position of future growth in the nickel market to seabed miners and the rest to land-based producers; a system whereby the private and national entities mining the area would share part of their income with the international community; composition and voting on the Council of the Seabed Authority; a review conference to be convened in 20 to 25 years to examine the success of the regime and prospective alternatives to govern seabed operations thereafter.

These issues have been discussed in several sessions of the Conference, yet wide gaps between the positions of developed and developing countries still exist. At stake is whether the development of deep ocean mining will be governed exclusively by the International Seabed Authority or whether private and national firms will have assured access to sites if they agree to reasonable terms and conditions in a negotiated contract.

In preparation for the next session of the Law of the Sea Conference in the spring of 1979, the U.S. Government has undertaken a review of U.S. positions on all major issues in the seabed negotiations. The redrafted texts, as well as alternative approaches to the issues, will be examined closely before reaffirming old positions or developing new ones.

International Monetary Affairs

World economic and financial developments

The world economy.—The world economy is continuing its steady but historically slow recovery from the 1974–75 recession, the proximate cause of which was the OPEC embargo and oil price hikes. The basic impact of the sharp rise in oil prices on underlying inflation rates remains an important factor in international relations. OECD inflation rates are slowly declining during 1978 and should average about 7.3 percent for calendar 1978 as opposed to 8.1 percent in 1977.

The rate of real economic growth in the 24 developed countries of the OECD in calendar 1978 is expected to be about 3 1/2 percent, compared with 3.7 percent in calendar 1977. These rates, while representing substantial progress, are far below the real growth rates experienced before the oil price hike. Real growth rates for the OECD averaged about 5 1/2 percent in the years 1960–73.

During calendar 1978, the pattern of real growth was shifting among the leading industrial nations. In the aftermath of the recession, the United States grew substantially faster than the six other major industrial countries (Japan, Canada, United Kingdom, France, Germany, and Italy). This higher than average U.S. real growth represented a sharp change from the decade of the sixties and the early seventies when U.S. growth averaged 4.2 percent while the other OECD members grew at about 6.8 percent. In 1977 the U.S. growth was 4.9 percent, compared with 3.3 percent for other major countries. In 1978, however, the real growth rates of both the United States and the "Big-6" are expected to converge to the 3 1/2-4-percent range.

Also during 1978, the structure of growth became more balanced in the major countries. Both real private consumption and real investment have picked up in most of the major industrial countries during 1978. The United States is expected to be the sole exception to both of these trends during calendar 1978. The growth rate of real investment in the "Big-6" is expected to be about 5 percent during 1978—up from 1 1/2 percent in 1977. U.S. real investment growth is expected to fall from a spectacular 13 1/2-percent growth rate in calendar 1977 to a still very rapid 8.1 percent in 1978. Private consumption is expected to grow at about 4 percent in the "Big-6" during calendar 1978, as opposed to a 2.3-percent growth in 1977. American private consumption, on the other hand, is expected to grow more slowly—a 3.4-percent growth is projected for 1978, compared with 4.7 percent in 1977.

The pickup in real growth in the major foreign industrial nations has not had a significant impact on reducing unemployment rates. The seriousness of the unemployment problem was demonstrated by the fact that it was designated as the primary economic problem facing the developed nations at the Bonn economic summit meeting in July 1978.¹³ No major foreign nation has achieved much success in fighting unemployment. Canada, Italy, and the United Kingdom have all had serious rises in measured unemployment rates since 1975. The United Kingdom and Italy have had the consolation of seeing their current account move from deficit to surplus during this period, but Canada has suffered a stubborn current account deficit as well as rising unemployment. The fall in the American unemployment rate from 6.8 percent in September 1977 to 6.0 percent in September 1978 was the only substantial fall in unemployment in the group.

The international balance of payments situation.—The most significant development in the world international payments pattern in 1978 is the reduction in the OPEC current account surplus from about \$32 billion in calendar 1977 (including official transfers) to about \$10 billion. The developed nations of the OECD have gone from a current account deficit of \$28 billion in calendar 1977 (including official transfers) to an estimated current account deficit of only \$2 billion in 1978. The American current account deficit, however, is expected to rise from \$15.2 billion to about \$17

¹³ See exhibit 57.

billion over the same period. Japan, on the other hand, has increased its surplus on current account from \$11.1 billion in calendar 1977 to at least \$18 billion in 1978.

The persistence of the Japanese current account surplus in the face of the very large appreciation of the yen remains one of the key international economic problems of 1978. The yen rose 22 percent against the U.S. dollar in calendar 1977 and had risen another 27 percent in 1978 as of September 30. In spite of this huge appreciation, the Japanese current account surplus had not at the end of the U.S. fiscal year shown clear signs of falling in dollar terms. Trade flows, however, in volume terms were reflecting the exchange rate changes as import volumes increased while export volumes declined. It is expected, however, that the economic stimulus package promised by Prime Minister Fukuda at the Bonn summit, together with the appreciation of the yen, will bring down the surplus in the near future.

Taken as a group, the current account deficit of the nonoil LDC's, which are traditionally net capital importers, is expected to rise to about \$16 billion in calendar 1978 (including official transfers), compared with \$12 billion in 1977. If official transfers are omitted, the year-over-year rise is from \$22 to \$27 billion. Because of improved access to private capital markets, the total international reserves of the nonoil LDC's have risen slightly in 1978 despite the current account difficulties of a few individual countries.

Role of private banks.—Private banks have continued to play a central role in the world financial system. Despite a narrowing of current account imbalances among countries, a substantial need for intermediation between surplus and deficit countries remained. Most of this intermediation fell to the private financial markets, and especially to the banks. Increased competition among lenders has facilitated this financing on substantially improved terms to borrowers. Loans have been extended for longer maturities while interest rates have dropped significantly relative to the cost of funds to banks. Many borrowers took advantage of the sharp improvement in terms to refinance higher cost obligations. Some countries used the opportunity to rebuild their reserves.

While welcoming the role played by banks in facilitating the "recycling" process, U.S. authorities have recognized the need to ensure adequate continuing surveillance of banks' activities in the face of the greater volume and changed nature of international lending.

The U.S. Government is now collecting more comprehensive data on the exposure of U.S. banks in foreign countries and has improved its other reporting systems. Development of a new uniform system for assessing the creditworthiness of U.S. banks' loans to individual countries is underway. In January 1978 the Comptroller of the Currency issued for comment an interpretive ruling on the application of the legal lending limit stipulated in 12 U.S.C. 84 to U.S. banks' loans to foreign governments and their instrumentalities.

Foreign exchange market developments and operations.—During the fiscal year, the dollar depreciated sharply against all major foreign currencies with the exception of the Canadian dollar. Exchange market conditions deteriorated, and a general lack of confidence in the dollar tended to develop, aggravating efforts in the United States and abroad to narrow payments imbalances, growth rates, and rates of inflation. The dollar depreciated by 34 percent against the Swiss franc, 28 percent against the Japanese yen, and 16 percent against the German mark. It appreciated by 10 percent against the Canadian dollar. On a trade-weighted basis against OECD currencies, the dollar depreciated by 12.5 percent. The currencies of the United Kingdom, France, and Italy also appreciated against the dollar but remained relatively stable on a trade-weighted basis. They were able to rebuild reserves, and Britain and Italy were able to reduce external indebtedness.

By late September 1977, the foreign exchange market was reacting increasingly to the disparities in rates of growth, inflation, and payments imbalances among major industrialized nations. Forecasts of U.S. trade and current account deficits for 1977 and 1978 contrasted sharply with the surpluses in Japan, Germany, and Switzerland, in particular. Uncertainty was increasing over prospects for an effective U.S. energy policy. Concern over the growing U.S. dependence on petroleum imports, low rates of growth in major U.S. export markets, U.S. inflation, and the implications of these factors for future exchange rate movements unsettled the market. The dollar had been depreciating against a number of major foreign currencies, particularly the German mark and Swiss franc, for several months, but market conditions had warranted only small and occasional U.S. intervention operations.

Early in October, market conditions began to deteriorate as doubts grew that policies in the United States and in the major surplus countries would be sufficient to meet the fundamental factors causing the imbalances. While U.S. authorities stressed that further depreciation of the dollar was not required or sought as a means of curing the U.S. deficit, the delays in the consideration of the energy legislation and some uncertainties concerning the course of U.S. monetary and fiscal policies added to the unsettled market conditions. In order to counter these conditions, the U.S. authorities, through the Federal Reserve, began intervening in the market from time to time, selling German marks drawn under the Federal Reserve swap arrangement with the Bundesbank. During October such sales totaled the equivalent of \$223 million. Operations were smaller and less frequent in November, but toward the end of November the speculative atmosphere deepened. The German mark, Swiss franc, and Japanese yen were appreciating sharply, and the movement in the DM stimulated additional speculative inflows on expectations of a realignment of currency parities among the participants of the European common margins ("snake") arrangement. Accordingly, the Federal Reserve increased substantially the extent of its market operations.

On December 21, President Carter expressed his concern about the disorder in the exchange markets and the rapid movement in exchange rates. He stressed the necessity to adopt an effective energy program and to stimulate U.S. exports, and indicated that the United States would continue to intervene to counter disorderly conditions in the foreign exchange market. During this period, Japan, Switzerland, and Germany each adopted measures to restrict capital inflows. However, market conditions deteriorated further. By the end of December, the Federal Reserve indebtedness under the Bundesbank swap arrangement, used to finance intervention during the 3 months, had increased to \$803 million. During the 3 months, the dollar had depreciated by 15 percent in terms of the Swiss franc, 9 percent in terms of the DM and the yen, and by over 5 percent on a trade-weighted basis in terms of OECD currencies.

On January 4, 1978, the Treasury and Federal Reserve Board announced that henceforth the Treasury's Exchange Stabilization Fund (ESF) would be utilized actively together with the Federal Reserve swap facilities and that the Treasury had entered into a swap agreement with the Bundesbank.¹⁴ Joint Treasury-Federal Reserve intervention operations in DM, conducted through the Federal Reserve Bank of New York, commenced immediately. Also, within a few days, the Federal Reserve discount rate was increased from 6 to 6 1/2 percent. Market conditions gradually improved, and the dollar appreciated. In combined operations, the U.S. authorities made net sales of \$749 million of DM in the market during January 4–13. Thereafter, operations were infrequent and small until mid-February, when selling pressure on the dollar intensified. Flows into German marks were stimulated by the latest reports of the German trade surplus and speculation on a realignment of the DM and other currencies within the snake, despite the devaluation of the Norwegian crown within the arrangement on February 13. During February 10–28, Treasury and Federal Reserve operations resulted in net sales of \$715 million of DM; in addition, the Federal Reserve commenced market operations in Swiss francs, selling francs drawn under its swap arrangement with the Swiss National Bank.

U.S. operations were generally light during most of March, though the market was unsettled from time to time, and selling pressure on the dollar intensified following release of the U.S. trade figures for February showing a record deficit of \$4.5 billion. By the end of March, the outstanding swap debts to the Bundesbank had increased to \$2.8 billion, of which \$1.8 billion was owed by the Federal Reserve and \$1 billion by the Treasury. During January–March, the dollar had depreciated further by 8 percent in terms of the Swiss franc and the yen, by 5 percent in terms of the DM, and by 1.5 percent on a trade-weighted basis.

On March 13, Secretary Blumenthal and Finance Minister Matthoefer of the Federal Republic of Germany issued a joint statement, following discussions

¹⁴ See exhibit 49.

between the two Governments and between the Federal Reserve and the Bundesbank.¹⁵ In connection with these discussions, they affirmed that close cooperation in countering disorderly exchange market conditions would be maintained. They announced that the swap agreement between the Federal Reserve and the Bundesbank would be doubled to \$4 billion, that the Treasury had arranged for the sale of SDR 600 million to purchase DM, and that the United States would draw against its reserve position in the IMF if and as necessary to acquire additional foreign exchange.

By early April, market conditions appeared to be improving. The dollar began to appreciate, and the Treasury and Federal Reserve commenced purchasing DM in market and nonmarket transactions for the payment of swap debts to the Bundesbank. Few further sales of foreign currencies in the market were made until late in July. The U.S. stock market rallied. Agreements within Congress were reported on major sections of the energy legislation. On April 11, the President announced new measures to counter inflation and called upon the Congress to act on the energy legislation. On April 19, the Treasury announced the initiation of a series of monthly public auctions of gold, to commence in May, to help reduce the U.S. trade deficit.¹⁶ On May 11, the Federal Reserve increased the discount rate from 6 1/2 to 7 percent. By late that month, the dollar was trading 4 to 8 percent above its levels at the end of March.

However, the demand for dollars was not sustained. The market again turned its focus to the persisting payments imbalances and inflation differentials. Moreover, foreign monetary authorities were perceived to have shifted from a stance of net dollar purchases to dollar sales as the effects of recent dollar intervention were unwound. The dollar began to depreciate again, especially in terms of the Japanese yen. The discussions in Europe about establishment of a European Monetary System added to market uncertainties. The further increase in the Federal Reserve discount rate from 7 to 7 1/4 percent on July 3 did not stimulate a demand for dollars in the market.

Discussions at the Bonn summit¹⁷ highlighted the U.S. commitment to reduce energy consumption, but consideration of possible future OPEC pricing actions remained a factor encouraging dollar sales. The German economic stimulus measures announced after the summit meeting were generally viewed as likely to have only a modest effect. Dollar selling accelerated, and the dollar depreciated sharply in terms of the German mark and other European continental currencies.

On August 16, the President announced that he had asked Secretary Blumenthal and the Chairman of the Federal Reserve Board to consider what actions might be appropriate on their part, and to recommend any future

¹⁵ See exhibit 51.

¹⁶ See exhibit 53.

¹⁷ See exhibit 57.

actions on his part, to deal with the foreign exchange market situation. He said that the sharp decline in the dollar and disorderly market conditions, at a time when the U.S. trade position was showing signs of real improvement, could threaten progress toward dealing with inflation and achieving orderly growth in the United States and abroad. On the next day, Secretary Blumenthal announced that he and the Chairman were giving urgent attention to proposals in a number of areas and expected a series of continuing actions to be announced as decisions were reached over the next few weeks. On August 18, the Federal Reserve announced an increase in the discount rate from $7\frac{1}{4}$ to $7\frac{3}{4}$ percent and a reduction in reserve requirements on Eurodollar borrowings. On August 22, the Treasury announced an increase in the amount of gold offered at the monthly auctions from 300,000 ounces to 750,000 ounces, beginning with the November auction.¹⁸

Market conditions continued to deteriorate gradually during August and September, despite the actions taken and the increasing consensus that payments imbalances and growth rate differences were narrowing. Concern about U.S. inflation was growing. Exchange rates moved in a wide range as the market awaited new actions. The \$2.99 billion July U.S. trade deficit, announced late in August, surprised the market and fortified market skepticism regarding trends. Moreover, speculation grew on the possibility of a realignment of the snake currencies, in advance of or in connection with a new European monetary arrangement. The Federal Reserve increased the discount rate from $7\frac{3}{4}$ to 8 percent on September 22, the Senate passed the natural gas bill, and a sharp decline to \$1.62 billion was reported in the U.S. July trade deficit, but market conditions remained unsatisfactory. The dollar, from its levels at the end of May, had depreciated by 7 percent in terms of the DM and on a trade-weighted basis, 14 percent against the yen, and 17 percent against the Swiss franc by the end of the fiscal year.

The Treasury and Federal Reserve had resumed sales of DM in market operations late in July. By that time, total swap indebtedness to the Bundesbank had been reduced to \$847 million, of which \$650 million represented Federal Reserve and \$197 million Treasury debts, utilizing for repayment DM purchased in market and nonmarket transactions since early in April. As the result of further operations in DM during August and September, however, at the end of the fiscal year the swap indebtedness to the Bundesbank had risen to \$690 million and \$341 million, respectively, to total \$1,031 million. In addition, the Federal Reserve's swap debt to the Swiss National Bank, resulting from current operations in Swiss francs, amounted to \$170 million.

The Treasury and Federal Reserve continued to make regular payments against pre-1971 Swiss franc indebtedness under the 3-year program agreed with the Swiss authorities in 1976. During the fiscal year, the Treasury's

¹⁸ See exhibit 60.

outstanding securities denominated in Swiss francs were reduced by \$521.9 million to \$767.5 million; the Federal Reserve's swap indebtedness was reduced by \$395.8 million to \$219.6 million.

Gold prices rose sharply during the fiscal year from \$152 1/2 to \$218 per fine troy ounce. Movements were frequently sharp and volatile, responding to increased industrial and investor demand, foreign exchange market developments, inflation, and political developments. Initiation of Treasury gold sales, and continued auctions by the IMF, had some effect on investor demand, but market volatility continued. In December, after prices rose steadily throughout the autumn to around \$170, investor demand accelerated, and by early April, gold traded near \$183 1/2. Prices eased over the following month to the \$169 level, reflecting the improved foreign exchange market conditions and market reaction to the announcement of gold sales by the Treasury. Subsequently, however, gold prices rose steadily in a speculative market atmosphere.

Implementing changes in the international monetary system¹⁹

A new phase of international monetary relations began this year with the entry into force of the second amendment of the Articles of Agreement of the International Monetary Fund. This amendment, on which agreement was reached in January 1976, after nearly 5 years of international monetary negotiations, represents the most fundamental change in the international monetary order since the Bretton Woods system was established in 1944. The amendment became effective on April 1 when the required three-fifths of the Fund's members representing four-fifths of the Fund's total voting power accepted it. The United States accepted the amendment pursuant to Public Law 94-564, approved October 19, 1976.

The 1976 and 1977 Annual Reports described in detail the central features of the new international monetary system, as embodied in the amended IMF Articles. The Fund has begun to implement the new provisions of the Articles, including new policies and procedures for its surveillance over members' exchange rate policies.²⁰ Consultation procedures and practices were adapted to take account of the Fund's surveillance responsibilities under Article IV, with Article IV consultations comprehending the traditional consultations under Articles VIII and XIV.

Meeting official financing needs

During fiscal 1978, major steps were taken to strengthen the ability of the IMF to promote economic stabilization and balance of payments adjustment in member countries through the provision of official balance of payments financing in support of programs to correct their balance of payments difficulties. These measures, which should significantly strengthen the

¹⁹See exhibit 58.

²⁰See exhibit 54.

international monetary system during the years ahead, include progress toward activation of the Supplementary Financing Facility, implementation of the increase in IMF quotas under the sixth general review of quotas, and general agreement on a further increase in IMF quotas under the seventh general review of quotas and on new allocations of special drawing rights (SDR's).²¹

Supplementary Financing Facility.—The 1977 Annual Report described in detail this arrangement designed to reinforce the IMF's ability to meet world balance of payments financing needs and to promote economic stabilization by member countries experiencing particularly serious payments difficulties over the next 2 to 3 years. This facility will total approximately SDR 8.5 billion (\$10.7 billion),²² with financing shared roughly equally by the oil-exporting and industrial countries. The United States, which played an important leadership role in the negotiation of the facility, has agreed to provide up to SDR 1,450 million²³ under the facility, approximately 17 percent of the total.

Legislation authorizing U.S. participation in the facility which was submitted to Congress on September 16, 1977, was passed by Congress and signed into law on October 10, 1978 [Public Law 95-435]. A request for appropriations to permit U.S. participation in the facility was submitted to Congress on September 12, 1978, and was passed as part of the foreign assistance appropriations bill for fiscal 1979. [Public Law 95-481, October 18, 1978, appropriates \$1,831,640,000 for U.S. participation in the facility.] The facility is expected to begin operations early in fiscal 1979, and will temporarily strengthen the IMF's capacity to provide balance of payments financing to members during a period of particular strain on the international monetary system and pending a further increase in the IMF's permanent resources.

IMF quotas.—As part of the overall agreements on monetary reform reached at Jamaica in January 1976, it was agreed to increase IMF quotas—the permanent base of IMF resources—by approximately one-third under the sixth general review of quotas. This increase in quotas became effective on April 1, 1978, raising total Fund quotas from SDR 29.2 billion to SDR 39 billion (approximately \$50 billion). The U.S. quota was increased from SDR 6,700 million to SDR 8,405 million (approximately \$10,767 million), pursuant to Public Law 94-564.

A further review of IMF quotas—the seventh general review—was initiated during the fiscal year. The Interim Committee of the IMF agreed in principle in April 1977 to a further increase in quotas under this review. Discussions on the major issues relating to the quota increase continued in the IMF Executive Board during fiscal 1978, and a consensus was reached on the following major issues at the September 1978 meeting of the Interim Committee:

1. *Size.*—The Committee took the view that a 50-percent increase in quotas—from SDR 39 billion to SDR 58.6 billion (approximately \$76

²¹ See exhibit 63.

²² All conversions from SDR's to dollars in this section are based on exchange rates as of Sept. 30, 1978.

²³ Subject to the dollar limitation placed by Public Laws 95-435 and 95-481.

billion)—would be appropriate to bring about a better balance between the size of the Fund and the need of members for balance of payments financing over the medium term. This view was based on a number of factors, including the expectations that world trade will continue to expand significantly during the years ahead, and that IMF member countries will continue to experience relatively large payments imbalances and financing needs. The quota increase will ensure that the Fund is capable of continuing to fulfill its responsibilities for promoting balance of payments adjustment through the provision of balance of payments financing to member countries in support of appropriate economic stabilization and adjustment programs.

2. *Distribution.*—In view of extensive changes in quota shares agreed on the occasion of the sixth quota review, the Committee agreed that this quota increase should be mainly equiproportional (i.e., equal percentage increases for most members), with only a very few selective increases available for countries whose quota shares are particularly small in terms of their relative positions in the world economy. Accordingly, the great bulk of IMF members will receive quota increases of 50 percent with selective increases confined to the following countries: Iraq, Iran, Korea, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Singapore, and the United Arab Emirates.
3. *Means of payment.*—It was also agreed that participants in the Special Drawing Rights Department should pay 25 percent of the increase in their quota subscriptions in SDR's and that nonparticipants should pay 25 percent of the increase in foreign exchange (128 of the IMF's 135 members, including the United States, are participants). The remaining 75 percent would be paid in members' own currencies. These subscription requirements will provide for a larger role for the SDR in IMF operations, enhance the importance of the SDR as a reserve asset in the international monetary system, and strengthen the IMF's liquidity.

[The IMF Board of Governors approved a resolution proposing the quota increase on December 11, 1978. Increases in quotas pursuant to this resolution cannot take effect until members having 75 percent of total quotas have consented to increases in their quotas, and it is not likely that the quota increase will take effect before the latter part of 1980. The increase in the U.S. quota would amount to 50 percent, from SDR 8,405 million to SDR 12,607 million (\$16,150 million), and will require congressional approval.]

Special drawing rights.—During fiscal 1977, a consensus was reached in support of further allocations of special drawing rights as well as on a number of measures to improve the characteristics and usability of the SDR. At its

September 1978 meeting,²⁴ the Interim Committee expressed the view that the Fund should make allocations of SDR 4 billion (approximately \$5 billion) per year over the next 3 years. This recommendation reflected the view that substantial increases in international transactions can be expected in the future, and that with such growth in the international economy there will be a need for growth in official reserves. An SDR allocation will meet a part of this need for reserves, will help to assure maintenance of the viability and credibility of the SDR as an important reserve asset, and will assist the SDR in fulfilling its important longrun potential in the international monetary system. The allocations will take place in 1979, 1980, and 1981. The United States would receive allocations totaling approximately SDR 2.67 billion (approximately \$3.5 billion) over the 3-year period.

The measures to improve the characteristics and usability of the SDR, which are designed to enhance its role as a reserve asset in the international monetary system, include:

Changes in the composition of the currency baskets used for determining the value and interest rate of the SDR, involving essentially an update of the baskets to reflect changing relative importance of currencies over time. These changes took effect July 1, 1978.

An increase in the SDR interest rate from 60 to 80 percent of the weighted average of short-term interest rates in the five largest countries.

Agreement in principle on the desirability of expanding the uses of SDR's to include three additional categories of SDR operations—settlement of obligations, loans, and security of obligations (collateral)—subject to further examination of operational and technical questions.

Reduction in the SDR "reconstitution" requirement (i.e., the obligation to maintain a minimum average balance of SDR's over specified periods) from 30 to 15 percent of allocations.

It is expected that formal decisions regarding the latter three measures will take effect at the time of the 1979 SDR allocation.

IMF operations

Use of the IMF resources during fiscal 1978 was substantially less than in the immediately preceding years. This development reflected improvement in some members' external financial positions as a result of successful stabilization efforts, the availability of financing from the private capital markets, and the fact that a number of countries had made substantial use of Fund resources during the previous years and consequently had limited additional access to the IMF as well as obligations to repurchase earlier drawings.

Transactions and operations in the IMF General Resources Account.—Total gross drawings (purchases) by IMF members in fiscal 1978 from the General Resources Account (including use of reserve tranches) amounted to SDR

²⁴ See exhibit 62.

1,347 million by 31 countries, compared with SDR 4 billion by 36 countries in the preceding year. Turkey and Zambia were the two largest purchasers, each with drawings of SDR 124 million, followed by Spain (SDR 99 million).²⁵ A large part of total drawings were made in special drawing rights (SDR 984 million), with the principal currencies drawn from the IMF being the United Kingdom pound sterling (SDR 102 million); U.S. dollar (SDR 60 million); and Argentine peso (SDR 57 million).

Repayment of outstanding drawings (repurchases) totaled a record SDR 3.6 billion in fiscal 1978, with the largest repurchases made by Italy (SDR 730 million); the United Kingdom (SDR 700 million); and Argentina (SDR 509 million). Currencies used in the repurchases included U.S. dollars (SDR 1,649 million); German marks (SDR 594 million); and Japanese yen (SDR 433 million).

SDR 1,036.5 million of total repurchases were attributed to drawings under the oil facility. The Fund repaid the equivalent of this amount to 14 lenders that had made loans to the Fund in connection with the oil facility.

As of September 30, 1978, cumulative drawings under the IMF's regular resources, from the beginning of IMF operations, amounted to SDR 46 billion, of which SDR 13.9 billion was in U.S. dollars. Cumulative repurchases amounted to SDR 25.5 billion, of which SDR 7.9 billion was in U.S. dollars.

The U.S. reserve position in the IMF decreased to SDR 3,289.6 million at the end of fiscal 1978 from SDR 4,104.9 million at the end of fiscal 1977 as a result of net repurchase of dollars by other countries.

Of the total SDR 1,347 million in gross purchases from the General Resources Account in fiscal 1978, purchases in the reserve (gold) and credit tranches accounted for SDR 643 million, 48 percent of the total. Purchases under the compensatory financing facility totaled SDR 554 million, with the largest borrowers under the facility being Spain (SDR 99 million); Turkey (SDR 74 million); and Israel (SDR 73 million). Drawings under the Extended Fund Facility during fiscal 1978 totaled SDR 150 million, with the largest purchases made by Egypt (SDR 75 million) and the Philippines (SDR 47 million). There were no purchases under the buffer stock facility.

General Arrangements to Borrow.—The General Arrangements to Borrow (GAB) was not activated during fiscal 1978.²⁵ In July 1978, the IMF repaid GAB lenders the equivalent of SDR 90 million, based on a repurchase by Italy of an earlier drawing financed by the GAB. A number of technical changes in the GAB, which were necessary in order to conform to the second amendment of the IMF's Articles of Agreement, became effective on August 11, 1978. In addition, the Group of Ten conducted an examination of the adequacy and the role of the GAB. This study, which was commissioned at the April 29 meeting of the Group of Ten, concluded inter alia that "the GAB as an additional means of official financing will remain valuable in the future and should be

²⁵ [The United States drew the equivalent of SDR 2.22 billion from its reserve tranche in November 1978. A part of this drawing, SDR 777 billion, was financed through the General Arrangements to Borrow (GAB), which was activated for this purpose.]

maintained" and that "no further changes of the Arrangements are considered necessary by the Deputies at the present time." The fourth review of the arrangements will be conducted during fiscal 1979.

Transactions and operations in the Special Drawing Rights Department.—Activity in the SDR Department increased to a record level during fiscal 1978 with total use by participants amounting to SDR 2,518 million. Transfers of SDR's by participants to other participants totaled SDR 1,385 million. These transfers include transfers between members by agreement and transfers with designation.

Transfers by participants to the General Resources Account amounted to SDR 1,134 million. These transfers were mainly for the purposes of making repurchases and payment of interest and charges on drawings. Use of SDR's by the General Resources Account equaled SDR 1,307 million, primarily to finance drawings by members and in payment of remuneration to creditors in the General Resources Account. As a result of all SDR transactions of the General Resources Account, the Account's SDR holdings declined by SDR 173 million during the fiscal year, to SDR 1,041 million as of September 30, 1978.

IMF gold sales.—During fiscal 1978, the IMF continued its program of gold sales in which 50 million ounces of the IMF's gold are being sold over a 4-year period as part of the process of reducing the role of gold in the international monetary system.

1. *Gold auctions.*—Half of the total 50 million ounces is being sold in public auctions by the IMF trust fund for the benefit of developing countries. In fiscal 1978, the IMF, on behalf of the trust fund, held 12 monthly auctions at which a total of approximately 7.25 million ounces of gold were sold, bringing total sales in the auction program to 15.65 million ounces as of September 30, 1978. The profits received from sales in fiscal 1978 equaled approximately \$981 million, bringing total profits accrued from all auctions held to approximately \$1.76 billion.

At each of the monthly auctions through May 1978, the IMF sold approximately 525,000 ounces. The amount for the remaining public auctions during fiscal 1978 was reduced to 470,000 ounces per month, to allow for noncompetitive bids by developing countries. The overall agreement on the gold sales program provided for the distribution of a portion of the profits accruing to the trust fund directly to eligible developing countries. As part of this agreement, eligible members have the option to use these profits to bid for gold on a noncompetitive basis at IMF auctions, paying market prices for the gold. At the monthly auctions held during June–September 1978, the IMF sold 1.17 million ounces to nine developing countries which exercised this option.

2. *Gold distribution.*—The other half of the 50 million ounces is being sold at the former official price (SDR 35 per fine ounce) directly to all countries that were members of the Fund as of August 31, 1975, in proportion to their quotas in the Fund. The second of four annual direct sales occurred during fiscal 1978, with the Fund selling a total of 6,090,362 fine ounces. The United States received 1,433,516.1 ounces.

Trust fund.—The trust fund was established in May 1976 for the purpose of providing additional balance of payments assistance to developing members from the profits of the IMF gold auctions. It is legally separate from the IMF but administered by the IMF as trustee. A portion of the profits on trust fund gold sales—that proportion that corresponded to the quota shares of eligible developing countries as of August 31, 1975—would be transferred directly to each eligible country in proportion to its quota, with the balance of the profits made available to finance balance of payments loans by the trust fund on concessional terms to the poorest countries.

The “direct transfer” of trust fund profits from the first 2 years of the gold sales took place in fiscal 1978, with a total of \$362.6 million being distributed to 104 developing member countries. As indicated above, eligible members have the option of using their profits to bid for gold on a noncompetitive basis at IMF auctions. Two further disbursements of trust fund loans were also made during fiscal 1978, with loans totaling approximately SDR 662 million made to 43 developing countries, bringing total disbursements under the first 2 years of the trust fund loan program to approximately SDR 841 million.

Oil facility subsidy account.—This subsidy account was established in August 1975 to assist the Fund’s most seriously affected members to meet the cost of using the 1975 oil facility. The objective of the account, which is financed by voluntary contributions from 24 members plus Switzerland and administered by the IMF as trustee, is to reduce the effective rate of annual charge payable on drawings under the 1975 oil facility by about 5 percentage points per year (from roughly 7.2 percent to 2.2 percent). During fiscal 1978, subsidy payments totaling SDR 24.95 million were made to 18 members, bringing total subsidy account payments to SDR 66.29 million.

Participation in the OECD

Secretary Blumenthal attended the annual meeting of the OECD Council at Ministerial Level in Paris on June 14–15, 1978. During this meeting, the assembled Ministers reached agreement on an OECD program of concerted action to achieve more sustained, noninflationary growth in the OECD economy.²⁶

The major components of this concerted action program had been developed during meetings of the OECD Economic Policy Committee (EPC), Executive Committee in Special Session (XCSS), and Trade Committee (see

²⁶ See exhibit 56.

"Trade negotiations" and "Export credits" sections of "Trade and Investment Policy"), and at the OECD's affiliated organization, the International Energy Agency (see "Energy policy" section of "Commodities and Natural Resources").

Two of the key components of the strategy agreed to were (1) closer coordination of demand management policies as recommended by the EPC and (2) promotion of more positive policies for facilitating adjustment to structural change as recommended by the XCSS.

Concerted action.—Treasury officials participated actively during fiscal 1978 in the work of the EPC and of its several working groups on growth, inflation, short-term economic prospects, and balance of payments.

The primary concern of the EPC and its working groups during this time was development of a concerted strategy for overcoming constraints on more rapid, sustained growth of the OECD area. Constraints seen limiting action by individual governments included persistent inflation, protracted current account imbalances, structural problems exacerbated by slow growth, and the lagged adjustment of trade flows to exchange rate changes.

At the November 1977 EPC meeting, the emphasis had been on the key role of certain "locomotive" economies in assuring the success of the OECD medium-term strategy for noninflationary growth. "Stronger" countries such as Germany and Japan were urged to meet their announced growth targets, with recent U.S. performance being cited as the example to follow.

By the February 1978 meeting, the emphasis of discussion shifted to factors constraining policy action by individual governments. A more concerted approach to raising the areawide OECD growth rate, one emphasizing the responsibilities of all member countries, was seen to be both possible and desirable. During this meeting Charles L. Schultze, Chairman of the U.S. Council of Economic Advisers, was elected chairman of the EPC.

At its May meeting, the EPC discussed the elements of a possible concerted action program.

1. *The program adopted.*—At the June meeting, the OECD Ministers agreed on the respective responsibilities of member countries in contributing to faster growth, greater price stability, and better payments equilibrium over the next 18 months. Eight countries (Belgium, Canada, France, Germany, Italy, Japan, Switzerland, and the United Kingdom) agreed to ensure that the expansion of their domestic demand was significantly greater than in 1977; the Netherlands agreed to maintain the boost in domestic demand achieved in 1977; and all other member countries agreed to concentrate primarily on reducing inflation and improving their balance of payments position.

The Ministers further agreed on renewal of the trade pledge, and stressed the importance of the multilateral trade negotiations, the Arrangement on Officially Supported Export Credits, and positive adjustment policies to the success of the concerted action program; stressed that strengthened energy

policies form an essential part of the program; and agreed that monetary policy has an important role to play in achievement of the program's objectives.

2. *WP-3*.—Treasury led the U.S. delegation to meetings of EPC Working Party 3 (international payments equilibrium). Under Secretary for Monetary Affairs Solomon attended the February, May, and September 1978 meetings. Assistant Secretary for International Affairs Bergsten attended the November 1977 meeting.

At both the November and February meetings of *WP-3*, the external payments situation of the United States and the policy posture of the U.S. authorities were primary topics of discussion. Continued rapid U.S. growth, despite projected large payments deficits, was considered essential to further recovery of the world economy. By February, the *WP-3* was also giving considerable attention to the desirability of faster growth outside the United States as a principal means of reducing payments imbalances and avoiding disorder in exchange markets.

At its May meeting, the *WP-3* reviewed the preceding period of relative calm in exchange markets, discussed the possible reasons, and considered the importance of concerted action to assuring continued market stability.

At its September meeting, the *WP-3* noted with approval the improved prospects for convergence of growth rates and for reduction of payments imbalances. The *WP-3* also heard a report on plans for the European Monetary System.

Positive adjustment.—In support of the concerted growth strategy, the XCSS during 1978 considered the development of more positive policies for facilitating adjustment to structural change. In addition, an ad hoc meeting of government representatives to discuss adjustment policies was held just before the May 1978 meeting of the EPC. Treasury officials attended the meetings of both groups.

The June Ministerial communique made reference to the need for more positive adjustment policies. In July, the OECD Council directed the sectoral committees of the Organization to begin working on this issue, concurrent with the work underway in the ad hoc group.

International Banking Act of 1978

Federal legislation to regulate the U.S. activities of foreign banks was enacted in September 1978, with the adoption of the International Banking Act of 1978 (Public Law 95-369). Treasury officials testified on behalf of the administration in general support of this legislation during congressional hearings.

The new law is designed to accord to the extent possible national treatment for operations of foreign banks in the United States and also to provide for more uniform Federal regulation of these foreign bank operations.

Under the new law, foreign banks are prohibited from engaging in both commercial banking and nonbanking activities in the United States, except to

the extent permitted domestic banks. Nonbank operations already in existence (including securities affiliates) are either permanently grandfathered or for those operations which commenced or were authorized between July 27 and September 16, 1978, grandfathered through 1985.

Federal deposit insurance is required at foreign bank branches which accept small deposits. Also, U.S. branches and agencies of foreign banks with over \$1 billion in assets are subject to the Federal Reserve's reserve requirements and interest rate ceilings which are applicable to member banks.

The act also subjects foreign banks to restrictions on new multi-State branching, while existing multi-State operations are permanently grandfathered. Foreign banks may continue to establish agencies outside their home State. They may not acquire a bank subsidiary outside their home State unless such acquisition would be permitted for a domestic bank holding company. Foreign banks may establish branches outside their home State if the new State approves and if the bank enters into an agreement with the Federal Reserve to receive only such deposits at that branch as would be permissible to an Edge Act corporation; i.e., deposits related to international financial transactions.

International investment and capital flows (OPEC investors)

The cumulative total of OPEC investable surpluses rose approximately \$27 billion between June 1977 and end-June 1978, down moderately from the year earlier period. However, as the current account surplus (excluding official transfers) of OPEC members as a group plummeted from over \$33 billion in 1977 toward \$14 billion in 1978, total OPEC financial investments in industrial countries declined by approximately \$3 to \$4 billion during the second quarter of 1978, due to the effects of seasonally low oil revenues and continuing disbursements of funds to developing countries under prior aid commitments. The withdrawal by oil-exporting countries as a group of about \$1.8 billion from the United States in the second quarter 1978 reflects the rapid decline in investable funds available to OPEC member nations.

Since 1974, when 86 percent of OPEC members' money market and portfolio investments in the United States were placed in short-term assets, OPEC investments in the United States have progressively shifted toward longer term instruments. This trend continued in 1978. Net new investments in U.S. stocks and domestic bonds, other than Treasury bonds and notes, amounted to \$1.2 billion in first half 1978, while there were net sales of other assets.

Developing Nations

Multilateral development banks²⁷

In fiscal 1978, the Congress appropriated \$2,514 million for increased U.S. participation in the World Bank group (the International Bank for Reconstruction and Development (IBRD), the International Development Association

²⁷ See exhibits 65, 66, and 67.

(IDA), and the International Finance Corporation (IFC); the Inter-American Development Bank (IDB) and its Fund for Special Operations (FSO); the Asian Development Bank and Fund (ADB and ADF); and the African Development Fund (AFDF). This amount, for use beginning in fiscal 1979, was 31 percent greater than the amount appropriated for the banks during the previous fiscal year. No new authorizing legislation for U.S. participation in the banks was submitted to Congress during fiscal 1978. A breakdown of the appropriations legislation approved by Congress is shown in the table below:

U.S. participation in the multilateral development banks during fiscal 1978
[\$ millions]

Institution	Fiscal 1979 appropriation	Comment
International Bank for Reconstruction and Development:		
Paid-in	16.3	Second installment of U.S. contribution to IBRD selective capital increase authorized in fiscal 1977. \$452.5 million callable and \$50.3 million paid-in remains to be appropriated for the second installment.
Callable	146.8	
International Development Association.....	1,258.0	\$800 million represents the second installment of the U.S. contribution to the fifth replenishment of IDA. \$458 million represents the U.S. contribution to IDA's fourth replenishment. \$292 million remains to be appropriated for the fourth replenishment.
International Finance Corporation.....	40.0	Appropriation is second installment of U.S. contribution to IFC capital increase authorized in fiscal 1977.
Inter-American Development Bank:		
Paid-in	27.3	Appropriation completed U.S. contribution to IDB replenishment authorized in fiscal 1976.
Callable	561.5	
Fund for Special Operations	175.0	\$150.3 million remains to be appropriated from replenishment authorized in fiscal 1976.
Asian Development Bank:		
Paid-in	19.4	Appropriation is second installment of U.S. contribution to second ADB capital increase authorized in fiscal 1977. \$40.3 million callable and \$4.5 million paid-in remains to be appropriated for the second installment.
Callable	175.1	
Asian Development Fund.....	70.5	Appropriation is second installment of U.S. contribution to first ADF replenishment.
African Development Fund.....	25.0	Appropriation is U.S. contribution to first AFDF replenishment authorized in fiscal 1977.
Total	2,514.0	

The multilateral development banks committed \$12,049 million to developing countries in fiscal 1978. The distribution of commitments by institution was as follows: World Bank group, \$9,345 million; Inter-American Development Bank, \$1,546 million; Asian Development Bank, \$1,002 million; and the African Development Fund, \$155 million. The development banks have become an important source of finance for developing countries. Estimates indicate that in 1977 multilateral agencies accounted for one-third of all official flows to developing countries.

The development banks are an extremely effective and efficient mechanism for promoting U.S. relations with developing countries and contributing to their social and economic development. In all cases, the loan appraisal processes of the banks are detailed and rigorous, insuring that the maximum developmental impact is obtained from every dollar lent. The banks provide developing countries with sound economic advice and serve as focal points for the coordination of the activities of official lenders. In addition, the banks permit the United States to share the burden of assisting the developing countries with other donors; for every dollar of U.S. contributions to the banks other countries contribute 3 dollars. The U.S. domestic economy also benefits directly by U.S. participation in the development banks through procurement contracts and the interest payments made to U.S. citizens who purchase bank bonds.

World Bank group

The World Bank group committed a total of \$9,345 million for economic assistance to its borrowing member countries in fiscal 1978, an increase of 29 percent over the previous fiscal year. IBRD lending totaled \$6,004 million in fiscal 1978, compared with \$5,541 million in fiscal 1977, an increase of about 8 percent. New IDA credits reached \$2,858 million in fiscal 1978, compared with \$1,437 million in fiscal 1977. IFC commitments increased to \$483 million in fiscal 1978 from \$269 million in fiscal 1977, an increase of 80 percent. As of September 30, 1978, IBRD commitments outstanding totaled \$34.4 billion and IDA credits totaled \$11,372 million. IFC commitments outstanding totaled \$2,206 million.

During fiscal 1978, both the IBRD and IDA increasingly concentrated their lending in agriculture. The IBRD increased its commitments to the agricultural sector in fiscal 1978 to \$1,383 million (31 percent of total lending), compared with \$1,614 million (29 percent of lending) in fiscal 1977. The amounts committed by IDA to agriculture increased from \$773 million in fiscal 1977 to \$1,415 million in fiscal 1978, an increase of almost 83 percent. Other important sectors of IBRD and IDA lending in 1978 included development finance companies and industry (16 percent), transportation (14 percent), and power (12 percent). IFC investments were concentrated in mining and iron and steel (14 percent), food and food processing (11 percent), general manufacturing (5 percent), and development finance companies and capital markets (4 percent).

The IBRD and IDA committed resources for 241 projects totaling \$8,862 million in 75 countries distributed by region as follows: Africa, 74 (\$1,041 million); Asia, 76 (\$3,960 million); Latin America, 49 (\$2,090 million); Europe, the Middle East, and North Africa, 42 (\$1,771 million). India was the largest borrower from the IBRD and IDA (\$1,595 million), while Brazil was second (\$688 million); the Philippines, Mexico, and Indonesia received \$526 million, \$495 million, and \$490 million, respectively.

IFC commitments during fiscal 1978 went to 53 projects in 33 developing countries. These commitments included 14 projects in Europe, the Middle East, and North Africa (26 percent of the total committed), 11 projects in Asia (12 percent), 18 projects in Latin America (55 percent), and 10 in Africa (7 percent). Mexico received the largest individual total (\$133 million) with Jordan second (\$73 million) and Brazil third (\$68 million).

At the September 1978 meeting of the World Bank in Washington, D.C., Secretary Blumenthal expressed his satisfaction at the rate of economic progress in the developing countries, but stressed the fact that even at the present rate of growth, 600 million people will face absolute poverty by the end of this century. To meet these needs, concerted action must be taken in the areas of trade expansion, nonconcessional finance to middle-income countries, concessional capital flows to the poorest countries (and to the poorest sectors within developing countries), and nonrural employment.

The Secretary expressed support for the new directions charted by the World Bank in financing social and economic development and the increased lending by the World Bank for expansion of energy resources in developing countries.

The lending operations of the IBRD are financed from five sources: Paid-in capital subscriptions; borrowings in private capital markets, and from governments and central banks; sales of participations; principal repayments on loans; and earnings on its loans and investments.

The Bank's outstanding funded debt increased during the IBRD fiscal year by \$4,124 million to reach \$22,602 million as of June 30, 1978. Estimates indicate that as of that date 26 percent of Bank bonds were held by investors in the United States, 24 percent in Germany, 13 percent in Japan, 6 percent in Saudi Arabia, and 11 percent in Switzerland. The remaining 20 percent of outstanding borrowings was held by central banks and government agencies in more than 80 countries.

The Bank's borrowing program for IBRD fiscal 1978 was set at the equivalent of \$4,200 million. Of this amount, \$600 million was borrowed in April 1977 as an advance in order to take advantage of favorable factors in the U.S. investment market. This issue was therefore included in the Bank's statistics for fiscal 1977. Actual borrowings in IBRD fiscal 1978 amounted to the equivalent of \$3,636 million.

As in fiscal 1977, the principal sources of borrowed funds to the Bank were borrowings on private capital markets. The Bank sold 20 issues totaling the equivalent of \$2,398 million in private markets, or about 66 percent of total funds raised through borrowings. This continues the trend of obtaining more from private financial sources rather than governments and central banks; in IBRD fiscal 1978, governments and central banks purchased \$1,220 million of Bank issues, or about 34 percent of the year's total. This was \$82 million more than in fiscal 1977.

During IBRD fiscal 1978, the Bank's public and private borrowings came principally from the following countries: \$750 million in the United States; \$1,120 million in Germany; \$700 million from the issuance of 2-year dollar bonds to central banks and other government agencies in some 80 countries; \$363 million in Switzerland; and \$571 million in Japan.

In IBRD fiscal 1978, the Bank also borrowed \$18 million from the interest subsidy fund, or third window. This facility was established in fiscal 1976 to permit lending on terms intermediate between those of the IBRD and IDA. Aggregate borrowings by the Bank from the subsidy fund totaled \$184 million as of June 30, 1978.

During IBRD fiscal 1978, the Bank's borrowers repaid \$890 million of principal, \$831 million to the Bank and \$59 million to purchasers of loans. Cumulative repayments on loans by June 30, 1978, were \$6,480 million to the Bank and \$2,425 million to purchasers of loans. Income on Bank investments amounted to \$614 million, up \$78 million, or nearly 14.6 percent, over the previous fiscal year. Income on loans rose by \$252 million, or 23.5 percent, to a total of \$1,325 million. For the same period, sales of participations in the Bank's loan portfolio amounted to \$183 million, compared with loan sales of \$189 million in fiscal 1977. Net income of the Bank in IBRD fiscal 1978 was \$238 million, up \$29 million, or nearly 13.9 percent, from the previous fiscal year. However, after taking adjustments arising from currency devaluations into account, income was \$348 million, compared with \$199 million in the previous fiscal year.

As discussed in last year's Annual Report, the United States believes that a substantial increase in IBRD capital is desirable in order to permit Bank lending to expand in real terms. The United States hopes that negotiations on a general capital increase can be concluded early in calendar 1979.

Asian Development Bank

ADB lending in fiscal 1978 totaled \$1,002 million, compared with \$722 million in fiscal 1977. Of fiscal 1978 loans, \$647 million came from Ordinary Capital resources and \$355 million from concessional funds. Lending in U.S. fiscal 1978 brings cumulative ADB lending through September 30, 1978, to \$4,744 million—\$3,430 million from Ordinary Capital and \$1,314 million on concessional terms.

In fiscal 1978, agriculture and agro-industry continued to be the largest beneficiaries of Bank lending, accounting for \$242 million, or almost 24 percent of total lending. Since the Bank's inception in 1966, power projects have received the largest amount of ADB loan funds (\$1,458 million, or 31 percent), followed by agriculture and agro-industry (\$1,151 million, or 24 percent), industry (\$896 million, or 19 percent), and transportation and communications (\$841 million, or 18 percent).

The three largest borrowers from the ADB's Ordinary Capital resources in

fiscal 1978 were Indonesia (\$181 million, or 28 percent), the Philippines (\$137 million, or 21 percent), and Korea (\$125 million, or 19 percent). Pakistan and Bangladesh were the two largest borrowers from the ADB's concessional resources, having borrowed \$123 million (35 percent) and \$70 million (20 percent), respectively.

ADB Ordinary Capital lending operations are financed by paid-in capital subscriptions, funds borrowed in private capital markets and from governments and central banks, repayments of principal and interest on loans, and net earnings on investments. Asian Development Fund resources—used for concessional loans—derive from member country contributions, amounts set aside from Ordinary Capital earnings, and repayments on loans.

As of September 30, 1978, the Bank's subscribed Ordinary Capital stock totaled \$8,389 million. In fiscal 1978, the Bank's gross borrowing totaled \$396 million, including \$70 million in 2-year U.S. dollar bonds. The ADB's outstanding borrowings amounted to \$1,692 million as of September 30, 1978.

In April 1978, at the 11th annual meeting of the Board of Governors in Vienna, the Carter administration reaffirmed its continuing support for the goals and operations of the Asian Development Bank, particularly the Bank's increasing efforts to assist rural development through the introduction of integrated rural development projects, and the special attention paid by the Bank to the use of appropriate technology. The U.S. representative expressed approval for the Bank's special attention to subregional development cooperation in the South Pacific and in the Association of Southeast Asian Nations (ASEAN).

In fiscal 1978, negotiations were completed on a second replenishment of the Asian Development Fund to finance its 1979–82 lending program. The intended U.S. contribution, subject to congressional authorization and appropriation, would be \$445 million over the 4-year period, or \$111 million in fiscal 1980–83. The U.S. contribution would represent 22.2 percent of the basic replenishment and 20.7 percent of the total replenishment including voluntary contributions.

Inter-American Development Bank

During fiscal 1978, the IDB committed a total of \$1,638 million, a 24-percent increase in lending over fiscal 1977. Of this amount, \$973 million was lent on conventional terms from the capital account and \$524 million was lent on concessional terms from the Fund for Special Operations. In addition, the IDB committed \$91 million in funds administered for various donors (primarily the Venezuelan trust fund). Cumulative lending by the IDB, as of September 30, 1978, totaled \$12.6 billion, of which \$6.3 billion had been lent from the capital accounts, \$5.4 billion from the FSO, and \$0.9 billion from other resources (primarily the U.S. social progress trust fund and the Venezuelan trust fund).

Agriculture, industry, and energy received the greatest attention in fiscal 1978. About 29 percent (\$474 million) of the funds committed were for energy projects, 27 percent (\$439 million) for industry, and 16 percent (\$264 million) for agriculture. On a cumulative basis, through the end of fiscal 1978, energy had received the largest amount, 23 percent, or \$2.9 billion, and agricultural projects had received the next largest amount, 22 percent, or \$2.8 billion. (In some instances, however, distribution of loans into sector categories such as these may tend to be misleading since many IDB projects are of a multipurpose character.)

IDB lending operations are financed principally from paid-in capital subscriptions, borrowings in international capital markets, and member country contributions to the FSO. As of September 30, 1978, the total subscribed capital of the Bank was \$9,943 million, of which \$1,283 million was paid-in and \$8,660 million was callable. The resources of the FSO amounted to \$5,905 million. The U.S. subscriptions to IDB capital shares amounted to \$3,458 million, or approximately 35 percent of the total. Including contributions authorized, but still pending appropriations, the United States accounted for \$3,690 million, or 62 percent of total resources contributed to the FSO.

In fiscal 1978, the IDB borrowed \$130 million equivalent in international capital markets, including \$9 million in the United States. In addition, the Bank sold \$35 million of 2-year bonds to central banks in Latin America and \$39 million of 2-year bonds to central banks in nonregional member countries. The Bank's outstanding funded debt amounted to \$2,637 million as of September 30, 1978.

At the 1978 annual meeting of the IDB in Vancouver, British Columbia, the U.S. representative affirmed the Carter administration's commitment to respect for the political integrity and economic and social aspirations of all nations, and our recognition of the essential interdependence of developed and developing economies—especially in light of the impressive progress made in many of the world's developing countries.

The U.S. representative commended the Bank on its impressive achievements in Latin America, urging that in light of the region's relatively advanced position along the spectrum of development, further efforts should be made to assure equitable distribution of resources to the poorest of the developing countries and to those poorest sectors within countries receiving assistance. The Bank's successful efforts to draw increasingly on private sources through the mechanism of complementary financing, as well as its efforts to promote the use of appropriate technologies in its activities, were commended.

During fiscal 1978, negotiations began on a replenishment of the resources of the Bank and the FSO. It is anticipated that the negotiations will be completed early in fiscal 1979.

African Development Fund

The African Development Fund was created on July 3, 1973, as the concessional lending affiliate of the African Development Bank (AFDB). The

AFDF is designed to channel resources to the poorest African nations; except in the most unusual circumstances, its loans are not extended to countries with a per capita GNP in excess of \$400.

The United States joined the AFDF in November 1976 with an initial contribution of \$15 million and contributed a further \$10 million in December 1977. In addition to the United States, membership in the AFDF includes 13 European countries, Canada, Brazil, Japan, Saudi Arabia, Kuwait, and the AFDB, which has no nonregional members. Total resources pledged to the fund amounted to \$463.3 million as of September 30, 1978.

In fiscal 1978, AFDF lending amounted to \$155.2 million, distributed among 23 African countries. This represented an increase of \$27.2 million, or 21 percent, above the 1977 lending level of \$128 million. The Central African Empire was the largest borrower (\$18.6 million), having received 12 percent of the year's loans; Mali was the second largest (\$15.5 million, or 10 percent); and Benin was the third (\$13.8 million, or 8.9 percent).

AFDF lending in 1978 helped to finance projects in health, water supply and sewerage, agriculture and rural development, and education and transportation. Transportation projects accounted for the largest sectoral share of AFDF lending at \$63.3 million, or 41 percent of total loans. The two other leading sectors benefiting from AFDF loans were agriculture (\$55.5 million, or 35.8 percent) and health and education (\$29.7 million, or 19.1 percent).

The fifth annual meeting of the African Development Fund was held in Libreville, Gabon, during May 1978. The U.S. representative expressed the administration's commitment to assisting Africa's growth and development and support for the African Development Fund. While applauding the great strides made in enhancing the fund's administrative capacity, the U.S. delegate stressed the need for continued vigilance in improving fund operations, including greater attention to the use of appropriate technologies and an intensified program of project evaluation and auditing. The United States also emphasized that fund resources should continue to be concentrated on the poorest African countries and on reaching the basic human needs of Africa's poor.

During the annual meeting, negotiations were completed on a second replenishment of the African Development Fund to finance its 1979-81 lending program. Donors agreed to a \$777 million target for the replenishment, of which \$693 million was actually pledged. The second replenishment will permit a 10-percent real growth in AFDF lending and reflects Africa's need for concessional aid. The intended U.S. contribution to the replenishment, subject to congressional authorization and appropriation, will be \$125 million, to be appropriated in three installments in fiscal 1980-82.

Situation of the non-OPEC developing countries

The overall economic situation of the non-OPEC developing countries in 1977 and 1978 is a mixed picture with significant improvements in some indicators and less progress in others.

Current account deficits for the group,²⁸ which declined significantly to \$26 billion in calendar 1976 and fell further to \$22 billion in calendar 1977, are projected to rise in 1978 to about \$28 billion. However, this nominal increase is not significantly different from historical averages when world inflation and economic growth are factored in, nor should it pose financing difficulties for the group as a whole.

Export earnings for the group grew 17 percent to around \$136 billion in 1977, while imports increased 11 percent to about \$162 billion. With export prices of the industrial countries rising an average of about 7.5 percent in 1977 and some continued softness in primary commodity prices, the terms of trade for the group declined. This trend is likely to continue through 1978.

Total official and private flows to non-OPEC developing countries were, however, more than adequate to cover the aggregate current account deficits of the non-OPEC LDC's, amounting to about \$34 billion in 1977. Official development assistance (grants and loans) from Development Assistance Committee countries and multilateral development banks to LDC's as a group increased in 1977 to about \$15 billion; concessional and nonconcessional flows from OPEC countries to non-OPEC LDC's were about \$5 billion. Gross foreign exchange reserves of the non-OPEC LDC's increased 29 percent to about \$53 billion by the end of calendar 1977. Projections for 1978 show slower growth in aggregate reserves although it is expected that import coverage (about 4 months) will not decline.

There are corresponding changes in the debt situation of these countries. In 1977, the rate of increased net external indebtedness dropped significantly from the very rapid rates experienced in the 1974-76 period. The rate of increase in 1978 is likely to be close to historical trends. At the same time, the distribution and composition of debt improved as the major borrowers made further progress in their adjustment efforts and as terms of borrowing in the international capital markets became more favorable. Multilateral arrangements to reorganize external debt were negotiated for Turkey and Peru. Zaire continued to experience critical debt-servicing difficulties.

The non-OPEC developing countries as a group experienced real GDP growth of just under 5 percent in 1977 and projections indicate that growth in 1978 will be somewhat more rapid. Inflation in many non-OPEC LDC's continues to be quite high. A small drop from the estimated aggregate 30-percent levels of 1976 and 1977 is expected in 1978.

Disaggregating non-OPEC developing countries is critical to better understanding their widely varying economic situations. For example, a few large countries skew the aggregate figures for GDP markedly, obscuring both higher growth in 1977-78 in Asia and the Middle East and slower growth in Africa and parts of Latin America. The same caveat is true for the widely varying current account positions of non-OPEC LDC's, for variations in inflation rates,

²⁸ Excluding official transfers. Including such transfers deficits were about \$17 billion in calendar 1976, \$12 billion in calendar 1977, and are projected at \$16 billion for calendar 1978.

debt positions and creditworthiness, methods of financing external balance of payments gaps as well as for virtually all other financial indicators.

Development Committee

Discussions and negotiations between the developed and developing countries, known collectively as the North-South dialog, take place in a variety of forums. The United Nations Conference on Trade and Development (UNCTAD) and the newly created Committee of the Whole explore a broad range of international economic issues. Specialized forums, most under U.N. auspices, explore specific issues such as commodities, trade, investment, technology transfer, and debt. The IBRD/IMF Development Committee, on which the United States is represented by the Secretary of the Treasury, is one of these forums.

The Development Committee was established in 1974 by the Governors of the World Bank and the International Monetary Fund to maintain an overview of the development process and to consider all aspects of the question of the transfer of real resources to developing countries. The resolutions establishing the Committee called for a review of its performance after 2 years. In 1976 the Committee's mandate was extended to 1978.

The Development Committee ministerial meeting in September 1978 devoted much of its discussion to the first annual World Development Report, prepared by the IBRD staff at the request of the Committee. The United States strongly supported the main conclusions of the report, which pointed out the importance of improving the domestic policies of the developing countries, the need to maintain flows of concessional and nonconcessional capital to developing countries, and the necessity of avoiding protectionism. Also discussed at the September meeting was a study of stabilization of export earnings prepared by Bank and Fund staff at the request of the Committee. The Committee decided that further work was needed on the adequacy of existing facilities to stabilize export earnings, proposals for other measures, and the medium-term shortfall problem.

It was agreed that the Committee Chairman, the IBRD President, and the IMF Managing Director should consult on ways to improve the effectiveness of the Committee and report back next year. Secretary Blumenthal stated in September that the United States shares the view of many developing and developed country members that the potential of the Committee has not yet been fully realized.

The Working Group on Access to Capital Markets this year completed its substantive examination of developing country access to the long-term bond market. Senior officials, meeting in September 1978, endorsed the study and concluded that while progress to liberalize capital market restrictions was still needed in some countries, lack of knowledge by lenders of potential borrowers' credit and lack of information by borrowers about the operation of capital markets and criteria for access accounted for a large part of the

difficulties experienced by developing countries. To address this latter problem, a seminar organized by the Committee Secretariat was held in October 1978 in Paris to bring together potential borrowers and market operators.

The Working Group on Capital Markets also began work on private direct investment, with the objective of reaching agreement on general policies for developed and developing countries which would maximize the benefits of investment while minimizing the adverse effects. As a result of these meetings, in which the United States participated, a draft report has been circulated to members recommending appropriate government policies.

The Working Group on Development Finance and Policy reviewed a survey of the multilateral development banks, identifying a number of policy issues regarding their relative roles, funding, and operational activities.

Delinquent debt

The total long-term principal outstanding on post-World War II debts owed the United States was \$45 billion on September 30, 1978. Most of this debt derives from foreign aid and export credit programs of the U.S. Government undertaken during the last 30 years. A total of \$20.4 billion of the indebtedness was contracted under the Foreign Assistance Act and its predecessor legislation; \$7.0 billion was contracted under Public Law 480; and \$13.3 billion was contracted under the Export-Import Bank Act and the Commodity Credit Corporation Act. An additional \$1.3 billion stems from activities directly related to World War II—primarily lend-lease and surplus property disposal programs.

Since World War II, the vast majority of these debts have been paid on time. During fiscal 1978, the United States collected over \$4 billion of principal and interest payments due on long-term credits, and the equivalent of almost \$300 million in principal and interest payments on loans repayable in foreign currencies. As of September 30, 1978, principal and interest due and unpaid 90 days or more on post-World War II debt amounted to \$611.6 million. More than two-thirds of this delinquent debt is subject to special political or other factors, as in the cases of China and Cuba, which make prompt payment unlikely at this time.

Foreign indebtedness to the U.S. Government resulting from World War I totaled approximately \$25.6 billion as of September 30, 1978, of which \$22.6 billion was delinquent. The collection of this debt presents special problems. Most debtor countries fulfilled their commitments under the debt agreements until 1933–34, but have made no payments since. Aside from the Soviet Union, which repudiated all foreign debts in January 1918, the principal debtor governments have never denied the validity of the debts. However, these nations have steadfastly maintained that they would only resume payments on their war debts to the United States on condition that the issue of Germany's war reparations was satisfactorily settled. Resolution of the problem of

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

On January 31, 1978, Treasury submitted to Congress the administration's fourth annual report on developing countries' external debt and debt relief provided by the United States as required by section 634(g) of the Foreign Assistance Act of 1961, amended in 1974. The report is comprehensive, containing detailed information on the debt situation of major debtor countries and the means by which the United States and other creditor countries have dealt with debt service problems.

Debt rescheduling

During fiscal 1978, the United States participated in multilateral debt reschedulings for Zaire and Turkey.

Zaire's major official creditors met in Paris on November 30 and December 1, 1977. In light of the deterioration in Zaire's economic situation, they decided to improve the terms of the multilateral rescheduling agreement negotiated the previous July 7 which covered debt service falling due in 1977. Under the amended terms, the creditors agreed to reschedule 85 percent of both principal and interest for all of 1977, rather than principal and interest in the first half and principal only in the second half. With regard to Zaire's request for reorganization of 1978 debt service, the creditors agreed to meet in April 1978 to study the question on condition that: (a) Zaire had adopted an effective stabilization program in the context of an IMF standby; (b) Zaire had concluded an arrangement with its private bank creditors, through a new medium-term credit or a direct rescheduling or refinancing, which was comparable to the agreement concluded with its official creditors; and (c) Zaire had made its best efforts to meet its external obligations, particularly payments to official creditors under the Paris Club reorganizations of 1976 and 1977. As these conditions were not fulfilled, the creditors did not meet in April and had not met by the end of fiscal 1978.

The United States and Zaire have negotiated a bilateral agreement implementing the multilateral agreements of July and December 1977, which is currently pending signature. This agreement reschedules \$56.5 million in debt service due in 1977. The weighted average interest rate charged by the United States is 7.5 percent. Under the 1977 rescheduling agreements, other creditors agreed to provide the equivalent of about \$110 million in debt relief. The rescheduled amounts are to be repaid in 10 years, including a 4-year grace period.

Turkey's principal official creditors met in Paris on May 18, 19, and 20, 1978, in the context of a working party of the OECD-led consortium for Turkey. To assist Turkey in overcoming its critical economic and financial problems, these creditors agreed to extend debt relief to Turkey on 80 percent

of payments of principal and interest falling due between May 21, 1978, and June 30, 1979. The United States subsequently negotiated a bilateral agreement with Turkey, which was signed in Washington on September 21, 1978, implementing the terms of the multilateral agreement. Under the terms of the bilateral agreement, the payments rescheduled by the United States amounted to about \$191 million, \$15 million of which related to short-term maturities of less than 1 year and the remainder of which relates to medium- and long-term maturities. The weighted average interest rate charged by the United States was 6.4 percent. Under the multilateral agreement, other creditors are expected to provide almost \$1 billion of debt relief to Turkey. The rescheduled amounts are to be repaid in 8 years, including a 3-year grace period.

Local currency management

One of the responsibilities of the Secretary of the Treasury is to determine which foreign currencies held by the United States are in excess of normal U.S. Government requirements. The purpose of this determination is to assure maximum use of local currencies in lieu of dollars for U.S. programs in the countries concerned. For fiscal 1979, Burma, Egypt, Guinea, India, and Pakistan will remain on the excess currency list.

As U.S. foreign currency receipts decrease and in-country expenses increase, currencies lose their excess status. When countries are removed from the excess list special foreign currency programs in those countries are phased out. These programs involve scientific and research projects which usually have some political benefit to the United States but, because of their lower priority, might not be funded were it not for the availability of excess currencies.

Development assistance policy

The Department of the Treasury, in addition to its responsibilities with regard to the multilateral development banks, participates in the formulation of U.S. development assistance policy through its membership in the National Advisory Council on International Monetary and Financial Policies, in the Development Coordination Committee (DCC), and in various other inter-agency committees designed to coordinate economic assistance programs. Treasury's principal concerns are to promote the efficient utilization of development assistance resources and to assure that bilateral aid objectives and programs remain consistent with overall U.S. economic interests and with U.S. multilateral aid efforts, in particular.²⁹

As a member of the DCC, Treasury has actively supported measures taken in early 1978 to strengthen that Committee's policy coordinating role. Treasury participates in each of the four new subcommittees which were

²⁹ See exhibit 64.

established to treat issues in the specific areas of multilateral assistance, bilateral assistance, food aid, and international organizations.

Multilateral Assistance Subcommittee.—As chairman of this DCC Subcommittee, Treasury has instituted new procedures for reviewing projects proposed by the World Bank and the regional development banks. These procedures are designed to allow for review and comment early enough in the bank's review process for the United States to suggest changes. At the same time, the Subcommittee is focusing increasingly on general policy issues which relate to multilateral assistance programs such as lending policies in specific sectors.

Bilateral Assistance Subcommittee.—As a member of this DCC Subcommittee, which is chaired by the Agency for International Development (AID), Treasury reviews broad policy issues related to AID development programs, including those which arise from proposed AID projects. A major objective of Treasury in this area is to assure maximum coordination between AID policies and programs and those of the multilateral development banks. It also participates in the Subcommittee's review of AID budget proposals. During fiscal 1978, AID committed \$3.3 billion in loans and grants for specific projects and supporting assistance. Of this amount \$1.6 billion was in grants and \$1.7 billion in loans.

Food Aid Subcommittee.—Treasury is represented on the DCC Food Aid Subcommittee (previously the Interagency Staff Committee) which reviews all Public Law 480 food for peace proposals. Treasury looks primarily at the impact of this program on the development efforts and financial prospects of the recipient countries as well as on the U.S. domestic economy. During fiscal 1978, Title I sales agreements with participating governments and private trade entities totaled \$812 million. Title II donations totaled \$337 million. Under the new Title III authority, two agreements were signed with recipient governments for a total of \$37 million.

International Organizations Subcommittee.—Treasury also participates in this DCC Subcommittee, which examines proposed U.S. contributions to the development programs of the United Nations and other international agencies.

With respect to other DCC work undertaken this year, Treasury has worked closely with other agencies in establishing a procedure for DCC review of U.S. development assistance strategies for selected individual countries. It is hoped that this procedure will enable all involved agencies to focus on development problems of high-priority countries and to formulate a coherent U.S. policy which integrates the full range of development assistance programs, bilateral and multilateral. The first such review—on Jamaica—has been completed.

The DCC is also developing U.S. policy on several issues, including the definition of a "basic human needs" strategy and how to implement it; the needs of the "middle-income" developing countries and how the United States should relate to them; and energy problems and prospects of the less developed world and programs the United States should undertake in this area. Treasury expects to be actively involved in this process.

Relations with developing nations

OPEC.—The combined current account surplus (excluding official transfers) of the 13 members of OPEC is expected to be about \$13 billion in 1978, a decline of \$21 billion from the 1977 level of about \$34 billion. The decline will result from a continued soft market for OPEC oil, an OPEC oil price freeze throughout the year, and continued growth of OPEC imports to sustain development plans. Since yearend 1973, the cumulative OPEC surplus has totaled nearly \$180 billion. About \$166 billion of this combined surplus was earned by six Arab Gulf countries (Saudi Arabia, Kuwait, Iran, Iraq, Qatar, and the United Arab Emirates). Almost \$79 billion of this was earned by Saudi Arabia alone, although Saudi Arabia's share of the total decreased to 40 percent from its 47-percent share in 1977. Estimates of the OPEC current account position for 1977-78 are contained in the accompanying table.

OPEC current account position
[\$ billion]

	1977	Forecast 1978
Trade:		
Oil exports (government-take basis)	131.5	127.0
Nonoil exports (f.o.b.)	9.2	10.4
Imports (f.o.b.)	-85.2	-97.4
Trade balance	55.5	40.0
Services and private transfers	-21.7	-26.5
Current account balance (excluding government transfers)	33.7	13.4
Surplus countries	38.3	24.7
Deficit countries	-4.6	-11.3
Total OPEC	33.7	13.4

OPEC oil earnings (government-take basis) totaled about \$131 billion in 1977 and should fall to around \$127 billion in 1978. Generally, slow economic activity and conservation in major consuming countries, along with greatly increased non-OPEC production, contributed to a slow 1-percent growth of exports during 1977. Oil consumption in the major industrial countries rose only 3 percent in 1977 compared with a 6-percent increase in 1976. Increased production from Alaska arrested the steady decline in U.S. production, and the North Sea accounted for a more than tripling of United Kingdom output. Production from all non-OPEC sources increased over 5 percent in 1977. For 1978, the sluggish demand for OPEC oil is expected to continue. The volume of OPEC oil exports is expected to decline by about 4 percent as non-OPEC oil production in Alaska and the North Sea increase, and as slow growth continues in the major consuming countries.

At OPEC ministerial meetings in December 1977 and in June 1978, it was decided that OPEC oil prices would not be increased during 1978. The OPEC ministers will meet again to discuss prices in December of this year.

It is expected that the aggregate value of OPEC imports will grow almost 14 percent this year, to about \$97 billion. Yearly growth in the volume of merchandise imports for OPEC as a group has trended downward since 1975. In the six strongest surplus countries, physical congestion in ports and transportation networks, the shortage of skilled and unskilled manpower to implement projects, and social factors have been the major constraints on import growth. While transportation constraints have been reduced substantially, the manpower shortage continues to be an important limitation on the rate of import absorption for all these countries, except Iraq. In 1978, concern over strong inflationary pressures and a desire for more efficient use of resources has tempered government spending programs.

The other OPEC countries have greater capacity to absorb a higher proportion of their export revenues in imports. However, in many of these countries actual or anticipated financing constraints, in addition to limited pools of trained labor, have caused cutbacks in development plans which in turn are bringing about lower rates of import growth. For Iran, concern over inflation, rather than financing, has been the main limitation on higher increases in the volume of imports.

The deficit on services and private transfers is expected to rise by about 22 percent in 1978, or almost \$5 billion. The rate of increase, however, is down from the 1977 rate of 28 percent and this trend is expected to continue. One important element is the adoption of restraining fiscal policies by more OPEC countries, reflecting moderation of development programs and desires to restrain the growth of foreign labor forces. The OPEC countries are also expected to incur lower demurrage costs in 1978 due to improvements in port operations. Service payments are increasingly being offset by growing net interest income on foreign investments, which should be slightly above \$6 billion in 1978. Kuwait's service account, for example, moved from deficit to surplus in 1975, due largely to these earnings.

Middle East.—Secretary Blumenthal visited Egypt, Israel, Saudi Arabia, Kuwait, and Iran in October and November 1977. The purposes of the Secretary's visit were to discuss economic and financial matters of mutual interest and to establish a personal relationship with key officials of each country. The subjects discussed included the outlook for petroleum prices and the world economy and, in Egypt and Israel, the outlook for U.S. economic assistance.³⁰ In Israel the Secretary also cochaired a meeting of the United States-Israel Joint Committee for Investment and Trade.

The Secretary subsequently met with a wide variety of Israeli and Arab Government officials in Washington during 1978.

*Latin America.*³¹—Treasury officials maintained a close working relationship with the Government of Mexico on a wide range of matters of mutual interest. Between April and September 1978, the Secretary met three times

³⁰ See exhibit 41.

³¹ See exhibit 65.

with Finance Minister Ibarra and other Mexican officials to discuss the multilateral development banks, negotiations covering U.S. bank loans to foreign governments, access to capital markets, trade issues, national economic policies, and Mexico's stabilization program. Earlier in the year, Under Secretaries Solomon and Anderson hosted meetings with a high-level Mexican delegation concerning the United States-Mexican Customs Agreement and expanded cooperation between the respective customs services. In addition, Assistant Secretary Bergsten met with Mexican officials on several occasions to discuss the Inter-American Development Bank replenishment. Treasury also agreed to a 2-year extension of a longstanding \$300 million swap line with Mexico, although in fiscal 1978 no drawings were made under this agreement.

Negotiations on countervailing duties, a proposed income tax treaty, and the replenishment of the Inter-American Development Bank were areas of mutual concern to the United States and Brazil.³² In December 1977, Assistant Secretary Bergsten spent a week in Brazil during which he called attention to Brazil's preeminent status as an advanced developing country and the need to find new ways to encourage greater collaborative efforts between our two governments in helping to resolve the world's key economic problems. He also urged accelerated bilateral negotiations on our subsidy/countervailing duty problems. A team of U.S. negotiators headed by a Treasury official traveled to Brasilia in February 1978 to outline our proposals for an MTN code on subsidies and to review the status of our bilateral tax treaty negotiations. Secretary Blumenthal met twice with Finance Minister Simonsen in an effort to resolve a pending textile countervailing duty case. Some progress was achieved in formulating a joint approach on how the MTN code on subsidies should be applied to developing countries and in establishing certain principles for conducting the IDB replenishment.

In April, Deputy Secretary Carswell met with Argentine Finance Minister de Hoz and Central Bank President Diz, who outlined the economic recovery realized since 1976 and some of Argentina's long-range economic objectives. Later in the year, Secretary Blumenthal also met with Minister de Hoz and other Argentine officials to exchange views on the replenishment of Inter-American Development Bank resources, and discuss Argentina's recent economic performance and human rights policies. In the past year, Treasury has conducted countervailing duty investigations on Argentine exports of leather wearing apparel, nonrubber footwear, and textiles based on complaints from U.S. industry.

The Department of the Treasury continued to work closely with the Government of Peru in its attempts to overcome balance of payments and budgetary problems. Treasury supported a 2 1/2-year IMF standby loan for Peru designed to strengthen Peruvian stabilization policies and set the stage

³² See exhibit 42.

for growth in key sectors of the economy. Secretary Blumenthal met on two occasions with Peruvian Government officials in Washington to review its economic situation and exchange views on the debt rescheduling negotiations of official bilateral credits to be considered in the context of a Paris Club meeting this fall.

Secretary Blumenthal met with Venezuelan President Perez in Bogota, where they discussed the results of the recent Bonn summit, commodity price stabilization, the future directions of the North-South dialog, and ways to increase bilateral aid cooperation in the Caribbean region.

Asia.—Secretary Blumenthal chaired a session of the second U.S./ASEAN Economic Consultations held in Washington, D.C., August 2–4, 1978. ASEAN (Association of Southeast Asian Nations) was established in 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. During the ministerial meetings, the United States and ASEAN exchanged views on a broad agenda of economic subjects, including extensive discussion of the global economy and North-South issues. The meetings achieved the basic U.S. objectives of promoting cohesion and strengthening ASEAN and helping to stimulate awareness of ASEAN in the United States. From the ASEAN side the meeting was also viewed as being productive, both politically and economically. ASEAN ministers welcomed U.S. proposals for development cooperation, the decision to send Eximbank and OPIC investment missions to the region, and the U.S. commitments to actively pursue the common fund negotiations to an early and successful conclusion.

On May 9, 1978, the Internal Revenue Service made a favorable ruling on a production sharing arrangement between the Government of Indonesia and U.S. oil firms producing oil in that country. Previously, in a ruling in May 1975 the IRS concluded that certain payments made by the U.S. oil companies were not creditable income taxes for purposes of the U.S. foreign tax credit. Subsequently, the Government of Indonesia changed its tax arrangements with the oil firms to meet the standards of a creditable tax and asked for a new ruling. The favorable ruling of this year is expected to improve the investment climate and oil production levels in Indonesia.

The Government of Singapore would like to arrange an investment treaty with the United States. Treasury participated in developing a draft treaty that was sent to the Government of Singapore in September 1978. Formal negotiations were expected to begin later in the calendar year. Assuming a treaty is successfully concluded, it would be the first such arrangement for the United States since 1968.

Treasury officials participated in the third annual meeting of the Indo-United States Economic and Commercial Subcommittee on October 26 and 27, 1977, in Washington, D.C. The array of topics discussed was quite broad. Treasury officials were particularly interested in the tax treaty negotiations, India's import regime, and its investment climate.

ADMINISTRATIVE REPORTS

ADMINISTRATIVE MANAGEMENT

Management and organization

During fiscal 1978, the Office of Management and Organization (OMO) was involved in numerous studies and special projects touching both the Office of the Secretary and Treasury's bureaus, and in several interagency efforts arising from the President's reorganization project and other administration initiatives. OMO was the principal liaison with the reorganization project.

Organization changes in the Office of the Secretary.—The position of Chief Deputy to the Under Secretary (Enforcement and Operations) was upgraded to Assistant Secretary (Enforcement and Operations) at Executive Level IV.

The position of Inspector General, reporting directly to the Secretary and Deputy Secretary, was established to receive and analyze allegations of official or employee misconduct within the Department.

Interagency projects.—During half of the fiscal year, a member of the OMO staff was detailed to the Task Force on Law Enforcement Reorganization. The task force made a comprehensive review of all Federal law enforcement activities.

Substantial effort was devoted by Office of the Secretary and Customs Service personnel to a set of task forces examining the complex problems which would surround the establishment of a Border Management Agency. The major feature of the proposed agency was to be the melding of the Immigration and Naturalization Service Border Patrol with the Customs Patrol.

OMO coordinated the response to the President's reorganization project Survey of Federal Economic Analysis and Policy Machinery. Several elements of the Office of the Secretary which have responsibilities for economic analysis and policymaking were asked to respond, as was the Assistant Commissioner (Planning and Research) of IRS.

The Deputy Assistant Secretary (Administration) served on the President's Interagency Task Force on Women Business Owners. Under her direction, a Treasury study director from OMO headed an internal task group which contributed Treasury's portion to the final task force report, an examination of the barriers facing women entrepreneurs in the areas of credit and capital formation.

Departmental projects.—During fiscal 1978, OMO was closely involved in studies of the field organizations of the Internal Revenue Service, the U.S. Customs Service, the Bureau of Alcohol, Tobacco and Firearms, and the U.S. Savings Bonds Division. These studies had been ordered by the Secretary in the previous fiscal year. Recommendations for changes in the field structures of the IRS and Savings Bonds were approved by OMB and implemented. Suggestions regarding Customs and ATF were held in abeyance pending the outcome of the larger law enforcement study being conducted by the President's reorganization project.

Staff advised the Office of Revenue Sharing in the preparation of a request for proposal and selection of a private contractor to conduct a congressionally mandated study of the antirecession fiscal assistance program. OMO participated in the final research design, after the contract was let, and reviewed the final report.

A senior analyst from OMO participated in the review of bullion refining at

the Mint's New York Assay Office; the purpose was to determine whether this activity should be continued or contracted out to private industry.

OMO conducted a study in response to proposals to merge the criminal investigator training and police training faculties at the Federal Law Enforcement Training Center; the report recommended organization and staffing, as well as target workload goals for instructors.

Office of the Secretary projects.—Early in fiscal 1978, Secretary Blumenthal directed the Assistant Secretary (Administration) to develop a more effective system for appraising employee performance and recognizing accomplishments through incentive awards. The OMO staff was given the charter to develop this system, drawing upon its own and other staffs in the Office of the Secretary, and upon an outside contractor. A system was developed to improve work planning and performance feedback between supervisors and subordinates, and to distribute incentive awards on the basis of documented performance. The Secretary launched the system at a meeting of top staff, and implementation will occur in fiscal 1979.

OMO also led the following management studies within the Office of the Secretary during the year:

1. A review of the Office of Industrial Economics and the asset depreciation range system which it administers. The purpose was to determine the effectiveness of the office's operations, and whether it was in the proper organizational location within Treasury.

2. A review of the organizational placement of the Office of Foreign Assets Control.

3. A study of the structure, staffing, and workload of the Telecommunications Operations Branch, Office of Administrative Programs.

4. A review of the workload and responsibilities associated with the Freedom of Information and Privacy Acts, and the mechanisms for dealing with them in the Office of the Secretary.

Zero-base budgeting objectives.—During fiscal 1978, most Treasury offices and bureaus went through initial participation in the zero-base budgeting objectives program, which replaced the management by objectives program. The object of the program is to maintain and track a set of management objectives in a manner integrated with the budgeting process. Objectives and associated resources, initially identified in the zero-base budgeting process, are picked up, refined, and tracked into the current operating year by the system managed by OMO.

Productivity management.—The departmental productivity management directive was issued, requiring bureaus, for the first time, to submit annual productivity plans. These plans cover projects to be undertaken to enhance productivity and efforts to be made to extend productivity measurement practices over an even-larger portion of bureau activities.

Advisory committee management.—The Secretary established new procedures whereby he would personally approve the establishment or renewal of any Treasury advisory committees. Under these procedures, five committees were renewed during the year and no new ones established. In addition to its own committees, Treasury took on management of one new Presidential advisory committee, the United States Tax Court Nominating Commission.

Assistance to international visitors.—The International Visitors Program office has provided orientation and specialized consultation and observational programs on a continuing basis to international visitors referred by the International Communication Agency, Agency for International Development, and other agencies, both governmental and nongovernmental. This

office handled appointments and programs for 118 visitors representing 51 countries, both industrial and less developed. In addition, the office arranged briefings at Treasury for five classes of junior Foreign Service officers.

Financial management

The major part of the Financial Management Division's (FMD) efforts in fiscal 1978 was devoted to the daily ongoing requirements of a budget, accounting, and payroll liaison operation for the Office of the Secretary.

The major achievements in fiscal 1978 were:

1. Completed initial transfer of all accounting data to a computerized system. This is a culmination of a 3-year effort that resulted in tripling the available accounting data that forms the base for the budget execution system, provides reports in a timely and usable manner, and is cost effective by offsetting a rising workload through mechanization instead of increased accounting personnel.

2. Instituted a new budget execution system that provides monthly status reports to office directors, thus giving them more control and understanding of their expenditures. FMD also instituted new control procedures on, among other things, the use of consultants, personnel hiring, and promotions.

3. Completed efforts on the transfer of the payroll system from the IRS Data Center to the Treasury payroll/personnel information system and designed a computer program system for the automatic transfer of the payroll data into the accounting system, thus eliminating 3 days of manual input monthly.

Emergency preparedness

The Emergency Planning Staff directed primary emphasis to the continuing enhancement of the Department's overall emergency preparedness posture. Improvement was achieved through program review, evaluation, internal activities, and participation in interagency projects, task forces, and civil readiness exercises. It is essential that Treasury's contingency plans be developed in keeping with changing concepts and technologies, and in anticipation of potential crises. To this end, a close working relationship was maintained with the Federal Preparedness Agency and other departments and agencies with emergency preparedness responsibilities under Executive Order 11490.

In April and May 1978, the departmental emergency planners participated in regional civil readiness exercises in San Juan, P.R., and Dallas, Tex., benefiting both regional and headquarters planners in improving organizational preparedness. Expanded participation in similar exercises is planned for fiscal 1979. For example, Treasury has commenced planning for nationwide civil readiness exercise REX-78 to be conducted in October 1978. REX-78 will permit Federal agencies to test and refine contingency plans and capabilities to support military mobilization and forces deployment, and to provide civilian resource agencies an opportunity to examine critical resource problems during a protracted period of conventional war. Treasury will be involved significantly because of its responsibility for developing policies, plans, and procedures applicable to emergency stabilization of the monetary, credit, and financial systems of the country.

An extensive Department-wide review of emergency policy and planning documents was made in fiscal 1978 with departmental and bureau officials revising those documents pertaining to their functional responsibilities.

Renegotiation of interdepartmental agreements and understandings continues.

Contingency planning for possible postal service disruption during the last half of fiscal 1978 was an active project, including interagency liaison, guidance to Treasury offices and bureaus, and close monitoring of the postal strike situation to avoid disruption of Treasury operations.

Review of major national plans and procedures was initiated during fiscal 1978, and included the National Plan for Emergency Preparedness, Federal Civil Emergency Actions Guidelist, Presidential Emergency Action Documents, and Treasury regional plans. Most significantly, Treasury participated in the President's reorganization project, Federal Emergency Preparedness and Response Study, conducted by OMB. Establishment of the Federal Emergency Management Agency, with its expanded role in multifaceted preparedness planning and response, could impose increased requirements on Treasury and other agencies. In fiscal 1979, Treasury will participate in the implementation of Reorganization Plan No. 3, and in an interagency coordinating group concerning the National Earthquake Hazards Reduction Act of 1977.

Treasury payroll/personnel information system

The Treasury Employee Data and Payroll Division has been reorganized into the Treasury Payroll/Personnel Information System (TPPIS) Division. The accounting, payroll, and systems modifications functions previously performed by the Bureau of the Mint were transferred to the TPPIS Division. The reorganization essentially centralized authority and responsibility for the management and control of all aspects of the system and will result in greater efficiency and effectiveness of the system operation. The Mint will continue to provide computer and administrative support services for TPPIS.

TPPIS has completed the conversion of all Treasury bureaus, with the exception of the IRS, to the system as well as three other organizations—the Executive Office of the President, Federal Trade Commission, and National Gallery of Art.

Budget and program analysis

The Office of Budget and Program Analysis continues to provide departmental leadership for developing, administering, and analyzing bureau budget estimates and short-term and long-range financial plans. In addition, it initiates selected analytic studies designed to systematically measure the achievement of bureau programs with stated objectives.

For fiscal 1978, budget estimates totaling \$56 billion were submitted to the Congress. The amount included \$3 billion for the operating accounts, \$6.9 billion for general revenue sharing and the antirecession programs, and \$46.1 billion for public debt interest and miscellaneous accounts.

During the period of this report, the staff—

1. Maintained controls on expenditures, number of personnel on roll, and motor vehicle fleet to comply with limitations and directives prescribed by OMB.
2. Obtained supplemental appropriations for the cost of pay increases authorized by Executive Order 11941, wage board actions, and administrative actions amounting to \$132.2 million.
3. Maintained control of the Department's execution of the approved budget levels which include the approval of certain reprogrammings.

4. Assisted in the preparation and presentation of budget requests totaling nearly \$1.925 billion to be appropriated to the President for the U.S. share to the multilateral development banks of which the Secretary of the Treasury serves as a Governor.

5. Assisted in the preparation and presentation of the budget request of \$1.8 billion for U.S. participation in the Supplementary Financing Facility of the International Monetary Fund.

6. Issued Department-wide zero-base budgeting directive updating the zero-base budgeting system within Treasury.

7. In conjunction with other staff offices in the Department, developed legislation to bring the Exchange Stabilization Fund administrative expenses on budget in fiscal 1979.

8. Coordinated a survey of Treasury program evaluation activities and a survey of Treasury information sources and systems for the General Accounting Office.

9. Evaluated the merits of contracting out or performing in-house the refining of the Bureau of the Mint's U.S. Assay Office, New York.

10. Prepared a report to the Congress on the utilization of Government-owned vehicles by employees permitted to take those vehicles to their place of residence overnight.

11. Analyzed currency and stamp demand forecasts to determine the need for expanding the production capacity of the Bureau of Engraving and Printing.

12. Improved procedures for preparing the annual Geographic Outlay Report to increase its accuracy and timeliness.

13. Studied the feasibility of developing computer models to estimate IRS resource requirements given certain workload levels.

14. Analyzed relationships between the purchase and retention of U.S. savings bonds and such characteristics as the denomination of the bond, the method of purchase, and the geographic area where purchased.

15. Monitored overseas staffing levels of Treasury bureaus and coordinated requests for changes and increases with the State Department.

16. Monitored Federal agency compliance with Treasury Circular No. 1082, Notification to States of Grant-in-Aid Information.

Internal auditing

The Office of Audit provides leadership and professional assistance to Treasury bureaus on their systems of auditing and administrative accounting. The staff also furnishes audit service directly to the Office of the Secretary and to other organizations upon request.

In fulfillment of a plan to make periodic reviews of the audit systems of Treasury bureaus, a formal review and appraisal was made of the internal audit activities of the U.S. Customs Service, which included field work in three of the nine Customs regions. The report to the Commissioner of Customs recognized the importance of actions planned by Customs in response to a need for more systematic audit planning. It also reenforced Customs efforts to improve audit coverage of ADP activities and to make more multiregional audits of the same subject matter.

An appraisal of the internal audit system of the Bureau of Government Financial Operations is in progress to compare the audit staff, organization, policies, plans, reports, and related matters with Federal audit standards and other desirable requirements for an effective program.

A substantial amount of assistance was provided to the Exchange Stabiliza-

tion Fund during the year. In addition to auditing work, the office, at the request of the Deputy Secretary, assisted in developing a memorandum issued by the Under Secretary for Monetary Affairs establishing procedures for the proper handling of Fund financial agreements. The office is also developing an operational accounting manual with specific emphasis on accounting principles and procedures for foreign exchange, special drawing rights, and other unique Fund transactions.

Other special projects included reviews at the request of the Under Secretary of the contracting procedures and practices of the Bureaus of the Mint, and Engraving and Printing.

Advisory service was continued in support of TPPIS. In particular, documentation of the system was monitored, and a directive developed for controlling audits. The office is responsible under the directive for the overall audit, but assistance of Treasury bureau audit staffs will be required and the plans and programs will be coordinated with them.

Direct audit services were provided to the Federal Law Enforcement Training Center. Coverage included an examination of financial operations, and an assessment of compliance with OMB Circular No. A-76 on acquiring commercial or industrial products and services. Also, reports were issued to the Director, Office of Revenue Sharing, on the audits of the trust funds and the administrative accounts, and on a special examination into revenue sharing payments made to certain cities.

The office prepared the consolidated 1977 report to the Secretary on internal auditing in Treasury. Audit activities summarized showed that audits contributed to improved financial management, increased efficiency and effectiveness, and stronger controls over the varied Treasury activities. Savings and benefits susceptible to dollar measurement totaled \$100 million.

The staff participated regularly in the activities of Intergovernmental Audit Forums led by the Comptroller General to provide an orderly approach to improving audits of Federal programs. Regular meetings were held with Treasury auditors to help unify the audit system.

Personnel management

Treasury's labor relations program continues to have an increasingly significant impact on personnel management. Sixteen different unions represent nearly 102,000 employees in 9 Treasury bureaus and in the Office of the Secretary. Treasury keeps its lead among all Cabinet agencies in the extent to which its employees have organized. Unions have consolidated bargaining units at the national level in the IRS and the Customs Service.

The Treasury labor relations program directive was extensively revised to meet current Executive order requirements. Pursuant to that directive, Treasury's labor relations staff has begun reviewing agreements negotiated at the bureau level and has been giving close scrutiny to cases appealed to the final arbiter in the program. The Department's Labor Relations Information Center, designed for research and case-handling informational resource requirements, has been used by the bureaus in preparing for negotiations. It permits access to a computerized retrieval system of Federal labor relations agreements and cases.

Summer training in the Department for young men and women ranging from disadvantaged high school youths to college and graduate-level students was highly successful in achieving the goals and objectives of the Federal summer employment program. On-the-job training experience provided by the employing bureaus afforded the summer employees an excellent opportunity

to find a workable balance between the academic world and the practical complex operations of the Federal Government. To complement the work experience, a series of seminars, panel discussions, workshops, and other related activities were conducted to inform summer employees of the many varied and complex issues now facing the Federal Government. The level of participation and interest shown by Secretary Blumenthal, members of his staff, and other high-ranking Federal officials who served as key speakers and discussion leaders was instrumental in making the sessions as productive and successful as possible from the viewpoint of the summer employees participating.

Bureaus are revising their old programs or developing new ones to increase the effectiveness of executive development. At the departmental level, efforts are being made to activate the Departmental Executive Resources Board as the first step in implementing the Senior Executive Service or a similar resources system.

The Career Development Program for Lower Level Employees (CADE), formerly known as the upward mobility program, underwent substantial change in 1978. Substantive changes were necessary to ensure implementation of a results-oriented program that would accommodate both the needs of the Department and employees. The impreciseness was corrected by requiring accountability for growth in the formal program. As an additional assurance of having a good program, skills training (to include counseling) is being conducted at both local and field levels.

The Personnel Security Manual (Chapter 732 TPMM) was revised and now provides meaningful guidance for the program Department-wide. Personnel security evaluations were conducted in seven bureaus during fiscal 1978.

One hundred and twenty-nine employees representing most Treasury bureaus, as well as components of the Departments of Health, Education, and Welfare, Justice, and Transportation, completed training in the onsite method of personnel management evaluation during four presentations of the Treasury-developed course by that name during 1978. This training is expected to yield practical benefits by providing bureaus with increased capability of conducting much-needed internal personnel management assessments.

Procurement and personal property management

Total commercial procurements for the Department in fiscal 1978 amounted to \$303 million, of which \$57 million in contracts was awarded to small business firms. This excludes contracts funded by the Saudi Arabian Government. Of the total, \$218 million was expended through Treasury negotiated and advertised contracts. The balance was ordered under established General Services Administration and other agency contracts. The expenditures made to minority owned and operated businesses, to the extent identifiable, both through the Small Business Administration's "8(a)" program and other contracts, totaled \$5.1 million, a significant increase over fiscal 1977's total of \$2 million.

During fiscal 1978, 44 blanket purchase agreements for use by all Treasury bureaus provided a savings in excess of \$96,000 over standard unit prices under existing Government contracts. The Department-wide consolidation of Treasury requirements for 951 law enforcement vehicles procured through GSA and in excess of 16 million rounds of small-arms ammunition resulted in a significant dollar savings over separate procurement methods. Compacts,

intermediate- and full-size automobiles, and 31 types of ammunition were purchased.

The Department issued a "Minority Business Contracting Handbook" to assist procurement personnel in taking positive steps to increase minority business contract awards. The program staff also held a training class for over 200 Treasury headquarters and field office personnel in minority business contracting procedures. Similar training was provided to all procurement personnel in the revised labor surplus area set-aside program, part of the administration's urban assistance efforts. The Department also continued its staff assistance visit program designed to help identify potentials for improvement in Treasury's overall contracting activities. Visits were made to three bureau headquarters and two regional cities.

In support of the U.S. technical cooperation agreement with the Saudi Arabian Government, and using Saudi funds, Treasury contract specialists awarded and administered contracts in excess of \$40 million in fiscal 1978. Contracted services and equipment were to improve several aspects of Saudi socioeconomic conditions.

Treasury significantly increased its participation in vendor procurement conferences during fiscal 1978. Departmental personnel or bureau personnel designated as Treasury representatives attended seven conferences throughout the Nation to provide information to small businesses and minority vendors interested in selling to Treasury.

During fiscal 1978, Treasury personal property transactions included the reassignment within Treasury of property valued in excess of \$945,000. Personal property valued in excess of \$11 million, no longer needed by the Federal Government, was transferred for use by State organizations and nonprofit groups. Treasury also obtained, without cost, personal property valued at over \$22 million from other Federal agencies.

As part of the vehicle management program, home-to-work driving authority for Government vehicles was successfully reduced from 940 to 558, meaning a significant cost savings.

Real property management

The Bureau of Alcohol, Tobacco and Firearms completed in June 1978 the relocation of its national laboratories from the IRS headquarters building to a new facility in Rockville, Md.

On March 17, 1978, the Assistant Secretary (Administration) accepted 31 townhouse buildings at the former Glynnco Naval Air Station, Brunswick, Ga., for Federal Law Enforcement Training Center student dormitories. This will result in a cost avoidance of about \$3.7 million.

The U.S. Customs Service completed its Washington, D.C., consolidation in August 1978, with the move of its computer facility into the headquarters building on Constitution Avenue.

A study of the long-range space and facility needs of the Bureau of Engraving and Printing determined that the Bureau does not need a new facility to meet its projected production levels. Technological improvements and policy changes mean that the existing facility can meet future production requirements. A new study in about 5 years will reevaluate this decision. On June 18, 1978, the Under Secretary released the Department's reservation of the south portal site, next to the Bureau's buildings, to its owner, the District of Columbia Department of Housing and Community Development.

On May 3, 1978, the Under Secretary approved a Bureau of the Mint decision on the future of the Park Hill (Denver, Colo.) site, acquired by the

Department in 1975 for a new mint. The Mint now plans to satisfy its expanding production levels by acquiring and adapting surplus Federal facilities. An assessment is being made to determine the most cost-effective way of fulfilling the Mint's nationwide facility requirements. Buildings at the Rocky Mountain Arsenal near Denver, and the former Frankford Arsenal near Philadelphia, are being evaluated as potential satellite production and storage sites. A formal proposal is expected by late calendar 1978.

Several space planning initiatives continue, aimed at achieving consolidations of bureau headquarters activities. Treasury now has 51 locations in the metropolitan Washington, D.C., area. Studies of the long-range space needs of the U.S. Secret Service and the Fiscal Service have been made, and the resultant proposals will be the basis of facility acquisition actions by the General Services Administration. Partial consolidation of the Office of the Secretary, now scattered in 13 locations, is being planned. This will help limit the acquisition of new office locations and anticipate the long-range Fiscal Service consolidation plan, which returns the Treasury Annex Building to the Office of the Secretary.

Approximately 11,000 square feet of nonoffice space in the Main Treasury Building is being reclaimed for office use to satisfy increasing space requirements without adding more locations, avoiding recurring annual space rental charges of about \$90,000.

The Main Treasury repair and improvement program is progressing:

1. Design work has been completed and construction contracts awarded for the first phase of structural repairs to the basement floors, chimneys, and fireplaces.
2. Design work is nearing completion on the project for primary electrical renovations, fire security alarms, and civil defense alarms. A contract should be awarded by January 1, 1979.
3. Design work on the project for air conditioning renovations, secondary electrical distribution, window repairs, and downspout and rain leader repairs is also nearing completion. Contracting will not be possible until next summer.
4. Studies of the balustrades and cornices are being done to identify potential safety hazards. Work on those elements will be done before the repointing of the exterior stonework begins.

Printing management

At the request of the U.S. Savings Bonds Division, Printing Management conducted a study of the Division's printing plant in Chicago and printing procurement function in Washington, D.C. The study included a detailed, onsite evaluation of the Chicago facility to determine the most efficient equipment to produce the promotional material required by the Savings Bonds operation. A recommendation was made to update two printing presses. The Division's internal procedures for procurement of printing were also evaluated and a recommendation was made to realign functions in its three branches in Washington.

In February 1978, Printing Management acquired an electronic phototypesetting system which means full pages of camera-ready copy can be provided very quickly. A new compatible typesetter for headlines was also acquired.

The departmental printing plant received about \$50,000 worth of virtually new printing equipment from the U.S. Secret Service as the result of the breaking up of a counterfeiting operation in Utah. The equipment includes a printing press, camera, platemaker, papercutter, and light table. The actual

cost to the Office of the Secretary for the equipment was \$814 for shipping from Salt Lake City.

A task force, proposed by Printing Management, was established to look into procuring alcohol tax stamps, currently produced at the Bureau of Engraving and Printing, from commercial printers. The task force, composed of members from Printing Management, the Government Printing Office, Bureau of Engraving and Printing, and the Bureau of Alcohol, Tobacco and Firearms, wrote specifications and contacted commercial contractors for production cost estimates. Preliminary information points to a substantial savings with commercial production. A final determination will be withheld pending the outcome of legislation that might negate the need for sequentially numbered stamps.

Physical security

The Department-wide training, orientation, and briefing program for employees who handle classified documents was revised. The new program is pictorial so that employees are more likely to participate in and understand the presentation. Other agencies have seen the program materials and have requested Treasury's assistance in their own program development.

To supplement the departmental defensive international travel briefing program, a booklet entitled "Overseas Assignment" was prepared for distribution to departmental personnel traveling or assigned overseas. It stresses awareness of the risks inherent in foreign travel and basic guidelines for protection to be followed by employees and immediate family members.

Treasury, along with certain other Government agencies, is participating in an FBI crime resistance program to reduce thefts at Government facilities in Washington, D.C. It will provide background and statistical data and stress employee awareness. The first half of the program has been devoted to the collection of information on past losses of Government property which has been provided to the FBI for analysis. During the last half of the program, the FBI will provide recommendations to Treasury which should help bring about a reduction in property losses.

Telecommunications

Treasury automated communications system.—Substantial progress has been made on the contract awarded in August 1977 for the Treasury automated communications system (TACS). The implementation of TACS in 12 months will round out the Treasury communications capability by providing a modern message processing and dissemination facility which will increase productivity and efficiency.

Treasury Centrex telephone system.—The Treasury Centrex system has been in service for nearly 2 years and now serves Treasury bureaus and 2 other Government agencies with over 18,000 telephone stations. An automated directory and information service is being designed and should be implemented in 1979. The use of the single line telephone in lieu of the more expensive multiline telephones or call directors is progressing well and is expected to result in significant savings. The new Centrex attendant service has permitted a reduction of seven telephone operators, one-third of the former staff.

Federal telecommunications system (FTS) cost reduction program.—Treasury met its goal of reducing long-distance telephone costs by \$2 million in fiscal 1978. GSA rebated over \$2 million in FTS costs to Treasury. Detailed calling data were collected and distributed and educational memoranda prepared on the proper use of the FTS for Treasury employees. Managers and supervisors indicated that the usage data proved to be valuable in controlling calls. This

program will be enhanced by a unique FTS off-net restriction capability now available on the Treasury system.

Departmental audiovisual management program.—Based on OMB Circular A-114, a draft Treasury directive was circulated for comment prescribing specific management criteria for audiovisual programs. Agreement on its final form has not yet been reached, but the directive has stimulated management thinking and activity in the reduction of audiovisual costs. Due in large part to the contributions of interested bureau audiovisual managers, a useful and economical audiovisual program will be in operation within the next fiscal year.

Overseas communications support.—Telecommunications Management has become deeply involved in providing a sophisticated satellite communications system between Riyadh, Saudi Arabia, and Washington, D.C. The system is supporting the Office of Saudi Arabian Affairs and numerous projects established under the auspices of the United States-Saudi Arabian Joint Commission on Economic Cooperation. The first phase of the project, which provides direct voice communications between the two cities, has been completed and the second, which will provide computer terminal access to data bases in the United States, is under development. Initial users, besides Treasury personnel, will be the Saudi Ministry of Finance. Other users are to be phased in as their communications requirements become known.

Radio frequency management.—During fiscal 1978, the Department doubled its capacity of radio frequency assignments and approximately 300 international negotiations were successfully undertaken. It is anticipated that the demands in fiscal 1979 will be 75 percent above present levels. Completed studies indicate that due to an upcoming major reorganization, the frequency requirements are projected to triple, but can be accomplished with only a 50-percent increase in cost as a result of innovative data-handling techniques.

Improvement of commercial carrier service to Treasury.—In 1978, the American Telephone & Telegraph Co. established a national account management staff to serve Treasury, and the associated Bell System companies realigned their marketing staffs accordingly. As a result, response to Treasury requirements has improved significantly. For example, the new A.T.&T. management team recently conducted a survey of U.S. Customs Service voice communications requirements along the United States-Mexican border and submitted its recommendation for improved service in this area. The project called for a coordinated effort among the three telephone companies serving the area and the national account management staff.

Departmental communications security.—Responsibility for the management of the departmental communications security (COMSEC) program was officially assigned to the Assistant Director (Telecommunications Management) by Treasury Department Order No. 254, dated August 12, 1977. The departmental COMSEC staff is charged with ensuring that classified and sensitive voice, record (message), and data communications (including automated data processing transmissions) are accomplished so that the information is not inadvertently disclosed by human or machine error, or intercepted by an adversary. COMSEC support is provided to the Office of the Secretary and to those other offices and bureaus within the Department that process or transmit sensitive or classified information.

Paperwork management

Departmental paperwork management program.—The staff continued developing programs in correspondence, forms, internal reports, and directives, and began a new program in the area of records maintenance and disposition. A

program directive was published to assure that only required records are maintained and disposition is timely.

Treasury's part in the President's program to reduce the reporting burden imposed on the public was again a success. In fiscal 1978, the Department reduced its reporting burden by more than 25 million work-hours, a 5-percent reduction in time required by the public to complete Treasury reports.

The forms management program established a central facility to store and distribute forms which allows for cost savings and better control.

Office of the Secretary program.—A more efficient realignment of clerical functions in the Records Management Branch led to the expansion of services such as word processing and microfilm.

Unneeded central files in the Office of the Assistant Secretary (International Affairs) were discontinued. A new filing system established official records locations at designated stations throughout the office to assure complete documentation and record accessibility. A new storage and holding facility was established, freeing hundreds of square feet of prime office space in the Main Treasury Building, to make it possible for program officials to store semiactive records for almost immediate access.

Schedules to permit the orderly, legal destruction of thousands of cubic feet of Office of the Secretary records currently stored in the Washington National Records Center and the Main Treasury Building are about 80 percent completed. This will result in significant savings to GSA and Treasury.

Disclosure program.—For the past 2 years, this program, which administers the Freedom of Information Act and Privacy Act provisions, had been staffed by people on temporary assignment throughout Treasury. Now it has a permanent full-time staff. The new Disclosure Officer is reviewing the systems before revising procedures and policies for disclosure. An orientation program has been developed to train new employees who will be associated with disclosure.

New directions.—Rapidly developing technology has led to several new programs that promise to revolutionize information management at Treasury. Heretofore nothing had been done to coordinate word processing activities on a Department-wide basis. The Office of Paperwork Management organized a word processing task force of representatives of each of the bureaus, chaired by an analyst on the staff. Standard guidelines now exist for acquiring and using word processing equipment throughout the Department.

The basis for a word processing system to allow originators, reviewers, and signers of correspondence to communicate almost instantly has also been established, eliminating the days or weeks of revision now associated with document preparation.

A computerized correspondence tracking system developed for the Office of Public Affairs permits the user to instantaneously identify all correspondence within the system and obtain status reports immediately.

Paperwork Management is developing an information locator system to prepare a number of reports required on a quarterly, semiannual, and annual basis. It will also identify sources of information throughout the Federal Government and eliminate most duplicative requests. The system, projected to save tens of thousands of dollars each year in forms and reports management personnel costs, will, more significantly, reduce even more the reporting burden imposed on the public.

General services

International support.—The IMF/IBRD annual meetings bring together the Finance Ministers, central bankers, and other top officials from around the world in discussions concerning international monetary and financial policies. The Office of General Services planned and coordinated all administrative requirements for Treasury's participation in the 1978 IMF/IBRD conference. Complete logistical support, including telecommunications, furniture and supplies, and other office services, was provided in a major temporary office installation for top Treasury officials in a wing of the Sheraton Park Hotel, Washington, D.C. Numerous events were arranged for the Secretary and other officials, including a reception by the Secretary for approximately 1,300 guests.

In addition, the Office of General Services continued to provide planning and coordination services for overseas travel by the Secretary and other top Treasury officials, as well as related protocol support services.

Environmental programs

Environmental quality.—The Assistant Secretary (Administration) approved the completed supplemental environmental assessment on the expansion of facilities at the Federal Law Enforcement Training Center. In addition, the first phase of environmental assessments was completed on the ATF explosives tagging program and the Customs Detector Dog Training Center expansion at Front Royal, Va. Assistance was provided to the Council on Environmental Quality in the formulation of new regulations implementing the National Environmental Policy Act.

Historic preservation.—Treasury continued its participation as a statutory member of the Advisory Council on Historic Preservation (ACHP). This included review of impact studies on Federal projects involving historic properties, and representation on task forces such as the Interagency National Heritage Trust Task Force and the Economic Policy Group of the Council on Historic Preservation. A comprehensive directive was prepared to establish responsibilities, standards, and procedures for complying with the National Historic Preservation Act. A report was prepared for the ACHP summarizing the Department's historic preservation activities and the processing of several inquiries concerning the impact of Department activities on historic buildings.

Energy conservation.—In order to facilitate preparation of the energy management plans required by Executive Order 12003, the Assistant Secretary (Administration) established a task force in March 1978. The task force completed the energy survey of 14 Treasury owned and operated buildings in order to determine actions to meet the President's stated goal of a 20-percent reduction in energy consumption. In the area of agency operations, the task force identified eight energy conservation options; among them were vanpooling, use of electric vehicles, energy conservation in the use of ADP equipment, and a driver training course. The latter two programs are being initiated for the first time in the Federal Government. A study was begun to determine necessary departmental response to a weather/fuel shortage crisis.

Pollution abatement.—In accordance with the Solid Waste Disposal Act of 1965 and the Resource Recovery Act, the Department completed a study on the feasibility of source separation of high-grade wastes. The study found source separation at the Main Treasury and Annex to be economically unfeasible, but advised the Environmental Protection Agency (EPA) that source separation will be done at the Bureau of Engraving and Printing. The

"Beverage Container Guidelines Non-Implementation Report," concerning departmental implementation of EPA's guidelines under the Solid Waste Disposal Act, was submitted in final to EPA. Also submitted to EPA was a reply concerning compliance with the National Pollution Discharge Elimination System permit granted to the Customs dog training center and alleged violations of the permit by that bureau.

Library

The library expanded its automation program in two major areas, internal operations and public services. Internally, a management information system for acquisitions and subscriptions control was implemented. For public services, the library acquired the automated reference services "Orbit" and the New York Times Information Bank, thereby expanding reference and bibliographic services.

Safety

Office of the Director of Safety.—The safety action plan project was completed on schedule in fiscal 1978. One bureau plan was unacceptable, however, and the project was extended until the plan is revised.

A directive, "Departmental Occupational Safety and Health Program," was published. The basic directive has nine parts. Parts I and II are in force; parts III–IX have been released for coordination. They cover legislated requirements for the Department's occupational safety and health program.

The criteria and evaluation procedures governing the Secretary's bureau safety awards were revised and published in a directive, "Department of the Treasury Safety Awards." The highest award of honor went to the Bureau of Engraving and Printing in calendar 1977 and to the Bureau of Government Financial Operations in calendar 1978. The next highest award of excellence went to the IRS in calendar 1977 and to the Secret Service in calendar 1978.

Treasury Occupational Safety and Health Council (TOSHC).—A TOSHC committee wrote a new organization and bylaws document published as a directive. The document reestablished the TOSHC as a forum for (1) discussion of departmental and bureau safety and health problems, (2) information on a regular basis on important safety and health topics, and (3) recommendations on departmental policy. Annual meetings of the Council, which included Office of the Secretary and bureau top staff, were held in November 1977 and May 1978. The Assistant Secretary (Administration) chaired the May meeting. The annual meeting is now an established spring event.

Treasury Historical Association

In 1978 the Treasury Historical Association began having three membership meetings a year instead of only one. These were held February 2 at the Bureau of Alcohol, Tobacco and Firearms, April 12 in the Treasury Cash Room, and September 27 at the National Archives.

Rex D. Davis, Vice President, was appointed to fill the vacated office of President and then agreed to stay on as President after he retired as Director of the Bureau of Alcohol, Tobacco and Firearms. Continuing in their current offices are Charles E. Walker, Chairman of the Board of Directors; Abby Gilbert, Secretary to the Board; and Arthur D. Kallen, Treasurer. Sidney Sanders resigned as Executive Secretary and was replaced by Tacy Cook.

By the end of fiscal 1978, the Association had 350 members.

BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

The responsibilities of the Bureau of Alcohol, Tobacco and Firearms (ATF) include: Reducing the criminal misuse of firearms and the misuse or unsafe storage of explosives; assisting other Federal, State, and local law enforcement agencies in reducing crime and violence in which firearms and explosives are used by helping enforce the firearms and explosives laws of the United States; collecting all revenue due under the Federal alcohol and tobacco tax statutes, and to achieve, to the maximum extent possible, voluntary compliance with those laws; eliminating the illicit manufacture and sale of nontaxpaid alcoholic beverages; and quashing commercial bribery, consumer deception, and other improper trade practices in the alcoholic beverage industry through administration and enforcement of the Federal Alcohol Administration Act.

Originally, ATF, as a unit of the Internal Revenue Service, was responsible mainly for the reduction of the manufacture and sale of illicit alcohol.

Criminal violence in the 1920's and 1930's prompted Congress to enact the National Firearms Act of 1934. ATF enforces and administers the law, which imposed a tax on, and required registration of, automatic and other gangster-type weapons. In 1942, Congress passed the Federal Firearms Act to regulate interstate commerce in firearms.

Similarly, an upsurge in violence in the 1960's led to broader law enforcement responsibilities for ATF. Increased firearms crimes, spurred by assassinations of political and other leaders, prompted passage of the Gun Control Act of 1968. It encompassed existing Federal firearms laws and added new provisions, to be enforced by ATF. In 1970, enactment of title XI of the Organized Crime Control Act assigned explosives regulation and enforcement jurisdiction to ATF.

Treasury Order No. 221, June 6, 1972, separated ATF from the IRS. ATF then became a separate Treasury bureau.

In fiscal 1978, the Bureau expanded its explosives enforcement program to investigate arson-related crimes by setting up arson task forces in major metropolitan areas in the United States.

A national pilot test was conducted in fiscal 1978 on the feasibility of adding microscopic, coded chemical particles, called taggants, to explosives during manufacture. When tagged dynamites, gels, and slurries are used in bombings, they can be identified at the bomb sites.

Agents and inspectors continued to identify sources and channels through which firearms moved from areas with minimal or no firearms laws to areas with strict laws. This effort began in Boston, Chicago, and Washington, D.C., when ATF started its concentrated urban enforcement (CUE) program in fiscal 1976.

Intensified enforcement efforts to suppress interstate and international movement of firearms and explosives intended for criminal use revealed new weapons sources. Complex criminal investigations were developed successfully and forwarded for prosecution.

During fiscal 1978, ATF collected more than \$8 billion in alcohol and tobacco excise taxes—the third largest source of U.S. revenue, following personal and corporate income taxes. ATF continued its efforts to investigate trade practice violations and to conduct compliance inspections of firearms and explosives industry members.

Several steps were taken by ATF to modernize laws, regulations, and rulings,

including steps to deregulate while assuring the collection of tax revenue. Consumer protection was promoted by issuing regulations to strengthen wine-labeling requirements, and by proposing regulations to require labels on alcoholic beverages to warn pregnant women of the dangers of alcohol to fetal development.

Criminal Enforcement

ATF agents investigate violations of Federal firearms, explosives, and alcohol laws. In fiscal 1978, as reports documented a rise in arson crimes in the United States, ATF agents developed investigative techniques for use in arson cases. Operation CUE continued to be an effective tool for charting the criminal misuse of firearms and explosives in metropolitan areas.

The work of ATF special agents opened 24,670 investigations, and led to recommendations that 4,264 defendants be prosecuted. ATF agents were responsible for the seizure of 8,898 firearms, 15,108 pounds of explosives, and 252 illicit distilleries. Undercover techniques used during investigations resulted in the purchase of 3,924 firearms and 2,184 pounds of explosives destined for use by the criminal element.

To enforce Federal explosives and firearms laws, the Bureau has developed special programs to meet the needs of its field agents and other law enforcement officers. Those programs include the stolen explosives and recoveries (SEAR) project, interstate theft project for firearms, international traffic in arms (ITAR), Operation CUE, arson task forces, and undercover storefront operations.

Explosives enforcement program

Explosives incidents involving death, injury, and property loss continued to rise in fiscal 1978. The illegal and improper use of explosives resulted in 116 deaths, 247 injuries, and more than \$2 billion in property losses. Agents investigated 3,459 explosives incidents, of which 1,075 were bombings, 342 attempted bombings, 63 accidental bombings, 409 incendiary incidents, and 85 arson bombings.

ATF investigated approximately 77 percent of all reported explosives incidents in the United States last year. Investigations by the Federal Bureau of Investigation, the U.S. Postal Service, and State and local law enforcement agencies account for the remaining cases.

To meet its explosives enforcement responsibility, ATF provides training for its agents and for other Federal, State, and local law enforcement officers. Training includes destructive device identification, explosives safety, security, bomb threats, bomb responses, and investigative techniques.

ATF also stresses public awareness and cooperation with other law enforcement agencies.

The stolen explosives and recoveries project and arson task forces are principal ATF explosives enforcement tools.

Stolen explosives and recoveries.—In an effort to curb explosives thefts in the United States, ATF developed the stolen explosives and recoveries project to assist ATF agents and other Federal, State, and local law enforcement agencies in detecting and recovering stolen or lost explosives.

After a public campaign advertising a toll-free explosives theft reporting number, 800-424-9555, ATF received an increase in explosives theft reports in 1978. Three hundred forty-eight explosives thefts involving 85,591 pounds were reported.

Through investigative efforts with other agencies, ATF recovered 59,662 pounds of explosives in undercover purchases, seizures, and abandonments. The detection and apprehension of individuals who steal explosives is an ATF priority, since many stolen explosives subsequently are used in bombings.

Arson task forces.—Incidents of arson have increased in recent years and have placed a multibillion-dollar financial burden on business communities, municipalities, and insurance agencies. Arson is committed to defraud insurance companies by the destruction of insured property.

Studies show that arson incidents have increased by 1,300 percent since 1950. Arson is the cause of more than 30 percent of building fires.

Because of ATF's law enforcement responsibilities, the Bureau is in a unique position to investigate the arson problem at the national level and to assist State and local authorities simultaneously in their efforts to solve arson crime. ATF's authority stems from the Gun Control Act of 1968 and the Organized Crime Control Act of 1970, of which the Explosives Control Act is a part.

ATF began its approach to arson with an experimental task force in Philadelphia. A task force is a combined strategy among law enforcement agencies in a geographical area. In the Philadelphia area, cases were perfected against a furniture store owner, an insurance adjuster, and two organized crime figures seeking to collect insurance on an arson-for-profit fire and a slum landlord who burned down several tenements to defraud underwriting insurance companies; other cases are under investigation. Because of the success of the Philadelphia task force, ATF formed 22 more task forces in major cities across the United States in conjunction with strike force operations.

Explosives and arson investigations.—ATF agents investigated major explosives and arson cases in fiscal 1978. Many bombings occurred in Kentucky and West Virginia during the 1978 United Mine Workers strike.

Typical ATF bombing investigations are illustrated by a train derailment in West Virginia during the coal-mine strike, in which ATF agents there conducted an investigation which resulted in the arrest of suspects 3 days later; or by the case in which six defendants were prosecuted in 1978 for blowing up a Letcher County, Ky., bridge which spanned the Kentucky River (the explosion caused \$200,000 damage to the bridge); and by yet another in which two suspects were arrested for possession of 100 pipe bombs during an investigation in Bellaire, Mich. They were planning to sell the bombs to undercover agents for criminal use.

Firearms enforcement program

In fiscal 1978, ATF agents conducted 20,825 firearms investigations, which led to recommendations that 3,652 defendants be prosecuted. During the investigations, agents seized 8,988 firearms and, while working undercover, purchased another 3,924. The seizures and purchases prevented the weapons from being used in crimes.

Because of ATF's ability to trace firearms used in crimes, Bureau analysts can identify sources and channels through which firearms illegally move from areas with minimal or no firearms laws to areas with strict laws. Local law enforcement officers are sometimes limited in their ability to curb the illegal flow because of jurisdictional restrictions or inadequate laws.

ATF has recently focused its efforts toward stemming the illegal interstate and intrastate flow of arms. The approach is to identify and apprehend principal illegal firearms traffickers and their sources, distributors, and coconspirators.

While local law enforcement officers investigate firearms cases within their jurisdiction, ATF agents will now concentrate on Federal violations such as complex investigations of major, organized firearms suppliers.

Two major programs in ATF firearms enforcement are the interstate theft project and the international traffic in arms project.

Interstate theft project.—The Bureau started a firearms theft reporting program in 1973 to help prevent firearms stolen from interstate shipments from becoming a source of weapons for criminals. The trucking industry and other interstate shippers voluntarily have reported thefts or losses of firearms to ATF yearly.

In fiscal 1978, ATF received 884 reports involving approximately 2,430 stolen or lost firearms. Seventy-four percent of the total, or 660 reports, were forwarded by United Parcel Service offices. ATF agents, working with local investigators, developed 6 criminal cases involving 14 defendants and recovered 332 stolen firearms.

International traffic in arms.—The ITAR project provides information which assists agents in curbing illegal international trafficking of firearms. Smuggling firearms, ammunition, and explosives out of the United States into other countries is an area of concern for Customs and ATF agents.

During fiscal 1978, ATF and Customs agents in several instances were successful in curbing the illegal flow of firearms and ammunition into other countries by perfecting cases against the U.S. suppliers of these weapons.

Four suspects were arrested after ATF undercover agents met with the individuals, who wanted to purchase 600 semiautomatic pistols for illegal shipment to Rhodesia. A criminal lawyer and onetime Rhodesian mercenary from Dayton, Ohio, was a major suspect. The individuals were arrested and later convicted on Gun Control Act violations.

Firearms destined for a South American country were seized in Miami after a 3-day surveillance. Agents arrested three suspects. The weapons were concealed in air conditioning units.

Agents learned that an individual in another Miami case had purchased 175 firearms in a brief period. After the suspect was observed purchasing more firearms, agents arrested the individual and an associate. One hundred firearms, valued at \$36,000 and destined for Colombia, were seized.

In Texas, ATF agents worked with U.S. Customs Service and Texas Department of Public Safety officers in a joint undercover operation to curb illegal firearms trafficking into Mexico. As a result, eight defendants were arrested as principal suppliers to Mexico. Federal search warrants at 5 locations in the Rio Grande Valley resulted in seizures of 43 firearms and a quantity of ammunition.

Firearms investigations.—ATF agents investigated major firearms cases in fiscal 1978 involving organized crime, illegal interstate transportation, and illegal possession.

An individual was arrested in Tampa, Fla., for illegal manufacture of silencers and assassination kits, which were briefcases mounted with silencer-equipped handguns, and were designed to fire at close range. The suspect was arrested after undercover agents purchased three silencers from him. Three assassination kits were seized later.

ATF agents in Chicago, Ill., and Mississippi worked together to uncover a Mississippi-to-Chicago gunrunning operation. A Chicago resident with associates in Mississippi illegally acquired about 300 firearms through a cooperating licensed dealer in Mississippi. The weapons were being sold to individuals

in high-crime areas in Chicago. Agents developed a successful conspiracy case involving the suspects.

In Philadelphia, ATF agents worked with local police to investigate members of a group called MOVE. Agents investigated one member of the group for Gun Control Act violations. Enforcement efforts culminated in the seizure of 10 firearms, 50 destructive devices, and a quantity of chemicals which could be used to manufacture explosives.

Alcohol enforcement program

ATF investigations into illicit liquor violations continued to diminish in fiscal 1978 as local law enforcement officials conducted more investigations. ATF has encouraged local enforcement against illegal liquor production while the Bureau restricts its involvement to large-scale illicit liquor violations and concentrates its efforts in explosives and firearms investigations.

ATF illicit liquor investigations resulted in seizures of 252 moonshine stills, 146,619 gallons of mash, and 5,686 gallons of illicit whisky. Agents developed 160 criminal cases for prosecution.

Legal manufacturers of alcoholic beverages also were the object of ATF enforcement scrutiny. Ten investigations ended in recommendations for prosecution.

Operation Concentrated Urban Enforcement

ATF began Operation CUE in 1976 at Boston, Chicago, and Washington, D.C., in response to a congressional mandate to expand Federal enforcement against firearms crime.

The Bureau concentrated enforcement resources in the three metropolitan areas to: Develop cases against individuals using firearms and explosives in criminal activities; reduce or eliminate illegal sources of street-type firearms and explosives; trace firearms seized in the metropolitan areas to determine type and sources of firearms used in crimes and to chart the flow of these firearms into the cities; and expand its firearms dealer inspection program to ensure compliance with Federal laws and regulations.

Operation CUE continued in the three cities during fiscal 1978. ATF agents began 2,928 investigations and recommended 816 defendants for prosecution. A total of 1,308 firearms and 684 pounds of explosives were seized during these ATF investigations. Undercover agents purchased 816 firearms and 228 pounds of explosives.

The Bureau traced 12,156 firearms to support CUE investigative efforts in identifying and cutting off illegal sources of firearms used in crime. ATF concentrated on tracing firearms used in major violent crimes such as murder, robbery, assault, and narcotics violations.

Tracing results continue to show that handguns under 3 years of age are being used less frequently in Boston, Chicago, and Washington, D.C., than they were before ATF began CUE investigations into legal and illegal sources of firearms.

Rates of violent firearm crimes in the CUE cities also have declined markedly since CUE began. The reduction is measured by statistics of robbery and aggravated assault with a firearm.

CUE investigations.—Agents investigated major firearms cases in the three CUE cities.

A series of thefts from licensed firearms dealers in northern Virginia prompted a CUE investigation which uncovered an organized theft ring in Delaware, Maryland, and Virginia. The suspects were a principal illegal source

of firearms in Washington, and were involved in other activities, including burglary and contract killings. The investigations ended in the arrest of 12 individuals and the seizure of 64 stolen firearms. One stolen firearm was the murder weapon in a local contract killing. ATF agents referred information during the investigation to other law enforcement agencies, which was used to pursue violations outside ATF jurisdiction.

In Chicago, information obtained in an explosives investigation helped solve two bombings in the city, and provided leads to other bombing and arson investigations in the area. ATF agents investigated a source believed to be supplying components for dynamite bombs in the Chicago area.

Through undercover work and surveillance, ATF agents purchased five dynamite bombs from the principal suspect in Chicago, and followed him to Tennessee, where he falsified records for a large quantity of explosives and related materials. When the suspect returned to Chicago, agents arrested him with two associates, and seized explosives and materials sufficient to manufacture more than 200 dynamite bombs.

In another CUE case, ATF agents investigated an exclusive yacht club in the Boston area. The club was visited frequently by known organized crime figures, and was identified as a source of illegal firearms. Agents infiltrated the club, purchased machineguns and handguns equipped with silencers, and developed leads about other illegal firearms sources in the Boston-Springfield area.

The investigation led to the purchase and seizure of 22 firearms and the arrest of 21 suspects, including 5 prominent members of Boston organized crime. With search warrants, agents recovered stolen paintings, art objects, and china worth \$250,000, and seized narcotics and explosives materials.

Undercover storefront operations

Storefront operations, popularly known as "stings," were developed by the law enforcement community to recover stolen merchandise and apprehend individuals who steal for profit. Those who steal often try to resell the merchandise through fences.

The antifencing operations set up by law enforcement agencies generally are funded by the Law Enforcement Assistance Administration (Justice). In addition to the arrest of suspects and recovery of merchandise, the undercover operations also provide many leads which result in solving other crimes ranging from larceny to homicide.

ATF participated in 27 undercover storefront operations in fiscal 1978 in major metropolitan cities throughout the United States. The Bureau's objective was to assist local law enforcement agencies and to develop leads which would help cut off the illegal sources of firearms into those cities. The 27 storefront operations ended in the recovery of more than \$10 million in stolen property, and netted some 1,700 suspects.

Regulatory Enforcement

The Office of Regulatory Enforcement regulates the alcohol, tobacco, firearms, and explosives industries to ensure fair trade practices, consumer protection, compliance with Federal law, and the collection of Federal excise taxes.

During fiscal 1978, the Bureau intensified efforts to investigate trade practice violations in the alcoholic beverage industry and to conduct compliance inspections of firearms and explosives industry members. ATF

also issued regulations involving wine labeling, offered proposals for an alcoholic beverage label warning of the effects of alcohol on fetal development, and began studies on powdered alcohol and on alcohol used as a fuel or fuel additive.

Regulatory compliance program

To ensure the accurate determination and full collection of more than \$5.4 billion in alcohol excise taxes, ATF inspectors conducted 6,934 revenue protection inspections at distilleries, breweries, and wineries, 3,877 alcohol application inspections, and 1,549 consumer protection inspections. In fiscal 1978, Regulatory Enforcement issued 1,857 original alcohol permits, amended 1,373, and terminated 8. More than 41,600 tax refund claims for permittees were processed. The Bureau audited semimonthly tax returns of approximately 261 distilleries, 106 breweries, and 772 wineries. Also, by utilizing a more flexible approach to supervise distilled spirits plants operations, the Bureau was able to reduce the number of inspectors providing joint custody at these plants.

The Bureau regulates and controls 335 tobacco permittees. To ensure the accurate determination and collection of more than \$2.2 billion in Federal excise taxes, Regulatory Enforcement processed 837 claims for tax refunds, conducted 842 revenue protection audits, and inspected 122 tobacco applications.

In fiscal 1978, ATF issued 144,161 firearms licenses, of which 139,338 were renewals and 29,963 were new applications. Regulatory Enforcement inspected 8,361 new firearms license applicants to explain Federal laws and regulations. Approximately 1,531 licenses and applications were denied, withdrawn, or revoked. Inspectors conducted 22,130 compliance audit inspections at the premises of firearms licensees to ensure accurate record-keeping and regulation compliance.

ATF received and processed 8,287 explosives permit and license applications and issued 7,065 permits and licenses. Inspectors conducted 4,639 inspections to examine explosives licensees for compliance with applicable laws and regulations. Under a memorandum of understanding with ATF, the Mine Safety and Health Administration (Labor) assisted the Bureau by inspecting 13,000 explosives applicants, licensees, and permittees in fiscal 1978. Special emphasis was placed upon the safe and secure storage of explosives and the prompt reporting of losses and thefts.

Alcohol regulation enforcement

As part of its regulation of the alcoholic beverage industry, ATF develops programs to ensure consumer protection and compliance with Federal laws.

Voluntary disclosure.—Since becoming a bureau in 1972, ATF has placed increased emphasis on the enforcement of unfair competition and unlawful trade practices provisions of the Federal Alcohol Administration Act (FAA). Industry members are encouraged to come forward under the Bureau's disclosure program, announced September 14, 1976. Industry members entering the program are advised that any information received may be used as evidence, that remedial action commensurate with the seriousness of the violation would be initiated against them, and that information received would be made available to other Federal and State agencies.

At the end of fiscal 1978, two industry members had paid offers in

compromise and several other members were under investigation as a result of their disclosures.

During the investigations, ATF cooperated with the Securities and Exchange Commission, which is interested in any disclosure made by a publicly held corporation, and with the IRS, which is interested in illegal expenditures claimed as business expenses.

Consumer protection.—In addition to the voluntary disclosure program, ATF conducts investigations into complaints of unfair trade practices not voluntarily disclosed. In fiscal 1978, ATF accepted 30 offers in compromise, which totaled \$898,250. There were also 4 suspensions and 28 revocations of basic permits. Many of these actions were the result of a task force approach in which a team of inspectors enters a market area to resolve complaints of unfair trade practices.

To ensure compliance with Federal law and to prevent deceptive labeling and advertising, 74,928 applications for label approval were reviewed and 9,270 were disapproved. Of an additional 1,723 applications for special natural wines and rectified products, 452 were disapproved, returned, or withdrawn.

ATF and the Food and Drug Administration continued a joint study on partial ingredient labeling of alcoholic beverages.

In fiscal 1978, the Bureau began work with three other Government agencies on a study to determine the effects of alcoholic beverage advertising on the perceptions and attitudes of the consumer. The other agencies are the National Institute on Alcohol Abuse and Alcoholism, the Department of Transportation, and the Federal Trade Commission.

Distilled spirits plant program.—ATF continued pilot operations at distilled spirits plants to measure the effectiveness of protecting Federal revenue while reducing or modifying Government supervision. Twenty-three distilled spirits plants, or 9 percent of the total, were involved in the pilot tests in fiscal 1978. Pilot operations offer greater flexibility for proprietors and an opportunity for ATF inspectors to use postaudits as alternatives to onsite supervision.

Wine labeling.—After more than 2 years of proposals and alternative proposals for new wine-labeling rules, ATF issued new regulations on August 23, 1978 to revise the wine-labeling terms for appellations of origin, estate bottled, grape varietal designations, and viticultural areas. The new wine regulations will go into effect January 1, 1983.

Metrication.—The Bureau began a program in fiscal 1975 and 1976 to require the wine and distilled spirits industries to convert containers to a metric system of standards of fill. During fiscal 1978, the Bureau extended the standards of fill for wine to include any container larger than 3 liters if the container was filled to a whole liter size. Previously, 3 liters had been the largest standard of fill allowed for wine under the regulations. By January 1, 1979, wine bottles will be in 100 ml., 187 ml., 375 ml., 750 ml., 1 liter, 1.5 liters, and 3 liters sizes.

Metric standards of fill for distilled spirits is mandatory by January 1, 1980. The six approved metric sizes are 50 ml., 200 ml., 500 ml., 750 ml., 1 liter, and 1.75 liters.

Advantages of metrication include aiding consumers by reducing the number of bottle sizes for comparative shopping and by promoting international trade through adoption of common standards. Metrication permits packaging and handling efficiencies, which result in a cost savings to industry.

Cautions on fetal alcohol syndrome.—In fiscal 1978, the Food and Drug

Administration advised the Bureau that research showed possible danger of birth defects to fetuses when pregnant women consumed quantities of alcohol. There was evidence that it was possible for some children born of women who consumed alcohol to have severe physical and/or mental deformities.

In response, the Bureau issued a notice of proposed rulemaking on January 16, 1978. The regulation proposed that alcoholic beverage containers bear labels cautioning women about the risks of fetal alcohol syndrome when alcohol is ingested during pregnancy.

With the recommendation of the Office of Science and Technology Policy, Office of the President, ATF selected three consultants to assess the scientific evidence and public comments. The three consultants were chosen from the fields of medical genetics, biochemistry, and social policy. The consultants submitted their recommendations to ATF on September 25, 1978.

Gasohol.—Interest in the production and use of alcohol as a fuel and fuel additive increased in fiscal 1978. "Gasohol" is a term most often used to describe alcohol fuel, and was copyrighted as "gasohol" by the Nebraska Agricultural Products Utilization Committee to describe a mixture of 90 percent unleaded gasoline and 10 percent alcohol.

ATF took several approaches to the interest in alcohol fuels. The Bureau approved the operation of seven experimental distilled spirits plants to test materials and processes for producing alcohol as a fuel or fuel additive. ATF responded to citizen inquiries concerning alcohol fuel and the qualification requirements for producing it. Bureau officials attended interest group meetings, testified at hearings concerning alternative energy sources, and commented to Congress concerning proposed legislation involving alcohol fuels.

ATF organized a task force to study statutes and regulations on the production and distribution of alcohol to simplify requirements for qualification and operation of alcohol fuel plants.

The Bureau compiled a brochure to explain existing regulations on the establishment and operation of distilled spirits plants and the requirements for converting ethyl alcohol to a fuel or fuel additive.

Powdered alcohol.—In fiscal 1978, the alcoholic beverage industry developed a powdered alcohol product which, when added to water, becomes beverage cocktails. The alcohol in the dry mixes is encapsulated within a material soluble in water. Changes in the alcoholic beverage industry, Federal law, and regulations could occur if industry members apply to market powdered alcohol.

Liquor bottle strip stamps.—The Bureau examined the feasibility of procuring strip stamps from commercial sources. With departmental assistance, and in conjunction with the Government Printing Office and the Bureau of Engraving and Printing, ATF developed stamp security specifications which could be included in a commercial contract. After soliciting stamp production and price estimates from the printing industry, ATF projected \$1.2 million yearly savings from a commercial contract.

Industry education.—ATF conducted two seminars for alcoholic beverage control State administrators to explain Bureau policy on trade practice issues and to hear the problems of State administrators. The seminars were sponsored jointly by ATF and the National Alcoholic Beverage Control Association, Inc.

Firearms regulation program

As part of its policy to work with firearms licensees to ensure compliance with Federal law, ATF furnished licensees with "Your 1978 Guide to Firearms Regulations," which lists Federal firearms laws and regulations and excerpts

from State laws and local ordinances related to firearms and ammunition. ATF also prepared and distributed to licensees a pamphlet, "Federal Firearms Licensee Information," which is a general guide to Federal requirements.

Proposed firearms regulations.—The Bureau issued a notice of proposed rulemaking on March 21, 1978, to update several firearms regulations and to propose three major changes. The changes included a requirement that each firearm receive a unique serial number when manufactured or imported into the United States, that all thefts and losses of firearms by licensees be reported to ATF within 24 hours, and that licensees report quarterly the manufacture and disposition of all firearms.

More than 340,000 comments were received from the public during a comment period extended to June 30, 1978. ATF submitted a summary report of the comments for departmental consideration at the end of fiscal 1978.

Explosives regulation program

In addition to permit, license, and premises inspection of explosives dealers, the Bureau developed other areas to improve explosives regulation.

In fiscal 1978, the Department of Defense asked ATF to review a proposed military directive which would require individuals or groups obtaining military contracts to store explosives according to ATF regulations. ATF and Defense will formalize a memorandum of understanding on the proposed military directive in fiscal 1979. Federal explosives laws exempt from Federal requirements any individual or group manufacturing explosives for a military department.

Pending approval in the Department are recodifications and amendments of the explosives materials regulations to allow ATF adoption of many standards of safety and security now generally recognized by the explosives industry and other regulatory agencies. The major amendments include revision of explosives storage and recordkeeping requirements, addition of new terms to conform to current industry terminology, and simplification of existing regulatory language to make regulations easier to understand.

Interagency cooperation

ATF continually cooperates with other Federal and State agencies in matters of mutual interest. The Bureau works with the Securities and Exchange Commission and the IRS in efforts resulting from voluntary disclosure of FAA Act violations by alcoholic beverage industry members. ATF cooperates with the Mine Safety and Health Administration on explosives compliance investigations at mines.

Cooperative initiatives by the Bureau with State and local agencies have resulted in increased legal compliance across the entire range of regulated industries. ATF, the IRS, and the Justice Department refer violations or potential violations of law to each other and maintain access to investigative files.

Technical and Scientific Services

The Office of Technical and Scientific Services provides technical, scientific, and data processing services to the Bureau in its enforcement and regulation of Federal alcohol, tobacco, and firearms laws.

Services are provided from Headquarters offices and five laboratories in Atlanta, Cincinnati, Philadelphia, San Francisco, and Rockville, Md. The National Laboratory Center in Rockville was opened in June 1978 to replace the inadequate ATF laboratory in downtown Washington.

Laboratories

Bureau laboratories provide technical and scientific support to both Regulatory and Criminal Enforcement operations. The ATF National Laboratory Center and four field laboratories examine evidence without charge for State and local law enforcement agencies. This accounts for about 15 percent of the laboratory's workload.

Both ATF special agents and local officers have Bureau laboratory support available for the analysis of physical evidence, using forensic sciences and identification technology. Because of ATF advances in specialized fields such as explosives tagging, ink tagging, voiceprints, and tape filtering techniques, several international scientists visited ATF facilities in fiscal 1978 to train in these fields.

ATF implemented a voiceprint identification program in 1972. In fiscal 1978, 76 cases involving 1,904 exhibits were examined. The ATF examiner is the only court-qualified voiceprint expert in a Federal agency who holds international certification, and is 1 of 19 in the United States.

In fiscal 1978, a National Science Foundation study concluded that voiceprint identification is scientifically valid. The study should help voiceprint identification gain acceptability in court.

Laboratory scientists examined 7,769 exhibits in 1,205 arson and explosives cases in fiscal 1978. The recovery of a dynamite bomb under a car in California led to an ATF laboratory ink examination which linked the device to a member of the Hell's Angels motorcycle group in San Diego. A search of the suspect's house uncovered a pen used to punch holes in the dynamite device. Though nitroglycerine was found on the tip of the pen, it was the pen's ink formulation which was the significant link between the suspect, the device and some dynamite wrappers involved in an earlier attempted bombing.

During the 1978 coal-mine strike in Kentucky and West Virginia, many samples from bombings involving dynamite and homemade devices were sent to the Atlanta Field Laboratory for analysis. Cooperation between agents and laboratory scientists helped lead to convictions.

Firearms and toolmark examinations are an important part of many investigations. Laboratory scientists examined 1,163 exhibits in 465 cases during fiscal 1978.

Bullet fragments dispersed in the brain of a victim in Montana were analyzed by forensic scientists to determine caliber. The scientists found the fragments to be from a high-velocity small-caliber bullet rather than from a large-caliber bullet, as originally suspected. The new information identified a different rifle, and pointed to a second suspect, who, as a result, pleaded guilty.

Forensic scientists examined 8,122 exhibits in 1,211 cases requiring fingerprint examination. The IRS requested ATF examination of some questioned documents in a \$1.5 million stock manipulation fraud case. An ATF fingerprint expert showed that some of the questioned documents were linked to five of nine defendants involved in the conspiracy.

Laboratory scientists also examined 7,734 exhibits in 980 gunshot residue examinations, 802 exhibits in 59 serology analyses, 196 exhibits in 146 illicit distilled spirits cases, and 1,637 exhibits in 156 cases involving comparative analysis of hair, paint, metal, and chemical samples in law enforcement cases.

Scientists examined 19,028 exhibits in 1,413 cases involving questioned documents and 1,221 exhibits in 120 cases requiring ink and paper analysis. Photographic service was provided for 169,992 exhibits in 5,519 separate requests.

In fiscal 1978, the National Laboratory expanded its use of the computer

data base information search and retrieval system, which is part of the laboratory library. The data base service was used extensively by all Bureau offices.

The headquarters Chemical Laboratory provides advisory and analytical services to Regulatory Enforcement operations for alcohol and tobacco products such as formula and label compliance, consumer protection, and analyses in connection with tax classification. It is concerned also with the accuracy of gauging instruments and the development of security devices to protect revenue. The field laboratories also provide many of these services.

In fiscal 1978, as part of its consumer protection responsibility, the laboratory revealed that certain flavored vodkas contained levels of the artificial flavoring coumarin in excess of those allowed by law. Upon ATF recommendation, the products were removed from sale.

The chemical and field laboratories examined 9,513 alcoholic beverages samples, 1,948 nonbeverage alcohol samples, and 4,845 specially denatured alcohol product samples. The laboratories also examined 962 exhibits in 82 investigative cases in which alcoholic beverage containers were refilled with beverages other than that indicated on the label.

Training.—The Bureau laboratories train foreign scientists, officials from other agencies, and forensic intern students from several universities. As part of an expanded in-house training program, the ATF National Laboratory developed courses in fiscal 1978 for Bureau scientists from field laboratories. The programs were designed to develop analytical procedures, train new staff, allow exchange of ideas, and open new areas of expertise to Bureau specialists. Programs include specialized schools for gunshot residue, arson, ink and paper analysis, regulatory chemistry, forensic microscopy, and firearms examination.

The Forensic Science Laboratory conducts proficiency tests to ensure accurate and reliable results on physical evidence examination by all laboratories. In fiscal 1978, as part of this effort, the Headquarters Forensic Laboratory began preparation of a manual of recommended methods of analysis. Similar testing is conducted by the Chemical Branch to ensure reliability. These interlaboratory studies involve both industry and ATF laboratories. From such testing and study, methodology is developed which is accepted as official and suitable for both routine use and in resolving questions arising among laboratories.

Automated data processing

The services provided by Automated Data Processing Services (ADP) Division have increased nearly 50 percent in fiscal 1978. The ADP Division issues 90 computer reports on a regular basis and is responsible for applying data processing techniques to all appropriate Bureau needs, streamlining existing systems, and providing efficient computer service.

A file of Federal firearms licensees and explosives permittees were added to the computer systems in fiscal 1978 to provide monthly printouts on microfiche. The two programs have netted significant savings in time, computer paper, and storage space.

In fiscal 1978, the ADP staff began studying microfiche formats for two other Bureau programs, the capital assets property system and criminal automated reporting system. Other systems—the automated inspection management system, the laboratory workload system, and the criminal automated reporting system—were combined with the ATF computerized financial management/planning system.

Firearms technology

ATF firearms technicians examine, identify, classify, and test firearms for Bureau agents as well as for other Federal, State, and local law enforcement authorities. Technicians also examine and evaluate foreign-made handguns to determine if they are eligible for importation into the United States.

In fiscal 1978, the Bureau opened a new vault to house its firearms reference library of more than 4,000 weapons. Technicians also provide training in the areas of firearms safety, handling, and identification for Treasury agents. Additionally, the technicians prepare replies to the general public, members of the firearms industry, and the Congress regarding technical matters dealing with the Gun Control Act of 1978.

Firearms tracing.—ATF's National Firearms Tracing Center traces domestic and imported firearms to the point of first retail sale as an investigative aid for Federal, State, and local law enforcement agencies. Firearm trace information is also used in compiling analytical data to study the flow of firearms into major cities.

Since the center's inception in October 1972, more than 240,000 firearms have been traced either to an individual or to the last retail dealer. Approximately 5,500 trace requests are received each month, with more than 64,000 traces requested during fiscal 1978.

The National Firearms Tracing Center can trace domestic firearms as well as firearms manufactured in 14 countries.

Imports

Under the International Security Assistance and Arms Export Control Act of 1976 (formerly the Mutual Security Act of 1954), import permits are issued for all firearms, ammunition, and implements of war. During fiscal 1978, the Bureau approved and issued 13,299 import permits. Of these, 11,236 pertained to firearms, 600 covered firearms and ammunition, 651 were for ammunition only, and 872 covered other implements of war. Disapproved applications totaled 267.

Importers of articles enumerated on the U.S. Munitions Import List are required to register with ATF. The registry is approved and maintained by the Bureau. Currently, there are 286 registered importers in the United States. Pursuant to agreement with the United States, certain foreign countries are entitled to request certification of legality of importation of articles on the U.S. Munitions Import List (27 CFR 47.51). During fiscal 1978, ATF issued 769 international import certificates.

National Firearms Act weapons

National Firearms Act (NFA) weapons, which include short-barreled shotguns and rifles, machineguns, silencers, and destructive devices, are controlled by ATF. In fiscal 1978, ATF processed 14,066 applications involving 202,695 firearms and destructive devices. This represents an increase of 2,720 firearms registered in the National Firearms Registration and Transfer Record during this period.

During the year, 3,275 searches of the National Firearms Registration and Transfer Record were conducted in response to ongoing criminal investigations. This work resulted in the preparation of 2,146 certifications of registration status for use as evidence in Federal court proceedings.

There are 808 firearms licensees registered to deal in NFA-type weapons.

Explosives technology

Technicians in the Explosives Technology Branch offer a variety of services to ATF personnel and other Federal, State, and local law enforcement officers.

ATF is responsible for the evaluation of new explosives developed for sale and distribution within the United States, and provides technical advice on Federal explosives storage regulations. The Bureau provides explosives training for State and local law enforcement officers.

During fiscal 1978, explosives specialists provided onsite investigative technical assistance at 75 bombings and accidental explosions. Destructive device and explosive determinations were made for 300 incidents. Ninety-nine criminal cases were successfully prosecuted in which technical assistance was provided during the year.

To support investigations involving destructive devices and explosives, technicians developed methodology helpful to field agents for classifying explosives and incendiary devices. Explosives specialists also expanded efforts to provide technical assistance in arson-related cases.

The National Explosives Tracing Center increased service to law enforcement agencies with more than 1,500 traces in fiscal 1978. Traces have helped provide investigative leads in bombing and explosives theft cases.

To assist in the Bureau's development of an explosives tagging program, the Explosives Tracing Center began providing distribution information concerning tagged explosives.

The Bureau trained more than 200 ATF special agents in the handling, transportation, and destruction of explosives to increase the Bureau's ability to safely dispose of seized or abandoned explosives.

Research and Development

The explosives tagging program is a major ATF project to help investigators identify explosives at a bomb scene and detect the presence of bombs before detonation. New developments were achieved during fiscal 1978, the program's second year of funding.

Tagging for identification

One part of the explosives tagging program is the addition of microscopic, coded chemical particles to explosives during manufacture. To test this technique, called tagging for identification, ATF began a national pilot test in which 7 million pounds of dynamites, water gels, and slurries were manufactured with identification taggants and distributed to commercial channels. This has been completely successful in all quality and safety tests and if the facility for large-scale manufacturing was built, commercial identification tagging could begin today.

Another crucial class of explosives to be tagged for identification are the black and smokeless powders, used more than any other class of explosives in bombings. Powders are more easily available than dynamites, water gels, and slurries, though they are generally less powerful and therefore usually less often the cause of deaths, injuries, and property damage.

However, because of special considerations in adding taggants to smokeless and black powders, ATF began conducting tests to ensure compatibility of the taggants with powders and adherence to safety requirements. The taggants also must not degrade the powders' ballistic qualities, create a wearing effect on a firearm, or damage a firearm's mechanism.

It is clear that the addition of identification taggants to commercial explosive

materials or their boosters will better enable law enforcement authorities to trace the explosive material from a bomb scene to its last recorded owner and, hopefully, to its ultimate user. The chances of solving more bombing crimes will be improved when identification tagging is introduced. In addition, many valuable investigative hours now necessarily spent attempting to identify the last legal owner of the explosives involved can be saved.

To demonstrate the bomb-scene effectiveness of the explosives tagging method, ATF held a test at Fort MacArthur near San Pedro, Calif., in November 1977. Congressman Glenn M. Anderson of California, government officials, police department representatives, and the news media attended the demonstrations. The Fort MacArthur test was the third major test of explosives tagging for government officials and news media since the program began.

Tagging for detection

A second part of the explosives tagging program is the detection of bombs before detonation. Research scientists developed a method of injecting vapors into the plugs of electric blasting caps. The electric blasting cap was chosen for first priority research because it is used in most explosives crimes. ATF also discovered a way to place detection tags in microcapsules which appear to the eye as minute grains of sand. These microcapsules can be added to the outer surfaces of the electric blasting caps. At the end of the fiscal year, ATF was experimenting with the addition of microcapsules to bulk explosives.

Substantial progress in developing a working capability to tag explosives so that they may be detected before exploding has recently been made. And it is this part of the tagging program from which the greatest direct benefits to the public safety can be expected. With detection taggants added to explosives materials and with detection devices placed at high target value locations, the Government can go beyond solving bombing crimes only after the destruction has happened and begin, through predetonation discovery, to prevent bombings from occurring.

Inspection

The Office of Inspection is responsible for protecting Bureau integrity, reviewing operational activities, auditing the Bureau's fiscal position, and implementing the ATF personnel and document security program. The staff also conducts all Bureau investigations into equal employment opportunity complaints, tort claims, and accidents.

Office of Inspection statistics were included in the ATF computerized automated information management system during fiscal 1978. The result is a more accurate assessment of open and closed investigations.

Integrity investigations

The Operations Review Division began 119 new investigations into allegations involving employee conduct in fiscal 1978. Completed investigations involving 178 employees, some of which were started in fiscal 1977, ended in 5 resignations, 31 adverse actions, 140 clearances, and 2 referrals to other law enforcement agencies. Fifty-six investigations still were being conducted at the end of fiscal 1978.

Operations review

The operations of selected offices of Criminal Enforcement, Regulatory Enforcement, and Technical and Scientific Services were reviewed. Manage-

ment uses the reviews to improve field operations when necessary. Inspectors also supervised 45 accident investigations involving ATF personnel and property.

Internal audits

The Internal Audit Division assists management by furnishing information, analyses, appraisals, and practical recommendations concerning Bureau objectives. The staff began 34 audits, continued work on 25 audits started before fiscal 1978, and issued 36 reports. The audits appraised the financial and program management activities of the Offices of Administration, Criminal Enforcement, Regulatory Enforcement, and Technical and Scientific Services.

Security

The Security Division coordinated 810 new employee background and security update investigations. One thousand seventy-eight investigations, some of which were started in fiscal 1977, were completed. One hundred forty-three still were being conducted at the close of fiscal 1978.

Equal employment opportunity

The Office of Inspection investigated nine equal employment opportunity complaints in fiscal 1978.

Administration

The Administration Office provides support services for Bureau personnel through its headquarters staff and seven regional offices. Support services include fiscal and personnel management, Bureau communications, training, facility improvement and maintenance, printing and distribution, forms management, and management analysis.

Fiscal management

The Bureau's fiscal 1978 budget totaled approximately \$128.6 million. About 4,000 employees were employed during the year. Firearms and explosives programs accounted for almost two-thirds of ATF expenditures, and reflected the Bureau's priorities in investigating violent crime. Alcohol and tobacco enforcement comprised the remainder of the budget.

To execute programs in alcohol, tobacco, firearms, and explosives enforcement and regulation, ATF spent 71.5 percent of its budget on salaries and benefits, 9.1 percent on communications and space, 4.2 percent on travel, 3.5 percent on printing, and 11.7 percent in miscellaneous areas.

In fiscal 1978, the Administration Office implemented an automated allocation/obligation system. Expenditure data for each of the Bureau's major offices are stored in a computer, and may be compared with projected expenditures to ensure fiscal control. Automated monthly reports allow headquarters and field managers to monitor their budgets more easily.

Personnel management

To help improve the classification system for special agent positions, the Administration Office began a criminal enforcement investigation analysis system in July 1978. When agents complete an investigation, their supervisors assign a GS grade level to the work, based on its complexity. The system is a tool in determining the grades for special agent positions, and allows supervisors to participate in the position classification process.

The Office of Administration requested and received permission from the Civil Service Commission to appoint 58 criminal investigator candidates without examination on a nontenured basis who have special skills and abilities necessary for sensitive undercover assignments.

The Employee Relations Branch continued refining the Bureau's agreement with the National Treasury Employees Union. The Bureau has avoided problems in executing the agreement by keeping supervisors of bargaining-unit employees regularly informed of interpretive decisions.

Communications

The Communications Center staff in Washington, D.C., spent 65 percent of its daily fiscal 1978 activity in support of law enforcement efforts. Communication helped in the apprehension of 534 suspects and the recovery of 197 stolen firearms. The remaining 35 percent of the center's work was made up of other communications and computer file maintenance.

Fourteen cities were added to the Bureau's Treasury enforcement communications system (TECS) network. The additions expanded TECS coverage of ATF field offices by 27 percent, and required a redesign of transmission facilities. The redesign incorporated faster line speeds, onsite channel equipment, and a 4,800-word-per-minute printer to receive online reports from the computer. Teletype terminals at Criminal Enforcement district offices also were upgraded. The Administration Office estimated the new terminals would meet Bureau needs for 5 to 7 years.

Training

More than three-fourths of 3,092 Bureau employees who participated in 1 or more training courses in fiscal 1978 were from Regulatory Enforcement and Criminal Enforcement. Employees from other areas of the Bureau attended specialized training in management, administrative, and technical subjects.

Criminal enforcement.—The ATF Law Enforcement Training Branch in Glynco, Ga., expanded its special agent basic training course 1 week to include instruction in hostage negotiation, stress management, radio communications, report writing, and practical courtroom procedures. One hundred sixteen new agents participated in the basic 7-week course during fiscal 1978.

The Bureau broadened the scope of its specialized enforcement training, offered at Glynco, to include certified explosives-handling instruction, advanced explosives investigation, and arson investigation. Staff from the ATF laboratories taught classes in arson evidence analysis, gunshot residue, and firearms and toolmark examination. About 1,271 senior agents participated in specialized enforcement training.

The Bureau continued to provide seminars in a number of law enforcement subjects for State and local police officers. Under a grant from the Law Enforcement Assistance Administration, 194 officers attended ATF-sponsored organized crime investigation seminars at various sites nationwide.

Regulatory enforcement.—The basic training course was revised in fiscal 1978 and was attended by 30 new inspectors. A total of 475 senior inspectors attended a variety of courses including audit seminars, refresher training, and specialized instruction in the Federal Alcohol Administration Act and National Firearms Act.

Other areas.—In fiscal 1978, 468 Bureau employees received specialized training offered by other government agencies, universities, and private industry. This represents a 9-percent increase over fiscal 1977.

Supervisory/management training was provided for 95 personnel in super-

visory and management positions. As part of its instructor training efforts, the Training Division began a course design class to teach selected employees a systems approach to training course development. In the systems approach, selection of training techniques is determined by an analysis of the principal tasks of the job which require training.

Printing and distribution

The Administration Office added new photocopy equipment to the headquarters reproduction facility in March 1978. By meeting more in-house printing needs, the new equipment will save about \$60,000 annually in reduction of outside printing and reproduction costs.

The Bureau also issued an ATF series of alcoholic beverage revenue strip stamps in March 1978. These replace IRS issues the Bureau had continued to use until the supply was exhausted. Strip stamps are affixed to bottles of distilled spirits to show proof of Federal taxpayment.

The ATF Distribution Center, located in Arlington, Va., stocks and distributes Bureau forms and publications. The center experienced a 6-percent increase in workload to almost 50,000 orders during fiscal 1978. The center shipped 58,495 packages and 101,257 envelopes at a cost of \$142,275. The distribution workload has stabilized since fiscal 1976.

Facility improvement

As part of its responsibility to manage ATF office space, the Administration Office worked with the ATF National Laboratory in Washington, D.C., to open new laboratory facilities in Rockville, Md. Planning by the laboratory staff and the Administrative Programs Division began in fiscal 1976. The new laboratory allows ATF scientists to meet increasing demands and to offer a broader range of services to ATF field employees and to other Federal, State, and local officials.

In fiscal 1978, ATF also moved its firearms reference collection from the IRS building in Washington, D.C., to Bureau headquarters offices. The move required a redesign of storage space to provide an expanded, climatically controlled weapons vault. The facility includes a work area for testing firearms involved in criminal investigations.

Chief Counsel's Office

Demands for services from the Chief Counsel's Office in Washington and its seven regional offices increased once again in fiscal 1978. More than 1,000 cases were referred for legal resolution each month.

Legal assistance also was provided for Bureau testimony and legislative programs. Attorneys helped prepare testimony for the Treasury Assistant Secretary (Enforcement and Operations) and the ATF Director on proposed firearms regulations and the problems of cigarette smuggling. The testimony was presented to the House Judiciary Subcommittee on Crime. For the Senate Human Resources Subcommittee on Alcoholism and Drug Abuse, the staff authored testimony on the issue of alcoholic beverage labels warning pregnant women of the dangers of alcohol.

Attorneys prepared the Bureau's legislative program, submitted draft legislation, and authored legislative reports for congressional committees on bills affecting the Bureau. Attorneys also appeared before the Joint Committee on Internal Revenue Taxation concerning distilled spirits, wine, and malt beverage tax proposals.

The Chief Counsel's Office participated in several studies involving the President's reorganization projects on law enforcement and attorney representation. Attorneys helped clarify aspects of the Federal Alcohol Administration Act by appearing before industry conferences.

Under the Federal Tort Claims Act, the Chief Counsel's Office processed numerous claims alleging negligence of ATF employees. Claims exceeding \$100,500 were reviewed and granted in fiscal 1978. The staff also made recommendations to the Department of Justice in the prosecution and defense of litigation involving the Bureau.

Chief Counsel attorneys participated regularly on matters arising from employee-employer relationships involving equal employment opportunity and unfair labor practice complaints.

As an outgrowth of positive working relationships between U.S. attorney's offices and the seven ATF regional counsel offices, Bureau attorneys received requests to prepare briefs, propose pleadings, propose court orders and other documents in litigation. At times, attorneys participated in the trial or oral arguments of civil and criminal cases.

Regional attorneys represented the Bureau before an administrative law judge in hearings concerning violations of the FAA Act and firearms and explosives laws.

Public Affairs

Information services

The Public Information Office services and materials included more than 100 news releases, factsheets, brochures, articles, speeches, news conferences, and media interviews.

News releases explained ATF missions and programs relating to firearms, explosives, alcohol, and tobacco. Examples include a news article describing ATF's pilot program for arson control, releases about the deadly toll in lives and property taken by explosives, coverage of illegal firearms seizures, and actions to curb alcohol trade violations.

Public information officers supported Bureau officials at 12 news events which took place away from Washington. Information officers answered more than 2,000 information requests received from throughout the United States and other nations.

The Public Information Office published 12 issues of the ATF newsletter, "All the Facts," to inform employees of Bureau events and programs. A summary of ATF-related news articles, which appeared in newspapers and magazines, was distributed three times weekly.

Congressional liaison

The Congressional Liaison Office coordinated replies to 700 congressional inquiries about proposed firearms regulations. Other issues generating congressional interest were wine labeling, ingredient labeling and possible warning labels for alcoholic beverages, explosives tagging, cigarette smuggling, and alcohol advertising.

Liaison officers supported the Director and other ATF managers on 16 occasions when they testified before committees of Congress. The office responded to a total of 1,500 congressional letters in fiscal 1978, and an average 160 telephone inquiries each month.

Convention liaison

Public Affairs officers participated at 12 conventions and meetings which served as contact points between ATF, law enforcement and industry representatives.

Office of Disclosure

The Disclosure Office responded to a 32-percent increase in Freedom of Information requests and a 15-percent increase in Privacy Act requests during fiscal 1978.

Freedom of Information Act requests numbered 566. Four hundred ten requests were granted in full, 115 were granted in part, and 41 were denied. Of 16 administrative appeals, 2 were granted in full, 5 were granted in part, and 6 were denied. Two appeals still were being processed at the close of the fiscal year. Fees collected for Freedom of Information Act requests were \$9,409.

Privacy Act requests numbered 466. Forty were granted in full, 392 were granted in part, and 34 denied. Forty-two requests were being processed at the fiscal year's close. Of four administrative appeals, three were granted in full and one was denied.

The Disclosure Office answered 95 percent of the requests within deadlines set by Federal regulation. Disclosure Office deadlines are 10 working days for Freedom of Information Act requests and 30 working days for Privacy Act requests.

The staff asked for voluntary extensions in 5 percent of the requests, which often required review of thousands of pages. Six civil actions were filed against ATF under the Freedom of Information Act and the Privacy Act.

To help Bureau employees better understand ATF disclosure policy, the Disclosure Office issued a comprehensive order describing the Freedom of Information Act and the Privacy Act. The office also changed accounting procedures to reduce use of the ATF Disclosure Accounting Form and to save the Bureau an estimated \$220,000 in fiscal 1979.

The Disclosure Office staff teaches ATF disclosure practices to Bureau agents and inspectors. Refresher training and course instruction for new agents and inspectors were expanded.

OFFICE OF THE COMPTROLLER OF THE CURRENCY ¹

The Office of the Comptroller of the Currency was established in 1863 by the National Currency Act, redesignated in 1864 as the National Bank Act (12 U.S.C. 38). The Comptroller, as Administrator of National Banks, is charged with regulating and supervising the national banking system, within the scope of existing statutes and in such a manner as to best serve the public interest.

Operations of the national banking system reflected the continued growth

¹ Additional information is contained in the separate Annual Report of the Comptroller of the Currency.

experienced by the U.S. economy. Total assets of the country's 4,655 national banks increased by 11.7 percent between yearend 1976 and yearend 1977. This increase is quite significant since it represents a change from the previous trend of asset growth evidenced by the previous year's increase of 5.4 percent.

The Office was reorganized to consolidate management functions, strengthen the administration of regional activities, and accommodate changes in the banking industry. Of particular significance was the formal establishment of the Customer and Community Programs Department, which includes the Divisions of Community Development, Consumer Programs, and Civil Rights.

In particular, the Customer and Community Programs Department coordinates implementation of the Community Reinvestment Act, recommends legislative proposals, helps train bank examiners in civil rights and consumer law compliance, and acts as a liaison to bring the banks together with the myriad governmental, institutional, public interest, and community groups concerned with redevelopment.

International banking issues which confronted the Office of the Comptroller of the Currency during the year included the rapid growth in foreign assets/deposits/earnings, substantial lending to foreign public sector borrowers and the applicability of the statutory legal lending limit to such credits, and expanded international money market and foreign exchange activity. The three Federal bank regulatory agencies have developed and implemented a joint semiannual Consolidated Country Exposure Report that shows, by country, the foreign claims held by U.S. banks and bank holding companies. Information from that report permits the systematic monitoring of overseas lending by U.S. banks. The monthly Foreign Currency Report continued to be used by the International Operations Division to monitor the foreign exchange trading activities of national banks.

Consumer affairs

The Consumer Affairs Division is responsible for enforcing all consumer protection laws applicable to national banks. The Office conducts specialized examinations of each national bank on a continuing basis to enforce compliance with consumer laws and regulations. In addition to those examinations, consumers' rights are protected by requiring national banks to comply with consumer laws and by informing consumers of their rights and available remedies.

Six more 2-week schools were conducted across the country this year to train bank examiners in consumer laws. The schools stress examination techniques and rely heavily on case studies to give the examiners a good functional background in consumer laws and regulations. Particular emphasis is placed on evaluating policies and practices to detect unlawful discrimination. Representatives from bank trade associations, consumer groups, and Federal and State regulatory agencies also attended the schools.

Bank examinations and related activities

The Office of the Comptroller of the Currency is required by statute to examine all national banks twice in each calendar year. However, the Comptroller may, at his discretion, waive one such examination in each 2-year period, or may cause such examinations to be made more frequently, if

considered necessary. In addition, the Comptroller examines all banks located in the District of Columbia.

For the year ended December 31, 1977, the Office examined 2,886 banks, 838 trust departments, and 96 affiliates and subsidiaries, and conducted 61 special examinations. The Office received 47 applications to establish new banks, and processed 721 applications for de novo branches and 2 applications to convert State banks to national banking associations.

National bank examinations are conducted to determine the condition and performance of banks, the quality of their operations, and the capacity of management, and to enforce compliance with Federal laws. The Office has fully implemented new examination policies and procedures placing greater emphasis on analysis and interpretation of financial data and less on detailed verification. Also, considerable reliance is placed on systems for internal control and work performed by internal and external auditors.

On December 31, 1977, the Office employed 2,082 examiners, 1,939 commercial and 143 trust examiners, or more than 70 percent of the total Office employment. A select group of examiners specially trained in computer operations and technology examine bank computer operations. This area of the examination function also has been updated to coincide with the new concepts employed by the Office in regular bank examination.

Administration

The Administration Department was reorganized during the year to consolidate the administrative and support functions of the Office. The Department now contains four divisions: Human Resources, Operations Planning, Finance and Administration, and Systems and Data Processing.

Human Resources.—The Human Resources Division is responsible for administration and implementation of the Office's personnel programs. Those programs are managed by functional program groups. Under the group concept, the Office has been successful in establishing ongoing programs in staff analysis, national recruitment, compensation, employee relations, personnel development, and staffing and operations.

To improve communications, regional directors of human resources were designated in each of the 14 regional offices. The Human Resources Division also instituted a computer-based information system which provides management with projections, personnel trends, and skill searches.

Operations Planning.—The Operations Planning Division manages the process by which each functional and operational unit prepares results-oriented operating plans for the oncoming budget year and the 3 years thereafter. Policy objectives set and updated by the Comptroller and operating goals established by functional unit heads in support of those objectives form the base for results-oriented, measurable performance targets and action programs. Unit plans are consolidated into an overall Office plan, and the performance of each unit is periodically monitored to determine the extent to which planned results are achieved.

Finance and Administration.—The Finance and Administration Division is responsible for accounting and promoting optimum utilization of the Office of the Comptroller of the Currency's financial and physical resources. Its functions are accounting, budgeting, contracting, office space leasing and management, and publications control and distribution. During this year, the Division refined the financial information system which was developed in 1976 and became fully operational in 1977. The Division also further refined the budget monitoring system which identifies potential cost-saving areas.

Systems and Data Processing.—The Systems and Data Processing Division supports operations through the development and operation of computer-based systems and the provision of management analysis services. The Division processes statistical and accounting data and designs, programs, and maintains all data processing systems, including data base management systems. During the year, the Division directed its efforts to the continued improvement and operation of the Office's information systems in three major areas: Regulation (national bank surveillance, enforcement and compliance, public disclosure); administration (human resources, Treasury payroll/personnel information); and finance (planning, budgeting, accounting).

Bank organization and structure

The Bank Organization and Structure Division is responsible for supervising the processing of bank structure applications. The first full year of operation under the Comptroller's revised corporate activity procedures, developed to improve efficiency and to expand the role of the regional offices in the decision-making process, particularly in the area of branching, has been completed. Initial review of the year's activities indicates that the new procedures have resulted in more expeditious processing of applications, more consistent application of policy, and improved analyses. It is expected that further improvement in those areas will continue.

Law Department

The Law Department, under the direction of the Chief Counsel, advises the Comptroller and his staff on legal matters arising in the administration of laws and regulations governing the national banking system. Attorneys in the Law Department deal directly with the management of national banks, with bank attorneys and accountants, and with the staffs of other Government agencies and congressional committees. The Department also participates in litigation involving the Office and exercises certain direct responsibility in enforcement and securities matters.

On January 1, 1977, 56 lawsuits were pending involving the Office. During the year, 27 new cases were filed and 28 cases were closed. As of December 31, 1977, 55 cases were pending. Fifty-five enforcement administrative actions were taken during the same period, and the Securities Disclosure Division reviewed the activities of the 340 national banks which have a class of securities registered pursuant to the Securities Exchange Act of 1934. The Legal Advisory Services Division processed 2,140 formal written inquiries during the year.

Operations review

The Operations Review Department, which functions as an internal inspector general in addition to its auditing duties, is responsible for reviewing, evaluating, and monitoring the quality and effectiveness of Office supervisory and regulatory functions.

During the year, Operations Review activity was widened to include: (1) Development and use of programs designed to assess the effectiveness and efficiency of functions other than examinations; (2) performance of investigations of a special, nonrecurring nature; and (3) implementation of review procedures for solicitation of comments from national banks. Plans were developed to reemphasize the peer review concept through the conduct of onsite reviews to assess examiner compliance with revised examination procedures.

OFFICE OF COMPUTER SCIENCE

The Office of Computer Science is the focal point for the ADP program in the Department. The Office has central management responsibilities for ADP planning, policy, and evaluation throughout the Department. Also, it furnishes computer processing and systems development services to the analytical, policy formulation, and administrative functions of the Office of the Secretary.

An integrated ADP planning and budgeting system for Treasury was developed by the Office of Computer Science in conjunction with the Office of Budget and Program Analysis. The system, built around Treasury's financial resource management system, zero-base budgeting, and the ADP financial plan, reduces the workload on the bureaus since only one submission is required for both offices rather than separate ones. It requires reporting major initiatives in the spring, planned acquisitions of all equipment in the summer, and a complete plan with supporting narrative in the fall.

The Office developed and implemented a departmental computer facility review program. One review has already been conducted in the Office of the Secretary, and the second is scheduled in the U.S. Customs Service in late 1978.

Guidelines were issued to aid data processing managers in meeting their Privacy Act responsibilities. One of the bureaus is planning to utilize the guidelines as the nucleus for a major privacy/security program.

ADP acquisition guidelines were developed to assist managers in obtaining the approval needed to acquire ADP computer equipment, software, and services. These guidelines, supplementing Treasury Directive 10-08 and Treasury's ADP Procurement Handbook, describe how to prepare feasibility studies, develop system requirements, and prepare the actual solicitation documents.

The Office aided in obtaining approval from the General Services Administration and the House Committee on Governmental Operations in acquiring larger computer systems for the Secret Service, the Detroit Data Center, and the Office of the Secretary.

The Office of Computer Science matched the processing needs of the Bureau of Government Financial Operations with excess ADP equipment from the Internal Revenue Service. This resulted in the transfer of an IBM 360/65 computer to BGFO, enabling it to release some obsolete equipment and postpone the acquisition of a new computer system for at least a year.

A Treasury directive, "Management of Data Processing in the Office of the Secretary" (TD 10-08.A), was issued in January 1978. It states the policy and delineates responsibilities for the management of ADP in the Office of the Secretary, and specifically provides for the establishment of an ADP planning process to be accomplished by the Applications Planning and Development Division for the Office of the Secretary. The first plan was completed this year along with the procedures for collecting and updating planning information.

Significant analytical and statistical support was provided to the Office of Equal Opportunity Program for the enforcement of the bank compliance program. Generalized software was utilized to provide statistical analysis on the affected class of employees of several large U.S. banks.

Workload processed by the Office of the Secretary Computer Center increased 23 percent in fiscal 1978. To provide the support necessary for such growth, the service capability of the Center was extended by increasing its

usable floor space, introducing larger capacity and more reliable equipment, and installing updated and new state-of-the-art equipment. Included in this delegation was approval to install an interim computer so that growing workload requirements can be met without any degradation in service to the user community.

OFFICE OF DIRECTOR OF PRACTICE

The Office of Director of Practice is part of the Office of the Secretary of the Treasury and is under the immediate supervision of the General Counsel. Pursuant to the provisions of 31 CFR, part 10 (Treasury Department Circular No. 230), the Director of Practice institutes and provides for the conduct of disciplinary proceedings against attorneys, certified public accountants, and enrolled agents who are alleged to have violated the rules and regulations governing practice before the Internal Revenue Service. He also acts on appeals from decisions of the Commissioner of Internal Revenue denying applications for enrollment to practice before the IRS made under 31 CFR, section 10.4.

During fiscal 1978, amendments to the provisions of Circular 230 governing solicitation and advertising were proposed. The proposed amendments, which appeared in 43 Fed. Reg. 115 dated June 14, 1978, were promulgated in light of recent judicial decisions in the area of advertising and seek to permit the expansion of advertising by practitioners before the IRS consistent with those decisions. In addition, an amendment to Circular 230 was proposed permitting individuals enrolled to perform actuarial services under the Employee Retirement Income Security Act of 1974 (ERISA) to engage in limited practice before the IRS. Notice appeared in 43 Fed. Reg. 150 dated August 3, 1978. Publication of the final rule on both proposals was pending at the end of the fiscal year.

On October 1, 1977, there were 166 derogatory information cases pending in the Office under active review and evaluation, 6 of which were awaiting presentation to or decision by an administrative law judge. During the fiscal year, 124 cases were added to the case inventory of the Office. Disciplinary actions were taken in 77 cases by the Office or by order of an administrative law judge. Those actions were comprised of 6 orders of disbarment, 36 suspensions (either by order of an administrative law judge or consent of the practitioner), 1 resignation, and 34 reprimands. The actions affected 32 attorneys, 34 certified public accountants, and 11 enrolled agents. Thirty-six cases were removed from the Office case inventory during fiscal 1978 after review and evaluation showed that the allegations of misconduct did not state sufficient grounds to maintain disciplinary proceedings under 31 CFR, part 10. As of September 30, 1978, there were 177 derogatory information cases under consideration in the Office.

During the fiscal year, 10 attorneys, certified public accountants, and enrolled agents under suspension or disbarment from practice before the IRS petitioned the Director of Practice for reinstatement of their eligibility to resume practice. Favorable disposition was made on eight of those petitions and reinstatement was granted. Two petitions remained pending at the year's end. In addition, the Director of Practice granted the petition pending from

the previous year. There were 19 appeals from denials by the Commissioner of Internal Revenue of applications for enrollment to practice before the IRS. These appeals remained pending as of September 30, 1978. There were three decisions on appeal pending from the previous fiscal year. Two decisions reversed the denial; one appeal was pending at the year's end.

Eighteen administrative proceedings for disbarment or suspension were initiated against practitioners before the IRS during fiscal 1978. Together with the 6 cases remaining on the administrative law judge docket on October 1, 1977, 24 cases were before the administrative law judge during the year. Five of those cases resulted in the acceptance of an offer of consent to voluntary suspension from practice before the IRS pursuant to 31 CFR, section 10.55(b) prior to reaching hearing. Initial decisions imposing disbarment were rendered in six of the cases. One complaint was dismissed. On September 30, 1978, 12 cases were pending on the docket awaiting presentation to or decision by an administrative law judge.

During fiscal 1978, one case was appealed to the Secretary from the initial decision by an administrative law judge. The appeal remained pending at yearend. In addition, one decision was issued by the Secretary on an appeal from the initial decision of an administrative law judge pending October 1, 1977. In that appeal, the administrative law judge's order of suspension was changed to an order of disbarment.

The Director of Practice is Executive Director of the Joint Board for the Enrollment of Actuaries. The Joint Board, formed pursuant to section 3041 of ERISA, is responsible for the enrollment of individuals who wish to perform actuarial services under the act and for the suspension and revocation of the enrollment of such individuals after notice and opportunity for hearing.

BUREAU OF ENGRAVING AND PRINTING

The Bureau of Engraving and Printing, the world's largest securities manufacturing establishment, designs and produces the major evidences of a financial character issued by the United States. It is responsible for the production of U.S. currency, postage stamps, public debt securities, and miscellaneous financial and security documents.

Finances

The regular operations of the Bureau of Engraving and Printing have been financed since July 1, 1951, by means of a revolving fund established pursuant to Public Law 656, August 4, 1950 (31 U.S.C. 181). Agencies which the Bureau serves are required to make reimbursement for all costs incidental to the performance of work or services requisitioned. Therefore, savings cited in this report mitigate the impact on those costs of generally rising labor, material, and other operating expenses.

In fiscal 1978, in accordance with Public Law 95-81, July 31, 1977, the Bureau received an appropriation of \$5 million in order to ease serious cash flow problems. This amount increased the appropriated portion of the revolving fund to a total of \$14,250,000. It was only the third time that such an appropriated increase was necessary since the inception of the fund. By

means of this fund, the Bureau financed a program involving a total projected cost for sales and services of \$130 million in fiscal 1978, as compared with \$118,592,000 in fiscal 1977.

Of long-range significance is the fact that Public Law 95-81 also authorized the Bureau to include in the charge for its products an amount to be accumulated for the acquisition of capital equipment and to provide future working capital. This authority should preclude the need to request future additional appropriations for those purposes.

During fiscal 1978, the Bureau included in the price of its products surcharges totaling about \$5,700,000—\$4,730,000 earmarked for equipment and \$970,000 recorded as additional working capital.

Currency program

Deliveries of currency in fiscal 1978 totaled 3.3 billion notes, as compared with 2.9 billion notes delivered in fiscal 1977. During fiscal 1978, the Bureau negotiated a buy-out-for-cash agreement for four high-speed intaglio printing presses that had been acquired on a lease-purchase contract. These presses are fully operational, and the agreement to buy out resulted in a savings of \$500,000. In addition, negotiations were initiated with other vendors supplying currency production equipment to the Bureau on a lease-purchase basis in an effort to produce similar savings by cash purchases of contracts.

During this period, the 1977 currency series bearing the signatures of Secretary Blumenthal and United States Treasurer Morton was introduced.

A revision in currency examining methods and procedures involving conversion to a single 16-subject examination, initiated during fiscal 1977, has been fully implemented. It is anticipated that \$1,500,000 in annual savings will be achieved.

Improvement of currency overprinting and processing methods, and refinement of production standards have contributed to a 14-percent increase in productivity, and will result in annual savings exceeding \$500,000.

Based on an economic evaluation of alternative processes, acquisition of the initial pieces of equipment that will constitute the next generation of security printing and processing equipment is proceeding. Initial procurement work is underway for the acquisition of two 50-subject currency presses which, because they represent a 56-percent increase in productivity over present 32-subject equipment, are expected to save in excess of \$1,500,000 annually. Ancillary numbering and processing equipment will also be acquired. Benefits in space and energy utilization will be realized as well.

A system has been developed to economically salvage perfect currency notes located on partially defective currency sheets. Because implementation of this proposal will reduce the volume of notes requiring destruction, it is expected to generate significant ecological benefits through reduced disposal of security waste material.

Replacement of chipboard trays and plastic bags, used for in-process transport and to secure currency, by a two-piece polypropylene box is expected to yield annual savings of \$50,000, as well as improve product security.

Typical printing errors with graphic illustrations of defective currency are described in an improved quality standard and updated training manual. The inspection accuracy program was improved to more definitively determine the effectiveness of currency examination. This program provides management quicker information for the retraining of examiners or other performance improvement.

A recently developed method of mechanical currency sheet examining has been expanded to include sheet counting and consolidating into a single operation. Plans for trimming and splitting 32-subject currency sheets are currently being formulated and will significantly increase productivity while providing greater note margin consistency. Expected savings cannot be determined without further experimentation.

An identification system compatible with automatic currency handling equipment at Federal Reserve banks (including fitness determination and detection of counterfeit notes) has been jointly selected by the Bureau and the Federal Reserve System. A contract is being negotiated by the Federal Reserve System for delivery of the equipment to the Bureau during 1980.

Postage stamp program

Deliveries of U.S. postage stamps were 28.5 billion units in fiscal 1978, as compared with 27.4 billion units in fiscal 1977. The program included production of a new series of 15-cent stamps issued in conjunction with the decision to change the prime postal rate. A supply of nondenominated stamps, some previously produced by the Bureau in anticipation of this situation, were also issued at the time of the rate change in order to meet the surge in demand for stamps at that time.

To determine public acceptance of a small-size postage stamp, the U.S. Postal Service authorized the issuance of the 13-cent Indian Head Penny Special Issue Stamp as an experiment. These stamps were printed in 600-subject sheet size (as opposed to normal 400-subject), and public reaction was favorable. Based on the results of the initial experimental issue, the Postal Service proposes to authorize additional issues of smaller size stamps in the future.

Installation and acceptance trials of six postage stamp booklet-forming machines were concluded during fiscal 1978. All machines are fully operational and are utilized for producing vending and over-the-counter postage stamp booklets.

An automatic labeling system, designed to affix pressure sensitive labels to coils of 100's, was installed in the Coil Manufacturing Section. The system, consisting of 9 machines, attains the same productivity as 12 machines previously required. A significant reduction in energy demands was realized since the new system requires no heating application. Additionally, methods improvements and the efficiency of the system will result in estimated savings of \$270,000.

The pile delivery on the L perforating machine was converted from a manual operation to a fully automated system, and is used to perforate approximately 25 percent of the annual postage stamp sheet production requirements. This system was developed from an in-house design and has reduced manpower requirement by 50 percent, resulting in annual savings of about \$16,000.

An innovative package for postage stamp booklets produced on the newly acquired booklet-forming machines was accepted and approved by the Postal Service. The design is a foldout tray containing popup divider panels made from inexpensive chipboard. This development enhances the integrity of the package and allows for improved security and accountability of its contents upon receipt at field post offices. Installation of a Bureau-designed system for the automatic subpackaging and overwrapping of postage stamp booklets is planned for fiscal 1979.

Improved handling methods have been developed for reducing the personnel complement required to load postage stamp coils into trays for packaging.

Annual savings of approximately \$310,000 are anticipated until the next generation of coil manufacturing and packaging equipment is operational.

Installation of a hydraulic roll splitter has significantly improved the operation for destruction of mutilated postage stamp rolls. Annual recurring savings of approximately \$15,000 are anticipated.

Improvement was made to the inspection accuracy program used to determine the effectiveness of postage stamp sheet examination. It provides more rapid management information for the retraining of examiners or other performance improvement.

Quality standards have been developed for the newly installed postage stamp booklet-forming equipment. These are designed to provide ready reference to operating personnel for maintaining required quality standards.

Research was conducted into the feasibility of reducing to one, from two or three, the number of sets of engraved cylinders currently required to produce a postage stamp issue by the gravure process. Studies revealed that a systematic method of dechroming and rechroming the original set of cylinders increased the lifespan so that the majority of commemorative issues required only one set of cylinders. Based on the average number of such issues printed by the Bureau by the gravure process, preliminary cost estimates indicate a recurring annual savings of approximately \$120,000.

Platemaking

A study was initiated in 1976 to determine the feasibility of reducing the 24-hour time cycle required for platemaking operations. After considerable modification of the work processes and the platemaking equipment, the operation was accomplished on a two-shift basis in January 1977. The technology developed included automation of several aspects of electroplating such as automatic temperature control, tank level, and ampere-hour limiting of current flow. By January 1978, it was possible to complete the platemaking activity on a single work shift. Annual savings of \$210,000 were realized. In addition, increased productivity and improved product quality and utilization of personnel were achieved.

Inks

Major formula variations have been made for the black and green currency intaglio inks in order to improve suitability and comply with environmental requirements. Similarly, a number of postage stamp inks have been reformulated to improve quality and to address changing raw material availability and environmental considerations.

A trial is being conducted to determine the feasibility of purchasing currency intaglio ink bases from commercial sources. This will provide research referencing to state-of-the-art ink-making technology, possibly reduce costs associated with ink manufacturing, printing, and processing, and improve the ink-manufacturing work environment by some elimination of dry pigments handling.

Efforts to develop water wipeable intaglio stamp inks have been successful and this expertise has been applied to a research and development program for water wipeable intaglio currency inks. Progress to date has been encouraging, and initial studies indicate resultant cost reduction in currency production by such conversion.

Long-range studies are underway to determine whether alternative imaging systems could reduce costs and provide higher quality products. These areas

involve the use of an excitation source such as electron beam curing, to effect immediate drying of the imaging materials as printed on the various substrates.

Food coupon program

The Bureau continues to exercise responsibility for administering contracts awarded to two private banknote companies for the production of food coupons for the Department of Agriculture. During this period, the Bureau provided the Department of Agriculture with technical assistance and rendered services in the areas of quality control, security, contract negotiating, accountability procedures, and financial management. In addition, periodic unscheduled audits have been made at the contractors' plants to verify that the prescribed quality and security standards are maintained.

Specifications were prepared, bids solicited, and a contract awarded for the production of a new \$10 food coupon book containing six coupons (five \$1 and one \$5), to be issued early in the next fiscal year.

Alien identification card

On March 25, 1977, production of the resident alien identification cards was begun for the Immigration and Naturalization Service. The central facility for fabrication of the cards initially established at the Bureau was transferred to a new location in Arlington, Tex., in July 1978.

Gasoline rationing program

In conjunction with the congressional requirement that the Department of Energy prepare a contingency gasoline rationing program, the Bureau has provided technical advice regarding the design of a secure rationing document, and data regarding private and public sector capabilities to produce the volume of documents required to meet projected program demands.

Forensic science research and development

A cooperative effort with another Government agency has led to the development of new types of distinctive red and blue fibers used in the manufacture of currency paper. During the next fiscal year, subsequent to the scheduled production of the fibers, the contracting agency will continue in cooperative research efforts to develop other fiber variations.

Bureau input is provided to contractual research being conducted by the National Bureau of Standards for defining parameters leading to extended currency circulation life. This can conceivably lead to the development of alternate paper fiber compositions more technically appropriate to end-use requirements and to raw materials cost reduction.

Forensic laboratory techniques have included research and the acquisition of instruments to improve capability for associating evidentiary materials relative to counterfeiting for the U.S. Secret Service.

Electronic processing programs

The systems definition for the prototype currency examining machine has been completed. Hardware and software elements are being assembled by the contractor and the prototype machine is scheduled for delivery during 1980.

The breadboard model and systems definition for an electronic counting system have been completed and the laboratory model for testing purposes will be ready for delivery to the Bureau in 1979.

An active development program is underway to apply the state-of-the-art electronic technology for (a) detection of inverted sheets at press, (b) identification and verification of numerical sequence of currency sheets, and (c) improved systems for drying security printings.

Security program

A new security access control system, replacing the pass-badge system, with perimeter card readers, provides for enhanced overall physical security control, restricts personnel movement into and within sensitive areas, and will eliminate the time-consuming system of handwritten logs for recording personnel movement. A compatible minicomputer to provide for incorporating anti-intrusion and fire alarms in the system is under consideration.

A handbook of security measures for self-protection, and for safeguarding property and home, was developed and the proposed manuscript has been endorsed by the Under Secretary of the Treasury for publication and distribution to all employees of the Department.

Safety program

About 5 percent of all Bureau employees have been trained in the techniques of cardiopulmonary resuscitation.

In the area of industrial hygiene, the Bureau has expanded its hearing conservation program. Audiometric tests will be given to all employees to establish base data as to their present hearing capability, with periodic testing to ascertain possible hearing loss. The frequency of testing will be predicated upon the employee's work environment. In addition, the Bureau is acoustically treating areas where excessive noise levels cannot be reduced by engineering design.

During fiscal 1978, lost-time cases associated with employee accidents were reduced by 15 percent from the previous fiscal period, reducing the Bureau's payment to the Office of Federal Workers' Compensation by \$260,000.

Internal audit program

An intensive program of internal audit provides for the evaluation and reexamination of operational and financial efficiency, economy, and internal control adequacy, as well as audit reviews of the financial accounts and reports, and ensures compliance with prescribed regulatory directives. During fiscal 1978, 67 reports of audit were published. Three hundred and twenty-seven recommendations for possible improvements were referred for management consideration. Coverage included fiscal and management-type audits and reviews of operations and programs conducted on a scheduled, special, and unannounced basis.

Personnel management

Traditionally, the position of plate printer has been filled in accordance with criteria prescribed by the Civil Service Commission and related Federal hiring requirements. In addition to the recruitment of qualified journeymen, an intensive 4-year apprenticeship program, including classroom and on-the-job training, is utilized to provide the required complement of journeyman plate printers. To augment these usual methods of selection and training, the position of intermediate plate printer was established. This will provide a recruiting supply of experienced press operators, and will reduce the period of time for a candidate to achieve journeyman plate printer's status from 4 years to 1. The position has been advertised with response from applicants

from all parts of the United States. Initial screening of applications will be made by a panel of experts approved by the Civil Service Commission, after which the potential candidates will be evaluated for final selection. Although the Bureau will continue to recruit and train candidates through the 4-year apprenticeship program, the establishment of the intermediate plate printer position will provide management with greater flexibility in filling these craft positions in order to meet short-term production requirements when an adequate supply of journeymen is unavailable.

Reorganization of supervisory positions throughout the Plate Printing Division has resulted in the abolishment of the position of plate printer foreman and the establishment of the positions of plate printer assistant foreman and plate printer general foreman. Under the reorganization plan, the 23 foreman positions will be replaced with 20 assistant foreman positions charged with responsibility over operating sections, and the 3 general foremen will be responsible for overall coordination of division operations on each of the 3 work shifts. While the salary rates of the former position of foreman and the newly established position of general foreman are identical, the salary rate for the position of assistant foreman will be 10 percent less than the prevailing rate for foreman. An annual recurring savings of \$150,000 will result.

Management development

As part of an effort to improve management effectiveness, the Bureau initiated a team-building and action planning process within the top management staff as well as specific divisions. After a preliminary organizational assessment that identified factors inhibiting maximum effectiveness, participants shared concerns and ideas for improvement and engaged in group problem solving. Specific objectives were to enhance communications and to promote cooperation in order to clarify roles, functions, and responsibilities.

Labor-management relations

The Bureau continues to foster constructive and harmonious relationships with its employees and the 17 bargaining units which represent them. In keeping with the spirit and intent of Executive Order 11491, as amended, management deals with 16 AFL-CIO affiliate unions representing 25 distinct craft groups, a noncraft unit, and a guard unit. One independent union represents the GS clerical/technical unit. Fourteen substantive negotiated labor-management agreements are now in force.

Training courses and seminars were held for each level of supervisory and management personnel to further improve the Bureau's record of effectiveness in negotiating with labor organizations and in dealing with labor relations matters.

Awards

During fiscal 1978, 1,222 employees received special achievement awards and 27 employees received high quality pay increases. Under the employee suggestion phase of the program, 150 suggestions were received, of which 57 were adopted with tangible savings of \$14,500. Twenty-nine summer employees were granted awards in recognition of their superior performance.

Performance evaluation system

The Bureau's performance evaluation system and incentive awards program are being redesigned to provide for regular dialog between supervisors and employees on factors germane to specific job performance. The redesigned

incentive awards plan relates directly to measurable individual or group contributions to improved organizational performance, and provides a more effective tool for recognizing such contributions.

Equal employment opportunity program

The Bureau continues to make progress in the advancement of minorities and women. One of several significant first accomplishments included the promotion of a black woman to the top line management position of Assistant Director (Operations), GS-16.

Numerical recruitment goals were established for occupations with under-represented percentages of minorities and women. Nine of the 17 identified goals had been accomplished by July 1978. The composition of the Bureau's work force continued to remain close to the availability of minorities and women in the local recruitment area, with employment constituting 72 percent blacks and 38 percent women.

Career development

Thirty-seven employees applied for three new positions identified to be filled through the CADE (upward mobility) program. Applicants were evaluated by the assessment center process and supervisory ratings. Individual development plans are being formulated for the three successful candidates, and counseling was afforded to all applicants.

Treasury payroll/personnel information system

During fiscal 1978, the Bureau successfully transferred the computation and processing of its payroll and personnel information to the Treasury payroll/personnel information system located at the Bureau of the Mint facility in San Francisco.

Service to the public

The Bureau continues to be one of the major attractions for visitors to the Washington area. During fiscal 1978, over 500,000 visitors utilized the self-guided tour facilities of the Bureau.

During the fiscal year, exhibits of securities were provided for five scheduled philatelic and numismatic events.

OFFICE OF EQUAL OPPORTUNITY PROGRAM

The Office of Equal Opportunity Program assists the Secretary and the Assistant Secretary (Administration) in the formulation, execution, and coordination of policies relating mainly to two programs: (1) The equal employment opportunity program for Treasury employees, and (2) compliance surveillance of the equal employment policies and programs of those financial institutions that are Federal depositaries or issuing and paying agents of U.S. savings bonds and U.S. savings notes. The President has expressed his intention to sign an Executive order in October 1978 consolidating the contract compliance program under the Department of Labor, thus relieving Treasury of the responsibility for this program.

Federal equal employment opportunity program

This component of the Office's program is concerned with administering Department-level equal opportunity program efforts for all of Treasury's employees. See the following table for a breakout of this work force by grade groups.

Department of the Treasury full-time employment by minority group status

	1968	1972	1974	1976 ^r	1977	Comparison 1976-1977		Comparison 1968-1977	
						No.	Percent	No.	Percent
Total employees*	82,155	102,813	114,686	122,003	123,472	1,469	1.2	41,317	50.2
Black.....	11,777	15,619	18,216	19,430	19,904	474	2.4	8,127	69.0
Hispanic.....	1,052	2,247	3,437	3,657	4,417	760	20.7	3,365	319.8
Native American.....	79	128	175	196	194	-2	-1.0	115	145.5
Asian American.....	482	813	1,230	1,219	1,330	111	9.1	848	175.9
Other.....	68,765	84,006	91,628	97,501	97,627	126	.1	28,862	41.9
GS 1-4:									
Total.....	19,120	24,126	25,526	27,531	28,051	520	1.8	8,931	46.7
Black.....	4,947	5,904	6,679	6,347	6,600	253	3.9	1,653	33.4
Hispanic.....	255	791	1,065	1,205	1,426	221	18.3	1,171	459.2
Native American.....	25	45	84	49	47	-2	-4.0	22	88.0
Asian American.....	80	159	181	197	247	50	25.3	167	208.7
Other.....	13,813	17,227	17,517	19,733	19,731	-2	-.01	5,918	42.8
GS 5-8:									
Total.....	19,480	27,601	33,295	31,643	32,977	1,334	4.2	13,497	69.2
Black.....	2,708	4,290	5,569	5,914	6,112	198	3.3	3,404	125.7
Hispanic.....	264	551	1,008	988	1,135	147	14.8	871	329.9
Native American.....	26	35	50	51	54	3	5.8	28	107.6
Asian American.....	141	249	445	342	385	43	12.5	244	173.0
Other.....	16,341	22,476	26,223	24,348	25,291	943	3.8	8,950	54.7
GS 9-12:									
Total.....	28,893	32,321	35,580	38,136	37,960	-176	-.4	9,067	31.3
Black.....	1,144	1,587	2,050	2,693	2,920	227	8.4	1,776	155.2
Hispanic.....	332	519	803	881	956	75	8.5	624	187.9
Native American.....	21	34	44	58	59	1	1.7	38	180.9
Asian American.....	186	222	368	391	409	18	4.6	223	119.8
Other.....	27,210	29,959	32,315	34,113	33,616	-497	-1.4	6,406	23.5
GS 13-18:									
Total.....	9,491	12,037	13,257	13,598	13,934	336	2.4	4,443	46.8
Black.....	151	307	399	473	511	38	8.0	360	238.4
Hispanic.....	35	88	136	135	151	16	11.8	116	331.4
Native American.....	3	8	16	16	15	-1	-6.2	12	400.0
Asian American.....	55	90	105	124	134	10	8.0	79	143.6
Other.....	9,247	11,544	12,601	12,850	13,123	273	2.1	3,876	41.9

^r Revised.

* The totals include wage board personnel. Grade comparisons are for GS series only.

Efforts are being focused on the development of a unified framework for achieving measurable EEO program results. These include:

1. The issuance of memoranda from the Secretary, Assistant Secretary (Administration), and bureau heads outlining top management commitment and support for the EEO programs and structuring a system of accountability at the highest levels in the Department.

2. The inclusion of EEO objectives in the overall zero-base budgeting objectives for each bureau, thereby utilizing the zero-base budgeting objectives system for the integration of the EEO program into the total departmental

management process. This provides for quarterly review at the highest management levels to track program progress and problems.

3. Organizational relocation of the EEO function in four of Treasury's largest bureaus, the IRS, Customs, Alcohol, Tobacco and Firearms, and Mint, so that the EEO officer has direct access to the bureau head and other top management officials.

The Department has made considerable progress in the expanded usage of special hiring authorities in the cooperative education program. Also, there has been increased use of the bilingual certification program for public contact positions, particularly in the IRS, Alcohol, Tobacco and Firearms, and Customs, to increase Hispanic employment.

A directives manual chapter outlining criteria for bureau nomination of employees and managers for a departmental EEO award has been developed. The award will be presented in January 1979.

Six personnel management evaluations of the bureaus' EEO operations have been completed, and five are planned for the balance of calendar year 1978. These survey efforts amplify the personal commitment of the Secretary and provide a regular context for learning about the accomplishments of each bureau, thus closely monitoring progress against stated goals.

Contract compliance program achievements

Minority employment in the banking industry has increased from 4.4 percent to 17.4 percent since 1966. Women, who comprise 65.6 percent of the industry work force, have doubled their representation in the "officials and managers" category since 1971 from 13 percent to 26 percent. Though fiscal 1978 activities have been curtailed by the need to prepare for the upcoming move to the Department of Labor, the Office has conducted to date 102 reviews with 96 still in progress. Financial institutions have signed 67 conciliation agreements committing a total of \$176,805 in major monetary adjustments, including backpay for relief of affected minority and women employees. The year's activities have produced 19,121 women and 4,887 minority hires and promotions.

FEDERAL LAW ENFORCEMENT TRAINING CENTER

The Federal Law Enforcement Training Center (FLETC) is an interagency training facility formally established as a Treasury bureau on March 2, 1970, and is under the supervision of the Assistant Secretary (Enforcement and Operations).

The Department of the Treasury is the lead agency for operating the Center and supervises its administrative and financial activities. Training policy, programs, criteria, and standards are established by a Board of Directors comprised of eight members at the Assistant Secretary level representing the major agencies which have organizations participating in the Center. Five are voting members—1 each from the Departments of Interior, Justice, and Treasury; 1 from the General Services Administration; and 1 representing the several other participating organizations with less than 500 law enforcement officers. Three are nonvoting members—one each from the Office of Management and Budget, the U.S. Civil Service Commission, and the U.S. Capitol Police Board.

The Center conducts basic and common advanced courses in criminal investigator and police training for the participating organizations. In addition, facilities and support services are provided so that participating organizations may conduct advanced, inservice, refresher, and specialized (AIRS) training for their own law enforcement personnel. Currently, 36 enforcement organizations, representing most major executive departments, independent agencies, and the legislative branch, participate in FLETC programs. In fiscal 1978, the Public Safety Service and Land Between the Lakes Patrol of the Tennessee Valley Authority, and the Amtrak Northeast Corridor Police Department began participating in the Center's programs. The Center also furnishes training on a space-available, reimbursable basis to personnel from other Federal, State, and local agencies.

The consolidation of Federal law enforcement training at the Center has resolved many of the difficulties previously encountered in the search for high-quality, cost-effective, standardized training. The continuing growth of the Center and plans for additional consolidation have thrust the Center into a position of national leadership in law enforcement training. The Center is meeting the responsibilities inherent in this leadership position, as it provides the programs and facilities to meet the changing law enforcement training needs of today, and prepares to meet the demands of the future.

Training and support facilities

In May 1975, the Congress authorized the expenditure of \$30 million for the adaptation of the former Glynco Naval Air Station as the facility for the FLETC. In September 1975, the Center relocated from the Washington, D.C., area to the former naval air station, located on the southeast coast of Georgia near the city of Brunswick. Many of the existing Navy facilities at the 1,500-acre site were renovated or modified to accommodate various training and support activities such as administrative offices, classrooms, instructor offices, dormitories, dining hall, instructional services (photolab, graphic arts, and TV production), motor pool and garage, printshop, interim physical training and driver training areas, indoor and outdoor practical exercise areas, and outdoor firing ranges.

Major construction projects started during fiscal 1978 include a new 96-point indoor firing range, a new classroom building, an expansion and modernization of the physical training complex, an expansion of the dining hall, and a new energy distribution system. Construction projects completed during fiscal 1978 include conversion of former Navy family housing units to quarters for visiting instructors, renovation of the former Navy officers club for use as a student center and registration area, renovation of several existing buildings to accommodate office space for representatives of the participating organizations, conversion of a former Navy barracks to a classroom building, and two new student dormitory buildings. In addition, 31 two-story townhouse buildings were transferred to Treasury from the General Services Administration, and are in use as student housing. Construction of a new driver training course will begin during fiscal 1979, with all master plan construction scheduled for completion by December 1979.

Training programs

Criminal investigator training.—During fiscal 1978, 19 basic 7-week criminal investigator classes were conducted and 824 students graduated. In addition, the Criminal Investigator Training Division (CITD) staff continued to provide instructional support as needed to the agencies conducting AIRS training at the Center.

Several texts and practical exercises used in the CITD program were revised to keep pace with changes and new developments in the criminal investigator field. A new felony car stop course with practical exercises and a new questioned documents course were developed and implemented. The CITD staff coordinated the planning and preparation of a white collar crime seminar for investigators. All training divisions at the Center, as well as participating organizations, contributed manpower and resources to the development of the curriculum for this seminar. It is expected to be offered for the first time during early fiscal 1979.

Police training.—During fiscal 1978, the Police Training Division (PTD) conducted 55 classes and graduated 1,797 students—a 34-percent increase in the number of classes and a 46-percent increase in students graduated over the previous fiscal year.

PTD staff members headed a task force to design and develop a training program to specifically meet the basic training needs of law enforcement agencies engaged in land management and recreation. The development of this program was completed during fiscal 1978. The first course will be conducted by PTD during early fiscal 1979.

In addition, the PTD staff continued to review and revise existing programs with the objective of acquiring additional equipment and materials to increase the realism of practical exercises.

Special training.—The special training programs in driving, firearms, and physical activities support the basic training divisions and the AIRS programs. During fiscal 1978, the number of students participating in Special Training Division (STD) programs increased substantially over fiscal 1977.

The staff of each of the branches of STD continued to revise and update lesson plans and course outlines to incorporate the most recent teaching techniques and law enforcement procedures. The Physical Training Branch instituted changes in the standard first-aid course to conform to the American Red Cross procedural changes regarding airway obstructions and the saving of choking victims. The Driver Training Branch designed and began using a new and improved evasive maneuvering course to test the driving skill and dexterity of students. The Firearms Training Branch restructured the instinctive and decision reaction courses to allow more students to participate at one time, began the experimental development of three-dimensional targets to add additional realism to the training, and began planning for a firearms instructor course to be offered as a Center-conducted AIRS program.

Advanced, inservice, refresher, and specialized training.—During fiscal 1978, AIRS training accounted for 27 percent of the man-weeks of training conducted at the Center. During the year, 4,100 students graduated from the various AIRS training programs, representing a 15-percent increase over fiscal 1977. A significant portion of the Center's services, facilities, and personnel was devoted to supporting these programs conducted by the participating organizations. The greater percentage of the AIRS programs was conducted by the Bureau of Alcohol, Tobacco and Firearms, National Park Service, Internal Revenue Service, U.S. Marshals Service, Federal Protective Service, and the U.S. Fish and Wildlife Service.

Training support

A word processing system has been developed and implemented to automate the preparation of student records, examinations, and certificates. The design of a computerized student registration system was initiated during fiscal 1978, and will result in more timely service to students and a more efficient method of collecting student data.

A student athletic and recreation program was funded and initiated for the

first time during fiscal 1978. It is designed to provide activities for students during nontraining hours. In addition to providing an outlet for student energies and contributing to their physical development, this program complements the instructional programs by creating a more complete living and learning environment.

Audiovisual support for the training activities was improved substantially during fiscal 1978 by the installation of audiovisual projection booths and improved remote controls in classrooms. In addition, several films used in the judgment pistol shooting portion of firearms training have been converted to video tape, resulting in a 50-percent reduction in the time required for training. Several video tapes used as training aids were produced by the Center staff for the first time. The volume of other audiovisual, graphic, and photographic support activities provided during the year increased substantially to keep pace with the increase in the number of students trained.

The Office of Research and Evaluation was created and staffed during fiscal 1978. This Office conducts research, program planning, program and curriculum analysis and evaluation, long-range planning, and faculty development courses of instruction. The Office has added significantly to the Center's capability to insure that training programs are of the highest quality and adequately meet the training needs of the participating organizations.

Administration

The impact of an increasing number of students made necessary the development of a supplement to the original environmental assessment of fiscal 1976. This supplement was prepared and approved in fiscal 1978.

An audit of the Center's financial activities for fiscal 1977 was conducted by auditors of the Bureau of Alcohol, Tobacco and Firearms. The audit found that financial operations were being carried out in a satisfactory manner.

The Center's outdated telephone system, originally installed by the Navy in 1942, was replaced by a new Dimension PBX system. The new system not only effects a 33-percent reduction in switchboard operator requirements, but also provides improved service. Data for the Treasury payroll/personnel information system can now be transmitted via telephone line.

A comprehensive occupational safety and health action plan for the Center was developed and implemented during fiscal 1978.

The Center's equal employment opportunity program received increased emphasis during fiscal 1978. A complete analysis of the work force resulted in a validation and revision of hiring and promotion goals.

Graduate and undergraduate student intern programs were developed and coordinated with regional colleges and universities, with the first interns being assigned to the Center during fiscal 1978.

Management improvement

The Center continued the trend of reducing the training cost per student during fiscal 1978. This fact is especially significant considering the simultaneous enhancements which occurred in training programs, support activities, and facilities. This cost reduction is due to economies achieved through the consolidation of programs and facilities, increased productivity by staff, and the Center's ability to obtain funding for student travel and en route per diem.

A management information system was developed and implemented during the year. This system collates and organizes data reflecting all aspects of the Center's operations. It provides pertinent information necessary for management review of existing operations and improvement of the decisionmaking process.

FISCAL SERVICE

Bureau of Government Financial Operations

The functions of the Bureau are Government-wide in scope. It disburses by check, cash, or other means of payment for most Government agencies; settles claims involving loss or forgery of Treasury checks; manages the Government's central accounting and financial reporting system by drawing appropriation warrants, by maintaining a system of accounts for integrating Treasury cash and funding operations of disbursing and collecting officers and of Government program agencies including subsystems for the reconciliation of check and deposit transactions, and by compiling and publishing reports of budget results and other Government financial operations; provides banking and related services involved in the management of the Government's cash resources; under specified provisions of law is responsible for investing various Government trust funds; oversees the destruction of currency unfit for circulation; provides central direction for various financial programs and practices of Government agencies; and directs a variety of other fiscal activities.

Disbursements and check claims

During fiscal 1978, the Division of Disbursement operated 11 disbursing centers servicing over 1,400 Federal administrative offices throughout the United States and in the Philippines. The Division also rendered disbursing services for embassies located in Central America, South America, and the Far East. In addition to its disbursement activities, the Division prepared and distributed Federal tax deposit forms for the Internal Revenue Service.

Management improvements and significant achievements.—The Division of Disbursement has been phasing in the presort program since November 1976. To obtain a 2-cents-per-item postage discount, checks are released to the Postal Service in ZIP code sequence permitting direct shipment to the delivery points. The Division is presorting each month an average of 35 million social security, supplemental security income, veterans compensation and pension, and railroad retirement checks, as well as approximately 45 million tax refund checks during the peak period of March through June. Since the inception of the program, there has been a postage discount of \$4,979,390 with a net savings of \$4,460,009 after operating costs. During fiscal 1979, the Division will begin presorting veterans education and civil service annuity checks, thereby adding approximately 1,360,000 to the monthly volume of presorted payments and increasing the net savings to a total of \$8 million.

The conversion of income tax refund nonreceipt claims from a manual operation to a magnetic tape transmission system was an important accomplishment. Stop payment requests for the social security, supplemental security income, and income tax refund programs processed under the tape claims system totaled 578,828, or approximately 38 percent of the total stop payments requested during the year. Veterans Administration, Civil Service Commission, and Railroad Retirement Board claims are scheduled for conversion to the system in fiscal 1979. The Division also began to research payment-issue information by computer for approximately 80 percent of the social security claims. As a result, manual microfilm operations have been

significantly reduced, and the Division is able to accomplish initial identification of the specific payment involved in less than 24 hours.

In fiscal 1978, 87,839,410 social security, railroad retirement annuity, civil service annuity, veterans compensation and pension, miners benefit, and revenue sharing payments were issued using Treasury's electronic funds transfer recurring payment system (EFT). EFT, a major element of the direct deposit system, permits the rapid computer-assisted transfer of funds between the Treasury, Federal Reserve banks, and member banks. Extension of EFT system to Federal salary payments was begun in September 1978 for one agency office, the National Aeronautics and Space Administration, Langley, Va. Two more agency payroll systems have been selected to participate—the Small Business Administration beginning February 1979, and the Veterans Administration beginning by midsummer.

A total of 5,671,627 payments were issued in fiscal 1978 using optical character recognition (OCR) equipment. In an OCR system, payment data typed on voucher schedules is captured electronically by an optical scanner and then transferred onto a magnetic tape for computer preparation of the checks. The eventual conversion of all manual payments to OCR processing is a primary goal of the Division of Disbursement.

Beginning in mid-fiscal 1979, all social security payments will be issued from the disbursing center nearest the delivery point. Expected benefits from geographic disbursement of checks include expedited delivery of social security payments, a more equitable distribution of workload among the disbursing offices, an increase in the number of payments eligible for the presort program, and improved delivery of EFT payments. Under geographic disbursement, each disbursing office will service only those Federal Reserve banks that fall within certain geographic areas; therefore, fewer payment tapes will need to be created.

Disbursing operations.—During fiscal 1978, a total of 687,455,206 checks, savings bonds, adjustments and transfers, and EFT payments were issued under Treasury's centralized disbursing system at an average cost of \$0.0444. In addition, 128,782,057 Federal tax deposit forms were prepared and mailed.

The following table is a comparison of the workload for fiscal years 1977 and 1978:

Classification	Volume	
	1977	1978
Operations financed by appropriated funds:		
Checks and electronic funds transfers:		
Social security benefits	379,493,103	390,317,774
Supplemental security income payments	51,957,379	52,050,282
Veterans benefits	77,772,027	76,410,883
Income tax refunds	68,005,540	69,399,321
Veterans national service life insurance dividends	2,956,546	2,278,299
Other	71,593,135	73,115,661
Savings bonds	7,896,031	7,966,722
Adjustments and transfers	243,986	249,471
	<u>659,917,747</u>	<u>671,788,413</u>
Operations financed by reimbursements:		
Railroad Retirement Board	13,705,160	13,871,202
Bureau of the Public Debt (General Electric Co. bond program)	1,684,412	1,795,591
Total workload—reimbursable items	<u>15,389,572</u>	<u>15,666,793</u>
Total workload	<u>675,307,319</u>	<u>687,455,206</u>

Settling check claims.—An automated reclamation system was implemented in the Division of Check Claims in mid-August. Under this system requests for refunds from commercial banks, which cashed fraudulently endorsed checks, are computer generated and followup demands are automatically generated. It is expected that this will significantly improve the cash flow for such items.

The check truncation system wherein the Federal Reserve banks microfilm Treasury checks and provide a magnetic tape of the payment data has resulted in claims being processed more quickly since the actual check does not have to be retrieved from a storage facility.

Claims modernization project.—Substantial progress has been made in the project initiated in December 1976 to improve and modernize the processing of claims for Treasury checks. A system developed in January 1977 to track claims-processing time has been refined to provide a more detailed indication of Bureau timeliness and effectiveness in taking settlement action on claims. The tracking system has also been expanded to cover other claims-processing functions which are now being reviewed for improvement. Negotiations are continuing with the Social Security Administration and other agencies with regard to improving the timeliness of claims processing under their control.

Arrangements were completed in January 1978 with the Internal Revenue Service whereby claim data on tax refund checks is submitted to disbursing offices on magnetic tape rather than paper documents. This system also includes claims received through the Social Security Administration, and negotiations are continuing for coverage of claims for checks processed by other major program agencies. Plans call for additional automated systems designed to further support claims-related operations and to improve management control.

Public Law 95-380, approved September 22, 1978, authorized issuance of substitute checks without undertakings of indemnity except as the Secretary of the Treasury may require. Implementation of this change will serve to protect the interests of the United States while avoiding any unnecessary delays and paperwork in issuing substitute checks to payees whose original checks have been lost or stolen. A comprehensive review of other statutes relating to claims processing has been initiated to identify further legislative initiatives which could be taken to achieve more effective and efficient service to the public.

Check claims operations.—During fiscal 1978, there were 1.5 million requests to stop payment of Government checks or to obtain information about check status. This resulted in 452,314 paid-check claims acted upon, including 69,304 referred to the U.S. Secret Service for investigation because of forgery, alteration, counterfeiting, or fraudulent issuance and negotiation. Reclamation was requested from those having liability to the United States on 120,618 checks.

During the year, 41,818 paid-check claims resulted in settlement checks to payees totaling \$12.8 million; 6,693 resulted in settlement checks to endorsers totaling \$2.1 million and 42,637 claims resulted in payments to other agencies of \$10.3 million for death and nonentitlement cases. In addition, 541,088 substitute checks were authorized to replace checks that were lost, stolen, destroyed, or not received.

Government-wide accounting

Government accounting systems.—Prototype consolidated financial statements covering fiscal 1976 and the transition quarter were released early in fiscal 1978. Publication of the statements is the result of an experimental undertaking aimed at extending accrual accounting concepts to governmental accounting. This undertaking is intended to contribute to the improvement of

accounting at all levels of government and to the development of accounting standards for public financial reporting by government entities. The inter-agency Advisory Committee on Consolidated Financial Statements, consisting of top-level representatives from various Government agencies and headed by the Comptroller General, continues to work on developing practical solutions and implementation procedures for some of the major problem areas such as valuation of assets, retirement system liabilities, allowance for losses on accounts and loans receivable, accrual of taxes, and inflation accounting. The results of the work of the task groups for the problem areas will be reflected in the fiscal 1977 and future reports.

A number of systems improvements were made to standardize and thus reduce the amounts of paperwork required for transactions flowing through the Treasury daily transcript and transit accounts. Changes have been completed to eliminate transactions involving transit accounts for the Bureau of the Public Debt's bond adjustments and for charges of food stamp coupons and postal money orders. Under the new system these items are charged directly to the appropriate agency location codes rather than transit accounts, resulting in a reduction of over 25,000 documents per year. A similar procedure was developed for erroneously paid checks. This procedure alone produced a reduction from 14,000 to 300 documents per year. Previously, the reclamation refund tickets were treated as deposit tickets on the daily transcript. A system change was made so that the amounts on the tickets are totaled and deposited on one standard deposit ticket each day. The reclamation refund ticket forms are forwarded directly to the Division of Check Claims by the Federal Reserve banks to support the confirmed copy of the deposit ticket. This change reduced the processing of forms on the daily transcript from 144,000 to 7,200 documents per year.

On January 1, 1978, a new procedure was implemented for agency transfers of withholdings and contributions for health benefits, group life insurance, and civil service retirement to the Civil Service Commission (CSC). Payment is accomplished by a journal voucher prepared by the Government agency which also reports the deposit to a CSC receipt account on its monthly statement of transactions. The agency forwards to CSC the completed journal voucher at the time the withholdings and contributions are collected during the month. At monthend, CSC reconciles the document to the amount reported to its receipt account by the agency. This change eliminated the processing of approximately 30,000 checks each year. The functioning of checks through commercial banks costs the Federal Government \$1.5 million per year in interest. Based on information provided on the journal voucher document, CSC invests the amounts in three trust funds. Under the check procedure the trust funds were losing \$1.2 million per quarter of interest on their investments due to the timing lag of receiving and depositing checks.

The BANK ON US promotional campaign that was first implemented in the Bureau in fiscal 1977 was expanded to a Department-wide campaign in fiscal 1978. The increase in the number of employees authorizing their salary checks to be sent directly to financial organizations as a result of that campaign will eliminate an additional 135,000 checks each year from the Treasury payroll alone. With the success of the Treasury campaign, BANK ON US was introduced Government-wide, and virtually every department or agency not already promoting this payroll option will be participating in a Government-wide BANK ON US campaign early in fiscal 1979.

Under regulations governing withholding of District of Columbia, State, city, and county income or employment taxes by Federal agencies (31 CFR 215), the Secretary of the Treasury has entered into tax withholding agreements with 41 States and 49 cities or counties. Public Law 95-365,

September 15, 1978, extends mandatory withholding to Federal employees who are residents of cities and counties where a withholding agreement is in force. Formerly, mandatory withholding was required only for employees regularly employed within the taxing jurisdiction.

A deposit-in-transit maintenance plan was drafted disclosing procedures to achieve 100 percent Government-wide use of the SF 215 "Deposit Ticket" and the SF 5515 "Debit Voucher" by February 1, 1979. Salient features of the plan include the use of written correspondence, meetings, and personal contacts to reinforce the need for compliance and a program to retire stocks of unacceptable forms. In a related area, a study was made of various ways the Treasury could assist agencies in revising their procedures to limit the number of SF 215's submitted to one per day.

In an ongoing effort to assist in the reduction of Government directives, the Bureau is codifying into the Treasury Fiscal Requirements Manual all Division of Disbursement circulars pertinent to the interests of Government departments and agencies. In addition, the Bureau is responsible for 175 Treasury Department circulars. A number of the Treasury circulars are being codified in the TFRM with the remainder classified as rescinded or inactive. The Fiscal Service Regulations were also reviewed and, as a result, an annual reporting requirement on financial accomplishments and plans was eliminated from Fiscal Service Regulation No. 5 "Review and Approval of Fiscal Accounting Systems." It was determined that similar information is available in other reports. These efforts further the goal of having the TFRM as the Bureau's sole prescribing document to be followed by agencies.

The Treasury financial communications system (TFCS) has been in operation since September 1976, and during fiscal 1978 processed a monthly average of \$2.7 billion for deposit transactions and \$2.5 billion for payment transactions. Utilizing a computer link to the Federal Reserve Bank of New York, this system provides access to the Federal Reserve Communications System and its associated financial data. TFCS automates the generation of nonrecurring payments and the receipt of Government deposits, and provides a comprehensive accounting and audit control mechanism for streamlining financial recordkeeping and reporting. During fiscal 1978, the deposit message retrieval subsystem was developed to allow agencies to receive immediate hardcopy notification of incoming messages by accessing the TFCS with a terminal device on the day that deposits are expected. Present efforts are devoted to developing a new subsystem of TFCS that can be utilized to accomplish letter-of-credit transactions. The implementation of this subsystem will provide the basis for the future expansion of the TFCS and the development of improved Government-wide financial management practices.

Assets and liabilities in the account of the U.S. Treasury.—Table 53 in the Statistical Appendix shows the balances at the close of fiscal years 1977 and 1978 of those assets and liabilities comprising the account of the U.S. Treasury. The assets and liabilities in this account include the cash accounts reported as the "operating balance" in the Daily Treasury Statement. Other assets included in the account of the U.S. Treasury are gold bullion, coin, coinage metal, paper currency, deposits in Federal Reserve banks, and deposits in commercial banks designated as Government depositories.

Treasury's gold balance was \$11,595.3 million at the beginning of the fiscal year and \$11,667.7 million at the yearend.

Stocks of coinage metal stood at \$282.2 million at the beginning of fiscal 1978 and \$261.9 million at yearend. Such stocks included silver, copper, nickel, zinc, and alloys of these metals which are not yet in the form of finished coins.

The number of depositaries of each type and their balances on September 30, 1978, are shown in the following table:

Depositaries	September 30, 1978	
	Number of accounts ¹	Balance
Federal Reserve banks and branches.....	37	² \$16,904,511,658
Other depositaries reporting directly to the Treasury:		
Special demand accounts	3	275,450,000
Other:		
Domestic.....	17	217,851
Foreign ³	40	94,042,608
Depositaries reporting through Federal Reserve banks:		
General	1,170	52,024,835
Special (Treasury tax and loan accounts)	14,063	5,796,586,685
Total.....	15,330	23,122,833,637

¹ Includes only depositaries having balances with the U.S. Treasury. Excludes those designated to furnish official checking account facilities or other services to Government officers but not authorized to maintain accounts with the Treasury. Banks designated as general depositaries are frequently also special depositaries, hence the total number of accounts exceeds the number of banks involved.

² Includes checks for \$257,326,624 in process of collection.

³ Principally branches of U.S. banks and of the American Express International Banking Corp.

Government officers deposit moneys which they have collected to the credit of the U.S. Treasury at Federal Reserve banks or at designated Government depositaries, domestic or foreign. Certain taxes are also deposited directly by the employers or manufacturers who withhold or pay them. All payments are withdrawn from the U.S. Treasury account.

Cash deposits and withdrawals affecting the Treasury's operating balance are summarized in the following table for fiscal years 1977 and 1978:

Deposits, withdrawals, and balances in the U.S. Treasury account
[In millions of dollars]

	Fiscal 1977	Fiscal 1978
Operating balance at beginning of period.....	17,414	19,104
Cash deposits:		
Gross tax collections (selected)	355,468	404,388
Public debt receipts	458,101	480,758
Gas and oil lease sale proceeds	1,510	
Other.....	54,446	65,122
Total cash deposits	869,525	950,268
Cash withdrawals:		
Public debt redemptions	416,250	440,402
Letter of credit transactions:		
Medicare	18,790	24,021
HEW grants.....	23,591	26,516
Unemployment insurance	2,308	9,385
Other.....	396,896	446,604
Total cash withdrawals	867,835	946,928
Operating balance at close of period.....	19,104	22,444

Investments.—The Secretary of the Treasury, under specific provisions of law, is responsible for investing various Government trust funds. The Department also furnishes investment services for other funds of Government agencies. At the end of fiscal 1978, Government trust funds and accounts held public debt securities (including special securities issued for purchase by major trust funds as authorized by law), Government agency securities, and securities of privately owned Government-sponsored enterprises. See the Statistical Appendix for tables showing the investment holdings by Government agencies and accounts.

Issuing and redeeming paper currency.—The Treasury is required by law (31 U.S.C. 404) to issue U.S. notes in amounts equal to those redeemed. In order to comply with this requirement in the most economical manner, U.S. notes are issued only in the \$100 denomination. U.S. notes represent only a very small percentage of the paper currency in circulation.

Federal Reserve notes constitute over 99 percent of the total amount of currency. The Bureau of Engraving and Printing prints and holds these notes in a reserve vault until needed by the Federal Reserve banks. The Bureau of Government Financial Operations accounts for Federal Reserve notes from the time they are delivered to the reserve vault by the Bureau of Engraving and Printing until redeemed and destroyed.

A comparison of the amounts of paper currency of all classes, issued, redeemed, and outstanding during fiscal years 1977 and 1978 follows:

[In thousands]

	Fiscal 1977		Fiscal 1978	
	Pieces	Amount	Pieces	Amount
Outstanding beginning of period	7,341,695	\$86,189,614	7,839,184	\$94,365,252
Issues during period	3,127,691	22,714,508	3,823,271	32,056,844
Redemptions during period	2,630,202	14,538,870	2,620,030	16,229,577
Outstanding end of period	7,839,184	94,365,252	9,042,425	110,192,519

Details of the issues and redemptions for fiscal 1978 and of the amounts outstanding at the end of the year are given by class of currency and by denomination in a table in the Statistical Appendix. Other tables in that volume give further information on the stock and circulation of currency and coin in the United States.

Data processing.—During fiscal 1978, 712.7 million checks were paid and reconciled by the electronic check payment and reconciliation system. These include all checks issued worldwide by civilian and military disbursing offices.

Additional improvements and further automation were incorporated into the central accounting system as part of an ongoing project. The system embraces all cash financial operations of the Government and is the data base for Federal budget results published in the Monthly Treasury Statement of Receipts and Outlays of the U.S. Government and in the annual Treasury Combined Statement of Receipts, Expenditures and Balances of the U.S. Government.

Extensive support services were provided to the Division of Check Claims. New reporting and data collection procedures were implemented to support case tracking and status reporting through the check claims process. Additional automated services were implemented to facilitate the Treasury check truncation system.

Banking and cash management

Division of Currency Claims.—Arrangements for the Federal Reserve branch bank at Baltimore to ship coin to, and receive deposits of coin from Washington, D.C., banks were completed September 30, 1978. The Treasury, which formerly provided these services, now performs no cash services with commercial banks or the general public except to redeem mutilated currency.

During fiscal 1978, nearly 50,000 mutilated currency claims were received and \$8.9 million was paid out in settlement thereof. At the end of the year, only 231 cases remained unprocessed. Nearly all of these are classified as "difficult" because considerable processing time is required due to the degree to which the currency has been burned or mutilated.

Foreign currency management.—During fiscal 1978, the Foreign Currency Staff developed and published the foreign currency section, chapter 8000, of the TFRM which promulgates cash management policies and objectives for all Government agencies. Included were procedures incorporating competitive bidding as part of the process for the selection of a commercial bank to provide the Government's required banking services overseas. As a result the Government has been able to obtain more favorable banking services with respect to the custody, purchase, deposit, and disbursement of foreign currencies.

Through competitive bidding, the Government has entered into a 1-year contract with a commercial bank to purchase all U.S. Government Japanese yen requirements at a premium rate. This arrangement will result in a savings of \$680,000.

Federal depositary system.—The types of depositary services provided and the number of depositaries for each of the authorized services as of September 30, 1977 and 1978, are shown in the following table:

Type of service provided by depositaries	1977	1978
Receive deposits from taxpayers and purchasers of public debt securities for credit in Treasury tax and loan accounts.....	14,029	14,063
Receive deposits from Government officers for credit in Treasury's general accounts.....	859	741
Maintain checking accounts for Government disbursing officers and for quasi-public funds.....	5,387	5,395
Maintain State unemployment compensation benefit payment and clearing accounts.....	44	(*)
Operate limited banking facilities:		
In the United States and its outlying areas.....	191	156
In foreign areas.....	215	(**)

* The responsibility for compensating banks for handling unemployment accounts was transferred to the Department of Labor, effective Oct. 1, 1977.

** The management and funding of the overseas military banking facility program were transferred to the Department of Defense, effective Oct. 1, 1977.

Paying grants through letters of credit.—At the close of fiscal 1978, 84 Government agency accounting stations were financing with letters of credit under the Federal Reserve bank system. During the period, the Bureau processed 145,945 withdrawal transactions aggregating \$68,998 million, compared with 99,294 transactions totaling \$60,420 million in fiscal 1977.

Treasury regulations governing advance financing under Federal grants and other programs that are contained in Treasury Department Circular No. 1075 have been revised to formally establish the letter of credit RDO system. At September 30, 1978, 61 Government agency accounting stations were financing with letters of credit under the Treasury RDO system. During the year, Treasury regional disbursing offices issued 75,507 checks totaling

\$19,340 million, in response to grantee requests, compared with 65,129 checks totaling \$15,069 million in fiscal 1977.

Tax and loan investment program.—Public Law 95-147, October 28, 1977, provided the Secretary of the Treasury the authority to invest Treasury's operating cash in (1) obligations of depositaries maintaining Treasury tax and loan accounts and (2) obligations of the United States and of agencies of the United States.

The funds maintained in Treasury tax and loan accounts will be invested with participating depository financial institutions, enabling the Treasury to earn a direct return on its temporarily excess operating cash. In return for the services provided as depositaries, financial institutions will receive a fee for each Federal tax deposit processed. The financial institutions eligible to become depositaries will be expanded to include savings and loan associations and credit unions. The fiscal activities to carry out this investment program will be performed by Federal Reserve banks.

Substantial progress was accomplished during this reporting period on the design and implementation phases of the program. Significant milestones achieved were: The issuance of proposed and final rulemaking to accomplish regulatory changes; the issuance of procedural instructions to depository financial institutions; the provision of procedural instructions to Federal Reserve banks; and the design and implementation of automated systems at Federal Reserve banks to carry out the fiscal activities required by this program.

Net earnings from this program have been projected at between \$50 million and \$100 million annually. The Treasury is scheduled to start the investment program in fiscal 1979.

Processing Federal tax deposits.—During fiscal 1978, the Fiscal Service regulation (31 CFR part 214) regarding the deposit of Federal taxes made by a taxpayer directly at a Federal Reserve bank was changed.

The former provisions of this regulation were very liberal and permitted a tax depositor to make a tax deposit at any Federal Reserve bank with a check drawn on any commercial bank. The provisions governing commercial banks acting as depositaries for Federal taxes were more restrictive and required a commercial bank to accept as payment of a tax deposit a check drawn on and to itself. As compared with a deposit at an authorized commercial bank, the former provisions concerning tax deposits at Federal Reserve banks permitted, and generally resulted in, slow availability of funds to the Treasury.

The regulation was changed to reflect the following: A Federal Reserve bank shall, through any of its offices, accept a tax deposit directly from a taxpayer when such tax deposit is in the form of cash or check drawn to the order of that bank and considered to be an immediate credit item by that bank. When a deposit of Federal taxes is not in accordance with this provision the bank will place a stamp impression on the FTD form reflecting the name of the bank and the date on which the proceeds of the accompanying payment instrument are collected by the bank. This date will be used to determine the timeliness of the Federal tax payment.

Destruction of unfit currency.—Emphasis in fiscal 1978 was in working with the Federal Reserve banks in the development and installation of automated high-speed currency-processing equipment, specifically as it relates to the identification, counting, and destruction of Federal Reserve notes which are no longer fit for circulation. During the year, nine pieces of equipment were tested at five banks for their acceptability in disposing of unfit currency.

This equipment shreds the unfit currency into 1/8-inch strips and supplants incineration at those banks which have only incinerators to destroy currency.

Consequently, much of the unfit currency is now being destroyed by the ecologically cleaner methods of pulverization at most of the banks which do not yet have high-speed equipment and shredding at the banks which have installed such equipment. This will increase substantially as additional banks install high-speed equipment.

Cash management.—Chapter 8000, entitled “Cash Management,” (included in part 6 of volume I of the Treasury Fiscal Requirements Manual) was issued on March 31, 1978. Chapter 8000 contains the detailed fiscal requirements which implement the provisions of Treasury Department Circular No. 1084 issued on December 29, 1976. This Circular established the policy governing cash management practices within the Federal Government.

Chapter 8000 prescribes the procedures to be observed by all Government departments and agencies whose financial transactions affect the cash account of the Treasury through billings, collections, deposits, disbursements, advance funding operations, and cash held outside the Treasury to assure effective management of the Government’s cash when these organizations are developing regulations, systems, and procedures. These fiscal requirements establish the regulations pursuant to which affected organizations are to conduct their financial activities in order to maximize the amount of cash available to this Department on a continuing basis for purposes of investment and to preclude unnecessary borrowing.

Operations planning and research

The Operations Planning and Research Staff is continuing its systems developmental activities for a number of fiscal functions, including the following major systems revisions:

(1) Expansion of the direct deposit-electronic funds transfer program through which recipients of recurring Federal payments receive credit directly in their accounts at their financial organizations is well underway. In 1978, the program was extended to include recipients of Federal salary payments of one agency as a pilot program. Plans are to include other agencies with their Federal salary payments beginning in 1979. The staff is also coordinating the inclusion of payments made by other Federal disbursing activities, particularly those of the Department of Defense. Approximately 88.2 million Treasury payments were made by the EFT system during fiscal 1978.

(2) The joint developmental efforts of the Treasury and the Federal Reserve to develop a check truncation system progressed to implementation within the Bureau and the Federal Reserve banks with approximately 85 percent of the checks being processed under the new system. Full-scale implementation of the system is scheduled for December 1978. Under this system, the flow of paid Treasury checks stops at the Federal Reserve bank level. Magnetic tapes and microfilm records are prepared for the hundreds of millions of checks formerly shipped by the Federal Reserve banks to Treasury for final payment and reconciliation.

Miscellaneous fiscal activities

Auditing.—During fiscal 1978 the Audit Staff issued 75 audit reports on financial, compliance, and operational matters. The audits ranged from small imprest funds to the accounting for multibillion-dollar Federal trust funds and the audit of U.S. Government-owned gold. Onsite examinations were made at several of the Bureau’s disbursing centers throughout the United States. Also, onsite audits were made of the cancellation, verification, and destruction of unfit currency at virtually all of the Federal Reserve banks and branches.

Substantial improvement in operations and internal controls resulted from the audits.

An auditor was assigned to the President's reorganization project, Office of Management and Budget, to assist in developing accounting and budgetary systems. An auditor also served on the audit improvement project of the Joint Financial Management Improvement Program. The work of this project involved the setting of audit policy on a Government-wide basis and developing ways to promote more effective use of Federal, State, and local audit resources. Another auditor served as a member of the Secretary's Committee for the Audit of the Exchange Stabilization Fund.

As a result of the annual Audit Staff examination of the financial statements and related supporting information of surety companies, 287 of these companies qualified for Certificates of Authority as acceptable sureties and reinsurers on bonds running in favor of the United States (6 U.S.C. 6-13). Certificates are renewable each July 1, and a list of approved companies (Departmental Circular 570, Revised) is published annually in the Federal Register for information of Federal bond-approving officers and persons required to give bonds to the United States.

Loans by the Treasury.—The Bureau administers loan programs with those corporations and agencies that have authority to borrow from the Treasury. See the Statistical Appendix for tables showing the status of those Treasury loans at September 30, 1978.

Federal Financing Bank.—During the period, loans outstanding were increased by \$12.7 billion, resulting in a balance at the end of fiscal 1978 of \$48.1 billion. Interest of \$2.8 billion was collected from borrowers and \$2.7 billion was paid on borrowings from the Secretary of the Treasury. See the Statistical Appendix for comparative financial data for the Federal Financing Bank.

Liquidation of Reconstruction Finance Corporation assets.—The Secretary of the Treasury's responsibilities in the liquidation of RFC assets relate to completing the liquidation of business loans and securities with individual balances of \$250,000 or more as of June 30, 1957, and securities of and loans to railroads and financial institutions. Net income and proceeds of liquidation amounting to \$60 million have been paid into Treasury as miscellaneous receipts since July 1, 1957. Total unliquidated assets as of September 30, 1978, had a gross book value of \$1.8 million.

Liquidation of Postal Savings System.—Effective July 1, 1967, pursuant to the act of March 28, 1966 (39 U.S.C. 5225-5229), the unpaid deposits of the Postal Savings System were to be transferred to the Secretary of the Treasury for liquidation. As of June 30, 1970, a total of \$65.1 million, representing principal and accrued interest on deposits, had been transferred for payment of depositor accounts. All deposits are held in trust by the Secretary pending proper application for payment. Payments for fiscal 1978 totaled \$202,472. Cumulative payments amount to \$58.5 million plus pro rata payments to the States and other jurisdictions of \$6 million. The undistributed funds balance as of September 30, 1978, was \$597,811.

Government losses in shipment.—Claims totaling \$231,007 were paid from the fund established by the Government Losses in Shipment Act, as amended (40 U.S.C. 721-729). Details of operations under this act are shown in the Statistical Appendix.

Donations and contributions.—The Bureau received "conscience fund" contributions totaling \$120,499 and other unconditional donations totaling \$805,450. Other Government agencies received conscience fund contribu-

tions and unconditional donations amounting to \$16,926 and \$212,276, respectively. Conditional gifts to further the defense effort amounted to \$850. Gifts of money and the proceeds of real or personal property donated in this period for reducing the public debt amounted to \$341,567.

Foreign indebtedness

World War I.—The Governments of Greece and Hungary made payments during fiscal 1978 of \$328,898 and \$78,576, respectively. For a complete status of World War I indebtedness to the United States, see the Statistical Appendix.

Credit to the United Kingdom.—The Government of the United Kingdom made principal and interest payments of \$85.8 million and \$67.6 million, respectively, which were due on December 31, 1977, under the Financial Aid Agreement of December 6, 1945, as amended March 6, 1957.

Indonesia, consolidation of debts.—The Government of the Republic of Indonesia made payments in fiscal 1978 of \$6,097,360 in principal and \$731,683 interest on deferred principal installments, in accordance with the Indonesian Bilateral Agreement of March 16, 1971. The normal payment of interest on principal is not due until June 11, 1985.

Payments of claims against foreign governments

The 18th installment of \$2 million was received from the Polish Government under the Agreement of July 16, 1960, and pro rata payments on each unpaid award were authorized.

The sixth installment of \$2,796,000 was received from the Hungarian Government under the Agreement of March 6, 1973. The sixth installment was greater than the minimum installment of \$945,000 because 6 percent of the dollar proceeds of imports into the United States from Hungary for the 12 months ending December 31, 1977, exceeded the minimum installment by \$1,851,000, thereby raising the annual installment from \$945,000 to \$2,796,000. An additional pro rata payment has been authorized to all entitled awardholders, and payments are now being made.

Administration

Equal employment opportunity.—In an effort to reduce the heavy expenses incurred during the EEO complaint process, the Bureau's EEO Staff initiated a program of annual in-house refresher training for its EEO counselors. The training is specifically aimed at improving their effectiveness during the informal counseling process. Consequent financial savings to be achieved cannot yet be estimated, but the Bureau has already experienced a reduction in the number of formal discrimination complaints.

Procurement activity.—Five new or upgraded word processing systems were installed with resulting annual savings estimated at almost \$1.3 million during the next 5 years. In a somewhat related area, following a cost-effectiveness study, the Bureau obtained approval to purchase copier machines, with a projected savings of \$131,000 over a 5-year period. Another development concerns efforts being exerted to widen the basis of Bureau procurement, with a view to stimulating economic growth, and assisting small, minority-owned business concerns.

Records control.—A comprehensive records control schedule, providing retention and disposition standards for all Bureau records, has been approved by the National Archives and Records Service, GSA. A reduction in retention

periods for certain records is expected to result in savings of over \$100,000 in filing and storage costs.

Labor-management relations.—The National Treasury Employees Union (NTEU) was certified the official collective bargaining representative of headquarters employees. Four of the Bureau's subordinate field offices are represented by other unions, and NTEU has filed a petition for a residual unit composed of the remaining nonunion Bureau employees in the field.

Training.—Labor relations training has been established for management and supervisors to acquaint them with management's rights and obligations under the above-cited Bureau headquarters agreement with NTEU. A supervisory course has also been implemented during the year; participation for non-Bureau personnel is possible, but on a space-available basis. Additionally, an individual learning center was opened during the year, permitting employees to participate at their own pace and convenience. Participation in the Co-op, summer employment, and stay-in-school programs continues. Further, the Career Development Program for Lower Level Employees (CADE) was highly successful; the CADE skills inventory is being automated, providing for greater efficiency and effectiveness. Finally, the Bureau placed one intern under the Presidential Management Intern Program.

Troubled employee program.—This program continues into its third year, including not only alcoholism and drug abuse, but all personal problems affecting an employee's job performance.

Part-time employment.—The Bureau has affirmed its policy of maximum utilization of persons interested in and qualified for part-time employment, and has designated certain positions as appropriate for such employment.

Bureau of the Public Debt

The Bureau of the Public Debt is charged with the administrative functions arising from the Treasury's debt management activities. These functions extend to transactions in the security issues of the United States, and of the Government agencies for which the Treasury acts as agent. The Bureau prepares the offering circulars and instructions relating to each offering of public debt securities, and directs the handling of subscriptions and making of allotments; prepares regulations governing public debt securities and conducts or directs all transactions thereof; supervises the public debt activities of fiscal agents and agencies authorized to issue and pay savings bonds; orders, stores, and distributes all public debt securities; audits and records retired securities and interest coupons; maintains individual accounts with owners of registered securities and authorizes the issuance of checks in payment of interest thereon; maintains book-entry accounts of eligible securities for individuals; processes and adjudicates claims on account of lost, stolen, destroyed, or mutilated securities; maintains accounting control over public debt financial and security transactions, security accountability and interest costs; and prepares public debt statements. The Bureau's principal office and headquarters is in Washington, D.C. An office is also maintained in Parkersburg, W. Va., where most Bureau operations related to U.S. savings bonds, U.S. savings notes, retirement plan bonds, and individual retirement bonds are handled.

Management Improvement

A new productivity and cost-effectiveness system, providing computer-generated monthly reports on volumes of work processed, costs, workyears consumed, unit costs, and productivity factors, was installed. These figures are also compared with budgeted and prior-year figures. The new report provides

earlier and better information to Bureau management and serves as a basis for regular reviews of productivity and resource utilization.

Four Federal Reserve banks and three branches began reporting their daily activity in securities transactions to the Bureau via magnetic tape. Fifteen banks and branches are now participating in this ongoing program. Magnetic tape reporting enables the Bureau to immediately introduce the daily public debt activity into the processing cycle without data conversion. Thus, processing is more timely and daily reporting is more timely and complete. In addition, 23 banks and branches are now reporting all or part of their monthend accountability balances via magnetic tape on a monthly basis.

The Treasury and agency securities accounting system can now produce Treasury, agency, and savings bond journals and ledgers in hard copy or on microfilm. The cash accounting system can also now produce the cash journal on microfilm. Microfilming of these journals and ledgers has resulted in space reductions in the filing and storing of these records.

The installation of systems furniture and mechanical file retrieval systems has also resulted in space savings. The use of these systems and a thorough analysis of current space configurations allows for the most efficient utilization of office space.

The use of revised workflow procedures and group dynamics resulted in a reduction in processing time for redeemed and retired securities. As a result, certified audit results and up-to-date information is being provided on a more timely basis.

The issues-on-tape program was expanded to include six additional issuing agents. Approximately 64 million sales of series E savings bonds were reported on tape by 69 participating agents. A recurring annual savings of approximately \$1,282,000 should be realized based on the volume of issues handled by these agents.

The Bureau established an ADP memoranda system which enables management to provide instructions related to the implementation of OMB, departmental, and Bureau policy and procedures related to the effective management of ADP resources. Some of the areas covered this year were (1) development of a glossary of ADP terms so that users and data processing personnel have a common ground of communication; (2) statement of policy regarding the review and disposition of excess ADP equipment; (3) installation of a formal ADP planning system which includes the requirement that long-range plans be made in conjunction with the budget process so that proper funding can be made; and (4) establishment of a system to ensure that proper steps are taken in the acquisition of ADP and data/telecommunications equipment, and that inventories of Bureau equipment are effectively maintained.

The following organizational and functional realignments were made to maximize work efficiency and improve personnel utilization:

1. A new Division of Investor Accounts was established to service and maintain the ever-increasing number of book-entry securities accounts and to assume the responsibility of establishing and maintaining accounts for registered securities.

2. With the transfer of the functions for establishing and maintaining accounts for registered securities to the Division of Investor Accounts, the name of the Division of Public Debt Accounts was changed to the Division of Public Debt Accounting. A new Accounting Review Branch was established to review and evaluate internal operating procedures and accounting systems,

participate in Bureau-wide accounting system development projects, and test and implement new accounting systems and procedures.

3. The Division of Securities Operations transferred its functions relating to book-entry securities to the new Division of Investor Accounts. Also, similar-type functions within the Division were combined where possible.

4. The Division of ADP Management reallocated its personnel due to a tapering off of its responsibility to convert existing computer systems to a new Univac 1110 computer. Emphasis will now be placed on developing new computer systems.

Bureau operations

During the fiscal year, 169,000 individual accounts covering publicly held registered securities other than savings bonds, savings notes, individual retirement bonds, and retirement plan bonds were opened, and 98,000 were closed. This increased the number of open accounts to 509,000, covering registered securities in the principal amount of \$37,449 million. There were 797,000 interest checks with a value of \$1,545 million issued during the period.

Redeemed and canceled securities received for audit, other than savings bonds, savings notes, and retirement plan bonds, included 2,642,000 bearer securities and 380,000 registered securities. Coupons totaling 7,578,000 were received.

During the period, 45,000 registration stubs of retirement plan bonds, 33,000 registration stubs of individual retirement bonds, 2,591 retirement plan bonds, and 634 individual retirement bonds were received for audit and recordation.

A summary of the public debt operations handled by the Bureau appears on pages 16-34 of this report and in the Statistical Appendix.

U.S. savings bonds.—The issuance and retirement of savings bonds result in a heavy administrative burden for the Bureau of the Public Debt, including auditing and classifying all sales and redemptions; establishing and maintaining registration and status records for all bonds; servicing requests from bond owners and others for information; and adjudicating claims for lost, stolen, and destroyed bonds.

Detailed information on sales, accrued discount, and redemptions of savings bonds will be found in the Statistical Appendix.

There were 164 million registration stubs or records on magnetic tape and microfilm received, representing the issuance of series E savings bonds, making a grand total of 4,422 million, including reissues, received through September 30, 1978. All registration stubs of series E bonds are microfilmed, audited, and destroyed, after required permanent record data are prepared by an EDP system in the Parkersburg office.

Of the 136 million series A-E savings bonds and savings notes redeemed and charged to the Treasury during the period, 132 million (96.8 percent) were redeemed by authorized paying agents. For these redemptions the agents were reimbursed quarterly at the rate of 15 cents each for the first 1,000 bonds and notes paid and 10 cents each for all over the first 1,000 for a total of \$16,710,000 and an average of 12.70 cents per bond and note.

Interest checks issued on current income-type savings bonds (series H) during the period totaled 4,222,000 with a value of \$510 million. New accounts established for series H bonds totaled 108,000 while accounts closed totaled 124,000.

Applications received during the period for the issue of duplicates of savings bonds and savings notes lost, stolen, or destroyed after receipt by the registered owner or his agent totaled 60,000. In 37,000 of such cases the issuance of duplicate bonds was authorized. In addition, 20,000 applications for relief were received in cases where the original bonds were reported as not being received after having been mailed to the registered owner or his agent.

OFFICE OF FOREIGN ASSETS CONTROL

The Office of Foreign Assets Control administers five sets of regulations which implement the Department of the Treasury's freezing controls.

The Foreign Assets Control Regulations and the Cuban Assets Control Regulations prohibit, unless licensed, all trade and financial transactions with North Korea, Vietnam, Cambodia, and Cuba and their nationals. South Vietnam and Cambodia were added to the schedule of blocked countries under the Foreign Assets Control Regulations following the takeover of these countries by Communist forces in April 1975. These regulations also block assets in the United States of the above-named countries and their nationals.

Under a general license contained in the Foreign Assets Control Regulations, all transactions with the People's Republic of China are now authorized, except transactions abroad by foreign firms owned or controlled by Americans involving shipment to the People's Republic of China of internationally controlled strategic merchandise unless the transaction is appropriately licensed under the Transaction Control Regulations (see below). Also, transactions in Chinese assets blocked in the United States as of May 6, 1971, remain prohibited.

During the fiscal year, the Foreign Assets Control and the Cuban Assets Control Regulations were amended to authorize persons in the United States to remit limited amounts annually to Cuba and Vietnam for the support of close relatives and on a one-time basis to enable such relatives to emigrate. The Cuban Assets Control Regulations were also amended by the addition of a general license authorizing certain transactions ordinarily incident to travel to, from, and within the United States by certain Cuban nationals holding U.S. visas. These regulations were further amended by the issuance of an announcement of the availability of licenses for transactions involving participation by certain Cuban nationals in public exhibitions or performances in the United States and by U.S. nationals when participating in similar events in Cuba.

The Transaction Control Regulations supplement the export controls exercised by the Department of Commerce over direct exports from the United States to Eastern Europe and the U.S.S.R. by controlling certain goods of foreign origin not subject to Commerce control. These regulations prohibit, unless licensed, the purchase or sale or the arranging of the purchase or sale of strategic merchandise located outside the United States for ultimate delivery to Communist countries of Eastern Europe, the U.S.S.R., the People's Republic of China, North Korea, Vietnam, and Cambodia. The prohibitions apply not only to domestic American companies, but also to foreign firms

owned or controlled by persons within the United States. A general license permits sales of these commodities to the listed countries (other than North Korea, Vietnam, and Cambodia) provided shipment is made from and licensed by a Coordinating Committee (COCOM)-member country. (COCOM is a NATO entity.)

The Office also administers controls on assets remaining blocked under the World War II Foreign Funds Control Regulations. Those controls continue to apply to blocked assets of Czechoslovakia, Estonia, Latvia, Lithuania, and East Germany and nationals thereof who were, on December 7, 1945, in Czechoslovakia, Estonia, Latvia, or Lithuania, or on December 31, 1946, in East Germany.

Finally, the Office administers the Rhodesian Sanctions Regulations which implement United Nations Resolutions calling upon member nations to impose mandatory sanctions on Southern Rhodesia. The regulations include comprehensive controls on the importation of merchandise of Rhodesian origin. There is also a prohibition, except as licensed, on the importation of ferrochromium produced in any country from chromium ore or concentrates of Rhodesian origin; on the importation of non-Rhodesian chromium ore, except when imported directly or on a through bill of lading; and on the importation from any country of ferrochromium and of steel mill products in their basic shapes and forms which contain more than 3 percent chromium. A general license in the regulations authorizes imports of ferrochromium and of steel mill products that are certified by the government of the producing country not to contain any chromium or ferrochromium of Rhodesian origin.

Under the Foreign Assets Control Regulations and the Transaction Control Regulations, the number of specific license applications received from October 1, 1977, through September 30, 1978 (including applications reopened) was 190. During that period, 190 applications were acted upon.

Applications for licenses and requests for reconsideration under the Cuban Assets Control Regulations totaled 484 during fiscal 1978. During this period, 508 applications were acted upon, including carryover cases.

During the period, 390 applications (including applications reopened) were received under the Rhodesian Sanctions Regulations; 389 applications were acted upon.

Nine applications (including applications reopened) were received under the Foreign Funds Control Regulations; 10 were acted upon, including carryover cases.

Certain broad categories of transactions are authorized by general licenses set forth in the regulations, and such transactions may be engaged in by interested parties without the need for securing specific licenses.

During the fiscal year, two criminal cases involving violations of the Foreign Assets Control Regulations were forwarded to the Justice Department. A payment of \$2,844 for violation of the Cuban Assets Control Regulations, as a mitigated penalty in lieu of forfeiture, was received by the U.S. Customs Service. At the fiscal yearend merchandise was under seizure in three cases for having been imported in violation of the regulations.

On September 8, 1978, the President made a determination that it was in the national interest of the United States to continue for another year the emergency legal authorities of section 5(b) of the Trading with the Enemy Act as a basis for the following: (1) The Foreign Assets Control Regulations, (2) the Transaction Control Regulations, (3) the Cuban Assets Control Regulations, and (4) the Foreign Funds Control Regulations.

INTERNAL REVENUE SERVICE ¹

The Internal Revenue Service administers the internal revenue laws embodied in the Internal Revenue Code (26 U.S.C.) and certain other statutes, including the Employee Retirement Income Security Act of 1974 (Public Law 93-406, 88 Stat. 829).

Collecting The Revenue

Returns processing

IRS service centers received 136.7 million tax returns of all types in fiscal 1978 compared with 133.5 million in 1977. Of the returns received in 1978, over 89.1 million were individual and fiduciary income tax returns as compared with 87.3 million in 1977.

After several years of increase up to 1977, the number of form 1040 filers decreased this year while the ranks of form 1040A filers continued to grow. The shift from form 1040 to the shorter 1040A was due to the simplification of the form and its increased availability made possible by the Tax Reduction and Simplification Act of 1977 and to the form 1040A being mailed to taxpayers who had used the 1040 in 1977 but were eligible to file the shorter form. The Service received 53.2 million forms 1040 in 1978, 6.1 percent less than the 56.5 million received last year. More than 34 million individual taxpayers, 39 percent of all individual filers, used the form 1040A, compared with over 29 million in 1977, an increase of 17.3 percent.

The IRS checked the mathematics on 87.6 million individual returns. As a result, 2 million taxpayers had decreases in the liability shown on their returns totaling \$309 million, an average of \$152 per return, resulting in larger refunds or smaller tax due. On 3.4 million returns, correction of taxpayers errors increased their tax liability by \$791 million—an average of \$235.

Error rates for forms 1040A processed dropped dramatically from last year. In 1977, 12 percent of all forms 1040A processed over the same period had mathematical errors, while in 1978 only 5.1 percent had such errors. Error rates for the redesigned form 1040 also fell, from 9.1 to 6.5 percent in a tally taken at the close of the annual filing period.

The decrease in math errors was mainly attributable to changes made by the Tax Reduction and Simplification Act of 1977 and redesign of the forms 1040 and 1040A. The new forms eliminated the need for many taxpayers to calculate their taxes which was the cause of numerous errors in previous years.

The Service also checked the estimated tax credit claimed on individual returns. The verification showed that taxpayers underclaimed \$259 million in estimated tax credits and overclaimed by \$474 million.

Receipts

Gross revenue collections amounted to \$399.8 billion, an increase of \$41.6 billion (11.6 percent) over 1977. All major tax categories with the exception of estate and gift taxes showed an increase. Factors contributing to this year's collection picture were higher personal income, higher corporate profits, and increases in the social security tax rate and base.

Income taxes accounted for over two-thirds of all tax receipts. Individual income taxes amounted to \$213.1 billion, a gain of \$26.3 billion (14.1 percent)

¹ Additional information will be found in the separate Annual Report of the Commissioner of Internal Revenue.

over the prior year. Corporation income taxes collected were \$65.4 billion—up \$5.3 billion (8.9 percent).

Employment taxes—social security, self-employment, Federal unemployment, and railroad retirement—totaled \$97.3 billion, advancing \$11.2 billion (13 percent). This increase reflected a higher level of wage and salary payments, increases in the amounts subject to social security and unemployment taxes, and an increase in the social security rate.

Excise taxes registered the smallest advance of any major tax category, rising \$800 million (4.7 percent) on collections of \$18.7 billion. Much of the gain was generated by excises related to autos and air transportation. A new excise tax on coal to finance the payment of black lung benefits to miners was effective April 1, 1978.

Estate and gift tax collections registered the only decrease, falling \$2 billion (27.5 percent). The decline was from last year's abnormally large gift tax receipts caused by the pending estate and gift tax revisions of the Tax Reform Act of 1976.

Refunds

The IRS paid refunds totaling \$39.6 billion to 69 million taxpayers whose income tax withholding, estimated tax payments, or credits were shown on their returns to have exceeded their tax liabilities. The average refund to individuals was \$495. This year's individual refunds included 4.3 million checks totaling \$900 million for the earned income credit (EIC). In 1977, 67.9 million individual refunds totaling \$36.5 billion were paid, with 4.4 million checks for \$900 million in EIC.

Penalties and interest

The IRS under the law can levy penalties such as those for failure to pay tax due, bad checks, delinquency, negligence, and fraud. More than 15 million penalties totaling \$1.3 billion were assessed with 1.4 million of these amounting to \$336 million abated. Almost half of the penalties were for individual returns.

The Service also is required to assess interest against taxpayers who fail to meet payment requirements. More than \$85 million in interest was assessed on individual returns this year, of which \$4 million was abated. For business returns, interest assessed was \$759 million with abatements of \$95 million. Interest paid this year amounted to \$108 million for individual and employment taxes and \$198 million for corporations.

Presidential election campaign fund

A total of 24.9 million individual income tax returns had designations for the Presidential election campaign fund in 1978—28.9 percent of the returns processed during that period. The amount designated was \$39.1 million. In 1977, there were 23.2 million individual tax returns—27.5 percent of those processed—with designations totaling \$36.5 million. The cumulative amount credited to the fund since it was initiated in 1972 is \$171.5 million.

Information returns

The IRS received nearly 484 million information returns from businesses and organizations required to report payments of wages, interest dividends, and other payments. Over 265 million of these documents were submitted on magnetic media as a result of the Service's continuing program to encourage payers that have computer capability or computers to do so.

Of the information returns received, all of those filed on magnetic media that report income paid to individuals and approximately 15 percent of those on paper will be matched against the master file.

Combined annual wage reporting

Combined annual wage reporting (CAWR) is a new system for reporting employee wage data which has been developed to reduce the reporting burden for employers.

This new system will satisfy the reporting requirements of both the IRS and the Social Security Administration (SSA). CAWR became effective for all wages paid after December 31, 1977. Under CAWR, the requirement to file schedule A with employment tax forms 941 and 943 became obsolete and the form W-2 was redesigned to transmit the Federal Insurance Contributions Act information formerly filed on schedule A. The forms W-2 are to be filed with the SSA which will transcribe the information and supply it to the IRS.

By eliminating schedule A, the President's Advisory Council estimated an annual savings to employers of \$235 million.

Assisting The Taxpayer

Direct assistance

The Service provides taxpayers with comprehensive information about the tax system and their responsibilities and rights under it. Aware that the process of determining income, exemptions, deductions, and correct tax can be difficult, the IRS provides direct assistance through personal contact, by telephone and by correspondence.

During 1978, the IRS received about 93,000 written, 28 million telephone, and 9 million walk-in inquiries. More than 63 percent of these inquiries occurred from January 1 through April 29, 1978—over 17 million phone calls, more than 6 million walk-in inquiries, and over 38,000 written inquiries—almost 24 million requests for assistance. Over 196,000 of the responses to telephone calls and returns prepared after IRS assistance were reviewed as part of the quality review system, and an overall national accuracy rate of 97.5 percent was found.

Filing period walk-in taxpayer assistance was offered at about 690 permanent offices and at 200 temporary offices set up for the filing period. These offices were located in the inner city, business districts, and suburban and rural areas. When possible, hours of service were extended for taxpayers unable to call or visit during normal business hours. Most taxpayers were required to wait less than half an hour and more than half waited less than 15 minutes for assistance.

The IRS continued to provide bilingual service to taxpayers who do not speak English. Of approximately 890 taxpayer service offices, 207 offices had tax assistants who spoke foreign languages. Spanish assistance was provided by 487 employees, and 515 employees assisted in other foreign languages. Bilingual taxpayer assistance also was provided through a questionnaire, translated into Spanish, Chinese, and Vietnamese, that was issued to taxpayers who could not communicate in English.

IRS toll-free telephone service continues to reach more taxpayers with greater efficiency than any other method of assistance. Almost 97 percent—17.2 million—of the telephone calls received during the 1978 filing period were on the toll-free system. This represented 72 percent of total taxpayer inquiries received during the same period.

The toll-free system makes IRS offices as close to taxpayers as their phones. By using this system, without paying a long-distance charge, taxpayers anywhere in the United States may call the IRS for assistance or clarification of bills or notices received. Toll-free numbers are listed in the tax packages and are also publicized to alert taxpayers to this service.

During this filing period, calls answered by TV phones and teletypewriter service for the deaf increased by 4 percent. This special service has a nationwide toll-free number, excluding Alaska and Hawaii, staffed by the Indianapolis district. As a result, hearing-impaired taxpayers have access to services similar to those offered other taxpayers.

This year marked the 10th year of the IRS volunteer income tax assistance (VITA) program. Under this program, the Service attracts, recruits, and trains volunteers to offer free tax assistance to low-income, elderly, or disadvantaged taxpayers at convenient locations and times. Approximately 30,000 volunteer assistants were trained by the Service as part of the VITA program—a 50-percent increase over last year.

While VITA assistance increased, a decline was noted in the quality of VITA-prepared returns. In 1979, the primary objective for VITA will be improved program quality and management.

The Service's taxpayer education program sponsored over 4,000 classes for about 200,000 individuals. Additionally, in the school programs, "Understanding Taxes" and "Fundamentals of Tax Preparation," about 5 million tax course books were distributed to high school and college-level students throughout the country.

Media assistance

The Service relies heavily on the mass media to inform the public about its operations and to explain tax laws, regulations, rulings, and procedures. During 1978, material was sent to 16,067 radio and TV stations, daily and weekly newspapers, magazines, and special publications. Additionally, Service personnel participated in 6,158 interviews and answered 18,568 media inquiries.

The IRS issued 4,901 releases to the media covering substantive technical and procedural matters, tax forms and publications, statistics, speeches by IRS officials on important tax topics, and organizational changes. There also were releases to assist taxpayers in meeting due dates and properly filling out forms and in understanding their rights and responsibilities under the tax law.

Four IRS half-hour color films presented information on the American tax system, audit and appeal rights and responsibilities, tax aspects of running a small business, and how to prepare a tax return. These films, two of which also were released in Spanish, appeared 514 times on TV across the Nation and 3,045 times before professional, trade, civic, educational, and other groups.

Earned income credit

The Service continued to alert the public to the earned income credit, which benefits low-income taxpayers. With the cooperation of other Federal agencies such as the Departments of Health, Education, and Welfare, Agriculture, and Labor special notices were sent to those considered eligible for the EIC. Also, nearly one million notices were sent to taxpayers who filed returns without claiming the EIC who possibly qualified according to their tax return information. As a result, nearly 452,000 additional claims for the EIC were allowed.

January 1 through September 30, approximately 5.6 million taxpayers claimed the EIC for a total of approximately \$1.1 billion, averaging out to nearly \$203 per taxpayer. Individuals who filed returns only to claim the EIC received almost 6 percent of these credits.

Simplifying the forms

The last-minute congressional preadjournment flurry of activity produced the year's most important legislation for the IRS, taxes and energy. The very real resulting problem for the IRS was to reflect these late changes in the law, in the forms and instructions being designed and printed for 1978 so they could be available for taxpayers in time.

Despite problems created by legislative changes, simplification efforts continued. This year's efforts focused on rewriting and redesigning the instructions for forms 1040A, 1040 and related schedules. The instructions now have a ninth-grade readability level compared with a 13-14 grade level 2 years ago. Graphic design changes were also made in an effort to improve the instructions.

But simplification efforts were not limited to the form 1040 family. The instructions for Form 941, Employer's Quarterly Federal Tax Return, were rewritten and Circular E, Employer's Tax Guide, is being rewritten, both to improve readability. In addition, after the Service requested comments on a simplified Form 940, Employer's Annual Federal Unemployment Tax Return, a new form 940 was developed which eases the computation of unemployment tax for over 90 percent of its filers.

Form 5329, Return for Individual Retirement Arrangement Taxes, and Form 5500-K, Annual Return/Report of Employee Pension Benefit Plan for Sole Proprietorships and Partnerships, also were revised. The 1978 form 5329 will be filed only by individuals who owe one of three individual retirement arrangement taxes on excess contributions, premature distributions, and certain accumulations in IRA accounts or annuities. Form 5500-K no longer is required for plans in which an owner-employee is the only participant in 1978 and all previous plan years, nor is it required for partnerships when the only plan participants are partners who own more than a 10-percent interest in either the capital or profits of the partnership.

In July the General Accounting Office issued a report entitled "Further Simplification of Income Tax Forms and Instructions Is Needed and Possible." The report stated that although the Service has progressed in making the forms and instructions easier to read and understand, more can be done. GAO suggested that the Service establish a high-level task force to improve the forms. This task force, consisting of the Commissioner, Deputy Commissioner, and several Assistant Commissioners, has met and is developing a plan of operation.

Also, public hearings on the forms were held in Denver, Colo.; Des Moines, Iowa; Columbia, S.C.; and Columbus, Ohio. Although many of the suggestions will help to improve the 1978 tax forms under existing law, others require change in the law.

Publications

All publications were revised to cover the many changes in the law and regulations, and continuing a policy adopted in recent years, the Service distributed a number of publications free of charge. During the year, 3.1 million copies of Publication 17, Your Federal Income Tax, were distributed, along with 1.1 million copies of Publication 334, Tax Guide for Small Business.

and 830 copies of Publication 225, Farmer's Tax Guide. Additional tax materials including tax return forms were furnished on request to over 6 million individual taxpayers, 600,000 tax practitioners, and 360,000 employers. Over 35,000 banks and Postal Service locations helped distribute more than 250 million tax forms and instructions.

Besides the three comprehensive tax guides, the Service issues over 80 small publications concerning such matters as income tax, excise tax, exempt organizations, pensions and annuities, and estate and gift tax. Three of the publications were written in Spanish—publications 597S, 556S, and 584S—explaining basic rules about preparing and filing a tax return, taxpayer rights if a return is examined, and the taxpayer's payment responsibilities if additional tax is due.

Resolving problems

Under the problem resolution program (PRP), the IRS attempts to resolve taxpayers' complaints not satisfied through normal channels and to identify systemic and procedural problems needing correction. During 1978, approximately 66,000 taxpayer problems were resolved through PRP.

Review and evaluation was continued this year with procedures rewritten to provide a more structured, uniform, and visible program and to expand PRP to service centers. Many systems and procedural changes have resulted from PRP, improving Service efficiency and responsiveness to the public.

A major success of the program has been the establishment of liaison with other Government agencies to assist in the resolution of taxpayer problems such as lost and stolen refund checks, and internal processing problems such as incorrect social security numbers.

Making information available

To reflect the Service's attitude that responding promptly to requests for information and documents under the disclosure laws and the Freedom of Information and Privacy Acts is an important part of service to the public, the Disclosure Operations Division and its field counterpart were moved from the Compliance function to the Office of the Assistant Commissioner (Taxpayer Service and Returns Processing). During calendar 1977, 7,913 requests were received for documents not available in IRS Freedom of Information Reading Rooms. Of these there were 5,438 full grants and 748 partial grants. In addition, the National Office Reading Room responded to 18,415 requests.

Under the Privacy Act, 738 requests for access to records were received, of which 475 were granted in full and 95 were granted in part. Only 10 requests were received to amend records.

The Service accelerated efforts to protect the confidentiality of tax returns and return information by increasing disclosure training for employees, beginning an annual review of safeguards of other Federal agencies that are entitled under the law to obtain confidential tax information, and by implementing recordkeeping and reporting requirements for the disclosure of tax returns and return information.

The Tax Reform Act of 1976 revised the disclosure provisions in the tax law by considerably restricting the methods by which Federal agencies may obtain tax information for nontax purposes, and requires that those who have access to such information maintain safeguards for its protection. Federal tax information received by States may be disclosed only to State agencies charged with administering State tax laws, upon request of the head of the State tax agency. A new provision permits disclosure of tax information to Federal,

State, and local child support enforcement agencies to collect child support obligations. Among disclosures made in this year were 3,148 to the Department of Justice, 35,249 to child support enforcement agencies, and approximately 80 million to State tax agencies.

Efforts to maximize the exchange of tax information between the Service and State tax administrators were undertaken and the responsibility given to the Disclosure Operations Division. The exchange of confidential tax information with the States is intended to increase tax revenues, reduce duplicate audits, and increase taxpayer compliance. As part of this program, the Service, through its field disclosure officers, visits each State tax agency semiannually to determine that safeguards adequately protect the confidentiality of information provided. All Federal/State agreements on coordination of tax administration that were in effect before enactment of the Tax Reform Act of 1976 were amended. There are now 97 agreements in effect.

Helping other countries

In 1963 the Service, through the Tax Administration Advisory Services Division and in cooperation with the Agency for International Development (AID), initiated a program to assist foreign governments in modernizing their tax administration systems, emphasizing effectiveness, efficiency, and equity. IRS advisers have been assigned to 37 countries, the Caribbean Community, and the Central American Secretariat for Economic Integration for periods of from 2 weeks to several years. Funding is provided by AID, the recipient countries, or international agencies.

This year long-term assistance programs were completed in El Salvador, Uruguay, and Trinidad and Tobago and onsite projects were initiated in Egypt, Liberia, Jordan, the Northern Mariana Islands, and the Trust Territory of the Pacific Islands. New projects are pending for El Salvador, Sierra Leone, and the Caribbean. Also, diagnostic surveys were completed in Nicaragua, Egypt, and Jordan, and a followup assessment was made of the Trinidad and Tobago project.

Since 1963 over 5,000 visitors from 127 countries have visited the Service for orientation and study observation programs. This year 387 officials from 66 countries participated.

There was an increase in the number of representatives from European countries—France, Italy, United Kingdom—with programs that focused on IRS automation and organizational structure and the voluntary compliance, self-assessment system. In addition, there were frequent exchange visits between Canadian National Revenue and IRS officials.

A 7-week middle-management seminar in tax administration for tax officials from six countries was presented, and a special 6-week intensive orientation in automatic data processing, sponsored by the Organization for European Community Development, was held for Turkish tax officials. Participants from Harvard's international tax program and two International Monetary Fund public finance groups visited the IRS. A group of high-level Nigerian civil servants, sponsored by Brookings Institution, received a special presentation by the Deputy Commissioner on the management structure of the IRS.

The Service's participation in the 26 member country Inter-American Center of Tax Administrators (CIAT) featured a presentation by the Commissioner, "Developing Tax Laws, Administrative Rules, and Procedures for Resolving Taxpayers' Disputes," to the 12th general assembly in Port-of-Spain, Trinidad and Tobago, in May 1978. Assistance was provided to CIAT for automatic data processing diagnostic studies in the Dominican Republic.

and Honduras and for systems analyst guidance in Guatemala. The Director, Tax Administration Advisory Services Division, finished his term as a member of CIAT's Executive Council, and the Assistant Commissioner (Data Services) was a member of the ADP Advisory Committee.

The Service's assistance to States, local governments, territories, and the Commonwealth of Puerto Rico includes the participation of their employees and officials in training courses conducted by the IRS, supplying training aids, and the assignment of IRS personnel for onsite technical assistance.

The Intergovernmental Personnel Act of 1970 has been an important vehicle for the assignment of administrative expertise between the IRS and the States and territories. The Tax Administration Advisory Services Division has coordinated 32 assignments to 10 States, Puerto Rico, Guam, the Virgin Islands, and the University of Southern California, with emphasis on mutual benefit. In 1978, the Division received 11 requests and inquiries from States, territories, and a university for assignments of IRS personnel. Two employees were detailed to the Virgin Islands and one to Guam to prepare and present revenue officer training courses. A new dimension of the law was its use to bring a Yale University faculty member to the National Office for a year.

Enforcing The Law

The IRS has a delinquency prevention program to identify potentially delinquent taxpayers and to assist them in maintaining compliance and in preventing future delinquencies.

Nonpayment of taxes withheld from employees' wages is the most serious delinquency problem facing the IRS Collection Division. The trust fund compliance program helps ensure that chronically delinquent taxpayers adhere to more strict filing and paying requirements, such as monthly rather than quarterly filing, and making deposits to a special bank account. Violations of certain requirements of the program can lead to criminal prosecution. Some 8,300 taxpayers were filing and paying their taxes monthly and 3,936 of these also were required to comply with the special bank account provisions as of September 30, 1978. During the first half of the year, 75 taxpayers were convicted of criminal violations for not maintaining separate accounting for certain collected taxes.

The Service published "The Collection Process (Employment Tax Accounts)," a booklet explaining the rights and duties of business taxpayers and the IRS in the collection of employment taxes. The publication is sent to business taxpayers with their second delinquency notice or delivered by a Collection representative on initial contact. A similar booklet, "The Collection Process (Income Tax Accounts)," designed for individual taxpayers, was first published in 1974.

Delinquent accounts and returns

The Collection Division disposed of over 2.3 million accounts receivable, including some 342,000 notices sent taxpayers who contacted IRS field offices to resolve their delinquencies. Collection employees had to initiate contact on the remaining 1.97 million delinquent accounts.

Over 1.3 million delinquent return investigations and 108,000 returns compliance leads were disposed of by Collection personnel in 1978. Approximately one million delinquent returns were secured, involving nearly 989 million in additional assessments.

Criminal investigations

The Criminal Investigation Division is responsible for investigating tax fraud and other criminal violations of the tax laws. The Division's enforcement activities are divided into the general program and the special enforcement program.

The general program provides balanced criminal tax enforcement for various types of violations, geographical locations, and economic and occupational status. Several enforcement efforts such as the questionable refund program and the illegal tax protester project have been initiated to correct specific abuses of the tax laws.

The special enforcement program covers the identification and investigation of persons who derive substantial income from illegal activities while violating the tax laws. The program includes strike force activities and a project on high-level narcotics financiers and traffickers. In addition, the Criminal Investigation Division this year again began investigating violations of the Federal wagering tax laws.

The Division completed 8,713 investigations and recommended prosecution of 3,439 taxpayers. Grand juries indicted or courts filed information on 1,724 taxpayers. Prosecution was completed successfully in 1,414 cases. Taxpayers entered guilty pleas in 1,056 cases; 133 pleaded nolo contendere, and 225 were convicted after trial. Acquittals and dismissals totaled 70 and 119, respectively. Of the 1,446 taxpayers sentenced during 1978, 681, or 47.1 percent, received jail sentences.

Organized crime

The IRS cooperates in the fight against organized crime by participating in the Federal organized crime and strike forces program. Strike force units located in 13 major cities are headed by attorneys from the Department of Justice. The program objective is to coordinate the combined forces of Federal law enforcement agencies against organized crime. The IRS is responsible for detecting criminal tax violations and for ensuring that the income from illegal activities is reported correctly and taxed. The IRS contributed 417 staff years of direct investigative and examination time to the strike force effort during 1978.

Under the program, 107 were convicted or pleaded guilty to tax charges during the year and 582 prosecutions were pending when the year ended. Since the inception of the organized crime program in 1966, some 941 organized crime members and associates have been convicted or have pleaded guilty to tax charges.

As part of its special enforcement program, the Service continued to identify and investigate significant tax violations by high-level narcotics financiers and traffickers. During 1978, the IRS completed 323 criminal tax investigations, obtained 65 indictments, and achieved 56 convictions of financiers and traffickers.

Examinations

The IRS examines returns to help ensure a high degree of voluntary compliance. Additionally, when returns are filed they are reviewed also by IRS employees and computers. They are first checked manually for completeness and for such obvious errors as the claiming of a partial exemption or duplicate deductions. Then the Service's computers check the taxpayer's arithmetic and pick up other errors that may have escaped manual detection.

The primary method used by the IRS in selecting individual returns for examination is a computer program of mathematical formulas—the discriminant function system (DIF)—that measures the probability of error. Returns selected by DIF are screened manually and those confirmed as having the highest potential of error are assigned for examination. New DIF formulas for individual returns were developed in 1978 and will be used for returns filed in 1979. Since DIF was introduced in 1969, the number of individual taxpayers whose examinations resulted in no tax change has been reduced from 43 percent in 1968 to 24 percent, indicating the superiority of DIF over manual selection for most returns.

Returns may also be selected for examination under the taxpayer compliance measurement program, a computerized system that makes a random selection of returns. Examinations under this program are more intensive because the results are used to develop information required for research purposes such as the measurement of compliance among various classes of taxpayers and to update DIF formulas. Compliance measurement is an important factor in determining audit coverage of different classes of taxpayers.

Computer selection of returns is complemented by manual selection. For example, if the IRS examines a partnership return, the returns of the partners also may be examined. Returns of shareholders and executives may be examined in connection with the examination of their corporation. Other returns may be selected based on information documents filed by payers of wages, dividends, and interest. The IRS also screens returns with adjusted gross income above certain amounts and some returns of taxpayers who submit claims for refund or credit after filing returns.

Examination results

The IRS examined 2,328,812 tax returns of all types in 1978. Of those, 169,390 were examined in service centers, compared with 150,730 last year, an increase of 12 percent. The remainder were examined in district offices by revenue agents and tax auditors.

Examinations conducted by revenue agents at the taxpayer's place of business or residence covered 728,253 returns, or an increase of 27,450 returns, or 4 percent, from last year. There were 1,431,169 returns examined by tax auditors under office audit procedures—a decrease of 86,507 returns, or 6 percent, from last year.

Examination coverage of income, estate and gift tax returns, excluding partnerships and forms 1120S, was 2.28 percent, compared with 2.46 percent in 1977. The coverage including partnerships and forms 1120S was 2.29 percent, compared with 2.44 percent in 1977.

The Service's examination program resulted in approximately \$6.3 billion in recommended additional tax and penalties. Assessments totaled \$5 billion, \$4.1 billion in tax and penalties and \$913 million in interest. In 1977, assessments were \$3.4 billion in tax and penalties and \$650 million in interest.

Examiners are required to determine a taxpayer's correct liability and to ensure that taxpayers neither overstate nor understate their liability. Service examinations disclosed overassessments on 132,600 returns, accounting for refunds of \$312 million. In 1977, there were 122,003 returns with refunds of \$281 million.

Service center program

The IRS service center review program, begun in 1972, generally is limited to the verification or resolution of issues that can be handled satisfactorily by

service center personnel through correspondence with the taxpayer. There were 663,173 returns checked by the Examination Division in service centers in 1978, compared with 913,460 for 1977—a 27-percent decrease.

Of those checked, 169,390 were examined; the remainder, a total of 493,780 returns, were verified and corrected, compared with 762,730 in the previous year. The decrease occurred primarily because of the continuing impact of the Tax Reform Act of 1976, which allows certain errors to be corrected during initial returns processing.

Computer-assisted examinations

The Service uses computer programs in the examination of automated accounting systems used by taxpayers. Both taxpayers and the IRS save time and expense since computer procedures take a fraction of the time required to do the same job manually.

Over 12,000 computer applications were performed in 1978—an increase of 2,000 over 1977. The applications are done by computer specialists who are experienced revenue agents with intensive training in computer systems, hardware, programming languages, and examination techniques.

Coordinated examinations

Corporations whose gross assets exceed \$250 million are included in the coordinated examination program. Financial institutions and utilities are included in the program if gross assets exceed \$1 billion.

Coordinated examinations involve complex accounting systems and the use of teams consisting of experienced revenue agents, economists, computer specialists, engineer agents, international and excise tax examiners, and employee plans specialists to examine these corporate returns.

At the end of 1978 there were 1,300 corporations in this program, with 3.2 open years per corporation.

During 1978, the IRS continued its practice of conducting industrywide examinations of major companies in a given industry. Ten industries currently are being examined by this approach and two more are in the planning stage.

Joint Committee review

The Internal Revenue Code requires that all income, estate, gift, private foundation, and pension plan tax refunds and credits in excess of \$200,000 be reported to the Joint Committee on Internal Revenue Taxation. This year 978 cases involving overassessments of \$1.1 billion were reported to the Joint Committee, as compared with 997 cases and \$984 million in 1977.

United States-United Kingdom arrangement

The Service developed a working arrangement with the United Kingdom Board of Inland Revenue for simultaneous examinations of multinational taxpayers. This is the second such arrangement between the United States and another country (the first was with Canada in 1977).

Under this arrangement, the United States and the United Kingdom separately examine taxpayers under their respective jurisdictions. Before an audit begins, representatives of each country meet to plan and coordinate the examination. During each stage of the examination, information is exchanged in accordance with the tax treaty between the countries.

Oil industry

The Service also implemented the oil industry program by forming an oil taxation unit in the Southwest regional office. Among the unit's principal functions are: Making determinations and recommendations on certain issues; negotiating letters of agreement on these issues; coordinating selected issues and examination activities; developing pricing methods and examination techniques unique to the oil industry; and making industry analyses.

Enrolled agents

The special enrollment examination enables individuals who are not attorneys or certified public accountants to demonstrate their competence in tax matters and become enrolled to practice before the IRS.

The current examination, patterned after the CPA examination, is divided into four parts and emphasizes Federal tax laws as they apply to business operations, sole proprietorships, partnerships, and corporations. The questions focus on the tasks enrolled agents must perform to complete forms and file returns and to represent taxpayers before the Service. Candidates are required to pass each part though they may retain credit for any part passed and need only retake those parts failed.

In 1978, 5,425 candidates filed applications, compared with 5,090 in 1977.

Appeals

The Service encourages the resolution of tax disputes through an administrative appeals system rather than litigation. A taxpayer who disagrees with a proposed change in tax liability is entitled to a prompt, independent review of the case. The appeals system is designed to minimize inconvenience, expense, and delay to the taxpayer in resolving contested tax cases.

Before October 2, 1978, district conference staffs were the first level of appeal in tax disputes between taxpayers and the IRS on issues arising from the examination of returns. If the dispute were not settled, the taxpayer could have requested a second appeal conference with the Appeals Division.

District conference staffs reached agreement with the taxpayer in about 69 percent of the cases they considered this year.

During 1978, all IRS appeals functions were consolidated into a single appeals body. Effective October 2, 1978, these activities will be conducted by the Office of the Regional Director of Appeals in each of the seven IRS regions.

Proceedings in the appeals process are informal. Taxpayers may represent themselves or be represented by an attorney, a certified public accountant, or other adviser enrolled to practice before the IRS. If the disputed tax liability for each taxable year involved is \$2,500 or less, the taxpayer may obtain a conference without filing a written protest.

In most cases, the taxpayers and the district conferee, or regional appeals officer, reached mutually acceptable agreements, so few cases went to trial. In the past 10 years, 97 percent of all disputed cases were closed without trial. In 1978, the appeals function disposed of 54,715 cases by agreement.

Cases considered by the Appeals Division fall into two broad categories, nondocketed and docketed. Nondocketed cases are those in which the taxpayer is protesting a proposed action by an IRS District Director involving additional taxes, a refund disallowance, or a rejection of an offer in compromise. These cases made up about 54 percent of the Division's workload

in 1978. Docketed cases involve situations in which taxpayers have filed a petition for a hearing before the U.S. Tax Court.

In 1978, 70 percent of nondocketed cases and 73 percent of docketed cases were closed by the Division by agreement with the taxpayer.

Other appeal options

If a tax dispute cannot be resolved at the administrative appeals level, the taxpayer is advised of additional appeal rights to the courts.

If the disputed tax does not exceed \$1,500 in any tax year, a simple procedure is available under the U.S. Tax Court's small-case procedures that permit informal hearings where taxpayers may present their cases before a special trial judge. Since a knowledge of courtroom proceedings is not required, an inexpensive forum for the taxpayer is provided. However, there is not provision in the law for an appeal of the Tax Court's decision under the small-case procedure.

If a taxpayer chooses to bypass the Tax Court, the tax deficiency may be paid and a claim for refund filed within 2 years from the date of payment. If the claim is denied or no action is taken by the Service on the claim within 6 months, the taxpayer may file suit for a refund in either a U.S. district court or the Court of Claims.

A taxpayer may appeal an adverse decision of the Tax Court or district court to the U.S. Circuit Court of Appeals having jurisdiction. Adverse decisions of the Court of Claims or a Circuit Court of Appeals may be appealed to the U.S. Supreme Court, although not all such appeals are accepted. The Tax Court tried 1,742 cases, and the U.S. district courts and Court of Claims 447 cases.

International operations

IRS foreign operations are the responsibility of the Office of International Operations (OIO). The Service maintains permanent foreign posts and Revenue Service representatives at these stations are involved in compliance and taxpayer assistance activities and maintain cooperative contacts with foreign tax agencies.

Since OIO established its first office in Paris in 1948, the number of foreign posts staffed by Revenue Service representatives has increased to 14. Currently, posts in Bonn, London, Paris, and Rome cover Western Europe and North Africa. Those in Mexico City, Caracas, and Sao Paulo are responsible for Mexico, Central America, and South America while Canada is serviced from Ottawa. Offices in Tokyo, Manila, Kuala Lumpur, and Sydney administer OIO activities in Japan, Southeast Asia, Australia, and New Zealand. A post in Tehran covers the Middle East, and the one in Johannesburg services Africa south of the Sahara.

This marked the 25th consecutive year that U.S. taxpayer received tax assistance abroad. Twenty-two assistants were detailed abroad during the year, providing assistance in 145 cities in 80 foreign countries. Approximately 151,000 taxpayers were assisted overseas, and several hundred members of the Armed Forces attended 5 military tax schools held overseas. The Armed Forces participants then helped thousands of military personnel prepare their own tax returns.

Toll-free telephone assistance was expanded to all U.S. taxpayers in Puerto Rico during 1978. Further, the Service entered into a tax administration agreement with Puerto Rico that, along with agreements with American

Samoa, Guam, and the U.S. Virgin Islands, allows the exchange of taxpayer return information and the development of mutual tax assistance programs.

OIO is responsible for ensuring compliance with Federal tax laws by U.S. citizens residing in foreign countries and foreign entities doing business in the United States. It is also concerned with U.S. business controlled by foreign interests and assists in the overseas examination of multinational corporations.

OIO examination and collection activities take place primarily in the United States. However, OIO does send revenue agents and tax auditors to the foreign posts to examine the returns of taxpayers living overseas. Those collection cases that cannot be settled through correspondence are sent abroad for personal contact.

OIO also administers the social security laws in U.S. possessions and Puerto Rico and the income tax laws for Puerto Rican residents on income from sources outside of Puerto Rico.

Under the reorganization of the Office of the IRS Chief Counsel, a District Counsel office was established to serve as principal legal adviser to OIO.

Treaties

Tax treaties with other countries are designed to eliminate double taxation, remove tax barriers to trade and investment, and help curb tax avoidance. The United States now has income tax treaties with 39 countries and estate tax treaties with 13 countries.

In 1978, meetings were held with tax officials from several treaty countries to improve the administration of the treaties involved. These conferences improved working arrangements for more effective exchanges of information and for resolution of recurring problems that arise from conflict of U.S. and foreign tax laws.

A limited number of tax treaties provide for mutual collection assistance and OIO is playing an increasing role on a reciprocal basis in collecting taxes of these treaty partners from aliens in the United States.

Employee plans and exempt organizations

The Office of Employee Plans and Exempt Organizations (EP/EO) administers the regulatory responsibilities of the Service for employee benefit plans and tax-exempt organizations.

At the National Office, the functions are Employee Plans, Exempt Organizations, and Actuarial Divisions. EP/EO field staffs are located primarily in the 7 regional IRS offices and 19 key districts.

The Employee Plans activity administers the Employee Retirement Income Security Act of 1974 (ERISA) with emphasis on developing regulations and procedures urgently needed by the public. The IRS continues to coordinate the implementation of ERISA with the Department of Labor and the Pension Benefit Guaranty Corporation. As part of an effort by the IRS to reduce the reporting burdens placed on taxpayers, plan sponsors and administrators are filing the 1977 annual return/report (form 5500 series) only with the IRS. In addition, a single computer system has been developed to provide return and data information needed by the three agencies.

A questionnaire mailout was developed in 1978 to survey employers who received benefit plan determination letters before the enactment of ERISA but who failed to request a determination letter for their plans to conform to ERISA's requirements. The survey provides an estimate of the volume and

expected receipt dates of determination letters and assists the Service in protecting the rights and benefits of plan participants.

Taxpayers have been encouraged to take advantage of IRS-approved pattern, model, master, and prototype plans to reduce the expense and paperwork in complying with ERISA.

Some 7 regulations, 15 revenue rulings and procedures, and 25 news releases were issued, as well as 4,836 National Office opinion letters on master and prototype plans dealing with self-employed plans, corporate plans, and individual retirement accounts and annuities.

The Service devoted an average of 854 field professional positions to carrying out employee plans responsibilities. Advance determination letters were issued on the qualification of pension, profit-sharing, and other employee benefit plans. Examinations were conducted to determine the qualification of plans in operation and to verify plan contribution deductions. During the year, 214,672 determination letters were issued on corporate and self-employed plans, an increase of 40 percent from 1977. The prohibited transactions activity closed 155 exemption cases, including 23 published proposed and final exemptions covering 116 individual cases.

On August 10, 1978, the President submitted an ERISA reorganization plan to Congress. The plan essentially will eliminate overlapping jurisdiction and duplication of effort in the administration of ERISA by separating the authority of the Treasury and Labor Departments.

The Exempt Organizations activity determines the qualifications of organizations seeking tax-exempt and private foundation status and examines returns to ensure compliance with the law. The number of active entities on the Exempt Organizations master file increased from 789,666 in 1977 to 810,048 in 1978.

During 1978, 4 regulations, 55 revenue rulings and procedures, 264 technical advice memoranda, 19 announcements, 7 news releases, and 8 publications were issued or revised. An average of 379 field professional positions were devoted to the examination of 17,238 exempt organization returns. Also, field professional positions were devoted to applications, reapplications, and requests for rulings on proposed transactions from organizations seeking a determination of tax-exempt status or of the effect of organizational or operational changes on their status.

In August 1978, a proposed revenue procedure was published providing more definitive guidelines to determine whether certain private schools claiming tax exemption operate on a racially nondiscriminatory basis as required by judicial decisions.

The selection of exempt returns for examination (SERFE) system, designed to recognize certain returns based on specific selection criteria, was implemented. SERFE is used instead of manual classification to identify returns that may warrant examination.

The decentralization of the processing of EO returns and related documents in 1977 from the Philadelphia Service Center to the Andover and Fresno Service Centers was expanded in 1978 to include the Atlanta, Austin, and Ogden Service Centers.

Basic principles and rules for uniform interpretation and application of the Federal tax laws involving actuarial matters are provided by the EP/EO Actuarial Division.

The Service devoted an average of 17 professional positions to carrying out actuarial responsibilities. The Division participated in public hearings on proposed regulations and serviced taxpayer requests for rulings.

Managing The Tax System

Planning and research

Planning, research, and analysis are integral, continuing management activities conducted throughout all IRS components. During 1978, planning activities included the preparation of the Service's long-range plan and work toward the development of a single, uniform program structure for use in planning and in zero-base budgeting. Service research activities included the testing of improved work technologies, the development of testimony and other materials for presentation to congressional committees, the analysis of pending legislation, and a number of statistical and analytical projects to identify optimum program designs and objectives. The Planning and Research function also initiated a new system for monitoring and coordinating studies, tests, and research projects throughout the Service to maximize the effectiveness of such activities, which account for nearly \$10 million in annual expenditures.

Reorganization

During the past year, Planning and Research provided guidance and support for a number of organizational studies within such components as Employee Plans and Exempt Organizations, the IRS Data Center, the Criminal Investigation function, the IRS service centers, and the Internal Security function. In addition, Planning and Research provided management, coordination, and analytical support to the IRS organization review group directed by the Deputy Commissioner. This group conducted a comprehensive assessment of the IRS that led to major revisions in operations, including the creation of a single level of taxpayer appeal and the combination of all IRS public service and information activities into a single organization.

The Accounts, Collection and Taxpayer Service (ACTS) organization has been redesignated "Taxpayer Service and Returns Processing." It now includes the taxpayer information activity, formerly assigned to the Public Affairs Division, and the Disclosure function, formerly a part of Compliance. The Collection function from the old ACTS organization has been shifted to the Assistant Commissioner (Compliance), consolidating all enforcement activities under a single authority.

Another major change was the creation of a new unit at the district level to provide centralized technical and administrative support services. Before the organizational review, field operating functions commonly had staffed and equipped their own support units.

The organization review group also recommended the redesignation of the Service's Administration organization as "Resources Management." In addition to retaining the traditional Administration activities, such as training, administrative services, and fiscal management, Resources Management also is responsible for the new district office Centralized Services unit and for a new Security function, formed to improve IRS safeguards of tax returns and other taxpayer records.

To more accurately describe their actual roles, Audit and Intelligence activities have been redesignated "Examination" and "Criminal Investigation."

Studies

As a part of the Service's efforts to simplify tax returns and the tax filing process, a short questionnaire was included in a randomly selected sample of 1977 tax packages to identify aspects of the tax returns, instructions, and

schedules that taxpayers find difficult to understand. The questionnaire also sought to determine how taxpayers try to overcome their returns preparation problems and solicited suggestions for simplifying the forms.

Among the 7,600 respondents, only 29 percent of 1040 filers and 11 percent of 1040A filers said that they had difficulty in understanding the tax returns or instructions. The tax computation portions of the tax forms were cited as causing the most difficulty. Most respondents said they cope with their preparation problems by rereading the instructions. The survey results suggested that further simplification of the tax forms and instructions would not significantly alter the proportion of respondents who seek professional assistance.

In another effort to get direct information from the public, the Service contracted with the Opinion Research Corp. of Ann Arbor, Mich., to determine the potential demand for free IRS return preparation services. The results of this survey will be used in a comprehensive review of the Service's current returns preparation policy.

The first thorough IRS examination of the economic, social, and behavioral factors that promote or discourage individual taxpayer compliance was undertaken in 1978. The Service awarded an 18-month contract to Westat Inc., of Rockville, Md., to conduct a study to develop methods for measuring the impact of factors identified as affecting individual taxpayer compliance. Once a working methodology is developed, further research will be conducted to obtain relevant data and to apply the study findings to tax administration program evaluation and planning.

The Service initiated a long-term series of studies to determine how well taxpayers understand and comply with the approximately 85 provisions in the tax law that permit the deferral of certain tax consequences to subsequent years. Some of the specific studies cover deferred gains on sales of personal residences, losses from activities not engaged in for profit, reductions of stock cost basis, and the recapture of the new residence purchase credit where the residence is sold within 3 years of purchase. Other areas under consideration for examination include deferred gains on installment sales, changes in accounting methods, at-risk loss limitations for various business activities, and generation-skipping trusts. The results of these studies will be used to determine the need for a system to track and better enforce individual taxpayer obligations under the deferred tax provisions.

There are civil penalties in the tax law for the violations of approximately 75 different rules governing the filing of tax returns, the timely payment of taxes due, and reporting Federal tax liability. The IRS began a review of these provisions to assess their fairness, effectiveness, and administrability. Upon completion of the study, scheduled for fiscal 1979, legislative recommendations will be developed to amend or repeal penalties provisions where changes are warranted. The study also will consider proposals for improving the administration of penalties and for monitoring their effectiveness.

Planning and Research is responsible for analyzing legislative proposals affecting the IRS and for determining their administrative implications. Once legislation is enacted, a plan for implementing each provision is developed and coordinated with those functions responsible for administering the legislation. Approximately 55 bills were analyzed for their impact on Service activities, and implementation plans were developed and carried out for 11 new public laws.

Productivity

A program was established to provide expanded incentives for promoting productivity at all IRS levels. The goal of this program is to improve efficiency by substituting investments in technology for staff, particularly in work processing, clerical, and other routine operations. An important part of the program is a productivity enhancement fund for financing projects that improve procedures, techniques, and equipment. Plans call for the Service to prepare an annual productivity plan, hold productivity management seminars, and improve work measurement systems.

Measuring compliance

The taxpayer compliance measurement program (TCMP) is a continuing enforcement and research effort by which the Service attempts to determine the nature and extent of tax law compliance. The TCMP data also are used to develop computer routines for selecting returns for examination. TCMP data are derived from examinations of tax returns selected on the basis of random probability samples.

During 1978, work continued on the first TCMP survey of fiduciary returns and on the sixth survey of individual income tax returns. Field examinations also were initiated for the third corporate TCMP survey. For the first time, this survey was expanded to include corporate returns filed with no balance sheets, as well as those returns with assets up to \$10 million. Plans are now being made to initiate the first TCMP survey of employee benefit plans in July 1979 and a second survey of tax-exempt organizations, beginning in January 1980.

Optical scanning

Recent developments in electro-optical technology have given rise to the possibility of using scanning equipment to record the data reported by taxpayers on their returns. During the past 2 years, the Service tested the performance of this technology on machine-prepared tax documents such as forms 1099 and 941 to determine what changes must be made in Service forms and procedures before optical character recognition (OCR) can be used. Meanwhile, plans are being made to test the feasibility of OCR processing of 1040A tax returns.

Federal-State test

The IRS is working with the National Association of Tax Administrators to promote the filing of forms 1099 and 1087 information documents on computer tape. Under the test program, which will begin in calendar 1979 using tax year 1978 information filed principally by institutional taxpayers in California, Minnesota, and New York, the Service will process the magnetic tapes, retaining information for Federal tax purposes and simultaneously producing information for use by the States in whatever medium and format they require. This arrangement will reduce recordkeeping and filing requirements for taxpayers and accelerate the use of more efficient electronic media by both the IRS and State tax administrators. If the test is successful, it will be a model for a similar arrangement among institutional filers, the IRS, the Social Security Administration, and the States in handling information from the form W-2 withholding statement.

Publishing statistics

The annual Statistics of Income (SOI) publications provide the public and the Government with a variety of data reported on income tax returns without

violating taxpayers' rights to privacy. Nearly all of the data are estimates based on representative samples of returns.

Preliminary SOI publications in 1978 covered individual income tax returns for 1976 and corporation and business returns for 1975. As required by the Tax Reform Act of 1976, the 1976 report for individuals included statistics on the tax liability of persons with high total income computed using several different concepts. Detailed statistics for 1975 and 1976 also were provided to the Office of Tax Analysis for a special publication on high-income taxpayers. Publication of statistics on this topic is required annually by the 1976 act.

An SOI supplemental report on individual income tax returns also was published, providing certain 1974 information for each county and for the 125 largest metropolitan areas.

Special statistical studies included information on sales of capital assets reported on individual income tax returns, the new jobs tax credit introduced by the Tax Reduction and Simplification Act of 1977, and the foreign tax credit and tax-exempt income earned abroad as reported on individual income tax returns.

Data also were provided for inclusion in reports to Congress on domestic international sales corporations, U.S. taxpayers that participated in international boycotts, and the revised system of taxing domestic corporations on their operations in Puerto Rico and U.S. possessions.

Statistics of Income publications may be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

Tax models

Developed in the early 1960's to meet Treasury's need for timely estimates of the impact and revenue effects of proposed tax legislation, tax models also have proved to be valuable tools for economic planning. Five basic models—individuals, corporations, sole proprietorships, partnerships, and estates—are updated each year to reflect changing levels and patterns of income. Each model consists of generalized manipulation and table-generating computer programs, used in conjunction with specially structured Statistics of Income files containing the most current available year's tax return data.

Planning throughout the Service is based on projections of the number of returns to be filed. The planning requirements of the various units of the Service require that workload projections be prepared for the entire United States as well as for service center areas, regions, and districts.

Special projections also are made for research purposes. Work planning projections are updated each year to incorporate changes in the economic and demographic outlook as well as the effects of tax law changes and filing patterns.

The number of primary returns and supplemental documents is expected to grow from 133.8 million in 1977 to 163.3 million in 1985. This increase of 22.1 percent reflects the expected growth in population and economic activity.

Resources Management

Resources Management—redesignated from Administration under the reorganization—is responsible for fiscal management, personnel, facilities management, training, centralized services, employment policy, security standards and evaluation, and management improvement. This office is also responsible for the functional supervision of Resources Management activities in the field.

Consistent with President Carter's commitment to improve the quality of public correspondence, participation in writing improvement workshops was increased this year. Nearly 700 IRS employees attended various workshops that stressed clarity and responsiveness in correspondence.

Four different workshops are offered to accommodate employee needs. The training ranges from 8 to 40 hours of classroom work, plus some self-study exercises. It is designed for the executive, the legal or technical originator, the reviewer, and those persons needing refresher courses.

A Security Standards and Evaluation Division was established, consolidating responsibilities previously placed in several different organizations. The Division directs the development, implementation, and evaluation of a comprehensive Service-wide security program. The program provides reasonable protection for employees and against loss, destruction or compromise of tax and other protected information, facilities and property, data systems, and other assets.

Equal employment opportunity

Total full-time regular employment from July 1977 through July 1978 increased by 2.9 percent, while the number of women increased by 5.9 percent and the number of minorities by 7.8 percent.

Women and minorities made gains in 19 of the 20 most populous IRS occupations, including revenue agent, revenue officer, tax auditor, attorney, and criminal investigator. The number of women and minorities at GS-13 and above also increased—women increased from 3.8 percent to 4.5 percent, and minorities in these positions increased from 5.4 percent to 5.8 percent.

During the year, the Service observed Black History Week as well as Hispanic Heritage Week and Women in Government Month.

Training to instruct special emphasis program coordinators, including those for women, Hispanic employment, upward mobility, and blacks, was developed and piloted. In addition, about 100 EEO counselors received training in handling class discrimination complaints.

Labor-management relations

In mid-1977, the Assistant Secretary of Labor for Labor-Management Relations ruled in favor of the National Treasury Employees Union's petition to consolidate 11 center bargaining units into 2 nationwide units. One unit consists of all service centers—except Andover—the Data Center, and the National Computer Center. The second unit consists of all districts—except Anchorage—and all regional offices—except the North-Atlantic appellate function and the Southeast regional office—and the National Office.

As a result of this consolidation, the Service revised its labor relations case-handling procedures, strengthened its basic labor relations training courses to include a complete package in discipline, adverse actions, and appeals, and initiated new communications techniques between the field and the National Office.

There has been an increase in the unfair labor practice caseload along with a continued upward trend in grievance activity. The Service republished the agency grievance procedure in handbook form and substantially revised its grievance examiner training course.

Paraprofessional savings

The IRS has established approximately 1,400 paraprofessional positions instead of as many higher graded professional and technical positions. This was

accomplished by identifying and splitting off the less complex work present in higher graded professional and technical positions and assigning it to paraprofessional employees at lower grades.

This resulted in a savings of approximately \$8 million in salary and benefit costs. In addition to the recurring dollar savings, establishing paraprofessional positions also increased the effectiveness and productivity of the Service's professional and technical employees, enabling them to spend more time on higher level work.

Paraprofessional positions have been established in Examination, Collection, Inspection, Criminal Investigation, and Resources Management. Similar positions are being considered for other occupational areas.

Jobs for the handicapped

The number of handicapped employees in the IRS increased from 1,667 in 1977 to 1,701 in 1978. The IRS nominee for Outstanding Federal Handicapped Employee of the Year was William J. Boucher, a tax auditor from the Austin district. Mr. Boucher also was selected as the Department's nominee for Outstanding Federal Handicapped Employee of the Year.

Awards for incentive

The IRS incentive awards program received special attention in 1978 with many employees receiving recognition for their outstanding contributions to the Service—including 2 Meritorious Service Awards, 15 Commissioner's Awards, 5 Special Achievement Awards of \$1,000 or more, and 2 special recognition awards for exposing bribery schemes.

Also, several IRS employees received recognition from organizations outside of the Service. Deputy Commissioner William E. Williams was the Department of the Treasury nominee for the 1977 Roger W. Jones Award for Executive Leadership. Sixty-five employees received Presidential Letters of Recognition for employee contributions that resulted in tangible benefits of \$5,000 or more.

Linda Molyneux of the Fresno Service Center was presented the 1977 John E. Fogarty Public Personnel Award for her outstanding efforts towards the hiring of the handicapped. This award, the highest given by the President's Committee on Employment of the Handicapped, was made on June 13, 1978, at the International Association of Personnel Employment Security convention in St. Louis.

Yolanda Carrillo of the Fresno Service Center has had an exceptional year beginning with an award of \$1,285 for a suggestion with a tangible benefit of \$184,000. In addition to the cash award, Ms. Carrillo's accomplishment brought a Presidential Letter of Recognition and made her 1 of 11 recipients of the 1977 Presidential Management Improvement Award. This award was presented in the White House Rose Garden on May 23, 1978, by the President.

Internal Revenue Manual

The Service adopted a new system to compose, print, and distribute its internal operating procedures in the Internal Revenue Manual. Using electronic technology, accurate copy is produced in 6- by 9-inch format at less cost and in less time than with the old method. Additional services, provided under a single contract, include filling orders for current parts or handbooks, comprehensive topical indexes and management summaries of recent functional or operational changes to any part of the Manual.

Training

The coordinated examination training program was developed and piloted in early 1978. This course will provide a cadre of revenue specialists who can make determinations of areas of accounting systems to be isolated for more thorough auditing and reducing or eliminating the time expended on nonproductive auditing.

This training also will increase the number of companies under the program, provide a greater degree of uniformity and consistency in resolving tax issues, simplify decisions on taxability, and eliminate duplication of effort. Some 325 senior agents are expected to be trained for the program in each future year.

The Service continued to conduct basic training for the Criminal Investigation Division at the Federal Law Enforcement Training Center. Several new programs were produced to support the Division—new on-the-job training for recruit special agents was tested, all special agents received review training in the implication of the new disclosure provisions, and a TV tape test similar to the national driver's exam was used. A wagering tax course also was written and piloted this year.

Tax shelters

A 3-day program to train examination employees—revenue agents, tax auditors, estate tax attorneys—for detailed identification and examination of abusive tax shelters was developed this year.

Tax shelter training is now an integral part of all new examiners' training courses. This training also is given to incumbent employees as part of the update courses, and a limited partnership portion serves to reinforce previous tax shelter training.

The training provides examiners with the general tools needed to recognize the abusive elements of a tax shelter regardless of its business nature or reporting form.

Data entry

The IRS trained approximately 4,000 data transcribers using a 60-hour training program. In previous years the direct data entry training program was 80 hours in length.

By using this new, shorter training program, the IRS saved approximately \$404,000 in training, administrative, and instructor costs. The reduced amount of training had no adverse effect on the trainees' ability to reach the job standards for speed and accuracy.

Instructing others

More than 100 employees of State and local governments participated in IRS training activities.

Financial investigative courses were held for the Maricopa County, Ariz., Sheriff's Association to train 20 participants from various local police and attorney general offices, and for 48 members of the Pennsylvania Crime Commission.

Students in the 5-week IRS special agent course included revenue employees from the Colorado Department of Revenue, the New Jersey Department of Law and Safety, and the Philippines, Dallas, Tex., and Phoenix, Ariz., governments.

Participants in various revenue agent training courses included employees of the Government of American Samoa; the States of Alaska, New York, Maine, and Oregon; and the cities of Milwaukee, Wis., and St. Paul, Minn.

Special investigation employees of the St. Louis Police Department attended the 8-day wagering tax course. Instructor training and course assistance was provided to the Idaho State Tax Commission to enable it to train employees in auditing techniques.

Logistics support

The Service continued its efforts to eliminate unnecessary internal reporting, canceling 21 reports in 1978 for annual savings of approximately \$406,000.

The IRS conducted an extensive study of the taxpayer assistance toll-free telephone system (TFTS) to determine if the efficiency of that operation could be improved. The study identified the best locations and the optimum number of sites to locate the TFTS answering operations. New procedures for planning and managing the telephone circuitry used in the toll-free system also were implemented to provide a better balance between incoming circuits and answering positions. The initial result of these efforts was a \$2 million reduction in the telecommunications cost for the toll-free program.

Other actions to reduce communications costs included implementation of new procedures for transmission of written records, such as facsimile, teletype, and express mail, and more control over commercial long-distance and Federal Telecommunications System usage. These efforts saved approximately \$1.6 million.

An internal management reporting system has helped the IRS to monitor and control its space inventory and costs. Approximately \$500,000 was saved by releasing space, using space-saving techniques, and closely reviewing utility and service charges. Continued implementation of multiple-occupancy work stations and open office planning concepts is resulting in more efficient utilization of property resources. During 1978, the Service reduced its field use of office space 4 square feet per person, saving 221,000 square feet at \$7.78 per square foot, or approximately \$1.7 million.

A revised inventory management system for property accountability will consolidate reporting requirements of three inventory systems into a single system at an estimated annual savings of \$100,000.

The IRS continued to rate as one of the top Federal agencies in occupational safety and health. In calendar 1977, the Service reduced both disabling injuries and motor vehicle accidents at a time when most agencies realized substantial increases in rates. The IRS had a rate of 3.4 disabling employee injuries per million staff-hours worked. Service employees drove 119 million miles on official business with 671 accidents, 72 less than in calendar 1976. The accident frequency rate decreased from 5.8 to 5.6 accidents per million miles driven.

A system of using unique service center ZIP codes was implemented for the 1978 filing season. This system reduced the average transit time of mail from the taxpayer to the service centers by 1 day. Because the Treasury has use of the tax revenue 1 day earlier, the Government saves some \$5 million in interest annually.

Records disposal resulted in the release of space and equipment valued at \$3,809,000. A total of 208,273 cubic feet of records was destroyed and 592,570 cubic feet of records was retired to Federal Records Centers.

Data services

Data Services is responsible for the development, implementation, and evaluation of computer systems, programs, and hardware requirements. The

Office of Assistant Commissioner (Data Services) originally provided for three developmental areas—the Service and Design Division, the Systems Programming Division, and the Systems Analysis Division—and two computer facilities—the National Computer Center and the Data Center.

Two areas have been added, the Systems Development office to develop and assess new computer systems to meet increasing IRS needs, and the Planning and Control staff to monitor Data Services personnel and hardware, to maintain an inventory of data processing requests and the resources to fill them, and to serve as Executive Secretary to the ADP Policy/Resource Board.

The Service is implementing a remittance processing system (RPS) for quicker and more efficient handling of remittances. RPS processes the remittance, encodes the source document with an audit trail, and prepares documentation for forwarding to the bank with the checks. RPS handles returns, estimated payments, and subsequent payments, forwarding transactions to the appropriate master file to indicate receipt of the remittances before the source documents are processed, aiding in answering taxpayer inquiries.

Automated information

Control of partnership returns on the audit information management system was implemented on a test basis in the Salt Lake City district office and the Ogden Service Center on July 1, 1978.

Under the system, the examiner of the partnership return is able to requisition an unlimited number of partner returns for shipment and examination in the partner's district office. The examiner of the partnership return receives a monthly report showing all partners established on the data base. Each district office receives a cumulated monthly report showing income adjustments applied to a partner's return in the district, resulting from partnership examination.

National Computer Center

The National Computer Center in Martinsburg, W. Va., plans, directs, and coordinates computerized master file operations of the integrated tax administration system. Eight large computers and three computerized micro-film systems are used in the testing and production processing of the individual, business, exempt organization, employee plans, and individual retirement account master files for the Nation.

The Computer Center operates 24 hours a day, 7 days per week and maintains reciprocal accounting with each of the 10 service centers. Input of data to the Computer Center such as tax returns, tax payments, and adjustments is primarily on magnetic tape shipped from the service centers and other organizations by air. The output, also on magnetic tape, contains data for printing notices such as bills, refund checks, etc., and is air shipped to the service centers and other Federal and State agencies. During the year, the Computer Center received more than 84,000 input tapes and shipped more than 82,000 output tapes.

As of August 1978 there were 121,063 magnetic tapes in the Computer Center library, with the individual master file containing 111,028,298 taxpayer accounts, the business master file, 17,106,712 accounts, the exempt organization master file, 1,007,496 accounts, the employee plans master file, 1,129,694 accounts, and the individual retirement account master file, 2,876,309 accounts.

Data Center

The Data Center in Detroit, Mich., is responsible for the performance of non-master-file data processing operations for the Service.

In 1978 a new system was selected to replace the current computer systems. Installation of the replacement system is scheduled for early calendar 1979 with testing and acceptance expected by the middle of the year.

Two new software systems were installed to monitor and report computer utilization and control development of new systems and produce reports of human resource utilization.

The Data Center is processing up to 1 million employee benefit plan forms for the Department of Labor this filing season, with work started in late 1978. Processing involves the filming of returns with special cameras and producing output on microfiche. Output will be shipped to service centers, the National Archives, and the Department of Labor.

Technical activities

The Service's tax ruling program consists of letter rulings, technical advice, and published revenue rulings.

A letter ruling is a written statement issued to a taxpayer by the National Office interpreting and applying tax law to a specific set of facts. Such a ruling provides guidance concerning the tax effects of a proposed transaction. Letter rulings are not precedents and may not be relied upon by taxpayers other than the recipient.

Technical advice provides guidance on the proper application of the tax laws to specific facts issued by the National Office at the request of a district office in connection with the audit of a taxpayer's return or claim for refund or credit. Frequently, the District Director's request is made at the suggestion of a taxpayer that technical advice be sought.

A revenue ruling is an interpretation of the tax laws issued by the National Office and published in the Internal Revenue Bulletin to inform and guide taxpayers, practitioners, and IRS personnel.

Tax shelter rulings

During 1978, the Service continued an active program of publishing revenue rulings to answer significant issues with respect to tax shelters and other artificial tax devices. The goals of this program are to provide technical guidance to taxpayers and to Service personnel on the specific issues presented and to increase public awareness that the Service will carefully scrutinize tax-motivated transactions. A highlight of this program was the publication on October 31, 1977, of nine revenue rulings addressing a number of current tax shelter issues.

Art Advisory Panel

The Art Advisory Panel held three meetings at the National Office during its 10th anniversary. Since 1968 this unpaid, 12-member panel of art experts—museum directors, curators, scholars, and dealers—has helped the Service to review taxpayers' appraisals and to determine the value of works of art donated to charity or for gift or estate tax purposes.

All appraisals of works of art claimed at \$20,000 or more in audited tax returns must be referred to the National Office for review. The claimed value of the average item referred to the panel recently has been close to \$100,000. Nearly half of all reviewed appraisals are found to be unacceptable.

The panel reviewed appraisals on 702 works of art with taxpayer-claimed values amounting to \$67 million this year, resulting in valuation adjustments of \$12 million. During its 10 years of operation, the panel has reviewed appraisals with claimed values of \$276 million which resulted in valuation adjustments of \$75 million.

Internal Revenue Bulletin

The weekly Internal Revenue Bulletin announces official rulings and procedures of the Service and publishes Treasury decisions, Executive orders, tax conventions, legislation, court decisions, and other items of general interest. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, with weekly and semiannual issues distributed within the Service and available to the public through the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

During 1978, the Bulletin included 499 revenue rulings, 39 revenue procedures, 8 public laws relating to Internal Revenue matters and 10 committee reports, 58 Treasury decisions containing new or amended regulations, 50 delegation orders, 4 Treasury Department orders, 14 notices of suspension and disbarment from practice before the Service, 268 announcements of general interest, and 8 court decisions.

The Bulletin Index-Digest System, with current supplements, aids in researching material published in the Bulletin after 1952.

Making rulings public

The Tax Reform Act of 1976 provided that IRS rulings and technical advice generally be opened to public inspection after the deletion of the taxpayer's identity, trade secrets, and confidential commercial and financial information.

Rulings and technical advice requested after October 31, 1976, generally are made available within 90 days after they are issued to taxpayers. Of the approximately 80,000 issued in answer to requests made before November 1, 1976, 25,000 were made available to the public in 1978. The remaining rulings will be opened for public inspection in 1979.

Publishing Services developed a computer-based system to produce microfiche indexes for the release of letter rulings. This dual system produces Code section indexes for the weekly release of current rulings. Nine monthly and cumulative indexes were developed to provide the ruling information in various formats based-on-user needs.

Inspection

The Inspection Service's internal audit and security programs aid IRS managers in maintaining the highest levels of efficiency and integrity.

The Internal Audit staff independently appraises the operations of the IRS to measure the extent of compliance with established management policies and to determine whether procedures are in accordance with law and regulations. Controls are reviewed in all IRS activities to ensure that both taxpayers' and the Government's rights are protected and that operations are carried out efficiently, effectively, and with integrity.

Internal Audit reviews operations that have widespread impact on the Service or that are considered high risk. The review of controls for safeguarding tax information and assuring fair and equitable treatment of taxpayers also is stressed.

To improve the efficiency of Service operations, national coordinated audits are being used more often to provide uniform coverage in several offices and to evaluate the operation of a program better on a nationwide basis. These audits provide managers with a better perspective of their operations, permit nationwide corrective action if necessary, and require less staff.

Abstracts of Internal Audit findings are prepared and distributed to Service officials nationwide to help identify operational areas that may need increased management attention.

Internal Audit issued 241 reports to Service managers during the fiscal year. Management actions on these problems resulted in better service to taxpayers, strengthened controls, and improved operations. In addition, response to Internal Audit findings resulted in measurable savings and additional revenue estimated to total \$157 million.

Maintaining integrity

Internal Audit gives priority to the detection of fraud, embezzlement, or other wrongdoing on the part of Service employees. During the year, Internal Audit informed Internal Security of possible breaches of integrity by 161 employees and 38 other individuals. Some 97 investigations were completed in 1978. As a result, 84 employees and 8 others were cleared of allegations of improprieties, while actions were taken or were pending against 1 employee and 4 others.

Internal Security

The Internal Security Division protects the integrity of the Service by investigating high-risk areas and alerting managers and employees to integrity hazards.

The Division investigates complaints of criminal misconduct or irregularities affecting IRS employees or operations. It also conducts investigations of non-Service persons who attempt to bribe, threaten, or assault Service personnel, the unauthorized disclosure of Federal tax return information, disclosure or use of information by preparers of returns, and charges against tax practitioners.

In addition, the Division investigates IRS job applicants and conducts special investigations and inquiries for the Commissioner and the Secretary of the Treasury.

During 1978, Internal Security inspectors arrested or were responsible for the indictment of 147 persons including 92 taxpayers and tax practitioners, and 55 employees or former employees. Ninety-five persons were convicted during the year, including 83 defendants who pleaded guilty. Forty-six of these convictions were for bribery, 11 were for assault, and the remainder involved such criminal charges as conspiracy to defraud the Government, obstruction of justice, subscribing to false returns, disclosure of confidential tax information, and embezzlement.

In one case, two high officials of a nationally known company were convicted of authorizing gratuities of approximately \$27,000 to IRS employees. The corporation also was convicted and fined \$36,000. Earlier an IRS audit manager was convicted of accepting free vacation trips from the company.

Bribery awareness

The Division increased the number of bribery awareness presentations to Service employees, expanding them to include video tapes that realistically portray bribery situations Service employees may encounter.

The effectiveness of these presentations may be gauged by the facts: 186

employees reported 252 possible bribery attempts resulting in 73 arrests or indictments and at the end of 1978, 31 persons were awaiting trial on bribery charges.

Assaults and threats

FBI statistics from last year show that 74 percent of all threats and 41 percent of all assaults on Federal employees were directed at IRS employees.

Internal Security responds promptly to protect IRS employees threatened or assaulted while performing their duties and seeks vigorous prosecution of these cases by the U.S. attorney. In instances where prosecution is declined—usually in verbal threat cases without physical assault—an inspector, with the approval of the U.S. attorney, contacts the alleged assailant to inform him or her of applicable Federal statutes concerning assaults or threats on Government employees. The person also is advised that repetitive acts could result in prosecution.

The Division is conducting studies seeking better ways to ensure the safety of IRS employees in assault and threat situations.

Checking the work force

The Internal Security Division completed 13,017 investigations of employees during the year and 15,674 police record checks on persons considered for temporary appointments.

These investigations and record searches resulted in the rejection of 85 job applicants and disciplinary actions, including separations, suspensions, reprimands, warnings, or demotions, against 741 employees. Also, at the request of the Office of the Secretary of the Treasury, the Division conducted special investigations involving employees of other Treasury bureaus.

While some investigations of IRS employees resulted in criminal prosecution or disciplinary action, in many other cases employees were exonerated of accusations of misconduct.

Taking precautions

In each region, 100 integrity development projects initiated by Internal Audit and Internal Security probed high-risk Service operations. As an alternative to merely reacting to complaints, allegations, or referrals, this approach is designed to identify and examine areas in Service operations particularly susceptible to corruption and fraud.

BUREAU OF THE MINT ¹

The Mint became an operating bureau of the Department of the Treasury in 1873, pursuant to the Coinage Act of 1873 (31 U.S.C. 251). All U.S. coins are manufactured at Mint installations. The Bureau of the Mint distributes coins to and among the Federal Reserve banks and branches, which in turn release them to commercial banks. In addition, the Mint maintains physical custody of Treasury stocks of gold and silver; handles various deposit transactions, including inter-Mint transfers of gold and silver bullion; and refines and processes gold and silver bullion.

During fiscal 1978, functions performed by the Mint on a reimbursable basis

¹ Additional information is contained in the separate Annual Report of the Director of the Mint.

included the manufacture and sale of proof coin sets and uncirculated coin sets, medals of a national character, and, as scheduling permitted, the manufacture of foreign coins.

The headquarters of the Bureau of the Mint is located in Washington, D.C. The operations necessary for the conduct of Mint business are performed at seven field facilities. Mints are situated in Philadelphia, Pa., and Denver, Colo.; assay offices are in New York, N.Y., and San Francisco, Calif.;² and bullion depositories are located in Fort Knox, Ky., (for gold) and West Point, N.Y. (for silver). The Old Mint, San Francisco, houses the Mint Data Center, the Mint Museum, and a numismatic order processing operation. The West Point Depository continued to produce coins during fiscal 1978.

The Mint security program provides appropriate and continuous protection for all employees and assets under the jurisdiction of the Bureau of the Mint. This is accomplished by the Mint Security Force, supported by extensive and sophisticated alarm systems, closed-circuit television coverage, special vaults or other controlled locking devices, and the Bureau's personnel security clearance program.

A total of 37 Mint security officers completed the 5-week police training course at Treasury's Federal Law Enforcement Training Center. The principal security supervisor from one of the mints completed the 7-week criminal investigator's course.

The Hungarian-owned Crown of St. Stephen and other related relics had been in custody of the Mint at the Fort Knox Bullion Depository for a number of years. Extraordinary security measures were employed in January 1978 at Fort Knox during the inspection, packing, and shipping of these Hungarian treasures, which were handled by Department of State employees. The items were returned to the Government of Hungary during the fiscal year.

The Mint's Laboratory continued to provide technical expertise on the authenticity of U.S. coins, examining 954 questioned coins submitted by the U.S. Secret Service and other law enforcement agencies. The coins involved 135 cases. Two hundred twenty-two counterfeit gold coins, the content of which is being returned to innocent collectors, were processed through the New York Assay Office. Gold granulations, valued at more than \$10,000, were returned to collectors who had innocently purchased counterfeit gold coins.

Following the upgrading of the electrostatic precipitator at the New York Assay Office, reported in the 1977 report, the Mint's refinery resumed gold production during fiscal 1978.

Internal audits during the fiscal year contributed to: A further strengthening of internal controls and accounting and reporting systems; better utilization of personnel, materials, and equipment; improved safety; and reduced operating costs.

The Continuing Committee for the Audit of U.S.-owned gold located at various depositories at appropriate intervals was established by the Fiscal Assistant Secretary during fiscal 1976. The Committee consists of one representative each from the Bureau of the Mint, the Bureau of Government Financial Operations, and the Federal Reserve Bank of New York, with representatives of the General Accounting Office invited to participate in the audits as observers. During fiscal 1978, gold audits were performed in three of the four Mint depositories where gold is stored (Fort Knox, Ky.; U.S. Assay Office, New York; and the Denver Mint). By September 30, 1978, more than 50 percent of the U.S.-owned gold had been audited and verified. The continuing audit is planned to provide for a complete audit of U.S.-owned gold over a 10-year cycle ending in 1984.

A total of \$414,432,568 was deposited into the general fund of the Treasury

²The San Francisco Assay Office also operates as a mint.

by the Bureau of the Mint during fiscal 1978. Seigniorage on U.S. coinage accounted for \$367,156,260 of the total.

Domestic coinage

In April 1978, Secretary Blumenthal transmitted to the Congress proposed legislation to authorize a smaller dollar coin to replace the current one. On August 22, 1978, the Senate approved S. 3036 which authorizes the Secretary to mint and issue the smaller dollar coin bearing the portrait of Susan B. Anthony on the obverse and the Apollo 11 eagle design on the reverse. An identical bill was approved by the House of Representatives on September 26, 1978. The legislation was awaiting the approval of President Carter at the end of the fiscal year. [Public Law 95-447 was signed October 10, 1978.]

The Anthony dollar will be a clad coin. The cladding is an alloy of 75 percent copper, 25 percent nickel. It will constitute 50 percent of the total thickness of the coin. The core will be pure copper. The coin will weigh 8.1 grams and have a diameter of 26.5 millimeters. The design has an 11-sided border on both sides of the coin within the outer circular configuration, which will make it distinguishable by touch, as well as sight.

The accompanying photograph illustrates both sides of the new dollar coin, which will be minted and issued for the first time during fiscal 1979.



The Susan B. Anthony dollar coin

During the 1978 fiscal year, U.S. mints manufactured for general circulation cupronickel-clad dollars, half dollars, quarters, and dimes, cupronickel 5-cent pieces, and 1-cent pieces composed of 95 percent copper, 5 percent zinc.

Coinage strip for the manufacture of U.S. coinage was obtained from both in-house fabrication and outside sources. All 5-cent, 10-cent, and 25-cent strip and a portion of the necessary 1-cent strip for the Philadelphia Mint was fabricated in-house. Coinage strip used by the Denver Mint and the San Francisco Assay Office was purchased on the open market. Most of the annealed/cleaned 1-cent blanks for West Point were furnished by the Philadelphia Mint, with lesser quantities purchased.

The Philadelphia Mint produced 5,260,137,000 coins; the Denver Mint 5,149,519,090 pieces; the West Point Depository manufactured 1,560,852,000 coins; and the San Francisco Assay Office 92,730,000 1-cent coins for general issue.

In this 12-month period, the Mint shipped approximately 13.4 billion coins to Federal Reserve banks and branches, establishing an alltime record.

The Bureau of the Mint maintained its close liaison with the Federal Reserve in determining coin requirements. Demand for coin, as measured by the net outflow from the Federal Reserve banks to commercial banks, totaled 13.1 billion coins. This represented an increase of approximately 14.5 percent over 1977. Joint Mint/Federal Reserve inventories of coins amounted to 5.9 billion on September 30, 1978, compared with 7 billion a year earlier.

Direct shipments of coins from the Mint to commercial banks without their passing into and out of the Federal Reserve banks was initiated. Direct shipments were being made to four banks in the New York Federal Reserve District and to two banks in the San Francisco District by the fiscal yearend. This is benefiting the Government in a number of ways, including savings in transportation costs, labor costs at the Federal Reserve banks, and the conservation of energy (fuel).

By June 1978, copper prices had become sufficiently stabilized and the 1-cent inventory had become large enough for Treasury to revoke the regulations which had been imposed in April 1974 prohibiting the exportation, melting, or treatment of 1-cent pieces. The revocation became effective June 7, 1978, following signature by Under Secretary Anderson.³

³ See exhibit 24.

U.S. coins manufactured, fiscal year 1978

Denomination	General circulation		Numismatic ¹		Total coinage	
	Number of pieces	Face value	Number of pieces	Face value	Number of pieces	Face value
1 dollar:						
Cupronickel.....	37,598,006	\$ 37,598,006.00	3,096,815	\$3,096,815.00	40,694,821	\$40,694,821.00
Silver-clad			131,908	131,908.00	131,908	131,908.00
50 cents:						
Cupronickel.....	33,588,506	16,794,253.00	3,096,815	1,548,407.50	36,685,321	18,342,660.50
Silver-clad			131,908	65,954.00	131,908	65,954.00
25 cents:						
Cupronickel.....	2 792,886,378	198,221,594.50	3,096,815	774,203.75	795,983,193	198,995,798.25
Silver-clad			131,908	32,977.00	131,908	32,977.00
10 cents.....	993,856,628	99,385,662.80	3,096,815	309,681.50	996,953,443	99,695,344.30
5 cents.....	676,286,872	33,814,343.60	3,096,815	154,840.75	679,383,687	33,969,184.35
1 cent.....	³ 9,529,021,700	95,290,217.00	3,096,815	30,968.15	9,532,118,515	95,321,185.15
Total	12,063,238,090	481,104,076.90	18,976,614	6,145,755.65	12,082,214,704	487,249,832.55

¹ All numismatic coins were made at the U.S. Assay Office, San Francisco, and consisted of 1,046,259 1977 proof sets, 2,050,556 1978 proof sets, and 131,908 silver-clad Bicentennial sets (110,044 proof, 21,864 uncirculated). Production of Bicentennial coins ceased on Dec. 31, 1976; however, sets continued to be packaged and sold after that date. Bicentennial sets reported in this table were packaged and sold during fiscal 1978.

² Includes 15,352,000 quarter dollars produced at the U.S. Bullion Depository at West Point.

³ Includes 1,545,500,000 1-cent coins manufactured at West Point and 92,730,000 made at the San Francisco Assay Office.

NOTE.—Dollars, half dollars, quarters, and dimes for general circulation and regular proof sets are three-layer composite coins—outer cladding 75 percent copper, 25 percent nickel, bonded to a core of pure copper. Dollars, half dollars, and quarters comprising the Bicentennial proof and uncirculated sets are three-layer composite coins with an outer cladding 800 parts silver, 200 parts copper, bonded to a core approximately 209 parts silver, 791 parts copper.

Bureau of the Mint operations, fiscal years 1977 and 1978

Selected items	Fiscal 1977	Fiscal 1978
Newly minted U.S. coins issued: ¹		
1 dollar.....	50,600,000	50,000,000
50 cents.....	75,200,000	78,400,000
25 cents.....	729,200,000	997,900,000
10 cents.....	814,500,000	1,184,600,000
5 cents.....	673,700,000	971,300,000
1 cent.....	8,362,600,000	10,185,800,000
Total.....	10,705,800,000	13,448,000,000
Inventories of coins in Mints, end of period.....	4,611,700,000	3,227,600,000
Electrolytic refinery production:		
Gold—fine ounces.....		2,040,848.525
Silver—fine ounces.....	3,331,771.75	3,257,560.10
Balances in Mint, end of period:		
Gold bullion—fine ounces.....	266,169,764	266,393,521
Silver bullion—fine ounces.....	39,401,062	39,208,331

¹ For general circulation only.

Reimbursable programs

Foreign coinage.—The Bureau of the Mint is authorized to produce coinage for foreign governments on a reimbursable basis provided that the manufacture of such coins does not interfere with U.S. coinage requirements. At the fiscal yearend Mint installations were processing coinage orders for the Dominican Republic and Panama.

Medals.—Public Law 95-229, February 14, 1978, authorized the Secretary to strike up to 104,000 medals for the U.S. Capitol Historical Society by December 31, 1978. The medals are to commemorate historic events and personalities of the 1777-1778 period. By September 30, 7,750 medals had been produced and delivered to the Society.

Special coin programs.—On April 3, 1978, the Mint began offering the 1978 proof coin sets for sale to the public at \$9 per set. These special sets, struck at the U.S. Assay Office at San Francisco, contain one coin of every current denomination. By June 30, 1978, when the ordering period closed, 3.1 million sets had been purchased. Shipment of the sets began in May and was scheduled to continue through December 1978.

During fiscal 1978, 1.7 million 1977 uncirculated 12-coin sets (consisting of one coin of each denomination struck at both the Philadelphia and the Denver Mints) were shipped to customers who had ordered them between September 1 and October 31, 1977.

Administration

Effective May 21, 1978, the Office of the Secretary of the Treasury assumed operation of the Treasury payroll/personnel information system (TPPIS). The Bureau of the Mint transferred 54 positions and \$400,000 to that Office to continue ongoing operations for the remainder of the fiscal year.

The Bureau of the Mint embarked on a program during fiscal 1978 to develop an automated financial management information system. The General Ledger and Appropriation Accounting/Reporting System, the first module, was in the design stage at the fiscal yearend.

Labor relations

Effective December 15, 1977, the Bureau of the Mint and Mint Council American Federation of Government Employees (AFGE) entered into the second national labor-management agreement. This agreement will remain in force for 3 years.

OFFICE OF REVENUE SHARING ¹

The Office of Revenue Sharing is located within the Office of the Assistant Secretary (Domestic Finance) for administrative purposes. The revenue sharing staff consists of approximately 200 professional and clerical positions, with 30 of them designated for the antirecession fiscal assistance (ARFA) program. Offices are located at 2401 E Street, NW. in Washington, D.C.

The Office of Revenue Sharing was made responsible for administering the ARFA program with the passage of title II of the Public Works Employment Act of 1976 (Public Law 94-369). Under the act, the Office had distributed more than \$3 billion by the end of fiscal 1978.

With the passage of the Intergovernmental Antirecession Assistance Act of 1977 (Public Law 95-30, May 23, 1977), the civil rights and audit requirements of the ARFA program were made identical to those of the general revenue sharing program.

During fiscal 1978, \$6.8 billion in revenue sharing funds was distributed to more than 38,000 States, counties, cities, towns, townships, Indian tribes, and Alaskan native villages which are recipients of shared revenues. This brought to \$42 billion the amount of money returned to States and local governments since the inception of the general revenue sharing program in 1972.

The State and Local Fiscal Assistance Act of 1972 (31 U.S.C. 1221-1263) authorized the distribution of \$30.2 billion for the 5-year period that ended December 31, 1976. The money was allocated according to formulas contained in the law which use data on population, per capita income, and general tax effort for each recipient unit of local government.

The ninth entitlement period in the general revenue sharing program is the second entitlement period authorized by the State and Local Fiscal Assistance Amendments of 1976 (Public Law 94-488, October 13, 1976). These amendments extended general revenue sharing from January 1, 1977, through September 30, 1980, at higher annual levels of funding than had been authorized by the original act. The amendment for the ninth period authorizes \$6.8 billion for distribution, bringing the total authorized for distribution to \$42 billion.

Data improvement

To ensure that all funds are distributed equitably, consistent with the intent of the Congress, all data used by the Office of Revenue Sharing in the formula allocation process must be of the highest quality, both in terms of currentness and accuracy.

To meet the first objective, all four data factors relating to local governments were updated by the Bureau of the Census for the allocation of funds for entitlement period 10, which extends from October 1, 1978, through

¹ Additional information is contained in the separate Annual Report of the Office of Revenue Sharing for 1978.

September 30, 1979. The population and per capita income estimates were updated to 1976 and 1975, respectively, and the adjusted taxes and intergovernmental transfers data elements were each updated to fiscal 1977. The Bureau of Indian Affairs also developed updated population estimates as of 1976 for Indian tribes and Alaskan native villages. In addition, revised 1974 per capita income estimates were developed and used to compute adjusted allocations for all local governments for entitlement period nine.

The second objective, that of ensuring the accuracy of the data, is met in large part through the Office of Revenue Sharing's annual data improvement program. This administrative procedure consists of notifying each government of the individual data elements to be used in determining its allocation, as well as an estimated allocation amount based on the preliminary data. Each government is then asked to examine its data factors in light of established data definitions, and propose corrections for any data element considered to be in error, submitting appropriate documentation to support any challenge. These are thoroughly reviewed, and appropriate revisions are made when justified.

Approximately 1,500 governments proposed challenges to 1 or more individual data elements believed to be in error, in response to the data improvement program for entitlement period 10, conducted in April 1978. Of this number, several hundred resulted in changes being made to the data in question. As a result of this program and the Census Bureau's ongoing data review, nearly 2,000 data revisions were made prior to the official entitlement period 10 allocations.

In determining the allocations to governments under the antirecession fiscal assistance program, the Office of Revenue Sharing uses updated unemployment data provided each quarter by the Department of Labor, Bureau of Labor Statistics, as required by statute. The Intergovernmental Antirecession Assistance Act of 1977 made it possible for Governors of States to supply to the Bureau of Labor Statistics unemployment rates prepared according to that agency's methodology for local governments for which the Bureau did not have local unemployment rates for the July 1978 payment quarter.

In each calendar quarter, the Office of Revenue Sharing provides each of the approximately 39,000 potentially eligible governments with notice of its antirecession data factors for review, as well as its quarterly allocation amount. The data can be corrected if a government notifies the Office of a processing error within 21 days after the mailing of the payment and allocation data notices. Approximately 125 governments write during a typical quarter to question the data factors used. Such correspondence occasionally results in corrections to the data and adjustments to the antirecession payments.

During 1978, a newly designed Actual Use Report, consolidating local government reporting of expenditures under both the general revenue sharing and antirecession fiscal assistance programs into a single concise format, was introduced by the Office in conjunction with the Bureau of the Census. This information, the collection of which is mandated by the enacting legislation, will be highly useful in periodically evaluating both programs' effectiveness.

Technical assistance

The Office of Revenue Sharing provides information and technical assistance to State and local governments receiving general revenue sharing and antirecession fiscal assistance funds. The past year was an especially active one because of the many State and local officials who assumed public office for the first time.

Technical assistance was provided in the form of more than 3,000 letters in response to written requests for specific information and guidance. In addition,

over 88,000 telephone contacts were made with recipient governments, various organizations, and others interested in the revenue sharing and ARFA programs. Six technical papers were prepared on various aspects of both programs and over 7,500 individual mailings were made of these and other informational materials.

The Office has established a network of liaisons within each of the 50 States and the 4 territories receiving ARFA funds. Over 60 technical assistance workshops were conducted during the year in cooperation with these liaisons and other cosponsors for the benefit of recipient governments.

Quarterly, each of the more than 38,000 recipient governments in the general revenue sharing program and each of the more than 20,000 governments which have received ARFA funds has been sent a letter to provide information which will enable the recipient government to continue to participate and remain in compliance with the requirements of the legislation.

Public participation

Considerable time was spent during the year informing recipient governments and public interest groups of the new public participation requirements. These provisions require two public hearings to be held by State and local governments receiving revenue sharing funds prior to the use of such funds, with attendant public notice and opportunity for examination of budget documents.

A series of publications designed to assist recipient governments to understand the new requirements was developed. Public participation compliance reviews were conducted in more than 100 recipient jurisdictions. Direction was provided to those governments which had failed to comply with public participation requirements.

Civil and human rights

Section 122 of the Revenue Sharing Act provides that: "No person in the United States shall, on the ground of race, color, national origin, or sex, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity of a State government or unit of local government, which government or unit receives funds * * *. Any prohibition against discrimination on the basis of age under the Age Discrimination Act of 1975 or with respect to an otherwise qualified handicapped individual as provided * * * shall also apply to any such program or activity. Any prohibition against discrimination on the basis of religion, or any exemption from such prohibition, as provided * * * shall also apply to any such program or activity."

Although the staff which has responsibility for monitoring and enforcing this section of the Revenue Sharing Act is small, it has been successful in investigating a significant number of civil rights complaints. Of even greater significance has been the success demonstrated by the Civil Rights Division in resolving most of the complaints, mainly through negotiation and efforts to achieve voluntary compliance. In those rare instances where recipient jurisdictions have been reluctant to take those steps necessary to come into compliance, the Office has demonstrated its mandated responsibility to enforce the law and has initiated action to fulfill its responsibilities through the route of administrative hearings to compel compliance.

Shown below is a table that demonstrates the growth of the activities of the Division.

Discrimination complaints

Year	Received ^r	Determinations/ findings	Closed ^r	Carried over ^r
1972	2	0	0	2
1973	27	1	2	27
1974	75	14	26	76
1975	213	8	29	260
1976	229	7	71	418
1977	276	125	142	552
1978	306	156	184	674

^r Revised.

Note.—The most significant unit of work measurement is the determinations/findings issued, rather than number of complaints closed. The major portion of the work process is completed upon the issuance of a determination/finding. Usually, the closure of the case is dependent upon a review and analysis of requested information from a recipient government after the issuance of a noncompliance determination, or finding.

To assist in conducting field investigations and to help resolve discrimination complaints, the Office continues to work in a cooperative effort with several major Federal agencies. The Office is currently attempting to renegotiate cooperative agreements with the Federal agencies with which it has shared agreements.

Audit procedures

The 1976 amendments to the Revenue Sharing Act require that a recipient government receiving \$25,000 or more annually in revenue sharing entitlements must have an independent audit of its financial statements conducted, in accordance with generally accepted auditing standards, not less often than once every 3 years. This requirement is applicable to more than 11,000 of the nearly 39,000 revenue sharing recipients.

During fiscal 1977, the Office reviewed the professional practice of all State auditors responsible for making financial and compliance audits of State and local governments and found the audits of 11 of these audit agencies to be unacceptable. Since State auditors audit about one-half of the recipients required by the 1976 amendments to have audits, the Office has given particular attention to those 11 agencies that were not doing an acceptable job. As of the end of the fiscal year, all 11 either had taken positive steps to bring their practice to an acceptable status or had decided to contract with independent public accountants to make the required audits.

In December 1977, a new audit guide was issued which incorporated the changes in the Revenue Sharing Act made by the 1976 amendments in accounting and auditing requirements and included the compliance audit procedures of the Antirecession Fiscal Assistance Act. A program was prepared for reviewing audit reports submitted to the Office by independent public accountants and State auditors. Also, the review programs of State auditors and independent public accountants were revised in view of the enlarged requirements of the 1976 amendments.

The Office definition of "independence" contained in its regulations was adopted by the American Institute of Certified Public Accountants (AICPA). In defining independence in relation to the auditing of governmental entities previously, the AICPA recognized only practicing certified public accountants as being independent for this purpose.

During the year, the Audit Division either received or was advised of the issuance of 2,700 audit reports of revenue sharing recipients. Copies of audit reports issued by independent public accountants for which a State auditor has

no legal responsibility must be furnished to the Office. Also, copies of audit reports must be submitted to the Office if they disclose violations of the Revenue Sharing or Antirecession Fiscal Assistance Acts and regulations. State auditors provide the Office with a quarterly report listing audit reports which they issue or receive for review from independent public accountants that do not contain findings of violations of the Revenue Sharing or Antirecession Fiscal Assistance Acts or regulations. These reports are kept on file by the State auditors for review by the Audit Division as a part of the periodic reviews made of State auditors' performance.

Considerable time was devoted during the year to the review of the professional practices of independent public accountants. During the year, 135 reviews were made involving 235 recipients. The practice of 65 of these independent public accountants deviated from generally accepted auditing standards to such an extent that they could not be considered to be in compliance with the requirements of the Revenue Sharing Act.

The Audit Division also responded to 4,000 requests from independent public accountants for confirmation of entitlement fund payments.

In fiscal 1978, 375 cases were opened of which 260 resulted from findings of audit reports. Cases closed totaled 580. Thus, open cases were reduced from 390 to 185 or a decrease of 205 during the year. There was also progress made in closing cases more promptly. As of September 30, 1978, there were only 40 cases that had been open for a year or more.

Legal issues

During the fiscal year, the Chief Counsel participated in the initiation or defense of 14 legal actions including 3 administrative hearings. Several court suits involved discrimination charges against recipient governments in which the Office was joined as a party defendant.

In regard to alleged charges of discrimination against recipient governments in which the Office was joined as a party defendant, the case *Committee for Full Employment v. Simon* is on appeal in the U.S. Court of Appeals for the District of Columbia Circuit. The district court (U.S.D.C., D.C.) in this case decided for the Secretary of the Treasury, agreeing that plaintiffs lacked standing to sue. The individual complaints filed with the Office in relationship to this case are expected to be settled through the adoption of compliance agreements between the concerned recipient governments and the Office prior to the oral argument on the case.

The Office was involved in several suits involving the application of adjusted tax data in the revenue sharing allocation formula, and the procedures of the Office in making downward adjustments to a recipient government's allocation. *Board of Supervisors of Henrico County, Virginia v. W. Michael Blumenthal et al.* (U.S.D.C., W.D. Va.) concerns the treatment of county highway funds with respect to the derivation of adjusted taxes in the revenue sharing allocation formula. *Edward V. Regan v. Jeanna Tully (Bernadine Denning)* (U.S.D.C., W.D. N.Y.) concerns whether the Office properly made a downward adjustment in Erie County, N.Y.'s seventh entitlement period allocation.

The Office also obtained a favorable data decision in the U.S. District Court for the District of Columbia in *City of Newark, New Jersey, et al. v. Blumenthal*, Civil Action No. 74-548 (January 17, 1978). In granting the defendant's motion for summary judgment and denying the plaintiffs' motion for summary judgment, the court held that the Secretary's discretion in adjusting revenue sharing allotments under S 109(a)(7)(B) is not reviewable (31 U.S.C.A. S

1228(a)(7)(B)). The cities of Newark and Baltimore had asked the court for a determination that their past and future allocations be increased to reflect an estimated black population undercount indicated in an updated analysis of the 1970 Census data originally relied upon by the Secretary.

Other court and administrative actions involving Nottoway and New Kent Counties, Va., were settled before trial in conformance with the earlier case of *Albemarle County, Virginia v. William E. Simon, Secretary of the Treasury, et al.* (U.S.D.C., W.D. Va.). These actions concerned the proper derivation of adjusted taxes for those Virginia counties with general revenue or "commingled" fund accounting systems.

An administrative proceeding against the town of Dover, N.J., was begun, founded on the Office's determination that the town had discriminated against Hispanics in its employment practices. A pretrial conference was conducted before an administrative law judge, and the action was settled before the date of the hearing on the merits. The town made lump-sum payments to the two individual complainants, and it submitted a satisfactory affirmative action plan pertaining to its employment practices.

An administrative hearing against the city of Akron, Ohio, was begun based upon an Office determination that the city had discriminated against an individual on the basis of handicapped status in violation of S 122(a) of the amended Revenue Sharing Act (31 U.S.C. 1242(a)). This action was settled at the commencement of the hearing on grounds favorable to the position of the Office.

An Office legislative program for the First Session of the 96th Congress was developed. This program recommended amending the Revenue Sharing Act of 1976 to provide, among other things, (1) the Secretary, when necessary, with the authority to reserve (in accordance with S 102(c) of the act) more than 0.5 percent of each State's allocations in order to pay any later required adjustments to the allocation of the State or any unit of local government within that State; (2) sanctions for noncompliance with the public participation requirements of S 121 of the act; (3) for deferral of Office jurisdiction to other Federal agencies, Federal or State courts when they are acting promptly and expeditiously on the same matter before the Office; and (4) for other technical amendments aimed at correcting drafting oversights in the act.

During the fiscal year, the Chief Counsel issued approximately 70 letter rulings to recipient governments seeking guidance for the use of ARFA funds. A digest of these letter rulings has been prepared for the use of recipient governments.

Antirecession fiscal assistance

Treasury distributes antirecession funds to States and local general governments based on unemployment rates and general revenue sharing entitlements. These funds supplement the general revenue sharing payments. Appropriations of funds to be distributed and of money to be used to administer the new program were first made available in fiscal 1977.

In May 1977, the Congress extended the ARFA program for four quarters beyond its original life, through September 1978, by enacting the Intergovernmental Antirecession Assistance Act of 1977. This legislation maintained the broad outlines of the original program.

In excess of \$3 billion has been distributed to over 25,000 State, general purpose local, and several U.S. territorial governments. These funds are intended by the Congress for use to maintain basic services normally provided by governments and to help these units avoid actions which run counter to national economic policies.

OFFICE OF TARIFF AFFAIRS

The Office of Tariff Affairs, which provides policy direction, review, and final action on recommendations by the Customs Service on administration of the Antidumping Act and the countervailing duty law, faced a radically increasing workload during the fiscal year, with antidumping cases rising to 247 percent of the 1977 level, and countervailing duty investigations increasing to 175 percent of the 1977 level. In February 1978, the Office began oversight of the trigger price mechanism for monitoring of steel imports for the purpose of determining when self-initiation of antidumping investigations of imported steel products might be appropriate. The Office also adopted a new antidumping regulation to deal more appropriately with imports from state-controlled-economy countries under the Antidumping Act.

During fiscal 1978, the Treasury initiated 47 antidumping investigations and reached final determinations of sales at less than fair value in 11 cases. There were eight dumping findings during that time. Over the same period, the Treasury initiated 28 investigations under the countervailing duty law, made 4 affirmative determinations and 8 negative decisions. Five waivers of countervailing duties were issued during that time. During the year, the Office also completed an investigation under section 232 of the Trade Expansion Act concerning an alleged threat to the national security arising from imports of metal fasteners, and provided assistance to Treasury participants in the multilateral trade negotiations insofar as they related to the negotiation of a countervailing duty code.

UNITED STATES CUSTOMS SERVICE

The principal missions of the U.S. Customs Service are to enforce customs and related laws against the smuggling of contraband; to assess, collect, and protect the levying of import duties and taxes; and to control carriers, persons, and articles entering or departing the United States by enforcing the Tariff Act of 1930 and numerous other statutes and regulations which govern international traffic and trade and protect the American public.

To accomplish these missions, the Customs Service performs the following:

1. As the principal border enforcement agency and a protector of the American consumer, Customs administers and enforces over 400 laws and regulations of over 40 Government agencies, relative to international traffic and trade.
2. Detection and prevention of all forms of smuggling and other illegal practices designed to gain illicit entry into the United States of prohibited articles, narcotics, drugs, and all types of contraband.
3. Detection and investigation of illegal activities to apprehend violators and otherwise take effective action to reduce, prevent, and deter violations of laws and regulations enforced by Customs.
4. Examination and clearance of carriers, persons, and merchandise consistent with the requirements for the proper assessment and collection of

customs duties, taxes, fees, fines and penalties, and compliance with the customs laws and regulations applying to international commerce.

5. The most effective application of resources to carry out the total Customs mission, consistent with efficiency in Government and economy and service to the public.

During fiscal 1978, Customs cleared over 273 million persons arriving in the United States. More than 82 million cars, trucks, and buses crossed the country's borders; an additional 211,000 ships and 441,000 aircraft also cleared Customs. This involved processing 16 million customs declarations.

Customs collected a record \$7.5 billion in duty and taxes and processed \$165 billion worth of imported goods which required over 4 million formal entries (those over \$250 in value). In addition, there were 47 million foreign mail parcels processed in fiscal 1978, requiring over 2.3 million informal mail entries.

The Customs enforcement mission also produced tangible results during fiscal 1978. Merchandise seized, including illicit drugs, prohibited articles, undeclared merchandise, etc., was valued at over \$2 billion. There were over 21,000 drug seizures. These seizures included 1,419 pounds of cocaine, 7.6 million units of polydrugs, and 2,308 tons of marijuana. There were 189 pounds of heroin seized.

Merchandise Processing

As part of its functions to examine and clear carriers, persons, and merchandise, in fiscal 1978, Customs processed 4 million formal entries; and collected \$7.5 billion in revenue on merchandise valued at more than \$165 billion.

Quotas

One of the principal uses of vital trade statistics is in the establishment of commodity quotas. Currently the Customs Service enforces more than 940 such quotas.

Mail operations

During fiscal 1978, Customs mail branches processed approximately 47 million parcels, prepared over 2 million mail entries, and collected approximately \$21 million in duty. Over 80 percent of the foreign mail is processed by Customs mail branches at locations in New York, Oakland, Seattle, Los Angeles, and Chicago. Streamlined procedures for revenue collection are being implemented with the aim of better servicing the public.

Containerization program

The container examination program was designed to separate containers of goods arriving from foreign countries into two categories, those on which an intensified examination was necessary and those which could be released upon a cursory examination. During fiscal 1978, 1,603,210 empty and merchandise-filled containers arrived in the United States. Of this number, 154,606 (10 percent) were given an intensified examination. A total of 303,485 "empty" containers were screened for controlled substances and presence of merchandise.

Reduced supervision of bonded warehouses

In a continuing effort to reevaluate the risk factors and controls in cargo processing, Customs has embarked upon a program to reduce the supervision

of bonded warehouses. This reduction, for the most part, consists of removing the Customs locks from the warehouse and physically supervising only selected, high-risk activities.

Automation of cargo control

Nearly all merchandise that enters the United States must be reported on the manifest of the carrier that brings it into the country. Customs checks each manifest for merchandise verification.

Customs reviewed its manifest controls during 1978 and decided to use the cargo manifest to initiate an audit trail for all goods entering the United States. The period covered will extend from the time they arrive until they finally leave Customs jurisdiction. This would include not only goods entered directly for consumption, but also the many shipments whose final entry or reexportation is delayed for transportation in bond to another port, entry for warehouse and subsequent withdrawal, unclaimed goods placed in general order, and similar situations.

Military predeparture program

There are over 150 predeparture inspection activities located overseas staffed by over 2,700 full- and part-time military customs inspectors (MCI's). MCI's perform inspections of cargo, passengers, crew, and their baggage; personal and household effects; aircraft; vessels; and mail. The purpose of this overseas program is to interdict narcotics, dangerous drugs, and other contraband prior to arrival in the United States, and thus expedite the movement of passengers, cargo, carriers, and mail.

Although the major military commands are responsible for the establishment of predeparture inspection programs and the assignment, training, and supervision of the MCI's, six customs officers have to serve as advisers to the major commands and ensure that effective inspection procedures are being utilized.

Customs laboratories

The Customs laboratories analyzed over 160,000 samples. Changes in classification occurred in over 12,000 of these samples as a result of laboratory analysis. Many of these changes involved high-risk merchandise such as metal, textiles, chemicals, and footwear (with a concurrent increase in revenue). Use of the National Commodity Sampling Information System (NCSIS—a report detailing classification change rates for imported commodities) was instrumental in increasing the sampling rates for high-risk imports. Further refinements and extensive dissemination of the NCSIS report will improve this ratio.

Trade

Antidumping and countervailing duty

During fiscal 1978, 56 new antidumping and 28 countervailing duty cases were initiated; 17 antidumping and 16 countervailing duty cases were published. Antidumping master lists on 77 manufacturers were circulated to field offices for their use in assessing dumping duties. Presently, 75 findings of dumping are in effect. Antidumping and countervailing duty investigations more than doubled from 1977 to 1978.

Antidumping.—Approximately 30 of the antidumping investigations conducted in fiscal 1978 concerned steel mill products. The greatly increased volume of steel imports and the generally depressed condition of the U.S. steel industry appear to have accounted for so many investigations involving steel products. As the trigger price mechanism has begun to take effect, the domestic industry has been withdrawing its complaints of dumping and investigations are being terminated.

Antidumping appraisalment procedures.—The major accomplishment in this area during fiscal 1978 was the appraisalment of televisions from Japan under the Antidumping Act. Approximately \$46 million has been assessed on entries of television receivers. However, accomplishing these appraisalments required such a large amount of manpower that Customs has been unable to reduce the backlog of antidumping appraisalments on other merchandise.

Countervailing duties.—The majority of the countervailing duty petitions filed in fiscal 1978 related to various textile products. These primarily concerned exports from South America and the Far East. Common elements of these petitions concerned allegedly favorable tax treatment for export industries and various measures to encourage economic development in specified areas of individual exporting countries. The Supreme Court has upheld the Government's position on the Japanese electronics products case that noncollection of the Japanese commodity tax does not constitute a bounty or grant under the countervailing duty law. Accordingly, the entries of consumer electronic products from Japan, which had been subject to this litigation, will be liquidated without assessment of countervailing duties.

Trigger price mechanism (TPM)

In 1977, the U.S. steel industry was experiencing financial difficulties which industry analysts attributed to unfairly priced steel imports. To help the steel industry, the President signed a comprehensive aid package, dealing with such matters as plant obsolescence, environmental controls, worker assistance, and imports. To alleviate the import problem and ensure free but fair competition, the report proposed a trigger price mechanism.

TPM is designed to monitor imports of steel products and enable Treasury to expedite dumping investigations when warranted. Trigger prices are calculated and published for steel mill products. During fiscal 1978, trigger prices had been published for 84 steel mill products covered by the program. These prices, which must be revised quarterly, consist of: A base price, a charge for "extra" specifications, ocean freight, handling, interest, and insurance.

Generalized system of preferences (GSP)

Customs participated in GSP in conferences in Malaysia, Singapore, the Philippines, and Hawaii to discuss verification procedures and other mutual problems concerning GSP implementation.

Amendments to sections 10.172 and 10.173 of the Customs Regulations were effective in January 1977. These changes relaxed the rigid requirements concerning liquidated damages and written claims under GSP. Currently, 140 countries/territories and 2,750 major item numbers in the Tariff Schedules of the United States are eligible for GSP. During fiscal 1978, the number of GSP imports represented 6 percent of the total line items processed.

Classification of exported goods

Customs participated in an interagency effort to achieve statistical comparability between U.S. import, export and production data. As a result of this

project, a new schedule B encompassing the classification of exported goods, a revised manufacturing code, and revised tariff schedules were published for use in fiscal 1978.

Enforcement

Interdiction

The tactical interdiction patrol program attempts to combat smuggling activity along the national borders by reducing the smugglers' options for choosing the method, time, and place for entering contraband into the United States. Customs seeks to accomplish this by maintaining a mobile interdiction force capable of operations on land, sea, and in the air.

Air interdiction.—In fiscal 1978, there were six air support branches located at military airbases near San Diego, Tucson, El Paso, San Antonio, New Orleans, and Miami. These locations were selected because of their proximity to major air smuggling routes. However, since the southern border of the United States is more than 3,000 miles long, each air branch has responsibility for protecting a corridor that, on the average, is 500 miles wide.

This year, the air program entered into another agreement with the U.S. Air Force for the loan of four T-39 Sabreliner high-performance jet aircraft. These aircraft will serve as the firstline interceptors for the airborne warning and control system (AWACS) operations. In addition to these aircraft, Customs continues to utilize the North American Radar Defense/Federal Aviation Administration (NORAD/FAA) long-range radar as well as mobile ground-based radar units for smuggler detection and tracking.

In concert with sophisticated radar and aircraft, Customs also utilized—

1. Intelligence information on suspect aircraft available through the Treasury enforcement communications system (TECS).

2. Data from the private aircraft reporting system (PARS), which requires all private aircraft crossing the Southwest border to give at least a 15-minute advance report before penetrating U.S. airspace and land at 1 of 14 specially designated airports.

3. The private aircraft inspection reporting system (PAIRS), which automates the arrival reports of all general aviation-type aircraft arriving from foreign countries and clearing U.S. Customs. Such arrival information is entered in TECS.

The combination of these elements enables Customs to concentrate on high-risk aircraft by screening out legitimate private aircraft.

On July 29, 1978, air surveillance detected a suspect aircraft in the vicinity of Homestead General Airport located south of Miami, Fla. As the aircraft landed at the airport four large suitcases were tossed onto the side of the taxiway. Customs air officers attempted to intercept the aircraft, and on an attempted departure the suspect plane crashed. The pilot managed to escape but further investigation led to identification of the suspect and subsequent indictment. Customs officers successfully seized the 4 suitcases which contained over 200,000 quaaludes.

During fiscal 1978, the air support program seized 62 vehicles, 56 aircraft, 596,428 pounds of marijuana, 74 pounds of hashish, 54.4 pounds of cocaine, 11 vessels, 27 weapons, and \$172,940 in cash, and made 177 arrests.

Border interdiction.—Customs land interdiction resources along our northern and southern borders consist of mobile tactical units which utilize border intrusion devices arranged into electronic sensor fields, night vision devices,

TECS and sector communications networks. At major ports of entry patrol officers search aircraft and vessels.

On January 2, 1978, a Miami customs officer observed a suspicious person remove a box from a banana boat and transfer it into a waiting vehicle. The vehicle was stopped; the box was found to contain 17 pounds of cocaine and the suspect driver of the vehicle was arrested. Following a search of the area located near the banana boat, an additional 31 pounds of cocaine was also seized for a total of 48 pounds of cocaine.

During fiscal 1978, the land program seized over 3 million pounds of marijuana and hashish. The program resulted in the arrest of 500 suspects. This is an increase of more than 200 percent over the number of seizures made during fiscal 1977. The seizures of hard narcotics increased more than 90 percent over the seizures for fiscal 1977.

Marine interdiction.—Customs marine interdiction units detected and apprehended marine violators in many coastal, lake, and river boundary areas. The violations included many smuggling attempts and delinquencies in reporting and entry requirements. These units utilized Customs patrol boats, special reporting and inspection facilities, reports of legitimate traffic, and intelligence concerning illicit activities. Four new marine patrol stations were put into operation in fiscal 1978.

On July 18, 1978, customs officers, on patrol off the coast of Florida, boarded two suspect 55-foot "Crawfish" vessels and discovered 35,000 pounds of marijuana. As a result, both vessels and the marijuana were seized along with a van and two 5-ton trucks. Twelve suspects were apprehended and arrested.

In fiscal 1978, the Customs marine interdiction program seized over 1 million pounds of marijuana and 200 pounds of cocaine along with 146 vessels. The program resulted in the arrest of 500 suspects.

Mail interdiction.—Customs mail facilities interdicted the smuggling of narcotics, weapons, explosives, stolen property, and other contraband, making over 6,000 seizures of illicit narcotics in both military and nonmilitary mail.

On June 9, 1978, at the Chicago mail facility, customs officers, examining a letter-class envelope from the Netherlands, discovered films dealing with child pornography. A subsequent controlled delivery to Paducah, Ky., resulted in one arrest and seizure of the film. The suspect was later convicted of smuggling controlled contraband into the United States and sentenced to three consecutive 5-year terms.

Enforcement Support

Treasury enforcement communications system

The Treasury enforcement communications system continues to be the major tool in Customs effective enforcement program through instant online communication. TECS makes available law enforcement information to enforcement personnel in ports of entry, to investigative offices in field and headquarters, locations within Customs, and to other Federal law enforcement activities. It has provided data instrumental in the arrests of thousands of fugitives; recovery of countless firearms, automobiles, and other stolen or missing property; seizure of thousands of articles of contraband and tons of narcotics and illegal drugs; and seizures of millions of dollars of currency and

negotiable instruments. Due to this effectiveness, and the flexibility of the Burroughs 7700 host computer and the redesigned TECS software, Customs is implementing a plan which has expanded the network to over 1,000 terminals with an integrated data base of almost 2 million records. The TECS redesign is being implemented as a system that will serve the needs of law enforcement officials within and outside Treasury with a minimum of cost to the taxpayers through the economies of sharing a computer and communication resources in the enforcement community. In addition, TECS provides enforcement-related management information indispensable to headquarters, field management and operations. It also serves as an index to all of Customs central files. This means rapid retrieval of supportive hard copy enforcement documentation.

In fiscal 1978, a stolen vehicle index based on National Crime Information Center (NCIC) records has been entered into TECS. The national availability of this index has resulted in the recovery of over 400 stolen vehicles and 500 related arrests this fiscal year.

The private aircraft inspection and reporting system was implemented on a national basis, providing for improved inspection, control, and reporting of private aircraft arrivals.

A fines, penalty, and forfeiture system was designed and implemented to provide a national index for Customs field use in processing penalty cases. The system also provides improved regional and national management control for timely and consistent penalty processing.

The Immigration and Naturalization Service (INS) Lookout Book was automated within TECS. This provided a base for increased Customs-INS cooperation resulting in the interception of about 80 individuals since implementation. Pilot tests of several passenger inspection configurations are underway at selected international airports.

Emphasis focused also on development of productivity and effectiveness measurement. Initial output of this effort results in establishment of zero-base budget objectives for 1978 and 1979, greater focus on improving the reliability and utilization of TECS terminals, as well as improved computer system configuration management and planning.

The first TECS telecommunications concentrator was installed in Washington. It is currently providing a \$6,000 monthly cost savings in telecommunication costs. This savings is expected to grow to \$12,000 monthly when all of the assigned terminals have been switched over to operation via the concentrator.

The systems security and privacy compliance program was initiated to establish and implement guidelines, policies, and procedures to ensure the security and integrity of all related TECS computer operational activities. The program addresses the objective, background, policies, responsibilities, and support action required to enhance the security of TECS. A security evaluation checklist has been produced which provides the program with a valuable reference document for use at Customs installations where TECS is in operation. In addition, a revised TECS Security Manual is being prepared for use and reference by Customs and non-Customs users of TECS. It will include informational guidelines regarding security procedures and records, personnel and data access controls, and physical security; recent developments regarding privacy and disclosure awareness are appropriately emphasized.

TECS service was extended this fiscal year to the Freeport, Toronto, and Calgary preclearance facilities, Miami Satellite and Newark Airports, INS headquarters, and State Department headquarters and field units as well as to additional stations at JFK Airport.

Joint projects were initiated with INS to identify a common use terminal device for land border and airport facilities to accommodate the processing of machine-readable travel documents, and shared use of the TECS telecommunications network.

Customs enforcement information system (CEIS)

CEIS is designed to provide information from various enforcement systems. Its purpose is to support the interdictory and investigative missions of Customs by providing immediate information to customs officers in the detection of violations of customs laws; enforcement statistics to evaluate programs and performance and to identify deficiencies; statistics for projecting requirements and for determining the optimum allocation of equipment and dollars and the optimum deployment of personnel; and data for intelligence analysis of, among other things, violation patterns, latest *modus operandi*, and courier profiles.

A computerized information system such as CEIS increases in value over the years as more data is fed into the system. During fiscal 1978, approximately 200,000 records were created or updated, bringing the TECS data base to more than 1.5 million records. In fiscal 1978 the enforcement lookout system aided in the seizure of heroin with a street value of \$16 million; marijuana with a street value of \$20 million; cocaine with a street value of \$20 million; hashish with a street value of \$4 million; dangerous drugs with a street value of over \$1 million; numerous vehicles, vessels, and aircraft used to transport such contraband into the country; more than \$560,000 in cash and bearer monetary instruments; and general merchandise valued at more than \$1 million.

The TECS interface with the FBI's NCIC also produces impressive results. Forewarned by TECS-NCIC hits in fiscal 1978, customs officers apprehended 1,058 fugitives wanted by other Federal, State, and local law enforcement agencies.

CEIS is continually being expanded and improved. The system is currently operational at Dulles Airport and the preclearance facilities in Nassau, Freeport, and Bermuda and is scheduled for implementation at additional preclearance ports in Canada.

Customs central enforcement files have continued to experience tremendous growth. The number of records microfiched during fiscal 1978 was up 79 percent over fiscal year 1977. The number of aircraft reports received in support of the private aircraft inspection reporting system has more than doubled since fiscal 1977.

A number of enforcement information systems designed to enhance Customs enforcement results were implemented or perfected in fiscal 1978. To support the Customs air interdiction program aimed primarily at drug smugglers, the private aircraft inspection reporting system was expanded nationwide. After a test period during fiscal 1977, PAIRS was brought on-line to all Customs and El Paso Information Center (EPIC) terminals. PAIRS charts arrivals from foreign countries by pilots in private aircraft. It also provides valuable information when used in conjunction with TECS records on individuals and aircraft. To counter narcotics smuggling via small vessels (as opposed to oceangoing commercial vessels with records in the Customs vessel violation profile system), the small boat program was implemented in fiscal 1977. Information sources have been expanded in fiscal 1978 and include Customs, Coast Guard, Drug Enforcement Administration, and State and local authorities. During fiscal 1978, the small boat program was

instrumental in the seizure of 189 pounds of cocaine valued at over \$50 million and approximately 3.5 million pounds of marijuana valued at over \$1 billion.

Detector dog program

During fiscal 1978, the strength of the detector dog program rose to 142 teams assigned to 43 ports of entry throughout the United States. These dog handler teams facilitated the expeditious processing of the traveling public and played an important role in the screening of imported merchandise and international mail. Detector dog teams seized 57 pounds of heroin, 91 pounds of cocaine, 17,428 pounds of marijuana, and 1,768 pounds of hashish.

Communications support program

The communications support program consists of the nationwide radio system, the administrative teletype system, and the facsimile system, as well as provides technical support for other Customs communications programs.

The overall objective of the program is to provide modern and responsive systems to meet the communications needs of the Customs Service. As the Service grows to meet new mission responsibilities, communications growth must follow. Advances in technology and equipment development must be closely monitored and integrated into the system as they are justified on the basis of costs and user needs. More specifically, the objectives are to: (a) Implement and operate a nationwide radio communications system which provides substantially complete radio coverage around the perimeter of the United States and at all locations where customs officers operate in a mobile environment; (b) provide an electronics system for rapid intraservice distribution of administrative textual and graphic correspondence; and (c) provide technical assistance directed toward reducing costs and increasing reliability of Customs data communications systems.

Significant accomplishments for fiscal 1978 included:

1. Regional communications centers were established in the Miami, New Orleans, and Houston regions. This was done by moving the Tampa sector to Miami, the Mobile sector to New Orleans, and merging the El Paso and San Antonio sectors into Houston.

2. A regional communications center was established in San Francisco and radio services were expanded to cover the border and coastal areas of this region.

3. A radio communications system was installed in the major cities and Great Lakes areas of the Chicago region. Plans were initiated with the Immigration and Naturalization Service to share a common radio system along the northern border of North Dakota and Minnesota.

4. Procurement of the Customs-designed two-position sector console was initiated. This new concept should greatly improve the productivity and services provided by the sector operators. The prototype unit will be installed in the Los Angeles center in the early part of calendar 1979.

5. A major modification of the administrative teletype system reduced annual costs by greater than 10 percent.

6. A new annunciator system was designed and installed at Dulles Airport to support the Customs-INS inspection test program.

Enforcement systems development and evaluation

Customs must cope with numerous and diverse ways of smuggling through ports and across miles of borders. In addition to having the opportunity to choose among many possible smuggling routes and methods, the smuggler

adds to his advantage by using modern equipment to carry out his illicit activity or to prevent its detection. To be effective in this situation, Customs needs equipment that will not only neutralize the smuggler's advantage, but also provide an advantage for the enforcement officer. The objective of the enforcement systems development and evaluation program is to support the enforcement officer, both in the port of entry and along the border, through the identification and provision of technical equipment that will improve the productivity of the individual officer and the overall performance of the Customs interdiction and investigative programs.

Significant accomplishments for fiscal 1978 included:

1. In contraband detection, Customs continued to develop and evaluate a number of complementary approaches to the detection of narcotics and other contraband concealed on people or in vehicles and merchandise, among other things. The principal utilization of these approaches will be at locations where a customs officer suspects the presence of concealed narcotics; e.g., at a private or remote airstrip, a marina, or along the border. Customs continued the development and the evaluation of the neutron backscatter device. This hand-held device is capable of detecting organic substances (i.e., narcotics) concealed in metal structures or sealed compartments on vehicles, aircraft, and vessels.

2. Radar systems are an essential element in the detection and tracking of aircraft and boats attempting to illegally cross the U.S. borders. Accordingly, Customs has continued its efforts to intelligently utilize either available Federal radar systems or its own equipment. One of the Nation's major radar resources is the Air Force airborne warning and control system. As the culmination of program efforts initiated in fiscal 1977, Customs has now signed an agreement with the Air Force permitting customs personnel aboard selected AWACS flights and at the AWACS base.

3. Customs continued its marine radar program by installing a second SPS-59 in a Miami patrol boat for evaluation purposes. A second installation of a similar radar was also completed in a small truck to provide a mobile shore-based radar for tracking boats operating within 2 to 3 miles of the coast or within harbors, rivers, and inland waterways.

4. In the area of day/night observation and surveillance systems, Customs began a joint program with the Immigration and Naturalization Service to test the utility of an infrared device mounted in a helicopter. The purpose of this device is to detect and help apprehend aliens and smugglers crossing the border on land or in small boats. The tests are being performed along the entire southwest border by INS Border Patrol and Customs patrol officers working as a team to operate, maintain, and evaluate the helicopter infrared system. Customs also conducted extensive tests at four sites ranging from Miami to Portland, Oreg., to determine the operational applications of the new hand-held thermal viewers to be delivered early in fiscal 1979. Extensive orientation and training programs on the variety of night vision and long-range viewing devices now available to Customs were also conducted.

Investigative Activity

Customs maintains a force of 640 special agents stationed at 66 domestic and 8 foreign offices. The mission of the special agent force is to function as the professional investigative arm of the Customs Service with sole responsibility to conduct investigations of violations of customs and related laws and regulations. The agents conduct criminal, civil, and factfinding investigations

involving a broad spectrum of violations covering 33 separate categories of investigative cases.

Of the 23,868 investigative cases closed during fiscal 1978, over three-quarters consisted of investigations relating to: General smuggling, fraud, navigation violations, customhouse licenses, currency violations, petitions for relief, investigations for other departments and agencies, neutrality violations, and cargo theft.

Currency reporting violations

During fiscal 1978, a major organizational development occurred with the establishment of a Currency Investigations Branch at Customs headquarters. The Branch is the focal point of the effort to (1) investigate economically oriented crime, (2) enforce compliance with reporting requirements, and (3) pursue organized crime, white collar crime, and narcotics trafficking figures via their financial transactions. Results are achieved by bringing currency reporting charges against these figures by disrupting and/or eliminating their financial base through seizures of illicit proceeds/assets.

The Branch will work closely with the newly established Treasury Reports Analysis Unit located in the Customs Building and staffed principally by Customs employees. The Unit was formed to improve the utilization of all information obtained from the three reports filed in compliance with the Bank Secrecy Act. Reports filed on Customs Form 4790, Report of the International Transportation of Currency and Monetary Instruments, will be included among those analyzed by the Unit.

A criminal fraud investigation conducted in Cleveland produced evidence of false invoicing (assists and rebates). Evidence was established that a large company had made rebate payments to a second company of which \$202,000, in the form of bearer bonds, was mailed into the United States from the Netherlands in violation of 31 U.S.C. 1101. On March 8, 1978, the Federal grand jury returned an indictment charging one firm with violation of 31 U.S.C. 1059 (felony currency) and 18 U.S.C. 371 (conspiracy). Additionally, a criminal information was filed by the U.S. attorney charging an individual with violation of 18 U.S.C. 371 (conspiracy). On March 16, 1978, the individual and counsel for the corporation appeared in the U.S. district court and pleaded guilty to the violations charged in the information and indictment. On May 2, 1978, the defendant was sentenced and received 2 years' probation and fined \$10,000. Sentencing for the firm is pending.

On April 26, 1978, as a result of an investigation conducted by Customs' Multinational Task Force, Falls Church, Va., counsel for a large computer firm appeared in U.S. district court, District of Columbia, and pleaded the corporation guilty to a criminal information charging violation of 31 U.S.C. 1059 (felony currency reporting) and 18 U.S.C. 1343 (wire fraud). Investigation had identified both the unreported movement of \$180,000 into the United States and the unreported movement of \$200,000 out of the United States. The failure to report was in violation of the Bank Secrecy Act. The funds exiting the United States were subsequently utilized to bribe a high-ranking foreign official.

Immediately following the corporation's plea, the court imposed a criminal fine of \$1,001,000 (\$1 million for two counts 31 U.S.C. 1059 and \$1,000 for one count 18 U.S.C. 1343), and directed the corporation to pay \$380,000 as civil liabilities incurred under 31 U.S.C. 1103 (settlement agreed to by the firm and the Department of Justice with concurrence of the Deputy Assistant Secretary (Enforcement)).

Neutrality violations

While the attempted smuggling of weapons and ammunition directly into foreign countries from the United States continues, violations of the Arms Export Control Act are evolving into a more complex and intricate character.

On February 13, 1978, customs agents in Chicago seized 140 firearms at O'Hare International Airport for violation of the neutrality statutes. These weapons were shipped to Illinois from a firm in Michigan and destined for export to Zurich, Switzerland. Subsequent investigation disclosed that the Michigan firm had made 20 shipments of munitions that had been illegally diverted to South Africa. A Chicago grand jury has returned multiple indictments.

Organized crime

During fiscal 1978, Customs became the lead Federal agency in three major organized crime operations and in five separate investigations; special agents developed evidence for legal sanction against three organized crime members and three organized crime associates.

Two undercover special agents in Newark, N.J., effected a deep covert penetration of organized crime cargo theft activity in the northern New Jersey waterfront area. As a result of their penetration, the agents were approached by a major crime figure to collect payments on shylock loans on his behalf. The operation expanded into a joint operation between Customs, New Jersey State authorities, and the Newark strike force, funded by a \$350,000 Law Enforcement Assistance Administration (LEAA) grant. The operation had to be closed after the special agents were placed in a highly dangerous confrontation which suggested that their true identity was known. However, the agents had made various purchases of stolen merchandise and obtained other evidence of criminal violations. Subsequently, 20 Federal search warrants were executed which resulted in various seizures, including merchandise and 35 firearms. The Newark strike force is preparing numerous indictments against 20 to 25 persons.

Cargo theft

The Office of Investigations cargo theft action plan was fully implemented during fiscal 1978. The plan, which suggested a three-phase enforcement approach—response, target selection, and covert penetration in areas of high theft incidences—resulted in the creation of cargo theft squads in several major offices. These squads and individual agent cargo theft specialists have become the nucleus of four new LEAA-funded anti-cargo-theft/antifencing operations in which Customs is serving as the lead Federal agency. The implementation of the action plan has also resulted in increased development of sources of information.

In early April a shipment of 3,450 men's suits from Romania, valued at approximately \$300,000, were reported stolen from JFK International Airport. A confidential informant provided information to the Special Agent in Charge, JFK, as to the whereabouts of the stolen property. A search warrant was issued and on April 21, 1978, the warrant was executed at a warehouse where 1,972 of the suits along with a tractor-trailer and a container were recovered. Also, 79 sacks of Colombian coffee beans and a second tractor-trailer rig, taken during an armed hijacking, were discovered and seized by special agents. Total domestic value of this seizure was \$370,000.

Fraud

Customs fraud is white collar crime committed on an international scale. Violations of customs laws adversely affect significant segments of the national economy—balance of trade, domestic industry, the American labor market, and U.S. trade policies—and thus constitute an important investigative priority for Customs. Major fraud investigations continue to be concentrated on cases which have a high potential for civil/criminal prosecution and revenue recoveries of consequence.

A Federal grand jury in Buffalo returned a 13-count indictment against two Canadian businessmen and a Canadian trading company. The indictment charged that these individuals attempted to defraud the United States by entering woven polyethylene sheeting into the country and paying less than the amount of duty legally due on the sheeting. The product was made in Japan and the loss of revenue amounted to more than \$523,000. The case involved the submission of various false documents including false Japanese laboratory reports. The submission of these false documents qualified the product for a lower tariff rate. If convicted, the defendants are facing prison terms plus substantial fines.

On August 2, 1978, a firm was found guilty on seven counts of violating 18 U.S.C. 542 (criminal fraud) in Federal District Court for the Middle District of Florida. The convictions related to the fraudulent entry of 937,000 barrels of residual fuel oil at Jacksonville during 1973–74 utilizing a fraudulently obtained fee-free import license issued by the Federal Energy Administration. The conviction culminated a 4-year investigation of the firm and resulted in a loss of revenue totaling \$167,745.

Modernization**Customs Procedural Reform Act**

The Customs Procedural Reform Act (Public Law 95–410) was passed by the House of Representatives on October 17, 1977. The Senate passed an amended version of the bill on June 8, 1978, and a conference committee composed of members of the House Ways and Means Committee and the Senate Finance Committee met early in August 1978 to resolve the differences. A conference report was filed in late August 1978, and action by both House and Senate on final version of the bill resulted in passage of the bill in September 1978.

The act provides greater flexibility in administering the customs laws while permitting the Customs Service to modernize and simplify customs procedures. It raises the personal exemption from \$100 to \$300 (and from \$200 to \$600 for U.S. citizens returning by way of American Samoa, Guam, and the Virgin Islands). In addition, the fraud and penalty provisions of the Tariff Act of 1930 were revised to provide due process safeguards and de novo judicial review in the Federal courts. Congressional authorization of Customs Service appropriations will create a new element of congressional review and oversight of Customs activities.

As part of Customs continuing effort to serve the public, new border stations were opened at Alexandria Bay (Wellesley Island), N.Y., and Cannon Corners, N.Y.

Mail facility

A new mail facility at Seattle was completed and occupied on June 19, 1978. With consolidation of the Seattle mail branch into the facility, both air and surface mail as well as registered mail will be processed together.

Automated merchandise processing system (AMPS)

To meet the requirements of merchandise processing, Customs instituted AMPS. AMPS is designed to improve nationwide the Customs Service supervision and control of imported merchandise, and collection of duties and taxes. The program combines a variety of process improvements and modern computer and communications technology applications to entry and revenue processing. The process improvements are generally in the direction of standardizing procedures. Modern business techniques are also introduced for more efficient processing of import transactions. Use of AMPS is enabling Customs to meet the demands of increasing workload.

In fiscal 1978, automated line-item processing of immediate delivery control, entry screening, and collection processing was maintained at Philadelphia, Baltimore, Chicago, Boston, Miami, and Los Angeles Airport.

A revised automated collection system was developed and implemented at Houston and Los Angeles Airport with implementation preparation for this new capability begun at New Orleans, San Francisco, Seattle, Newark, New York, Wilmington, Washington, Norfolk, Charleston, and Savannah. With these ports scheduled for operation in early fiscal 1979, 17 percent of all customs entries and 65 percent of all customs collections will be automated.

An automated interface which provides statistical data to the Census Bureau was developed and operationally tested prior to implementation in fiscal 1979. This automated interface eliminates the manual processing and keypunching required by the present Customs-Census interface operation.

An automated manifest clearance system was designed and developed this year for pilot testing at Los Angeles Airport. This system is scheduled to become the standard manifest clearance system used by all carriers nationwide.

Improvements in passenger processing

The Customs accelerated passenger inspection system (CAPIS) was developed to provide airport inspectors with an environment to selectively screen passengers, whose numbers swell at an annual rate of 12 percent. Approximately 80 percent of all arriving passengers are released from the area at "primary," where a brief interview, hand luggage inspection, and TECS/NCIC check are made. The remaining 20 percent are referred to "secondary" for various reasons where complete baggage inspections are conducted. In 1978, additional CAPIS units were installed at Dulles, JFK, Miami, O'Hare, and Seattle-Tacoma Airports.

Customs, in conjunction with the Immigration and Naturalization Service, installed a one-stop citizen inspection system at selected airports having CAPIS. This system was successfully tested and implemented at Dulles Airport.

Regulatory Efforts**Regulatory audit**

The regulatory audit program is part of a broad-based Customs effort to modernize and simplify the processing of commercial transactions. The purpose of the program is to improve the revenue-producing function in addition to protecting both the revenue and the importing public. Regulatory Audit's objective is to provide Customs with an external audit capability to verify transactions and claims of importers, carriers and exporters. This will

be accomplished by means of onsite audits of their records, accounts, statements, and operating facilities in lieu of more costly physical control or other means of verification.

By application of scientific sampling methods and information quantified through computer analysis, companies can be selected for audit which are identified as most likely to provide Customs with high-payoff transactions. An analysis of importers transacting business with Customs has revealed that 15,000 importers represent 90 percent of the total dutiable entry workload. Audits of a relatively small percentage of selected persons and firms reduce the need for individual processing of millions of transactions. The resultant reduction of routine paperwork permits more cost-efficient utilization of manpower elsewhere in Customs.

During fiscal 1978, approximately 80 field auditors in 9 regional offices completed audits of various types which resulted in recovered revenues for Treasury or the importing public in excess of \$11 million.

Type of audit	Number	Amount recovered
Customhouse brokers.....	89	\$1,807,200
TSUS 806.30/807	29	4,542,800
Drawback	348	2,043,800
Agent assists.....	4	31,500
Containerized importations.....	162	77,800
Other	94	2,916,500
Total.....	726	11,419,600

Internal security

Working in coordination with other agencies, including the office of the U.S. attorney, 70 customs investigators closed and completed a total of 781 investigations. Of that total, 75 were either referred for criminal prosecution, or resulted in arrests and/or indictments. Also undertaken during fiscal 1978 were 109 investigations involving either administrative discipline (adverse action) or procedural change. The majority of these investigations refuted the original allegation or found that the allegation could not be substantiated.

Full field investigations

Due to an accelerated hiring program, 1,783 full field investigations were conducted in fiscal 1978 with each taking an average of 50 man-hours to complete.

Security clearances

Continued efforts on the part of Customs to reduce the number of security clearances have resulted in reducing the number to 220 issued in fiscal 1978.

Internal audit

In fiscal 1978, 152 audits, surveys, and special reports were completed by headquarters and regional offices. During the year, increased emphasis was placed on servicewide multiregional audits for specific operational programs. Upgrading of audit potential was achieved during the year through the hiring of computer science specialists, and through the rotation of auditors between

regional and headquarters offices. Substantial savings were achieved, or monetary losses disclosed with appropriate recommendations for correction or improvement through Internal Audit disclosures during the year.

These audits showed—

1. Consolidating drug and seizure facilities could result in annual savings of \$1.175 million.
2. Review of appraisement procedures in connection with importation of turbines disclosed undervaluations resulting in underpayment of duties exceeding \$630,000.
3. Review of vessel entrance in the Houston region disclosed that over \$500,000 in tonnage taxes were never billed.
4. Disclosure of the loss of \$142,000 at New York due to irregular delivery of merchandise by customs inspectors.
5. Annual savings of \$56,300 have been achieved through improved mail operations in the New Orleans district.

Other Activities

International Customs Conference

The First International Customs Conference for cooperation in the control of narcotics trafficking took place in Varna, Bulgaria, September 11-16, 1978. Participating were delegations of the customs administrations from Austria, Belgium, Bulgaria, Czechoslovakia, Denmark, the Federal Republic of Germany, Finland, France, the German Democratic Republic, Great Britain, Hungary, Italy, Morocco, the Netherlands, Norway, Pakistan, Poland, Spain, Sweden, Switzerland, Turkey, the United States, the U.S.S.R., and Yugoslavia, as well as representatives of the United Nations and the Customs Cooperation Council. The Conference was organized by the Bulgarian Customs Administration and the Customs Administration of the United States.

The Conference brought together competent customs officials from the participating countries for an exchange of experience and to find new and more efficient ways for customs cooperation in the control of narcotics trafficking.

In the course of the sessions the delegates unanimously emphasized the usefulness and the significance of the Conference as a new and important step in the common efforts to curtail drug abuse and to strengthen control of narcotics trafficking.

The Conference completed its work with the adoption of recommendations concerning the improvement of contacts between customs administrations, increased efficiency of customs control, and improved training of customs officers in detecting narcotics smuggling.

Throughout the Conference a series of bilateral meetings was arranged to enable participating countries to make a more profound examination and discussion of specific problems.

Relocation of Customs National Data Center

The Customs National Data Center, including all equipment and personnel, was moved from Silver Spring, Md., to the Customs headquarters building. Site preparation for the move commenced late in fiscal 1977. Full implementation at the new site was accomplished by a relocation team in August 1978, with no delay in scheduled processing.

Revised work ticket system

Culminating several years of effort, the revised work ticket system was implemented nationwide during the fiscal year. The work ticket system insures payment of overtime compensation to Customs employees and generates corresponding billings to parties-in-interest for inspectional services provided in accordance with the Customs overtime laws. The implementation was accomplished on a region-by-region basis and included training regional personnel in proper preparation and correction procedures. The revisions to the system were necessary to accommodate data processing equipment changes. As a result, revised work tickets and billings to parties-in-interest are now processed on a more timely and accurate basis.

Foreign trade zones

Foreign trade zones are geographical enclaves not considered part of the customs territory of the United States. Importers may bring merchandise into these zones for processing without the payment of customs duties and taxes. As of August 1978, there were 34 foreign trade zones and 4 special purpose subzones in operation. Applications are pending before the Foreign-Trade Zones Board for seven additional zones. In comparison, 10 years ago, 1968, there were 13 zones in operation.

Labor-management relations

On February 23, 1978, the Assistant Secretary of Labor for Labor-Management Relations granted a petition by the National Treasury Employees Union (NTEU) seeking consolidation of 12 Customs bargaining units for which NTEU and/or its local chapters were the exclusive representatives. The consolidation will permit NTEU to negotiate a single, nationwide collective bargaining agreement covering all professional and nonprofessional Customs employees in headquarters and regional offices who are exclusively represented by NTEU and/or its local chapters. Negotiations are expected to begin in 1978.

International narcotics control and reimbursable assistance program

The International Narcotics Control (INC) programs (formerly the Cabinet Committee on International Narcotics Control) continue to provide assistance to foreign governments in narcotics enforcement areas. U.S. Customs continued to play an important role in this assistance. Emphasis in both international narcotics control and U.S. Customs centered around development of more self-sufficient customs services with narcotics control capabilities within the foreign governments borders.

U.S. Customs narcotics control programs involve help to foreign customs services in both advisory assistance and narcotics enforcement training programs. Under International Narcotics Control funding, Customs stations narcotics-oriented advisory teams in various countries. In fiscal 1978, two such advisers were stationed in Ecuador and three in Thailand.

The narcotics enforcement training programs that are part of the International Narcotics Control/U.S. Customs assistance to foreign governments involve several different programs. All are designed to train foreign enforcement officers and upgrade foreign customs services in border control activities and narcotics interdiction capabilities. Emphasis is placed upon narcotics identification, border surveillance, cargo and passenger control, and search and seizure methods. These programs include an executive-level observation tour of U.S. Customs facilities for foreign heads of customs services; a midmanagement-level training program offered in the United States to foreign

officers who are supervisors or at the midmanagement level of their careers; a program offered in a foreign country to operational line officers in narcotics interdiction methodology; and a program designed to train handlers of narcotics detector dogs. Since the inception of these training programs, U.S. Customs has provided training to over 5,000 foreign officers representing some 60 different countries.

In addition, two international conferences on the use of narcotics detector dogs were held in Singapore for the East Asian countries and in Miami for Latin American countries. Appropriate law enforcement officers from throughout these areas gathered to exchange information and ideas on the use of this proven tool which accounted for over half of all hard narcotics seizures in the United States last year.

UNITED STATES SAVINGS BONDS DIVISION

The U.S. Savings Bonds Division promotes the sale and retention of U.S. savings bonds, thereby encouraging individual thrift. Because the average life of series E and H savings bonds is about twice that of the marketable debt, this form of borrowing constitutes a long-term underwriting of the Treasury's debt structure and makes possible the widespread distribution of the national debt through its ownership by a substantial number of small savers.

The program is carried out by a Treasury staff of less than 450 people with the active assistance of thousands of volunteers who are leaders in business, labor, finance, and the media. An estimated 670,000 people provide volunteer services of some kind for the program.

In fiscal 1978, Americans saved \$8 billion through savings bonds purchases, bringing the total value of outstanding savings bonds to over \$80 billion. Savings bonds are held by one out of every three American households, and more than 16 million men and women buy them each year—9 1/2 million through the payroll savings plan.

Office of the National Director

In support of President Carter's Government reorganization efforts, the Savings Bond Division thoroughly reviewed its field structure and began to implement improvements which will allow the Division to operate more efficiently and effectively. The changes, which will be fully implemented by mid-fiscal 1979, reduced the number of regional offices from 7 to 6 and consolidated 42 State-level offices of varying size into 25 balanced sales districts. The benefits of the new organization include: Standardizing the role, grade level, and span of control of field supervisors; shortening the chain of command in key urban areas; better allocating staff resources and improving cost-effectiveness.

In addition to directing the reorganization efforts, Mrs. Azie Taylor Morton, Treasurer of the United States and National Director of the United States Savings Bonds Division, began work on an updated and more specific role and mission for the Division which will stress the importance of savings bonds to the financing of the public debt.

She and other senior officials of the Division also conducted active speaking schedules on behalf of the savings bonds program in addition to directing the divisions and programs discussed in the following sections.

Industrial payroll savings campaign

The 1978 U.S. Industrial Payroll Savings Committee, appointed by Secretary Blumenthal, is chaired by Charles J. Pilliod, Jr., chairman of the board, Goodyear Tire and Rubber Co. The Committee is composed of top business leaders each representing either a major industry group or geographic area.

Mr. Pilliod hosted a meeting of the Committee in Washington, D.C., on January 11, 1978. Secretary Blumenthal charged the Committee with its 1978 calendar year goal of signing up 2.6 million new or increased-allotment savers.

Members of the U.S. Industrial Payroll Savings Committee conduct meetings of top management people, urge chief executives in their areas and industries to conduct payroll savings drives, and set strong examples by conducting campaigns in their own companies.

Chairman Pilliod, in contributing much of his own time and effort to the program, traveled to 17 cities and addressed 20 meetings of business and community leaders on the importance of savings bonds to our economy. He also provided some excellent sales tools for savings bonds volunteers, including a brochure for top executives entitled "Take Stock in America," three newsletters to volunteers to publicize the campaign, and a full-page ad in the Wall Street Journal featuring the 1978 Committee members. The three Goodyear blimps added a special touch to the savings bonds program as they crisscrossed the country—120,000 miles of America—displaying animated savings bonds messages.

Volunteer activities

State and county volunteers are the grassroots "mainstay" of the savings bonds program. Governors, appointed by the Treasury Secretary, serve as honorary chairmen of their States, while a working State chairman provides direction. At the local level, more than 3,000 county chairmen coordinate savings bonds activities for their areas.

Richard B. Sellars, former chairman and chief executive officer, Johnson & Johnson Co., is both the State chairman for New Jersey and the National Chairman, Volunteer State Chairmen's Council. While presiding at the Council meeting in Washington, D.C., on October 3 and 4, 1977, Mr. Sellars encouraged the State chairmen to hold payroll savings campaigns in their own companies as the first step in an active 1978 program. Mr. Sellars also traveled extensively, early in 1978, to help kick off campaigns in Take Stock in America Centers throughout the country. To help identify important areas of activity during the year, he published for top volunteer leaders in every State a special brochure containing information on bond program history and sales since 1941, as well as an action plan for volunteers.

A special kit of materials, "A Program for the Nation's Volunteers," also distributed, included suggested proclamations for State and local governments, sample speeches, radio and TV scripts, and other information materials.

National organizations

The National Organizations Committee, under the chairmanship of Valerie F. Levitan, executive director of Soroptimist International, continued its strong support for the savings bonds program. As part of the national organizations program, the national presidents of 41 civic, fraternal, service, and women's clubs sent letters to their members, sponsored advertisements, or placed articles in various magazines in support of savings bonds.

The Division is investigating ways to improve and expand the involvement of these important voluntary organizations.

Labor support

America's labor unions and their leaders continued to support the savings bonds program and the payroll savings plan. Through the labor press, more than 20 million union and independent employee association members were exposed to savings bonds advertising. Other union and employee associations published editorials and sent more than 3 million letters urging individual members to join the payroll savings plan where they work.

The Division honored eight AFL-CIO-affiliated national labor organizations, at their conventions, for outstanding support to the bond program. They were: County and Municipal Employees; American Federation of Government Employees; International Union of Electrical, Radio and Machine Workers; United Steelworkers of America; International Chemical Workers Union; United Brotherhood of Carpenters and Joiners of America; International Brotherhood of Electrical Workers; and United Rubber, Cork, Linoleum and Plastic Workers of America. The National Association of Postmasters of the United States was also honored.

In addition, the AFL-CIO-affiliated Amalgamated Clothing and Textile Workers Union, and the National Association of Letter Carriers, received awards. Three State labor organizations, South Carolina AFL-CIO, Georgia State AFL-CIO, and the Ohio Conference of Teamsters, were also recognized.

During 1978, 104,250 savings bonds leaflets were distributed at 9 major union conventions, and 230 national labor kits, part of the unions' educational and community services program, were sent to the AFL-CIO Community Services Department.

Financial institutions support

A major factor in the growth of savings bonds sales has been support from the Nation's financial institutions. Banks, savings and loan associations, and similar institutions provide more than 39,000 over-the-counter sales outlets. They also issue bonds for many companies offering the payroll savings plan.

In 1978, American banks and bankers sent more than 10 million letters recommending bonds to their customers and mailed more than 53 million promotional leaflets as enclosures with bank statements. Banks and other financial institutions also sponsored many bond newspaper advertisements, and Secretary Blumenthal's "Message to Bankers" appeared in the industry's daily publication.

This promotional effort was spearheaded by the American Bankers Association Savings Bonds Committee, chaired by John D. Chisholm, president of the Marquette Bank & Trust Co., Rochester, Minn. In 1978, Mr. Chisholm was the keynote speaker at numerous "Take Stock in America" campaigns and at several State bankers association conventions.

For 1979, the ABA Savings Bonds Committee will continue to encourage bankers to support the savings bonds program through the five-point banking program of bank letters, bank leaflets, bank sponsorship of ads, bank teller training, and payroll savings programs established in banks.

Federal Government savings campaign

The 1978 savings bonds campaign for Federal workers, under the chairmanship of Secretary of Labor Ray Marshall, was the most successful of its kind in the last 15 years.

The campaign resulted in more than 397,000 new or increased-allotment savers—66,000 more than the 1977 bond drive produced. Sixty-one percent of all civilian employees of the Federal Government are now on the payroll

savings plan. Dollar sales this year will meet or exceed last year's outstanding results of \$1.1 billion.

President Carter provided leadership from the top, with a strong endorsement of savings bonds. On February 1, a Presidential memo to White House employees said, in part, "I urge you to enthusiastically support this campaign. Our leadership * * * will greatly assist in meeting the very worthy goals of this program."

On April 6, television star Arte Johnson, honorary chairman of the Federal savings bonds campaign, and Chairman Marshall kicked off the Federal campaign at a meeting with 1,800 Federal employees.

Advertising support

The public service advertising campaign for savings bonds, conducted in cooperation with The Advertising Council, was well received by all media. The council estimates that more than 29,000 ads were published in newspapers, 255,000 lines appeared in national magazines, and 4 billion home impressions resulted from television use of savings bonds announcements.

The advertising campaign focused on ways in which savings bonds enrich the lives of Americans by helping them reach specific savings goals. Created by the Leo Burnett Co., a volunteer task-force agency of the council, the ads continue to use the general theme and tag line "Take Stock in America."

Information activities included completion of an all-new copy kit for daily and weekly newspapers and several feature articles for newspapers, and continued publication of "The Bond Teller" for bank personnel and the "Savings Bond Salute" for volunteers. The pocket speech guide for volunteers, "In Which We Serve," was completely revised and updated.

Public affairs

The Office of Public Affairs provides information on the savings bonds program and encourages its use by newspapers, television stations, and other forms of media. During 1978, strengthened contacts with national media people resulted in increased coverage of the program.

Direct assistance was given to the savings bonds industrial payroll savings campaign and to the Federal campaign for payroll savings through providing remarks and press releases, arranging for press coverage and photographic services, and similar activities. During the year, the office also provided speech material to government officials speaking on behalf of the program.

The office handles a large volume of telephone and mail inquiries from the general public on savings bonds.

UNITED STATES SECRET SERVICE

The major responsibilities of the U.S. Secret Service are defined in section 3056, title 18, United States Code. The investigative responsibilities are to detect and arrest persons committing any offense against the laws of the United States relating to coins, obligations, and securities of the United States and of foreign governments; and to detect and arrest persons violating certain laws

relating to the Federal Deposit Insurance Corporation, Federal land banks, joint-stock land banks, and Federal land bank associations. The protective responsibilities includes protection of the President of the United States and the members of his immediate family; the President-elect and the members of his immediate family unless the members decline such protection; the Vice President or other officer next in the order of succession to the Office of the President, and the members of his immediate family unless the members decline such protection; the Vice President-elect, and the members of his immediate family unless the members decline such protection; a former President and his wife during his lifetime; the widow of a former President until her death or remarriage; the minor children of a former President until they reach 16 years of age, unless such protection is declined; a visiting head of a foreign state or foreign government; and, at the direction of the President, other distinguished foreign visitors to the United States and official representatives of the United States performing special missions abroad. In addition, Public Law 90-331 authorizes the Secret Service to protect major Presidential and Vice Presidential candidates, unless such protection is declined; the spouse of a major Presidential or Vice Presidential nominee, except that such protection shall not commence more than 60 days prior to the general Presidential election.

Investigative operations

Counterfeiting.—The Secret Service received \$22.3 million in counterfeit U.S. currency during fiscal 1978. This represents a 49-percent decrease from fiscal 1977. Losses to the public decreased 18 percent, from \$4.9 million in fiscal 1977 to \$4 million in fiscal 1978. Seizures prior to circulation decreased 53 percent, with \$18.3 million being seized.

Of interest is the fact that 26 percent of the \$4 million passed on the American public originated with overseas operations. In contrast, only 1 percent of the \$18.3 million seized in the United States prior to circulation stemmed from overseas activities.

Six percent, or \$234,000, of the notes passed on the public involved the violations of raising or altering genuine currency.

The following case summary illustrates counterfeit investigations successfully concluded during fiscal 1978.

On September 15, 1977, the Secret Service received information that a new counterfeit \$50 note was being distributed by a Brooklyn, N.Y., bakery company route driver. At that time none of the new counterfeit notes had been passed.

However, by October 6, 1977, a sample of the new counterfeit note had been obtained, the suspect identified, and a meeting between the suspect and undercover Secret Service agents arranged. The following day agents purchased \$25,000 of these new counterfeit notes. Ten days later a second meeting was arranged with the suspect. He was arrested and an additional \$17,000 in counterfeit \$50 notes was seized. When the suspect was interviewed, he identified a previously known counterfeiter as the printer of these new counterfeit notes.

The suspect printer, owner of two legitimate printing concerns, was immediately placed under surveillance in order to locate the counterfeit plant. Numerous attempts to corroborate the printer's alleged involvement culminated in success on November 15, 1977, when the printer and two others were arrested as they delivered over \$30,000 in counterfeit notes. Postarrest

statements by the defendants enabled Secret Service agents to recover over \$2.1 million in counterfeit notes.

Check forgery.—During fiscal 1978, the Service received 85,286 checks for investigation. Treasury paid approximately 717 million checks during fiscal 1978. The Service received 119 checks per million paid, or 1 check for investigation for approximately every 8,400 checks paid.

During fiscal 1978, the Service made 9,409 check forgery arrests, compared with 8,779 last year—a 7.2-percent increase.

The backlog of pending check cases for fiscal 1978 decreased to 53,733, as compared with 81,488 last year. Any possible reduction in the check workload caused by the direct deposit or electronic funds transfer programs is considered minimal.

A check forgery investigative summary follows.

Between November 1977 and February 1978, special agents of the Secret Service New York field office and New York postal inspectors carried out a joint “sting” operation using the code name “Audubon Check Cashing Service.” Checks were not actually cashed, but rather purchased at a percentage of the amount for which issued.

Associates handed out business cards in preselected sections of New York City, providing a special telephone number to handle customer orders. When calls came in, a mobile unit responded for on-the-spot check purchases. The Audubon Check Cashing Service purchased checks with a face value of \$135,000 within the first few months.

When Operation Audubon was terminated, personnel of the Audubon Check Cashing Service surfaced as Government agents and the negotiables included stolen Treasury checks, State and county social security and welfare checks, and other obligations.

The Audubon Check Cashing Service was the first mobile undercover fencing operation of its kind and culminated in the arrest of approximately 90 individuals.

Bond forgery.—Bond forgery investigations decreased during fiscal 1978, with 10,399 bonds received for investigation, as compared with 12,189 last fiscal year.

At yearend, there were 950,463 stolen bonds, representing a face value of \$64.1 million, entered into the National Crime Information Center by the Secret Service.

During fiscal 1978, 164 persons were arrested for bond forgery, as compared with 152 persons in fiscal 1977.

During the fiscal year, the Secret Service recovered, prior to forgery and redemption, 8,648 stolen bonds with a face value of \$728,530 compared with fiscal 1977 when 14,631 stolen bonds were recovered with a face value of \$1 million.

The summary of a typical bond forgery investigation follows.

The executor for the estate of a deceased registered owner removed 147 U.S. savings bonds from a safe-deposit box assigned to the deceased registered owner. The bonds, which were to be negotiated as part of a normal procedure in settling the estate of the registered owner, were stored in the office of the executor. A month later, the executor took the bonds to a bank for negotiation, unaware that approximately \$8,500 worth of the bonds were now missing. The theft was discovered months later when the executor received payment for the bonds from the bank, short approximately \$8,500.

Subsequent investigation revealed that a janitor in the building where the office of the executor was located stole the missing bonds, opened a checking

account in the name of the deceased registered owner, and redeemed the stolen bonds by depositing them into that account and writing checks on those funds. Following investigation by the Secret Service, the janitor was arrested and pleaded guilty.

Identification Branch

The Identification Branch of the Special Investigations and Security Division serves all field offices by conducting technical examinations of handwriting, handprinting, typewriting, fingerprints, palmprints, striations on counterfeit currency, altered documents, and other types of physical evidence.

During fiscal 1978, members of the Identification Branch conducted examinations in 10,986 cases involving 732,847 exhibits. This resulted in 3,291 identifications of persons and a total of 316 court appearances to furnish expert testimony.

Organized crime

The Secret Service provides special agents to each of the 14 organized crime strike forces located throughout the United States. All information is coordinated and disseminated to Secret Service field offices by the Special Investigations and Security Division at headquarters. The agent in charge of this Division, as a member of the National Organized Crime Planning Council, participates in the establishment of targets for the strike forces. This Council, made up of representatives of all Federal law enforcement agencies, meets monthly at the Department of Justice.

Treasury Security Force

The Treasury Security Force, a uniformed branch of the U.S. Secret Service, protects the Main Treasury and Treasury Annex Buildings and participates in providing security for the White House. It also enforces Treasury's restricted access policy and conducts investigations involving petty larceny cases, theft, and other improper actions which take place on Treasury premises.

During fiscal 1978, the Force made 54 felony arrests and interviewed 58 persons for attempted unauthorized entry into the Treasury Building.

Protective operations

The Secret Service provided protection for the President and Mrs. Carter; their children, Amy, Jack, James, and Jeff; and grandsons, James and Jason. Protection continued for Vice President and Mrs. Mondale.

Protection was also provided for former President and Mrs. Gerald R. Ford; former President and Mrs. Richard M. Nixon; and former First Ladies Mrs. Harry Truman, Mrs. Dwight Eisenhower, and Mrs. Lyndon Johnson.

Protection was highlighted during the fiscal year by numerous foreign trips. The President and Mrs. Carter visited Poland, Iran, India, Saudi Arabia, Egypt, France, and Belgium during the period December 29, 1977, through January 6, 1978, and Venezuela, Brazil, Nigeria, and Liberia March 28 through April 3, 1978. Secret Service protective security arrangements were also made for President and Mrs. Carter's July trip to Germany, the President's June trip to Panama, and Mrs. Carter's visits to Costa Rica and Italy.

The Vice President and Mrs. Mondale visited Mexico City in January, the Philippines, Thailand, Indonesia, Australia, and New Zealand during May, and Israel and Egypt at the end of June and early July. The Vice President was in Canada in January and May. Mrs. Mondale visited Helsinki, Finland, and Leningrad, U.S.S.R., in December 1977.

Former First Lady Mrs. Lyndon Johnson made nine foreign trips during the past fiscal year, visiting Mexico, Venezuela, England, Jordan, Iran, Israel, and the Virgin Islands.

The Secret Service continued to provide security for the Secretary of the Treasury on a limited basis—on all foreign trips, on some domestic trips, and, occasionally, in the Washington, D.C., area.

During fiscal 1978, foreign dignitary protection continued to be a major effort with 126 foreign dignitaries receiving protection. These included 123 visits by heads of foreign states or governments and 3 other distinguished foreign visitors to the United States. Included in the figures are 12 foreign dignitaries who received protection during the NATO Summit Conference in Washington, May 30–31, 1978, and 28 foreign dignitaries who received protection during the United Nations Disarmament Conference in New York City, May 20 through June 7, 1978.

The U.S. Secret Service Uniformed Division continued to provide protection for the White House, Presidential offices, the official Vice Presidential residence, the Blair House when visiting heads of state or government are in residence, and foreign diplomatic missions of 136 countries at 405 locations in the metropolitan area of the District of Columbia. In addition, the Uniformed Division provided protection for the World Bank/International Monetary Fund meetings in Washington, D.C., in September 1978.

Protective research

During fiscal 1978, the Secret Service continued, and will complete in fiscal 1979, a major study to provide more comprehensive data for the evaluation of individuals suspected of threatening the life of the President and others protected by the Service.

Protective research study groups completed a feasibility study for converting handwriting specimens and other graphic images to microforms for storage in an automated microform retrieval system. They also examined and identified the need to obtain secure computer equipment to facilitate the processing and retrieval of classified data of protective significance. A study to allow the application of geoprocessing technology to intelligence files continued.

The Intelligence Division implemented and conducted formal training sessions for Division personnel and field office agents assigned to protective research in order to increase understanding between headquarters and the field. Division personnel received specialized training in handwriting examination and were trained in the use of supplemental data systems such as the New York Times Information Bank.

The Division has implemented a number of engineering improvements to the protective intelligence and events automatic data processing system which will permit the efficient use of computers by more employees.

The Technical Security Division implemented regulations for Executive Order 12036, section 1–1004, signed by the President in January 1978, regarding new audio countermeasures procedures.

Communications

During fiscal 1978, the Communications Division completed software and hardware enhancements on the teletype message switcher to improve and expedite the handling of message traffic. A high-speed terminal was installed in the Washington field office.

Installation of new radio systems in the resident agencies and upgrading of existing systems in the field offices continued.

Protective communications support was provided for the Office of Protective Operations. Mobile command post units were employed on several occasions.

Liaison

Through fiscal 1978, the Liaison Division maintained personal liaison at the headquarters level with law enforcement, intelligence, and other governmental agencies to assure proper coordination, communication, and exchange of information in matters relating to protective and criminal investigation responsibilities.

Increased visits by protectees, both domestic and foreign, resulted in much activity by the Division at the U.S. Capitol, State Department, foreign embassies, Department of Defense facilities, and numerous other Federal agencies.

Creation and staffing of the Emergency Preparedness Branch in this Division resulted in better efficiency and operability of these programs.

During fiscal 1978, the Freedom of Information and Privacy Acts Office processed 1,909 Freedom of Information Act requests and 268 Privacy Act requests.

Administration

An employee assistance program was established to assist employees with personal problems through counseling or referral services. Counseling is provided to aid the employee in recognizing the existence of a problem (especially those personal problems that affect job performance). Community agencies that can provide further counseling and/or treatment are recommended.

A health maintenance program for Secret Service employees age 40 and over was established. The program provides for an optional annual physical examination for all eligible employees assigned to offices in Washington, D.C., or at field office locations.

The employee performance evaluation program was rewritten to provide better guidance to both supervisors and employees, and additional documenting requirements were prescribed to enhance the quality of annual performance rating discussions.

Overcrowded space conditions and increasing fragmentation of headquarters' offices to separate locations continue to reinforce the need for a consolidated building site. The contractor selected by the General Services Administration submitted a report projecting the Service's office space requirements over the next 10 years, supporting the need for a consolidated facility, and recommending the 1800 G Street building for that purpose. The report has been submitted for departmental approval.

The safety program has realized greater visibility with the addition of a full-time safety staff. Employee safety awareness has been increased through the establishment of Occupational Safety and Health Committees and the distribution of safety promotional materials. In addition, environmental evaluations are being performed at the Service's indoor firing ranges, garages, and other facilities, and significant changes are being made.

A substantial increase in the reuse of excess property was noted during the fiscal year. A program for managing the redistribution of surplus property among Secret Service offices, and the acquisition and distribution of excess property from other Federal agencies, has been implemented.

Efforts were made to increase the number of contract and purchase order awards to minority small businesses. The plan included establishing liaison with the Small Business Administration and the Office of Administrative Programs, in order to locate minority firms that could fulfill the Service's requirements. Special emphasis was placed on identifying minority contractors approved by the Small Business Administration for awards authorized by section 8(a) of the Small Business Act.

A 2-year effort to identify future automated data processing needs is culminating in a procurement to replace current Secret Service computer hardware. The new equipment will be of larger scale and more technologically advanced, and is expected to be fully operational by the 1980 Presidential campaign.

Management information systems continue to be improved, in order to be more responsive to a greater number of managers within the organization. Primary emphasis has been placed on increased flexibility in reporting collected data to enhance the Service's financial and man-hour accounting systems, workload measurement systems, and investigation control systems.

During fiscal 1978, the Treasury payroll/personnel information system (TPPIS) became fully operational in the Secret Service. Substantial progress was made to maximize the benefits attainable from TPPIS. Enhancements to the automated accounting system resulted in automatic cost accounting distribution, improved financial records based on TPPIS-provided payroll information, and savings in processing time.

The Service implemented the Government bill of lading method for moving employee household goods upon transfer during fiscal 1978. Under the method, the Service makes the arrangements with a carrier, monitors the shipment, and processes loss and damage claims. Since the method can be used only when a real savings to the Government exists, this method will be cost beneficial for the Service.

The Presidential Protection Assistance Act of 1976, Public Law 94-524, provides that Federal agencies be reimbursed for providing assistance in support of Secret Service protective duties. During fiscal 1978, the Service established written instructions for the submission of requests and provided them to other Federal agencies.

Training

There were 89,310 man-hours of training conducted by the Secret Service, Office of Training, during fiscal 1978. In addition, 14,927 man-hours of interagency and 20,258 man-hours of non-Government training were completed for a total of 124,495 man-hours.

An inservice course, designed to update senior special agents in the state of the profession, was given to 150 agents.

The 4-day advanced emergency care course graduated 125 participants to aid in the Service's protective and investigative mission. Reports have been received of lives saved because of care given by course graduates, both on and off duty.

Technical operations briefings, designed to provide expertise in modern technical equipment, were given to 61 special agents. These agents are able to maximize the use of camera and surveillance equipment in accordance with the latest legal and organizational policies.

There were 23 exercises simulating various attacks on a principal. These 1-day exercises were performed for temporary and permanent dignitary protective details.

The protective forces driving course, designed especially for the Service's protective function, was taken by 84 special agents. This course prepares the agent for safe operation of limousines and security vehicles under stress conditions. Improvement of normal driving skills is a collateral benefit.

Protective research briefings were provided to 66 senior agents and 5 intelligence research specialists. The briefings updated agents working protective intelligence in the field and aided the intelligence research specialists in the analysis and evaluation of intelligence data.

A clerical orientation program, designed for lower graded employees outside the Washington, D.C., area, was developed and pilot-tested in one major field office. It is anticipated that the course will be offered to all field clerical personnel in the future.

To ensure safe and proficient use of firearms, approximately 30,000 individual courses were fired by Service and other Federal law enforcement personnel who are required to carry a firearm.

In addition, 1,432 uniformed personnel of the Service received specialized training in such areas as the Cuban Mission detail and protective details at the Blair House. Along with the specialized training, there were inservice courses designed to update the professional skills of captains, lieutenants, and sergeants.

While providing formal training for its own personnel, the Service is committed to training other Federal, State, and local officials to the following extent. Eleven dignitary protection seminars were conducted to aid 213 command-level police officers. Protective operations briefings were given to 110 lower echelon police officials. These briefings, 2 days shorter than the dignitary protection seminar, are designed for generally the same purpose, but are directed toward the line officer.

Numerous protective seminars were provided for Secret Service administrative personnel and other law enforcement agencies to improve skills and enhance coordination with the Service in the area of protection. Similarly, 1- to 3-day programs were offered in the area of criminal investigation.

Firearms training was provided to 1,539 employees of 21 Federal law enforcement agencies. In addition, 32 employees from other Federal, State, and local agencies were trained to be firearms instructors.

In addition to the programmed events, the Office of Training had conducted specialized security surveys for various police agencies, directed several intraorganizational research projects, and offered individual or small group briefings when the participants' inclusion in a programmed course was impractical.

Inspection

The Office of Inspection conducted 61 office inspections during fiscal 1978. In addition, 32 special investigations, and other in-depth studies and reviews were completed.

Inspectors were diverted from their regular duties to serve as supervisors on several temporary protective details, including the NATO Conference, the Panama Canal Treaty signing, and the United Nations Disarmament Conference. One inspector is currently coordinating the planning of the candidate/nominee protective details for the 1980 elections.

Inspectors have been involved in the continuing maintenance of the classified document program and the headquarters and field emergency readiness plan. One inspector has served on a committee to develop an

improved merit promotion plan. A comprehensive in-house study of the inspection program was also made, and several inspection procedures and areas of emphasis were revised.

The internal auditors issued several audit reports during fiscal 1978, including a feasibility study on using Government bill of lading for transporting household goods and personal effects of employees involved in permanent change-of-station transfers. Auditors also made preaward reviews of cost proposals submitted by potential contractors concerning several procurements. These reviews have been used by contracting officers as a basis for contract negotiations. One auditor was also assigned to the ADP procurement team to assist in evaluating offers made by vendors competing for a contract to provide a new ADP system.

Legal counsel

During fiscal 1978, the Secret Service resubmitted a legislative proposal to the Secretary of the Treasury that would amend title 18, United States Code, section 871, "Threats against the President or successors to the Presidency," to cover threats made against most protectees of the Secret Service.

The Secret Service proposed a new section 510 to title 18, United States Code, "Forgery of Government checks, bonds, and other obligations," which, in effect, eliminates the need to rely on title 18, United States Code, section 495, "Contracts, Deeds, and Powers of Attorney" and other Federal statutes in the investigation of any violations concerning Treasury check, bonds, and other obligations.

EXHIBITS

Public Debt Operations, Regulations, and Legislation

Exhibit 1.—Treasury notes

A Treasury circular covering an auction for cash with an interest rate determined through competitive bidding is reproduced in this exhibit. Circulars pertaining to the other note offerings during fiscal 1978 are similar in form and therefore are not reproduced in this report. However, essential details for each offering are summarized in the table in this exhibit, and allotment data for the new notes will be shown in table 37 in the Statistical Appendix. During the year there were no offerings in which holders of maturing securities were given preemptive rights to exchange their holdings for new notes.

DEPARTMENT CIRCULAR NO. 14-78. PUBLIC DEBT

**DEPARTMENT OF THE TREASURY,
Washington, June 15, 1978.**

1. INVITATION FOR TENDERS

1.1. The Secretary of the Treasury, under the authority of the Second Liberty Bond Act, as amended, invites tenders for approximately \$3,000,000,000 of United States securities, designated Treasury Notes of June 30, 1980, Series Q-1980 (CUSIP No. 912827 HV 7). The securities will be sold at auction with bidding on the basis of yield. Payment will be required at the price equivalent of the bid yield of each accepted tender. The interest rate on the securities and the price equivalent of each accepted bid will be determined in the manner described below. Additional amounts of these securities may be issued to Government accounts and Federal Reserve Banks for their own account in exchange for maturing Treasury securities. Additional amounts may also be issued for cash to Federal Reserve Banks as agents of foreign and international monetary authorities.

2. DESCRIPTION OF SECURITIES

2.1. The securities will be dated June 30, 1978, and will bear interest from that date, payable on a semiannual basis on December 31, 1978, and each subsequent 6 months on June 30 and December 31, until the principal becomes payable. They will mature June 30, 1980, and will not be subject to call for redemption prior to maturity.

2.2. The income derived from the securities is subject to all taxes imposed under the Internal Revenue Code of 1954. The securities are subject to estate, inheritance, gift or other excise taxes, whether Federal or State, but are exempt from all taxation now or hereafter imposed on the principal or interest thereof by any State, any possession of the United States, or any local taxing authority.

2.3. The securities will be acceptable to secure deposits of public monies. They will not be acceptable in payment of taxes.

2.4. Bearer securities with interest coupons attached, and securities registered as to principal and interest, will be issued in denominations of \$5,000, \$10,000, \$100,000, and \$1,000,000. Book-entry securities will be available to eligible bidders in multiples of those amounts. Interchanges of securities of different denominations and of coupon, registered and book-entry securities, and the transfer of registered securities will be permitted.

2.5. The Department of the Treasury's general regulations governing United States securities apply to the securities offered in this circular. These general regulations include those currently in effect, as well as those that may be issued at a later date.

3. SALE PROCEDURES

3.1. 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, Tuesday, June 20, 1978. Noncompetitive tenders as defined below will be considered timely if postmarked no later than Monday, June 19, 1978.

3.2. Each tender must state the face amount of securities bid for. The minimum bid is \$5,000 and larger bids must be in multiples of that amount. Competitive tenders must also show the yield desired, expressed in terms of an annual yield with two decimals, e.g., 7.11%. Common fractions may not be used. Noncompetitive tenders must show the term "noncompetitive" on the tender form in lieu of a specified yield. No bidder may submit more than one noncompetitive tender and the amount may not exceed \$1,000,000.

3.3. All bidders must certify that they have not made and will not make any agreements for the sale or purchase of any securities of this issue prior to the deadline established in Section 3.1. for receipt of tenders. Those authorized to submit tenders for the account of customers will be required to certify that such tenders are submitted under the same conditions, agreements, and certifications as tenders submitted directly by bidders for their own account.

3.4. Commercial banks, which for this purpose are defined as banks accepting demand deposits, and primary dealers, which for this purpose are defined as 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.

3.5. Tenders will be received without deposit for their own account from commercial banks and other banking institutions; primary dealers, as defined above; Federally-insured savings and loan associations; States, and their political subdivisions or instrumentalities; public pension and retirement and other public funds; international organizations in which the United States holds membership; foreign central banks and foreign states; Federal Reserve Banks; and Government accounts. Tenders from others must be accompanied by a deposit of 5% of the face amount of securities applied for (in the form of cash, maturing Treasury securities or readily collectible checks), or by a guarantee of such deposit by a commercial bank or a primary dealer.

3.6. Immediately after the closing hour, tenders will be opened, followed by a public announcement of the amount and yield range of accepted bids. Subject to the reservations expressed in Section 4, noncompetitive tenders will be accepted in full, and then competitive tenders will be accepted, starting with those at the lowest yields, through successively higher yields to the extent required to attain the amount offered. Tenders at the highest accepted yield will be prorated if necessary. After the determination is made as to which tenders are accepted, a coupon rate will be established, on the basis of a 1/8 of one percent increment, which results in an equivalent average accepted price close to 100.000 and a lowest accepted price above the original issue discount limit of 99.500. That rate of interest will be paid on all of the securities. Based on such interest rate, the price on each competitive tender allotted will be determined and each successful competitive bidder will be required to pay the price equivalent to the yield bid. Those submitting noncompetitive tenders will pay the price equivalent to the weighted average yield of accepted competitive tenders. Price calculations will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final. If the amount of noncompetitive tenders received would absorb all or most of the offering, competitive tenders will be accepted in an amount sufficient to provide a fair determination of the yield. Tenders received from Government accounts and Federal Reserve Banks will be accepted at the price equivalent to the weighted average yield of accepted competitive tenders.

3.7. Competitive bidders will be advised of the acceptance or rejection of their tenders. Those submitting noncompetitive tenders will only be notified if the tender is not accepted in full, or when the price is over par.

4. RESERVATIONS

4.1. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders in whole or in part, to allot more or less than the amount of securities

specified in Section 1, and to make different percentage allotments to various classes of applicants when the Secretary considers it in the public interest. The Secretary's action under this Section is final.

5. PAYMENT AND DELIVERY

5.1. Settlement for allotted securities must be made or completed on or before Friday, June 30, 1978, at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt, wherever the tender was submitted. Payment must be in cash; in other funds immediately available to the Treasury; in Treasury bills, notes or bonds (with all coupons detached) maturing on or before the settlement date but which are not overdue as defined in the general regulations governing United States securities; or by check drawn to the order of the institution to which the tender was submitted, which must be received at such institution no later than:

- (a) Wednesday, June 28, 1978, if the check is drawn on a bank in the Federal Reserve District of the institution to which the check is submitted (the Fifth Federal Reserve District in case of the Bureau of the Public Debt), or
- (b) Monday, June 26, 1978, if the check is drawn on a bank in another Federal Reserve District.

Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at the applicable Federal Reserve Bank. Payment will not be considered complete where registered securities are requested if the appropriate identifying number as required on tax returns and other documents submitted to the Internal Revenue Service (an individual's social security number or an employer identification number) is not furnished. When payment is made in securities, a cash adjustment will be made to or required of the bidder for any difference between the face amount of securities presented and the amount payable on the securities allotted.

5.2. In every case where full payment is not completed on time, the deposit submitted with the tender, up to 5 percent of the face amount of securities allotted, shall, at the discretion of the Secretary of the Treasury, be forfeited to the United States.

5.3. Registered securities tendered as deposits and in payment for allotted securities are not required to be assigned if the new securities are to be registered in the same names and forms as appear in the registrations or assignments of the securities surrendered. When the new securities are to be registered in names and forms different from those in the inscriptions or assignments of the securities presented, the assignment should be to "The Secretary of the Treasury for (securities offered by this circular) in the name of (name and taxpayer identifying number)." If new securities in coupon form are desired, the assignment should be to "The Secretary of the Treasury for coupon (securities offered by this circular) to be delivered to (name and address)." Specific instructions for the issuance and delivery of the new securities, signed by the owner or authorized representative, must accompany the securities presented. Securities tendered in payment should be surrendered to the Federal Reserve Bank or Branch or to the Bureau of the Public Debt, Washington, D.C. 20226. The securities must be delivered at the expense and risk of the holder.

5.4. If bearer securities are not ready for delivery on the settlement date, purchasers may elect to receive interim certificates. These certificates shall be issued in bearer form and shall be exchangeable for definitive securities of this issue, when such securities are available, at any Federal Reserve Bank or Branch or at the Bureau of the Public Debt, Washington, D.C. 20226. The interim certificates must be returned at the risk and expense of the holder.

5.5. Delivery of securities in registered form will be made after the requested form of registration has been validated, the registered interest account has been established, and the securities have been inscribed.

6. GENERAL PROVISIONS

6.1. As fiscal agents of the United States, Federal Reserve Banks are authorized and requested to receive tenders, to make allotments as directed by the Secretary of the

Treasury, to issue such notices as may be necessary, to receive payment for and make delivery of securities on full-paid allotments, and to issue interim certificates pending delivery of the definitive securities.

6.2. The Secretary of the Treasury may at any time issue supplemental or amendatory rules and regulations governing the offering. Public announcement of such changes will be promptly provided.

PAUL H. TAYLOR,
Acting Fiscal Assistant Secretary.

SUPPLEMENT TO DEPARTMENT CIRCULAR NO. 14-78. PUBLIC DEBT

DEPARTMENT OF THE TREASURY,
Washington, June 21, 1978.

The Secretary of the Treasury announced on June 20, 1978, that the interest rate on the notes designated Series Q-1980, described in Department Circular—Public Debt Series—No. 14-78, dated June 15, 1978, will be 8 1/4 percent. Interest on the notes will be payable at the rate of 8 1/4 percent per annum.

PAUL H. TAYLOR,
Acting Fiscal Assistant Secretary.

Summary of information pertaining to Treasury notes issued during fiscal year 1978

Date of preliminary announcement	Department circular		Concurrent offering circular No.	Treasury notes issued (all offered for cash)	Type of auction ¹	Accepted tenders			Minimum denomination	Issue date	Maturity date	Date tenders received	Payment date ²
	No.	Date				Average price	High price	Low price					
<i>1977</i>		<i>1977</i>								<i>1977</i>		<i>1977</i>	
Sept. 27	23-77	Sept. 28	7-1/8	percent Series F-1982	Yield	99.750	3 99.876	99.666	1,000	Oct. 17	Nov. 15, 1982	Oct. 5	Oct. 17
Oct. 12	24-77	Oct. 13	7-1/4	percent Series V-1979	Yield	99.963	3 100.092	99.927	5,000	Oct. 31	Oct. 31, 1979	Oct. 18	Oct. 31
Oct. 21	25-77	Oct. 25	26-77, 27-77	1-1/8 percent Series J-1980	Yield	99.695	3 99.748	99.668	5,000	Nov. 15	Nov. 15, 1980	Oct. 28	Nov. 15
Oct. 21	26-77	Oct. 25	25-77, 27-77	7-5/8 percent Series A-1987	Yield	99.552	3 99.759	99.415	1,000	Nov. 15	Nov. 15, 1987	Nov. 1	Nov. 15
Nov. 14	28-77	Nov. 15		percent Series W-1979	Yield	99.991	3 100.009	99.972	5,000	Nov. 30	Nov. 30, 1979	Nov. 22	Nov. 30
Nov. 21	29-77	Nov. 22		7-1/4 percent Series L-1981	Yield	99.776	3 99.845	99.741	1,000	Dec. 7	Dec. 31, 1981	Nov. 30	Dec. 7
Dec. 13	30-77	Dec. 14	7-1/8	percent Series X-1979	Yield	99.863	3 99.936	99.808	5,000	Jan. 3	Dec. 31, 1979	Dec. 21	Jan. 3
<i>1978</i>		<i>1978</i>										<i>1978</i>	
Jan. 12	1-78	Jan. 13	7-1/2	percent Series K-1980	Yield	99.909	3 99.963	99.891	5,000	Jan. 31	Jan. 31, 1980	Jan. 18	Jan. 31
Jan. 25	2-78	Jan. 26	3-78, 4-78	7-1/2 percent Series M-1981	Yield	99.849	3 99.935	99.792	5,000	Feb. 15	May 15, 1981	Jan. 31	Feb. 15
Jan. 25	3-78	Jan. 26	2-78, 4-78	8 percent Series A-1985	Price	100.65	3 100.80	100.58	1,000	Feb. 15	Feb. 15, 1985	Feb. 1	Feb. 15
Feb. 10	5-78	Feb. 10	7-5/8	percent Series L-1980	Yield	99.863	3 99.918	99.845	5,000	Feb. 28	Feb. 29, 1980	Feb. 16	Feb. 28
Feb. 15	6-78	Feb. 16	7-7/8	percent Series G-1982	Yield	99.928	3 99.997	99.894	1,000	Mar. 6	Mar. 31, 1982	Feb. 22	Mar. 6
Mar. 15	7-78	Mar. 16	7-1/2	percent Series M-1980 ⁴	Yield	99.891	3 100.000	99.872	5,000	Mar. 31	Mar. 31, 1980	Mar. 22	Mar. 31
Mar. 21	8-78	Mar. 22	7-7/8	percent Series C-1983	Yield	99.698	3 99.740	99.657	1,000	Apr. 5	May 15, 1983	Mar. 28	Apr. 5
Apr. 12	9-78	Apr. 13	7-3/4	percent Series N-1980	Yield	99.909	3 100.000	99.873	5,000	May 1	Apr. 30, 1980	Apr. 19	May 1
Apr. 26	10-78	Apr. 27	11-78	8-1/4 percent Series A-1988	Yield	99.732	3 99.933	99.665	1,000	May 15	May 15, 1988	May 2	May 15
May 17	12-78	May 18		8 percent Series P-1980	Yield	99.837	3 100.000	99.819	5,000	May 31	May 31, 1980	May 23	May 31
May 22	13-78	May 23		8-1/4 percent Series H-1982	Yield	99.911	3 100.013	99.877	1,000	June 7	June 30, 1982	May 31	June 7
June 14	14-78	June 15		8-1/4 percent Series Q-1980	Yield	99.873	3 100.000	99.855	5,000	June 30	June 30, 1980	June 20	June 30
July 12	16-78	July 13		8-1/2 percent Series R-1980	Yield	99.802	3 99.964	99.784	5,000	July 31	July 31, 1980	July 20	July 31
July 26	17-78	July 27	18-78, 19-78	8-3/8 percent Series N-1981	Yield	99.779	3 99.831	99.753	5,000	Aug. 15	Aug. 15, 1981	Aug. 1	Aug. 15
July 26	18-78	July 27	17-78, 19-78	8-1/4 percent Series B-1985	Yield	99.426	3 99.843	99.166	1,000	Aug. 15	Aug. 15, 1985	Aug. 2	Aug. 15
Aug. 17	20-78	Aug. 18		8-3/8 percent Series S-1980	Yield	99.991	3 100.009	99.973	5,000	Aug. 31	Aug. 31, 1980	Aug. 23	Aug. 31
Aug. 22	21-78	Aug. 23		8-3/8 percent Series J-1982	Yield	99.859	3 99.961	99.826	1,000	Sept. 6	Sept. 30, 1982	Aug. 29	Sept. 6

¹ All auctions but one for issues of notes were by the "Yield" method in which bidders were required to bid on the basis of an annual yield; one issue of notes was by the "Price" method, in which case the interest rate is announced prior to the auction, and bidders were requested to bid a price. After tenders were allotted in the "Yield" method auction an interest rate for the notes was established at the nearest 1/8 of one percent increment that translated into an average accepted price close to 100.000.

² Payment could not be made through Treasury tax and loan accounts.

³ Relatively small amounts of bids were accepted at a price or prices above the high shown. However,

the higher price or prices are not shown in order to prevent an appreciable discontinuity in the range of prices, which would make it misrepresentative.

⁴ Since auction resulted in coupon rate of 7 1/2 percent, this was considered an additional issue of the 4-year notes C-1980 issued Mar. 17, 1976, maturing Mar. 31, 1980.

NOTE: The maximum amount that could be bid for on a noncompetitive basis for each issue was \$1,000,000.

Exhibit 2.—Treasury bonds

A Treasury circular covering an auction of Treasury bonds for cash is reproduced in this exhibit. Circulars pertaining to other bond offerings during fiscal 1978 are similar in form and therefore are not reproduced in this report. However, essential details for each offering are summarized in the table in this exhibit, and allotment data for the bonds will be shown in table 38 in the Statistical Appendix. During the year there were no offerings in which holders of maturing securities were given preemptive rights to exchange their holdings for new bonds.

DEPARTMENT CIRCULAR NO. 31-77. PUBLIC DEBT

DEPARTMENT OF THE TREASURY,
Washington, December 20, 1977.

1. INVITATION FOR TENDERS

1.1. The Secretary of the Treasury, under the authority of the Second Liberty Bond Act, as amended, invites tenders for approximately \$1,500,000,000 of United States securities, designated Treasury Bonds of 1993 (CUSIP No. 912810 CA 4). The securities will be sold at auction with bidding on the basis of yield. Payment will be required at the price equivalent of the bid yield of each accepted tender. The interest rate on the securities and the price equivalent of each accepted bid will be determined in the manner described below. Additional amounts of these securities may be issued for cash to Federal Reserve Banks as agents of foreign and international monetary authorities.

2. DESCRIPTION OF SECURITIES

2.1. The securities will be dated January 6, 1978, and will bear interest from that date, payable on a semiannual basis on August 15, 1978, and each subsequent 6 months on February 15 and August 15, until the principal becomes payable. They will mature February 15, 1993, and will not be subject to call for redemption prior to maturity.

2.2. The income derived from the securities is subject to all taxes imposed under the Internal Revenue Code of 1954. The securities are subject to estate, inheritance, gift or other excise taxes, whether Federal or State, but are exempt from all taxation now or hereafter imposed on the principal or interest thereof by any State, any possession of the United States, or any local taxing authority.

2.3. The securities will be acceptable to secure deposits of public monies. They will not be acceptable in payment of taxes.

2.4. Bearer securities with interest coupons attached, and securities registered as to principal and interest, will be issued in denominations of \$1,000, \$5,000, \$10,000, \$100,000, and \$1,000,000. Book-entry securities will be available to eligible bidders in multiples of those amounts. Interchanges of securities of different denominations and of coupon, registered and book-entry securities, and the transfer of registered securities will be permitted.

2.5. The Department of the Treasury's general regulations governing United States securities apply to the securities offered in this circular. These general regulations include those currently in effect, as well as those that may be issued at a later date.

3. SALE PROCEDURES

3.1. 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, Tuesday, December 27, 1977. Noncompetitive tenders as defined below will be considered timely if postmarked no later than Monday, December 26, 1977.

3.2. Each tender must state the face amount of securities bid for. The minimum bid is \$1,000 and larger bids must be in multiples of that amount. Competitive tenders must also show the yield desired, expressed in terms of an annual yield with two decimals,

e.g., 7.11%. Common fractions may not be used. Noncompetitive tenders must show the term "noncompetitive" on the tender form in lieu of a specified yield. No bidder may submit more than one noncompetitive tender and the amount may not exceed \$1,000,000.

3.3. All bidders must certify that they have not made and will not make any agreements for the sale or purchase of any securities of this issue prior to the deadline established in Section 3.1. for receipt of tenders. Those authorized to submit tenders for the account of customers will be required to certify that such tenders are submitted under the same conditions, agreements, and certifications as tenders submitted directly by bidders for their own account.

3.4. Commercial banks, which for this purpose are defined as banks accepting demand deposits, and primary dealers, which for this purpose are defined as 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.

3.5. Tenders will be received without deposit for their own account from commercial banks and other banking institutions; primary dealers, as defined above; Federally-insured savings and loan associations; States, and their political subdivisions or instrumentalities; public pension and retirement and other public funds; international organizations in which the United States holds membership; foreign central banks and foreign states; Federal Reserve Banks; and Government accounts. Tenders from others must be accompanied by a deposit of 5% of the face amount of securities applied for (in the form of cash, maturing Treasury securities or readily collectible checks), or by a guarantee of such deposit by a commercial bank or a primary dealer.

3.6. Immediately after the closing hour, tenders will be opened, followed by a public announcement of the amount and yield range of accepted bids. Subject to the reservations expressed in Section 4, noncompetitive tenders will be accepted in full, and then competitive tenders will be accepted, starting with those at the lowest yields, through successively higher yields to the extent required to attain the amount offered. Tenders at the highest accepted yield will be prorated if necessary. After the determination is made as to which tenders are accepted, a coupon rate will be established, on the basis of a 1/8 of one percent increment, which results in an equivalent average accepted price close to 100.000 and a lowest accepted price above the original issue discount limit of 96.250. That rate of interest will be paid on all of the securities. Based on such interest rate, the price on each competitive tender allotted will be determined and each successful competitive bidder will be required to pay the price equivalent to the yield bid. Those submitting noncompetitive tenders will pay the price equivalent to the weighted average yield of accepted competitive tenders. Price calculations will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final. If the amount of noncompetitive tenders received would absorb all or most of the offering, competitive tenders will be accepted in an amount sufficient to provide a fair determination of the yield. Tenders received from Government accounts and Federal Reserve Banks will be accepted at the price equivalent to the weighted average yield of accepted competitive tenders.

3.7. Competitive bidders will be advised of the acceptance or rejection of their tenders. Those submitting noncompetitive tenders will only be notified if the tender is not accepted in full, or when the price is over par.

4. RESERVATIONS

4.1. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders in whole or in part, to allot more or less than the amount of securities specified in Section 1, and to make different percentage allotments to various classes of applicants when the Secretary considers it in the public interest. The Secretary's action under this Section is final.

5. PAYMENT AND DELIVERY

5.1. Settlement for allotted securities must be made or completed on or before Friday, January 6, 1978, at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt, wherever the tender was submitted. Payment must be in cash; in other funds immediately available to the Treasury; in Treasury bills, notes or bonds (with all coupons detached) maturing on or before the settlement date but which are not overdue as defined in the general regulations governing United States securities; or by check drawn to the order of the institution to which the tender was submitted, which must be received at such institution no later than:

- (a) Wednesday, January 4, 1978, if the check is drawn on a bank in the Federal Reserve District of the institution to which the check is submitted (the Fifth Federal Reserve District in case of the Bureau of the Public Debt), or
- (b) Tuesday, January 3, 1978, if the check is drawn on a bank in another Federal Reserve District.

Checks received after the dates set forth in the preceding sentence will not be accepted unless they are payable at the applicable Federal Reserve Bank. Payment will not be considered complete where registered securities are requested if the appropriate identifying number as required on tax returns and other documents submitted to the Internal Revenue Service (an individual's social security number or an employer identification number) is not furnished. When payment is made in securities, a cash adjustment will be made to or required of the bidder for any difference between the face amount of securities presented and the amount payable on the securities allotted.

5.2. In every case where full payment is not completed on time, the deposit submitted with the tender, up to 5 percent of the face amount of securities allotted, shall, at the discretion of the Secretary of the Treasury, be forfeited to the United States.

5.3. Registered securities tendered as deposits and in payment for allotted securities are not required to be assigned if the new securities are to be registered in the same names and forms as appear in the registrations or assignments of the securities surrendered. When the new securities are to be registered in names and forms different from those in the inscriptions or assignments of the securities presented, the assignment should be to "The Secretary of the Treasury for (securities offered by this circular) in the name of (name and taxpayer identifying number)." If new securities in coupon form are desired, the assignment should be to "The Secretary of the Treasury for coupon (securities offered by this circular) to be delivered to (name and address)." Specific instructions for the issuance and delivery of the new securities, signed by the owner or authorized representative, must accompany the securities presented. Securities tendered in payment should be surrendered to the Federal Reserve Bank or Branch or to the Bureau of the Public Dept, Washington, D.C. 20226. The securities must be delivered at the expense and risk of the holder.

5.4. If bearer securities are not ready for delivery on the settlement date, purchasers may elect to receive interim certificates. These certificates shall be issued in bearer form and shall be exchangeable for definitive securities of this issue, when such securities are available, at any Federal Reserve Bank or Branch or at the Bureau of the Public Debt, Washington, D.C. 20226. The interim certificates must be returned at the risk and expense of the holder.

5.5. Delivery of securities in registered form will be made after the requested form of registration has been validated, the registered interest account has been established, and the securities have been inscribed.

6. GENERAL PROVISIONS

6.1. As fiscal agents of the United States, Federal Reserve Banks are authorized and requested to receive tenders, to make allotments as directed by the Secretary of the Treasury, to issue such notices as may be necessary, to receive payment for and make delivery of securities on full-paid allotments, and to issue interim certificates pending delivery of the definitive securities.

6.2. The Secretary of the Treasury may at any time issue supplemental or amendatory rules and regulations governing the offering. Public announcement of such changes will be promptly provided.

PAUL H. TAYLOR,
Acting Fiscal Assistant Secretary.

SUPPLEMENT TO DEPARTMENT CIRCULAR NO. 31-77. PUBLIC DEBT

DEPARTMENT OF THE TREASURY,
Washington, December 28, 1977.

The Secretary of the Treasury announced on December 27, 1977, that the interest rate of the bonds described in Department Circular—Public Debt Series—No. 31-77, dated December 20, 1977, will be $7\frac{7}{8}$ percent per annum. Accordingly, the bonds are hereby redesignated $7\frac{7}{8}$ percent Treasury Bonds of 1993. Interest on the bonds will be payable at the rate of $7\frac{7}{8}$ percent per annum.

PAUL H. TAYLOR,
Acting Fiscal Assistant Secretary.

Summary of information pertaining to Treasury bonds issued during fiscal year 1978

Date of preliminary announcement	Department circular		Concurrent offering circular No.	Treasury bonds issued (all auctioned for cash)	Type of auction ¹	Accepted tenders			Issue date	Maturity date	Date tenders received	Payment date ²
	No.	Date				Average price	High price	Low price				
1977		1977							1977		1977	1977
Oct. 24	27-77	Oct. 25	25-77, 26-77	7 7/8 percent of 2002-2007	Yield	99.261	³ 99.487	99.148	Nov. 15	Nov. 15, 2007	Nov. 2	Nov. 15
Dec. 19	31-77	Dec. 20		7 7/8 percent of 1993	Yield	99.315	³ 99.575	99.228	1978 Jan. 6	Feb. 15, 1993	Dec. 27	1978 Jan. 6
1978		1978							1975		1978	
Jan. 25	4-78	Jan. 26	2-78, 3-78	8 1/4 percent of 2000-2005	Price	100.13	100.73	100.01	May 2 ⁴	May 15, 2005	Feb. 2	Feb. 15
Apr. 26	11-78	Apr. 27	10-78	8 3/4 percent of 1995-2000	Price	99.02	³ 99.23	98.91	May 15 ⁵	Aug. 15, 2000	May 3	May 15
June 19	15-78	June 20		8 5/8 percent of 1993	Yield	99.924	³ 100.008	99.924	1978 July 11	Aug. 15, 1993	June 28	July 11
July 26	19-78	July 27	17-78, 18-78	8 3/8 percent of 2003-2008	Yield	99.402	100.055	99.079	Aug. 15	Aug. 15, 2008	Aug. 3	Aug. 15

¹ Some issues of bonds were auctioned by the "Price" method, with the interest rate being announced prior to the auction, and bidders were required to bid at a price. Other auctions were held by the "Yield" method in which case bidders were required to bid at a yield. After tenders were allotted in the "Yield" method auction an interest rate for the bonds was established at the nearest 1/8 of one percent increment that translated into an average accepted price close to 100.000.

² Payment could not be made through Treasury tax and loan accounts for any of the issues.

³ Relatively small amounts of bids were allotted at a price or prices above the high shown. However,

the higher price or prices are not shown in order to prevent an appreciable discontinuity in the range of prices, which would make it misrepresentative.

⁴ Interest was payable from Feb. 15, 1978.

⁵ Interest was payable from May 15, 1978.

NOTE: The maximum amount that could be bid for on a noncompetitive basis for each issue was \$1,000,000. All issues had a minimum denomination of \$1,000.

Exhibit 3.—Treasury bills

During the fiscal year there were 52 weekly issues of 13-week and 26-week bills (the 13-week bills represent additional amounts of bills with an original maturity of 26 weeks), 13 52-week issues, 1 issue of 139 days, and 4 issues of short-dated ("cash management") bills. A press release inviting tenders for 13-week and 26-week bills is reproduced in this exhibit and is representative of all releases except those for short-dated bills. The offering press release of March 1, 1978, inviting tenders for 43-day bills is also included and is representative of all such releases. Also reproduced is a press release which is representative of releases announcing the results of offerings. Data for each issue during the fiscal year appears in table 39 in the Statistical Appendix.

PRESS RELEASE OF DECEMBER 6, 1977

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$5,700 million, to be issued December 15, 1977. This offering will provide \$200 million of new cash for the Treasury as the maturing bills are outstanding in the amount of \$5,516 million. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$2,300 million, representing an additional amount of bills dated September 15, 1977, and to mature March 16, 1978 (CUSIP No. 912793 P3 4), originally issued in the amount of \$3,377 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately \$3,400 million to be dated December 15, 1977, and to mature June 15, 1978 (CUSIP No. 912793 Q8 2).

Both series of bills will be issued for cash and in exchange for Treasury bills maturing December 15, 1977. Federal Reserve Banks, for themselves and as agents of foreign and international monetary authorities, presently hold \$2,855 million of the maturing bills. These accounts may exchange bills they hold for the bills now being offered at the weighted average prices of accepted competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Except for definitive bills in the \$100,000 denomination, which will be available only to investors who are able to show that they are required by law or regulation to hold securities in physical form, both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D.C. 20226, up to 1:30 p.m., Eastern Standard time, Monday, December 12, 1977. Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series) should be used to submit tenders for bills to be maintained on the book-entry records of the Department of the Treasury.

Each tender must be for a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. In the case of competitive tenders the price offered must be expressed on the basis of 100, with not more than three decimals, e.g., 99.925. Fractions may not be used.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, or for

bills issued in bearer form, where authorized. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and price range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$500,000 or less without stated price from any one bidder will be accepted in full at the weighted average price (in three decimals) of accepted competitive bids for the respective issues.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches, and bills issued in bearer form must be made or completed at the Federal Reserve Bank or Branch or at the Bureau of the Public Debt on December 15, 1977, in cash or other immediately available funds or in Treasury bills maturing December 15, 1977. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

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

Department of the Treasury Circulars, No. 418 (current revision), Public Debt Series—Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

PRESS RELEASE OF MARCH 1, 1978

The Department of the Treasury, by this public notice, invites tenders for approximately \$3,000 million of 43-day Treasury bills to be issued March 8, 1978, representing an additional amount of bills dated October 20, 1977, maturing April 20, 1978 (CUSIP No. 912793 P8 3).

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.

Competitive tenders will be received at all Federal Reserve Banks and Branches up to 1:30 p.m., Eastern Standard time, Friday, March 3, 1978. 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 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.

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 Wednesday, March 8, 1978.

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.

PRESS RELEASE OF MARCH 3, 1978

Tenders for \$3,004 million of 43-day Treasury bills to be issued on March 8, 1978, and to mature April 20, 1978, 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)
			Percent
High	99.246	6.313	6.45
Low	99.238	6.380	6.52
Average	99.242	6.346	6.48

NOTE.—Tenders at the low price were allotted 67 percent.

Total tenders received and accepted by Federal Reserve districts

Location	Received	Accepted
Boston	\$15,000,000	\$3,350,000
New York	5,845,000,000	2,566,850,000
Philadelphia	—	—
Cleveland	—	—
Richmond	117,000,000	3,000,000
Atlanta	—	—
Chicago	696,000,000	182,920,000
St. Louis	26,000,000	14,000,000
Minneapolis	15,000,000	7,350,000
Kansas City	20,000,000	—
Dallas	—	—
San Francisco	550,000,000	226,700,000
Total	7,284,000,000	3,004,170,000

Exhibit 4.—Department Circular No. 653, Ninth Revision, April 23, 1974, amended, offering of United States savings bonds, Series E

DEPARTMENT OF THE TREASURY,
Washington, February 27, 1978.

SUMMARY: The purpose of this amendment to the current offering of United States Savings Bonds, Series E, is to revise the tables of redemption values and investment yields contained therein to reflect the entrance of bonds of various issue dates into their first or next extended period.

EFFECTIVE DATE: Upon publication.

SUPPLEMENTAL INFORMATION: The tables contained in the offering circular for Series E savings bonds show the redemption values and investment yields for bonds of all possible issue dates. Each Table covers a particular consecutive group of issue dates. Whenever the earlier dated bonds covered by a particular Table reach the end of an original or extended maturity period, it is necessary to provide a supplemental Table to cover the extended maturity period those bonds will next enter. During 1978, earlier dated bonds in each of the following groups will begin a new extended maturity period.

- (1) Table 18—bonds dated June 1 through November 1, 1948;
- (2) Table 19—bonds dated December 1, 1948, through May 1, 1949;
- (3) Table 59—bonds dated June 1 through August 1, 1960;
- (4) Table 60—bonds dated September 1 through November 1, 1960;
- (5) Table 61—bonds dated December 1, 1960, through February 1, 1961;
- (6) Table 62—bonds dated March 1 through May 1, 1961;
- (7) Table 94—bonds dated June 1 through November 1, 1972;
- (8) Table 95—bonds dated December 1, 1972, through May 1, 1973.

Also, Table 97 covers bonds bearing issue dates of December 1, 1973, through August 1, 1976. Of those bonds, only those bearing an issue date of December 1, 1973, will enter their first extended maturity period during 1978.

To reflect these new extended maturity periods, Tables 18, 19, 59, 60, 61, 62, 94, and 95 are being supplemented to show redemption values and investment yields for the first or next extended maturity period applicable thereto. It should be noted, however, that later dated bonds covered by these Tables will not enter their first or next extended maturity period until after 1978. While these bonds have already been irrevocably granted such extension, the supplemental Tables will only be applicable thereto if there is no intervening interest rate change.

With respect to Table 97, new Table 98 is being added to cover bonds dated January 1, 1974, through August 1, 1976, which will not enter their first extension until a later time. Table 97, which will now only cover bonds dated December 1, 1973, is being supplemented at this time to show redemption values and investment yields of these bonds for their first extended maturity period. These are the only bonds covered by former Table 97 that will enter an extension during 1978.

Accordingly, Department of the Treasury Circular No. 653, Ninth Revision, as amended, dated April 23, 1974 (31 CFR, Part 316), is hereby further amended by the deletion of current Table 97 and the issuance of new Tables 18-A, 19-A, 59-A, 60-A, 61-A, 62-A, 94-A, 95-A, 97, 97-A, and 98.

The foregoing amendments were effected under authority of section 22 of the Second Liberty Bond Act, as amended (49 Stat. 21, as amended; 31 U.S.C. 757c) and 5 U.S.C. 301. Notice and public procedures thereon are deemed unnecessary as the fiscal policy of the United States is involved.

PAUL H. TAYLOR,
Deputy Fiscal Assistant Secretary.

TABLE 18-A

BONDS BEARING ISSUE DATES FROM JUNE 1 THROUGH NOV. 1, 1948

Issue price	\$7.50	\$18.75	\$37.50	\$75.00	\$150.00	\$375.00	\$750.00	Approximate investment yield (annual percentage rate)		
Denomination	10.00	25.00	50.00	100.00	200.00	500.00	1000.00			
Period (years and months after second extended maturity at 30 years 0 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*							(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to 3rd extend- ed maturity
	THIRD EXTENDED MATURITY PERIOD**									
								Percent	Percent	Percent
0-0 to 0-6 1/(6/1/78)	\$24.56	\$61.40	\$122.80	\$245.60	\$491.20	\$1228.00	\$2456.00	—	5.99	6.00
0-6 to 1-0 (12/1/78)	25.30	63.24	126.48	252.96	505.92	1264.80	2529.60	5.99	6.01	6.00
1-0 to 1-6 (6/1/79)	26.06	65.14	130.28	260.56	521.12	1302.80	2605.60	6.00	5.99	6.00
1-6 to 2-0 (12/1/79)	26.84	67.09	134.18	268.36	536.72	1341.80	2683.60	6.00	6.02	6.00
2-0 to 2-6 (6/1/80)	27.64	69.11	138.22	276.44	552.88	1382.20	2764.40	6.00	5.99	6.00
2-6 to 3-0 (12/1/80)	28.47	71.18	142.36	284.72	569.44	1423.60	2847.20	6.00	5.98	6.00
3-0 to 3-6 (6/1/81)	29.32	73.31	146.62	293.24	586.48	1466.20	2932.40	6.00	6.00	6.00
3-6 to 4-0 (12/1/81)	30.20	75.51	151.02	302.04	604.08	1510.20	3020.40	6.00	6.01	6.00
4-0 to 4-6 (6/1/82)	31.11	77.78	155.56	311.12	622.24	1555.60	3111.20	6.00	5.99	6.00
4-6 to 5-0 (12/1/82)	32.04	80.11	160.22	320.44	640.88	1602.20	3204.40	6.00	6.02	6.00
5-0 to 5-6 (6/1/83)	33.01	82.52	165.04	330.08	660.16	1650.40	3300.80	6.00	5.99	6.00
5-6 to 6-0 (12/1/83)	34.00	84.99	169.98	339.96	679.92	1699.80	3399.60	6.00	6.00	6.00
6-0 to 6-6 (6/1/84)	35.02	87.54	175.08	350.16	700.32	1750.80	3501.60	6.00	6.01	6.00
6-6 to 7-0 (12/1/84)	36.07	90.17	180.34	360.68	721.36	1803.40	3606.80	6.00	5.99	6.00
7-0 to 7-6 (6/1/85)	37.15	92.87	185.74	371.48	742.96	1857.40	3714.80	6.00	6.01	6.00
7-6 to 8-0 (12/1/85)	38.26	95.66	191.32	382.64	765.28	1913.20	3826.40	6.00	6.00	6.00
8-0 to 8-6 (6/1/86)	39.41	98.53	197.06	394.12	788.24	1970.60	3941.20	6.00	5.99	6.00
8-6 to 9-0 (12/1/86)	40.59	101.48	202.96	405.92	811.84	2029.60	4059.20	6.00	6.01	6.01
9-0 to 9-6 (6/1/87)	41.81	104.53	209.06	418.12	836.24	2090.60	4181.20	6.00	6.01	6.00
9-6 to 10-0 (12/1/87)	43.07	107.67	215.34	430.68	861.36	2153.40	4306.80	6.00	6.00	6.00
10-0 2/ (6/1/88)	44.36	110.90	221.80	443.60	887.20	2218.00	4436.00	6.00 3/	—	—

1/ Month, day, and year on which issues of June 1, 1948, enter each period. For subsequent issue months add the appropriate number of months.

2/ Third extended maturity reached at 40 years 0 months after issue.

3/ Yield on purchase price from issue date to 3rd extended maturity date is 4.49 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 19-A

BONDS BEARING ISSUE DATES FROM DEC. 1, 1948, THROUGH MAY 1, 1949

Issue price	\$7.50	\$18.75	\$37.50	\$75.00	\$150.00	\$375.00	\$750.00	Approximate investment yield (annual percentage rate)		
Denomination	10.00	25.00	50.00	100.00	200.00	500.00	1000.00			
Period (years and months after second extended maturity at 30 years 0 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*							(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to 3rd extend- ed maturity
	THIRD EXTENDED MATURITY PERIOD**							Percent	Percent	Percent
0-0 to 0-6 1/(12/1/78)	\$24.90	\$62.24	\$124.48	\$248.96	\$497.92	\$1244.80	\$2489.60	6.01	6.01	6.00
0-6 to 1-0 (6/1/79)	25.64	64.11	128.22	256.44	512.88	1282.20	2564.40	6.01	5.99	6.00
1-0 to 1-6 (12/1/79)	26.41	66.03	132.06	264.12	528.24	1320.60	2641.20	6.00	6.00	6.00
1-6 to 2-0 (6/1/80)	27.20	68.01	136.02	272.04	544.08	1360.20	2720.40	6.00	6.00	6.00
2-0 to 2-6 (12/1/80)	28.02	70.05	140.10	280.20	560.40	1401.00	2802.00	6.00	6.00	6.00
2-6 to 3-0 (6/1/81)	28.86	72.15	144.30	288.60	577.20	1443.00	2886.00	6.00	6.02	6.00
3-0 to 3-6 (12/1/81)	29.73	74.32	148.64	297.28	594.56	1486.40	2972.80	6.00	6.00	6.00
3-6 to 4-0 (6/1/82)	30.62	76.55	153.10	306.20	612.40	1531.00	3062.00	6.00	5.98	6.00
4-0 to 4-6 (12/1/82)	31.54	78.84	157.68	315.36	630.72	1576.80	3153.60	6.00	6.01	6.00
4-6 to 5-0 (6/1/83)	32.48	81.21	162.42	324.84	649.68	1624.20	3248.40	6.00	6.01	6.00
5-0 to 5-6 (12/1/83)	33.46	83.65	167.30	334.60	669.20	1673.00	3346.00	6.00	5.98	6.00
5-6 to 6-0 (6/1/84)	34.46	86.15	172.30	344.60	689.20	1723.00	3446.00	6.00	6.01	6.00
6-0 to 6-6 (12/1/84)	35.50	88.74	177.48	354.96	709.92	1774.80	3549.60	6.00	6.00	6.00
6-6 to 7-0 (6/1/85)	36.56	91.40	182.80	365.60	731.20	1828.00	3656.00	6.00	6.00	6.00
7-0 to 7-6 (12/1/85)	37.66	94.14	188.28	376.56	753.12	1882.80	3765.60	6.00	6.01	6.00
7-6 to 8-0 (6/1/86)	38.79	96.97	193.94	387.88	775.76	1939.40	3878.80	6.00	6.00	6.00
8-0 to 8-6 (12/1/86)	39.95	99.88	199.76	399.52	799.04	1997.60	3995.20	6.00	5.99	6.00
8-6 to 9-0 (6/1/87)	41.15	102.87	205.74	411.48	822.96	2057.40	4114.80	6.00	6.01	6.00
9-0 to 9-6 (12/1/87)	42.38	105.96	211.92	423.84	847.68	2119.20	4238.40	6.00	6.00	6.00
9-6 to 10-0 (6/1/88)	43.66	109.14	218.28	436.56	873.12	2182.80	4365.60	6.00	5.99	5.99
10-0 2/ (12/1/88)	44.96	112.41	224.82	449.64	899.28	2248.20	4496.40	6.00 3/	---	---

1/ Month, day, and year on which issues of Dec. 1, 1948, enter each period. For subsequent issue months add the appropriate number of months.

2/ Third extended maturity reached at 40 years 0 months after issue.

3/ Yield on purchase price from issue date to 3rd extended maturity date is 4.53 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 59-A

BONDS BEARING ISSUE DATES FROM JUNE 1 THROUGH AUG. 1, 1960

Issue price	\$18.75	\$37.50	\$75.00	\$150.00	\$375.00	\$750.00	\$7500	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after first extended maturity at 17 years 9 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*							(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to 2nd extend- ed maturity
	SECOND EXTENDED MATURITY PERIOD**									
								Percent	Percent	Percent
0-0 to 0-6 1/(3/1/78)	\$43.18	\$86.36	\$172.72	\$345.44	\$690.88	\$1381.76	\$1381.76	6.02	6.02	6.00
0-6 to 1-0 (9/1/78)	44.48	88.96	177.92	355.84	711.68	1423.36	1423.36	6.02	5.98	6.00
1-0 to 1-6 (3/1/79)	45.81	91.62	183.24	366.48	732.96	1465.92	1465.92	6.00	5.98	6.00
1-6 to 2-0 (9/1/79)	47.18	94.36	188.72	377.44	754.88	1509.76	1509.76	5.99	6.02	6.00
2-0 to 2-6 (3/1/80)	48.60	97.20	194.40	388.80	777.60	1555.20	1555.20	6.00	6.01	6.00
2-6 to 3-0 (9/1/80)	50.06	100.12	200.24	400.48	800.96	1601.92	1601.92	6.00	5.99	6.00
3-0 to 3-6 (3/1/81)	51.56	103.12	206.24	412.48	824.96	1649.92	1649.92	6.00	6.01	6.00
3-6 to 4-0 (9/1/81)	53.11	106.22	212.44	424.88	849.76	1699.52	1699.52	6.00	5.99	6.00
4-0 to 4-6 (3/1/82)	54.70	109.40	218.80	437.60	875.20	1750.40	1750.40	6.00	6.00	6.00
4-6 to 5-0 (9/1/82)	56.34	112.68	225.36	450.72	901.44	1802.88	1802.88	6.00	6.00	6.00
5-0 to 5-6 (3/1/83)	58.03	116.06	232.12	464.24	928.48	1856.96	1856.96	6.00	6.00	6.00
5-6 to 6-0 (9/1/83)	59.77	119.54	239.08	478.16	956.32	1911.64	1911.64	6.00	5.99	6.00
6-0 to 6-6 (3/1/84)	61.56	123.12	246.24	492.48	984.96	1969.92	1969.92	6.00	6.01	6.00
6-6 to 7-0 (9/1/84)	63.41	126.82	253.64	507.28	1014.56	2030.12	2030.12	6.00	5.99	6.00
7-0 to 7-6 (3/1/85)	65.31	130.62	261.24	522.48	1044.96	2091.92	2091.92	6.00	6.00	6.00
7-6 to 8-0 (9/1/85)	67.27	134.54	269.08	538.16	1076.32	2154.64	2154.64	6.00	6.01	6.00
8-0 to 8-6 (3/1/86)	69.29	138.58	277.16	554.32	1108.64	2219.28	2219.28	6.00	6.00	6.00
8-6 to 9-0 (9/1/86)	71.37	142.74	285.48	570.96	1141.92	2285.84	2285.84	6.00	6.00	6.00
9-0 to 9-6 (3/1/87)	73.51	147.02	294.04	588.08	1176.16	2352.32	2352.32	6.00	6.01	6.00
9-6 to 10-0 (9/1/87)	75.72	151.44	302.88	605.76	1211.52	2423.04	2423.04	6.00	6.00	6.00
10-0 2/ (3/1/88)	77.99	155.98	311.96	623.92	1247.84	2495.68	2495.68	6.00 3/	----	----

1/ Month, day, and year on which issues of June 1, 1960, enter each period. For subsequent issue months add the appropriate number of months.

2/ Second extended maturity reached at 27 years 9 months after issue.

3/ Yield on purchase price from issue date to 2nd extended maturity date is 5.20 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 60-A

BONDS BEARING ISSUE DATES FROM SEPT. 1 THROUGH NOV. 1, 1960

Issue price	\$18.75	\$37.50	\$75.00	\$150.00	\$375.00	\$750.00	\$7500	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after first extended maturity at 17 years 9 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*							(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to 2nd extend- ed maturity
	SECOND EXTENDED MATURITY PERIOD**							Percent	Percent	Percent
0-0 to 0-6 1/(6/1/78)	\$43.57	\$87.14	\$174.28	\$348.56	\$871.40	\$1742.80	\$17428	----	6.01	6.00
0-6 to 1-0 (12/1/78)	44.88	89.76	179.52	359.04	897.60	1795.20	17952	6.01	5.97	6.00
1-0 to 1-6 (6/1/79)	46.22	92.44	184.88	369.76	924.40	1848.80	18488	5.99	6.01	6.00
1-6 to 2-0 (12/1/79)	47.61	95.22	190.44	380.88	952.20	1904.40	19044	6.00	6.01	6.00
2-0 to 2-6 (6/1/80)	49.04	98.08	196.16	392.32	980.80	1961.60	19616	6.00	6.00	6.00
2-6 to 3-0 (12/1/80)	50.51	101.02	202.04	404.08	1010.20	2020.40	20204	6.00	5.98	6.00
3-0 to 3-6 (6/1/81)	52.02	104.04	208.08	416.16	1040.40	2080.80	20808	6.00	6.04	6.00
3-6 to 4-0 (12/1/81)	53.59	107.18	214.36	428.72	1071.80	2143.60	21436	6.00	5.97	6.00
4-0 to 4-6 (6/1/82)	55.19	110.38	220.76	441.52	1103.80	2207.60	22076	6.00	6.02	6.00
4-6 to 5-0 (12/1/82)	56.85	113.70	227.40	454.80	1137.00	2274.00	22740	6.00	5.98	6.00
5-0 to 5-6 (6/1/83)	58.55	117.10	234.20	468.40	1171.00	2342.00	23420	6.00	6.01	6.00
5-6 to 6-0 (12/1/83)	60.31	120.62	241.24	482.48	1206.20	2412.40	24124	6.00	6.00	6.00
6-0 to 6-6 (6/1/84)	62.12	124.24	248.48	496.96	1242.40	2484.80	24848	6.00	5.99	6.00
6-6 to 7-0 (12/1/84)	63.98	127.96	255.92	511.84	1279.60	2559.20	25592	6.00	6.00	6.00
7-0 to 7-6 (6/1/85)	65.90	131.80	263.60	527.20	1318.00	2636.00	26360	6.00	6.01	6.00
7-6 to 8-0 (12/1/85)	67.88	135.76	271.52	543.04	1357.60	2715.20	27152	6.00	6.01	6.00
8-0 to 8-6 (6/1/86)	69.92	139.84	279.68	559.36	1398.40	2796.80	27968	6.00	5.98	6.00
8-6 to 9-0 (12/1/86)	72.01	144.02	288.04	576.08	1440.20	2880.40	28804	6.00	6.03	6.00
9-0 to 9-6 (6/1/87)	74.18	148.36	296.72	593.44	1483.60	2967.20	29672	6.00	5.99	5.99
9-6 to 10-0 (12/1/87)	76.40	152.80	305.60	611.20	1528.00	3056.00	30560	6.00	5.99	5.99
10-0 to 2/ (6/1/88)	78.69	157.38	314.76	629.52	1573.80	3147.60	31476	6.00 3/	----	----

1/ Month, day, and year on which issues of Sept. 1, 1960, enter each period. For subsequent issue months add the appropriate number of months.

2/ Second extended maturity reached at 27 years 9 months after issue.

3/ Yield on purchase price from issue date to 2nd extended maturity date is 5.24 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 61-A

BONDS BEARING ISSUE DATES FROM DEC. 1, 1960, THROUGH FEB. 1, 1961

Issue price	\$18.75	\$37.50	\$75.00	\$150.00	\$375.00	\$750.00	\$7500	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after first extended maturity at 17 years 9 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*							(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to 2nd extend- ed maturity
	SECOND EXTENDED MATURITY PERIOD**									
								Percent	Percent	Percent
0-0 to 0-6 1/(9/1/78)	\$43.65	\$87.30	\$174.60	\$349.20	\$873.00	\$1746.00	\$17460	6.00	6.00	6.00
0-6 to 1-0 (3/1/79)	44.96	89.92	179.84	359.68	899.20	1798.40	17984	6.00	6.01	6.00
1-0 to 1-6 (9/1/79)	46.31	92.62	185.24	370.48	926.20	1852.40	18524	6.00	6.00	6.00
1-6 to 2-0 (3/1/80)	47.70	95.40	190.80	381.60	954.00	1908.00	19080	6.00	6.00	6.00
2-0 to 2-6 (9/1/80)	49.13	98.26	196.52	393.04	982.60	1965.20	19652	6.00	5.98	6.00
2-6 to 3-0 (3/1/81)	50.60	101.20	202.40	404.80	1012.00	2024.00	20240	6.00	6.01	6.00
3-0 to 3-6 (9/1/81)	52.12	104.24	208.48	416.96	1042.40	2084.80	20848	6.00	5.99	6.00
3-6 to 4-0 (3/1/82)	53.68	107.36	214.72	429.44	1073.60	2147.20	21472	6.00	6.00	6.00
4-0 to 4-6 (9/1/82)	55.29	110.58	221.16	442.32	1105.80	2211.60	22116	6.00	6.00	6.00
4-6 to 5-0 (3/1/83)	56.95	113.90	227.80	455.60	1139.00	2278.00	22780	6.00	6.01	6.00
5-0 to 5-6 (9/1/83)	58.66	117.32	234.64	469.28	1173.20	2346.40	23464	6.00	6.00	6.00
5-6 to 6-0 (3/1/84)	60.42	120.84	241.68	483.36	1208.40	2416.80	24168	6.00	5.99	6.00
6-0 to 6-6 (9/1/84)	62.23	124.46	248.92	497.84	1244.60	2489.20	24892	6.00	6.01	6.00
6-6 to 7-0 (3/1/85)	64.10	128.20	256.40	512.80	1282.00	2564.00	25640	6.00	5.99	6.00
7-0 to 7-6 (9/1/85)	66.02	132.04	264.08	528.16	1320.40	2640.80	26408	6.00	6.03	6.00
7-6 to 8-0 (3/1/86)	68.01	136.02	272.04	544.08	1360.20	2720.40	27204	6.00	6.00	6.00
8-0 to 8-6 (9/1/86)	70.05	140.10	280.20	560.40	1401.00	2802.00	28020	6.00	6.00	6.00
8-6 to 9-0 (3/1/87)	72.15	144.30	288.60	577.20	1443.00	2886.00	28860	6.00	5.99	6.00
9-0 to 9-6 (9/1/87)	74.31	148.62	297.24	594.48	1486.20	2972.40	29724	6.00	6.00	6.01
9-6 to 10-0 (3/1/88)	76.54	153.08	306.16	612.32	1530.80	3061.60	30616	6.00	6.01	6.01
10-0 2/ (9/1/88)	78.84	157.68	315.36	630.72	1576.80	3153.60	31536	6.00 3/	----	----

1/ Month, day, and year on which issues of Dec. 1, 1960, enter each period. For subsequent issue months add the appropriate number of months.

2/ Second extended maturity reached at 27 years 9 months after issue.

3/ Yield on purchase price from issue date to 2nd extended maturity date is 5.24 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 62-A

BONDS BEARING ISSUE DATES FROM MARCH 1 THROUGH MAY 1, 1961

Issue price	\$18.75	\$37.50	\$75.00	\$150.00	\$375.00	\$750.00	\$7509	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after first extended maturity at 17 years 9 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*							(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to 2nd extend- ed maturity
	SECOND EXTENDED MATURITY PERIOD**							Percent	Percent	Percent
0-0 to 0-6 . . . 1/(12/1/78)	\$44.05	\$88.10	\$176.20	\$352.40	\$881.00	\$1762.00	\$17620	5.99	5.99	6.00
0-6 to 1-0 . . . (6/1/79)	45.37	90.74	181.48	362.96	907.40	1814.80	18148	5.99	6.00	6.00
1-0 to 1-6 . . . (12/1/79)	46.73	93.46	186.92	373.84	934.60	1869.20	18692	5.99	5.99	6.00
1-6 to 2-0 . . . (6/1/80)	48.13	96.26	192.52	385.04	962.60	1925.20	19252	5.99	6.03	6.00
2-0 to 2-6 . . . (12/1/80)	49.58	99.16	198.32	396.64	991.60	1983.20	19832	6.00	6.01	6.00
2-6 to 3-0 . . . (6/1/81)	51.07	102.14	204.28	408.56	1021.40	2042.80	20428	6.00	5.99	6.00
3-0 to 3-6 . . . (12/1/81)	52.60	105.20	210.40	420.80	1052.00	2104.00	21040	6.00	6.01	6.00
3-6 to 4-0 . . . (6/1/82)	54.18	108.36	216.72	433.44	1083.60	2167.20	21672	6.00	5.98	6.00
4-0 to 4-6 . . . (12/1/82)	55.80	111.60	223.20	446.40	1116.00	2232.00	22320	6.00	6.02	6.00
4-6 to 5-0 . . . (6/1/83)	57.48	114.96	229.92	459.84	1149.60	2299.20	22992	6.00	5.98	6.00
5-0 to 5-6 . . . (12/1/83)	59.20	118.40	236.80	473.60	1184.00	2368.00	23680	6.00	6.01	6.00
5-6 to 6-0 . . . (6/1/84)	60.98	121.96	243.92	487.84	1219.60	2439.20	24392	6.00	5.97	6.00
6-0 to 6-6 . . . (12/1/84)	62.80	125.60	251.20	502.40	1256.00	2512.00	25120	6.00	6.02	6.00
6-6 to 7-0 . . . (6/1/85)	64.69	129.38	258.76	517.52	1293.80	2587.60	25876	6.00	6.00	6.00
7-0 to 7-6 . . . (12/1/85)	66.63	133.26	266.52	533.04	1332.60	2665.20	26652	6.00	6.00	6.00
7-6 to 8-0 . . . (6/1/86)	68.63	137.26	274.52	549.04	1372.60	2745.20	27452	6.00	6.00	6.00
8-0 to 8-6 . . . (12/1/86)	70.69	141.38	282.76	565.52	1413.80	2827.60	28276	6.00	6.00	6.00
8-6 to 9-0 . . . (6/1/87)	72.81	145.62	291.24	582.48	1456.20	2912.40	29124	6.00	5.99	6.00
9-0 to 9-6 . . . (12/1/87)	74.99	149.98	299.96	599.92	1499.80	2999.60	29996	6.00	6.00	6.00
9-6 to 10-0 . . . (6/1/88)	77.24	154.48	308.96	617.92	1544.80	3089.60	30896	6.00	6.01	6.01
10-0 2/ (12/1/88)	79.56	159.12	318.24	636.48	1591.20	3182.40	31824	6.00 3/	---	---

1/ Month, day, and year on which issues of March 1, 1961, enter each period. For subsequent issue months add the appropriate number of months.

2/ Second extended maturity reached at 27 years 9 months after issue.

3/ Yield on purchase price from issue date to 2nd extended maturity date is 5.28 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 94-A

BONDS BEARING ISSUE DATES FROM JUNE 1 THROUGH NOV. 1, 1972

Issue price	\$18.75	\$37.50	\$56.25	\$75.00	\$150.00	\$375.00	\$750.00	\$7500	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	75.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after original maturity at 5 years 10 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*								(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to extended maturity
	EXTENDED MATURITY PERIOD**								Percent	Percent	Percent
0-0 to 0-6 1/(4/1/78)	\$26.28	\$52.56	\$78.84	\$105.12	\$210.24	\$525.60	\$1051.20	\$10512	6.01	6.01	6.00
0-6 to 1-0 (10/1/78)	27.07	54.14	81.21	108.28	216.56	541.40	1082.80	10828	6.01	5.98	6.00
1-0 to 1-6 (4/1/79)	27.88	55.76	83.64	111.52	223.04	557.60	1115.20	11152	6.00	6.03	6.00
1-6 to 2-0 (10/1/79)	28.72	57.44	86.16	114.88	229.76	574.40	1148.80	11488	6.01	5.99	6.00
2-0 to 2-6 (4/1/80)	29.58	59.16	88.74	118.32	236.64	591.60	1183.20	11832	6.00	6.02	6.00
2-6 to 3-0 (10/1/80)	30.47	60.94	91.41	121.88	243.76	609.40	1218.80	12188	6.01	5.97	6.00
3-0 to 3-6 (4/1/81)	31.38	62.76	94.14	125.52	251.04	627.60	1255.20	12552	6.00	5.99	6.00
3-6 to 4-0 (10/1/81)	32.32	64.64	96.96	129.28	258.56	646.40	1292.80	12928	6.00	6.00	6.00
4-0 to 4-6 (4/1/82)	33.29	66.58	99.87	133.16	266.32	665.80	1331.60	13316	6.00	6.01	6.00
4-6 to 5-0 (10/1/82)	34.29	68.58	102.87	137.16	274.32	685.80	1371.60	13716	6.00	6.01	6.00
5-0 to 5-6 (4/1/83)	35.32	70.64	105.96	141.28	282.56	706.40	1412.80	14128	6.00	6.00	6.00
5-6 to 6-0 (10/1/83)	36.38	72.76	109.14	145.52	291.04	727.60	1455.20	14552	6.00	5.99	6.00
6-0 to 6-6 (4/1/84)	37.47	74.94	112.41	149.88	299.76	749.40	1498.80	14988	6.00	5.98	6.00
6-6 to 7-0 (10/1/84)	38.59	77.18	115.77	154.36	308.72	771.80	1543.60	15436	6.00	6.01	6.00
7-0 to 7-6 (4/1/85)	39.75	79.50	119.25	159.00	318.00	795.00	1590.00	15900	6.00	5.99	6.00
7-6 to 8-0 (10/1/85)	40.94	81.88	122.82	163.76	327.52	818.80	1637.60	16376	6.00	6.01	6.00
8-0 to 8-6 (4/1/86)	42.17	84.34	126.51	168.68	337.36	843.40	1686.80	16868	6.00	6.02	6.00
8-6 to 9-0 (10/1/86)	43.44	86.88	130.32	173.76	347.52	868.80	1737.60	17376	6.00	5.99	5.99
9-0 to 9-6 (4/1/87)	44.74	89.48	134.22	178.96	357.92	894.80	1789.60	17896	6.00	5.99	5.99
9-6 to 10-0 (10/1/87)	46.08	92.16	138.24	184.32	368.64	921.60	1843.20	18432	6.00	5.99	5.99
10-0 to 2/ (4/1/88)	47.46	94.92	142.38	189.84	379.68	949.20	1898.40	18984	6.00 3/	---	---

1/ Month, day, and year on which issues of June 1, 1972, enter each period. For subsequent issue months add the appropriate number of months.

2/ Extended maturity reached at 15 years 10 months after issue.

3/ Yield on purchase price from issue date to extended maturity date is 5.95 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 95-A

BONDS BEARING ISSUE DATES FROM DEC. 1, 1972, THROUGH MAY 1, 1973

Issue price	\$18.75	\$37.50	\$56.25	\$75.00	\$150.00	\$375.00	\$750.00	\$7500	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	75.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after original maturity at 5 years 10 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*								(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to extended maturity
	EXTENDED MATURITY PERIOD**								Percent	Percent	Percent
0-0 to 0-6 . . . 1/(10/1/78)	\$26.34	\$52.68	\$79.02	\$105.36	\$210.72	\$526.80	\$1053.60	\$10536	6.00	6.00	6.00
0-6 to 1-0 . . . (4/1/79)	27.13	54.26	81.39	108.52	217.04	542.60	1085.20	10852	6.00	5.97	6.00
1-0 to 1-6 . . . (10/1/79)	27.94	55.88	83.82	111.76	223.52	558.80	1117.60	11176	5.98	6.01	6.00
1-6 to 2-0 . . . (4/1/80)	28.78	57.56	86.34	115.12	230.24	575.60	1151.20	11512	5.99	6.05	6.00
2-0 to 2-6 . . . (10/1/80)	29.65	59.30	88.95	118.60	237.20	593.00	1186.00	11860	6.01	6.00	6.00
2-6 to 3-0 . . . (4/1/81)	30.54	61.08	91.62	122.16	244.32	610.80	1221.60	12216	6.01	5.96	6.00
3-0 to 3-6 . . . (10/1/81)	31.45	62.90	94.35	125.80	251.60	629.00	1258.00	12580	6.00	5.98	6.00
3-6 to 4-0 . . . (4/1/82)	32.39	64.78	97.17	129.56	259.12	647.80	1295.60	12956	6.00	6.05	6.00
4-0 to 4-6 . . . (10/1/82)	33.37	66.74	100.11	133.48	266.96	667.40	1334.80	13348	6.00	5.99	6.00
4-6 to 5-0 . . . (4/1/83)	34.37	68.74	103.11	137.48	274.96	687.40	1374.80	13748	6.00	5.99	6.00
5-0 to 5-6 . . . (10/1/83)	35.40	70.80	106.20	141.60	283.20	708.00	1416.00	14160	6.00	5.99	6.00
5-6 to 6-0 . . . (4/1/84)	36.46	72.92	109.38	145.84	291.68	729.20	1458.40	14584	6.00	5.98	6.00
6-0 to 6-6 . . . (10/1/84)	37.55	75.10	112.65	150.20	300.40	751.00	1502.00	15020	6.00	6.02	6.00
6-6 to 7-0 . . . (4/1/85)	38.68	77.36	116.04	154.72	309.44	773.60	1547.20	15472	6.00	6.00	6.00
7-0 to 7-6 . . . (10/1/85)	39.84	79.68	119.52	159.36	318.72	796.80	1593.60	15936	6.00	6.02	6.00
7-6 to 8-0 . . . (4/1/86)	41.04	82.08	123.12	164.16	328.32	820.80	1641.60	16416	6.00	5.99	5.99
8-0 to 8-6 . . . (10/1/86)	42.27	84.54	126.81	169.08	338.16	845.40	1690.80	16908	6.00	6.01	5.99
8-6 to 9-0 . . . (4/1/87)	43.54	87.08	130.62	174.16	348.32	870.80	1741.60	17416	6.00	5.97	5.99
9-0 to 9-6 . . . (10/1/87)	44.84	89.68	134.52	179.36	358.72	896.80	1793.60	17936	6.00	6.02	6.00
9-6 to 10-0 . . . (4/1/88)	46.19	92.38	138.57	184.76	369.52	923.80	1847.60	18476	6.00	5.98	5.98
10-0 2/ (10/1/88)	47.57	95.14	142.71	190.28	380.56	951.40	1902.80	19028	6.00 3/	----	----

1/ Month, day, and year on which issues of Dec. 1, 1972, enter each period. For subsequent issue months add the appropriate number of months.

2/ Extended maturity reached at 15 years 10 months after issue.

3/ Yield on purchase price from issue date to extended maturity date is 5.97 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 97

BONDS BEARING ISSUE DATE DEC. 1, 1973

Issue price Denomination	\$18.75 25.00	\$37.50 50.00	\$56.25 75.00	\$75.00 100.00	\$150.00 200.00	\$375.00 500.00	\$750.00 1000.00	\$ 7500 10000	Approximate investment yield (annual percentage rate)		
Period (years and months after issue)	(1) Redemption values during each half-year period (values increase on first day of period)								(2) From issue date to begin- ning of each 4-yr. period	(3) From begin- ning of each 4-yr. period to beginning of next 4-yr. pd.	(4) From begin- ning of each 4-yr. period to maturity
									Percent	Percent	Percent
0-0 to 0-6 . . . 1/(12/1/73)	\$18.75	\$37.50	\$56.25	\$75.00	\$150.00	\$375.00	\$750.00	\$ 7500	—	3.73	6.00
0-6 to 1-0 . . . (6/1/74)	19.10	38.20	57.30	76.40	152.80	382.00	764.00	7640	3.73	5.34	6.25
1-0 to 1-6 . . . (12/1/74)	19.61	39.22	58.83	78.44	156.88	392.20	784.40	7844	4.54	5.00	6.37
1-6 to 2-0 . . . (6/1/75)	20.10	40.20	60.30	80.40	160.80	402.00	804.00	8040	4.69	4.98	6.57
2-0 to 2-6 . . . (12/1/75)	20.60	41.20	61.80	82.40	164.80	412.00	824.00	8240	4.76	5.24	6.83
2-6 to 3-0 . . . (6/1/76)	21.14	42.28	63.42	84.56	169.12	422.80	845.60	8456	4.86	5.39	7.15
3-0 to 3-6 . . . (12/1/76)	21.71	43.42	65.13	86.84	173.68	434.20	868.40	8684	4.95	5.53	7.59
3-6 to 4-0 . . . (6/1/77)	22.31	44.62	66.93	89.24	178.48	446.20	892.40	8924	5.03	5.92	8.29
4-0 to 4-6 . . . (12/1/77)	22.97	45.94	68.91	91.88	183.76	459.60	918.80	9188	5.14	6.09	9.48
4-6 to 5-0 . . . (6/1/78)	23.67	47.34	71.01	94.68	189.36	473.40	946.80	9468	5.25	12.93	12.93
5-0 2/ . . . (12/1/78)	25.20	50.40	75.60	100.80	201.60	504.00	1008.00	10080	6.00	—	—

1/ Month, day and year on which issues of December 1, 1973, enter each period.

2/ Maturity value reached at 5 years and 0 months after issue.

TABLE 97-A

BONDS BEARING ISSUE DATE DEC. 1, 1973

Issue price	\$18.75	\$37.50	\$56.25	\$75.00	\$150.00	\$375.00	\$750.00	\$7500	Approximate investment yield		
Denomination	25.00	50.00	75.00	100.00	200.00	500.00	1000.00	10000	(annual percentage rate)		
Period (years and months after original maturity at 5 years 0 months)	(1) Redemption values during each half-year period (values in- crease on first day of period)*								(2) From begin- ning of current maturity period to beginning of each ½-yr. pd.	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to extended maturity
	EXTENDED MATURITY PERIOD								Percent	Percent	Percent
0-0 to 0-6 1/(12/1/78)	\$25.20	\$50.40	\$75.60	\$100.80	\$201.60	\$504.00	\$1008.00	\$10080	----	6.03	6.00
0-6 to 1-0 (6/1/79)	25.96	51.92	77.88	103.84	207.68	519.20	1038.40	10384	6.03	5.93	6.00
1-0 to 1-6 (12/1/79)	26.73	53.46	80.19	106.92	213.84	534.60	1069.20	10692	5.98	6.06	6.00
1-6 to 2-0 (6/1/80)	27.54	55.08	82.62	110.16	220.32	550.80	1101.60	11016	6.01	5.95	6.00
2-0 to 2-6 (12/1/80)	28.36	56.72	85.08	113.44	226.88	567.20	1134.40	11344	5.99	5.99	6.00
2-6 to 3-0 (6/1/81)	29.21	58.42	87.63	116.84	233.68	584.20	1168.40	11684	5.99	6.03	6.00
3-0 to 3-6 (12/1/81)	30.09	60.18	90.27	120.36	240.72	601.80	1203.60	12036	6.00	5.98	6.00
3-6 to 4-0 (6/1/82)	30.99	61.98	92.97	123.96	247.92	619.80	1239.60	12396	6.00	6.00	6.00
4-0 to 4-6 (12/1/82)	31.92	63.84	95.76	127.68	255.36	638.40	1276.80	12768	6.00	6.02	6.00
4-6 to 5-0 (6/1/83)	32.88	65.76	98.64	131.52	263.04	657.60	1315.20	13152	6.00	6.02	6.00
5-0 to 5-6 (12/1/83)	33.87	67.74	101.61	135.48	270.96	677.40	1354.80	13548	6.00	5.96	6.00
5-6 to 6-0 (6/1/84)	34.88	69.76	104.64	139.52	279.04	697.60	1395.20	13952	6.00	6.02	6.00
6-0 to 6-6 (12/1/84)	35.93	71.86	107.79	143.72	287.44	718.60	1437.20	14372	6.00	6.01	6.00
6-6 to 7-0 (6/1/85)	37.01	74.02	111.03	148.04	296.08	740.20	1480.40	14804	6.00	6.00	6.00
7-0 to 7-6 (12/1/85)	38.12	76.24	114.36	152.48	304.96	762.40	1524.80	15248	6.00	5.98	5.99
7-6 to 8-0 (6/1/86)	39.26	78.52	117.78	157.04	314.08	785.20	1570.40	15704	6.00	6.01	6.00
8-0 to 8-6 (12/1/86)	40.44	80.88	121.32	161.76	323.52	808.80	1617.60	16176	6.00	5.98	5.99
8-6 to 9-0 (6/1/87)	41.65	83.30	124.95	166.60	333.20	833.00	1666.00	16660	6.00	6.00	6.00
9-0 to 9-6 (12/1/87)	42.90	85.80	128.70	171.60	343.20	858.00	1716.00	17160	6.00	6.01	5.99
9-6 to 10-0 (6/1/88)	44.19	88.38	132.57	176.76	353.52	883.80	1767.60	17676	6.00	5.97	5.97
10-0 2/ (12/1/88)	45.51	91.02	136.53	182.04	364.08	910.20	1820.40	18204	6.00 3/	----	----

1/ Month, day, and year on which issues of Dec. 1, 1973 enter each period.

2/ Extended maturity reached at 15 years 0 months after issue.

3/ Yield on purchase price from issue date to extended maturity date is 6.00 percent.

* For earlier redemption values and yields see appropriate table in Department Circular 653, 9th Revision, as amended and supplemented.

** This table does not apply if the prevailing rate for Series E bonds being issued at the time the extension begins is different from 6.00 percent.

TABLE 98

BONDS BEARING ISSUE DATES FROM JAN. 1, 1974, THROUGH AUG. 1, 1976

Issue price	\$18.75	\$37.50	\$56.25	\$75.00	\$150.00	\$375.00	\$750.00	\$ 7500	Approximate investment yield (annual percentage rate)		
Denomination	25.00	50.00	75.00	100.00	200.00	500.00	1000.00	10000			
Period (years and months after issue)	(1) Redemption values during each half-year period (values increase on first day of period)							(2) From issue date to begin- ning of each ½-yr. period	(3) From begin- ning of each ½-yr. period to beginning of next ½-yr. pd.	(4) From begin- ning of each ½-yr. period to maturity	
								Percent	Percent	Percent	
0-0 to 0-6 1/ (1/1/74)	\$18.75	\$37.50	\$56.25	\$75.00	\$150.00	\$375.00	\$750.00	\$ 7500	—	3.73	6.00
0-6 to 1-0 (7/1/74)	19.10	38.20	57.30	76.40	152.80	382.00	764.00	7640	3.73	5.34	6.25
1-0 to 1-6 (1/1/75)	19.61	39.22	58.83	78.44	156.88	392.20	784.40	7844	4.54	5.00	6.37
1-6 to 2-0 (7/1/75)	20.10	40.20	60.30	80.40	160.80	402.00	804.00	8040	4.69	4.98	6.57
2-0 to 2-6 (1/1/76)	20.60	41.20	61.80	82.40	164.80	412.00	824.00	8240	4.76	5.24	6.83
2-6 to 3-0 (7/1/76)	21.14	42.28	63.42	84.56	169.12	422.80	845.60	8456	4.86	5.39	7.15
3-0 to 3-6 (1/1/77)	21.71	43.42	65.13	86.84	173.68	434.20	868.40	8684	4.95	5.53	7.59
3-6 to 4-0 (7/1/77)	22.31	44.62	66.93	89.24	178.48	446.20	892.40	8924	5.03	5.92	8.29
4-0 to 4-6 (1/1/78)	22.97	45.94	68.91	91.88	183.76	459.40	918.80	9188	5.14	6.09	9.48
4-6 to 5-0 (7/1/78)	23.67	47.34	71.01	94.68	189.36	473.40	946.80	9468	5.25	12.93	12.93
5-0 2/ (1/1/79)	25.20	50.40	75.60	100.80	201.60	504.00	1008.00	10080	6.00	—	—

1/ Month, day and year on which issues of January 1, 1974, enter each period. These are representative dates. For subsequent issue dates, substitute the month, day and year of issue on the first line, and the appropriate six-month accrual date on each succeeding line. For example: if the issue date of the bond is October 1, 1974, the entries on succeeding lines in this column would be 10/1/74, 4/1/75, 10/1/75, 4/1/76, 10/1/76, etc., to the maturity date of 10/1/79; if the issue date of the bond is July 1, 1976, the line entries would be 7/1/76, 1/1/77, 7/1/77, 1/1/78, 7/1/78, etc., to the maturity date of 7/1/81.

2/ Maturity value reached at 5 years and 0 months after issue.

Exhibit 5.—Department Circular No. 905, Sixth Revision, April 19, 1974, amended, offering of United States savings bonds, Series H

DEPARTMENT OF THE TREASURY,
Washington, February 27, 1978.

SUMMARY: The purpose of this supplement to the current offering circular for United States Savings Bonds, Series H, is to show the schedule of interest payments and investment yields for bonds of various groups of issue dates, which will be applicable to their first or next extended maturity period.

EFFECTIVE DATE: Upon publication.

SUPPLEMENTAL INFORMATION: The Tables contained in the offering circular for Series H savings bonds show the schedule of interest payments and investment yields for bonds of all possible issue dates. Each of the Tables covers a particular consecutive group of issue dates. When the earlier dated bonds in any of these groups reach the end of an original or extended maturity period it is necessary to publish a new Table to reflect the interest payments and investment yields that will be applicable to the first or next extended maturity period those bonds will enter. During 1978, the earlier dated bonds in each of the following groups will enter their first or next extended maturity period:

- (1) Table 15—bonds dated June 1 through November 1, 1958;
- (2) Table 16—bonds dated December 1, 1958 through May 1, 1959;
- (3) Table 35—bonds dated June 1 through November 1, 1968; and
- (4) Table 36—bonds dated December 1, 1968, through May 1, 1969.

It should be noted, however, that in some cases, later dated bonds in each of the above groups will not enter their first or next extended maturity period until after 1978. Since such extension already has been irrevocably granted to them, the supplemental Tables to be published below will be applicable to them so long as there is no intervening change in the interest rate paid on savings bonds.

Accordingly, Department of the Treasury Circular No. 905, Sixth Revision, as amended, dated April 19, 1974 (31 CFR, Part 332) is hereby supplemented by the addition of Tables 15-A, 16-A, 35-A, and 36-A.

PAUL H. TAYLOR,
Deputy Fiscal Assistant Secretary.

TABLE 15-A

BONDS BEARING ISSUE DATES FROM JUNE 1 THROUGH NOV. 1, 1958

ISSUE PRICE	\$500	\$1,000	\$5,000	\$10,000	APPROXIMATE INVESTMENT YIELD (ANNUAL PERCENTAGE RATE)		
REDEMPTION AND MATURITY VALUE	500	1,000	5,000	10,000			
					(2) FROM BEGINNING OF CURRENT MATURITY PD. TO EA. INTEREST PMT. DATE	(3) FOR HALF-YEAR EACH PD. PRE- CEILING INTEREST PAYMENT DATE	(4) FROM EACH INTEREST PMT. DATE TO 2ND EXTENDED MATURITY
PERIOD OF TIME BOND IS HELD AFTER EXTENDED MATURITY AT 20 YEARS, 0 MONTHS	(1) AMOUNTS OF INTEREST CHECKS FOR EACH DENOMINATION *				SECOND EXTENDED MATURITY PERIOD**		
					PERCENT	PERCENT	PERCENT
.5 YEARS . . . (12/1/74)	\$15.00	\$30.00	\$150.00	\$300.00	6.00	6.00	6.00
1.0 YEARS . . . (6/1/79)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
1.5 YEARS . . . (12/1/79)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.0 YEARS . . . (6/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.5 YEARS . . . (12/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.0 YEARS . . . (6/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.5 YEARS . . . (12/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.0 YEARS . . . (6/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.5 YEARS . . . (12/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.0 YEARS . . . (6/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.5 YEARS . . . (12/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.0 YEARS . . . (6/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.5 YEARS . . . (12/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.0 YEARS . . . (6/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.5 YEARS . . . (12/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.0 YEARS . . . (6/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.5 YEARS . . . (12/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.0 YEARS . . . (6/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.5 YEARS . . . (12/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
10.0 YEARS 2/ . . (6/1/88)	15.00	30.00	150.00	300.00	3/ 6.00	6.00	---

1/ MONTH, DAY AND YEAR ON WHICH INTEREST CHECK IS PAYABLE ON ISSUES OF JUNE 1, 1958, FOR SUBSEQUENT ISSUE MONTHS AND APPROPRIATE NUMBER OF MONTHS.

2/ SECOND EXTENDED MATURITY REACHED AT 30 YEARS AND 0 MONTHS AFTER ISSUE DATE.

3/ YIELD ON PURCHASE PRICE FROM ISSUE DATE TO SECOND EXTENDED MATURITY IS 4.73%.

* FOR EARLIER INTEREST CHECKS AND YIELDS SEE APPROPRIATE TABLE IN DEPARTMENT CIRCULAR 905, 6TH REVISION, AS AMENDED AND SUPPLEMENTED.

** THIS TABLE DOES NOT APPLY IF THE PREVAILING RATE FOR SERIES H BONDS BEING ISSUED AT THE TIME THE EXTENSION BEGINS IS DIFFERENT FROM 6.00 PERCENT.

TABLE 16-A

BONDS BEARING ISSUE DATES FROM DEC. 1, 1958 THROUGH MAY 1, 1959

ISSUE PRICE	\$500	\$1,000	\$5,000	\$10,000	APPROXIMATE INVESTMENT YIELD (ANNUAL PERCENTAGE RATE)		
REDEMPTION AND MATURITY VALUE	500	1,000	5,000	10,000			
PERIOD OF TIME BOND IS HELD AFTER EXTENDED MATURITY AT 20 YEARS, 0 MONTHS	(1) AMOUNTS OF INTEREST CHECKS FOR EACH DENOMINATION *				(2) FROM BEGINNING OF CURRENT MATURITY PD. TO EA. INTEREST PMT. DATE	(3) FOR HALF-YEAR EACH PD. PRE- CEDING INTEREST PAYMENT DATE	(4) FROM EACH INTEREST PMT. DATE TO 2ND EXTENDED MATURITY
	SECOND EXTENDED MATURITY PERIOD**						
					PERCENT	PERCENT	PERCENT
.5 YEARS 1/ (6/1/79)	\$15.00	\$30.00	\$150.00	\$300.00	6.00	6.00	6.00
1.0 YEARS (12/1/79)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
1.5 YEARS (6/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.0 YEARS (12/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.5 YEARS (6/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.0 YEARS (12/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.5 YEARS (6/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.0 YEARS (12/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.5 YEARS (6/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.0 YEARS (12/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.5 YEARS (6/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.0 YEARS (12/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.5 YEARS (6/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.0 YEARS (12/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.5 YEARS (6/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.0 YEARS (12/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.5 YEARS (6/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.0 YEARS (12/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.5 YEARS (6/1/88)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
10.0 YEARS 2/ (12/1/88)	15.00	30.00	150.00	300.00	3/ 6.00	6.00	----

1/ MONTH, DAY AND YEAR ON WHICH INTEREST CHECK IS PAYABLE ON ISSUES OF DEC. 1, 1958, FOR SUBSEQUENT ISSUE MONTHS ADD APPROPRIATE NUMBER OF MONTHS.

2/ SECOND EXTENDED MATURITY REACHED AT 30 YEARS AND 0 MONTHS AFTER ISSUE DATE.

3/ YIELD ON PURCHASE PRICE FROM ISSUE DATE TO SECOND EXTENDED MATURITY IS 4.78%.

* FOR EARLIER INTEREST CHECKS AND YIELDS SEE APPROPRIATE TABLE IN DEPARTMENT CIRCULAR 905, 6TH REVISION, AS AMENDED AND SUPPLEMENTED.

** THIS TABLE DOES NOT APPLY IF THE PREVAILING RATE FOR SERIES H BONDS BEING ISSUED AT THE TIME THE EXTENSION BEGINS IS DIFFERENT FROM 6.00 PERCENT.

TABLE 35-A

BONDS BEARING ISSUE DATES FROM JUNE 1 THROUGH NOV. 1, 1968

ISSUE PRICE	\$500	\$1,000	\$5,000	\$10,000	APPROXIMATE INVESTMENT YIELD (ANNUAL PERCENTAGE RATE)		
REDEMPTION AND MATURITY VALUE	500	1,000	5,000	10,000			
PERIOD OF TIME BOND IS HELD AFTER FIRST MATURITY AT 10 YEARS, 0 MONTHS	(1) AMOUNTS OF INTEREST CHECKS FOR EACH DENOMINATION *				(2) FROM BEGINNING OF CURRENT MATURITY PD, TO FA, INTEREST PMT, DATE	(3) FOR HALF-YEAR EACH PD, PRE- CEILING INTEREST PAYMENT DATE	(4) FROM EACH INTEREST TO FIRST EXTENDED MATURITY
	EXTENDED MATURITY PERIOD**				PERCENT	PERCENT	PERCENT
.5 YEARS . . . 1/ (12/1/78)	\$15.00	\$30.00	\$150.00	\$300.00	6.00	6.00	6.00
1.0 YEARS . . . (6/1/79)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
1.5 YEARS . . . (12/1/79)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.0 YEARS . . . (6/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.5 YEARS . . . (12/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.0 YEARS . . . (6/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.5 YEARS . . . (12/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.0 YEARS . . . (6/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.5 YEARS . . . (12/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.0 YEARS . . . (6/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.5 YEARS . . . (12/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.0 YEARS . . . (6/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.5 YEARS . . . (12/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.0 YEARS . . . (6/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.5 YEARS . . . (12/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.0 YEARS . . . (6/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.5 YEARS . . . (12/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.0 YEARS . . . (6/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.5 YEARS . . . (12/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
10.0 YEARS 2/ . . (6/1/88)	15.00	30.00	150.00	300.00	3/ 6.00	6.00	----

1/ MONTH, DAY AND YEAR ON WHICH INTEREST CHECK IS PAYABLE ON ISSUES OF JUNE 1, 1968, FOR SUBSEQUENT ISSUE MONTHS AND APPROPRIATE NUMBER OF MONTHS.

2/ EXTENDED MATURITY REACHED AT 20 YEARS AND 0 MONTHS AFTER ISSUE DATE.

3/ YIELD ON PURCHASE PRICE FROM ISSUE DATE TO EXTENDED MATURITY IS 5.57%.

* FOR EARLIER INTEREST CHECKS AND YIELDS SEE APPROPRIATE TABLE IN DEPARTMENT CIRCULAR 905, 6TH REVISION, AS AMENDED AND SUPPLEMENTED.

** THIS TABLE DOES NOT APPLY IF THE PREVAILING RATE FOR SERIES M BONDS BEING ISSUED AT THE TIME THE EXTENSION BEGINS IS DIFFERENT FROM 6.00 PERCENT.

TABLE 36-A

BONDS BEARING ISSUE DATES FROM DEC. 1, 1968 THROUGH MAY 1, 1969

ISSUE PRICE	\$500	\$1,000	\$5,000	\$10,000	APPROXIMATE INVESTMENT YIELD (ANNUAL PERCENTAGE RATE)		
REDEMPTION AND MATURITY VALUE	500	1,000	5,000	10,000			
PERIOD OF TIME BOND IS HELD AFTER FIRST MATURITY AT 10 YEARS, 0 MONTHS	(1) AMOUNTS OF INTEREST CHECKS FOR EACH DENOMINATION * ----- EXTENDED MATURITY PERIOD**				(2) FROM BEGINNING OF CURRENT MATURITY PD. TO EA. INTEREST PMT. DATE	(3) FOR HALF-YEAR PD. PRE- CEDING INTEREST PAYMENT DATE	(4) FROM EACH INTEREST PMT. DATE TO FIRST EXTENDED MATURITY
					PERCENT	PERCENT	PERCENT
.5 YEARS 1/ (6/1/79)	\$15.00	\$30.00	\$150.00	\$300.00	6.00	6.00	6.00
1.0 YEARS (12/1/79)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
1.5 YEARS (6/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.0 YEARS (12/1/80)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
2.5 YEARS (6/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.0 YEARS (12/1/81)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
3.5 YEARS (6/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.0 YEARS (12/1/82)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
4.5 YEARS (6/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.0 YEARS (12/1/83)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
5.5 YEARS (6/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.0 YEARS (12/1/84)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
6.5 YEARS (6/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.0 YEARS (12/1/85)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
7.5 YEARS (6/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.0 YEARS (12/1/86)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
8.5 YEARS (6/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.0 YEARS (12/1/87)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
9.5 YEARS (6/1/88)	15.00	30.00	150.00	300.00	6.00	6.00	6.00
10.0 YEARS 2/ (12/1/88)	15.00	30.00	150.00	300.00	3/ 6.00	6.00	----

1/ MONTH, DAY AND YEAR ON WHICH INTEREST CHECK IS PAYABLE ON ISSUES OF DEC. 1, 1968, FOR SUBSEQUENT ISSUE

MONTHS ADD APPROPRIATE NUMBER OF MONTHS.

2/ EXTENDED MATURITY REACHED AT 20 YEARS AND 0 MONTHS AFTER ISSUE DATE.

3/ YIELD ON PURCHASE PRICE FROM ISSUE DATE TO EXTENDED MATURITY IS 5.64%.

* FOR EARLIER INTEREST CHECKS AND YIELDS SEE APPROPRIATE TABLE IN DEPARTMENT CIRCULAR 905, 6TH REVISION, AS AMENDED AND SUPPLEMENTED.

** THIS TABLE DOES NOT APPLY IF THE PREVAILING RATE FOR SERIES M BONDS BEING ISSUED AT THE TIME THE EXTENSION BEGINS IS DIFFERENT FROM 6.00 PERCENT.

Exhibit 6.—An act to increase the temporary debt limit, and for other purposes

[Public Law 95-120, 95th Congress, H.R. 9290, October 4, 1977]

Public debt limit.
Temporary increase.
31 U.S.C. 757b note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That during the period beginning on the date of the enactment of this Act and ending on March 31, 1978, the public debt limit set forth in the first sentence of section 21 of the Second Liberty Bond Act (31 U.S.C. 757b) shall be temporarily increased by \$352,000,000,000.

Repeal; effective date.
31 U.S.C. 757b note.

SEC. 2. Effective on the date of the enactment of this Act, the first section of the Act of June 30, 1976, entitled "An Act to increase the temporary debt limit, and for other purposes" (Public Law 94-334), is hereby repealed.

SEC. 3. The last sentence of the second paragraph of the first section of the Second Liberty Bond Act (31 U.S.C. 752) is amended by striking out "\$17,000,000,000" and inserting in lieu thereof "\$27,000,000,000".

Exhibit 7.—An act to extend the existing temporary debt limit

[Public Law 95-252, 95th Congress, H.R. 11518, March 27, 1978]

Public debt limit.
Temporary increase.
31 U.S.C. 757b note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the first section of the Act of October 4, 1977, entitled "An Act to increase the temporary debt limit, and for other purposes" (Public Law 95-120), is amended by striking out "March 31, 1978" and inserting in lieu thereof "July 31, 1978".

Exhibit 8.—An act to provide for a temporary increase in the public debt limit

[Public Law 95-333, 95th Congress, H.R. 13385, August 3, 1978]

Public debt limit.
Temporary increase.
31 U.S.C. 757b note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, during the period beginning on the date of the enactment of this Act and ending on March 31, 1979, the public debt limit set forth in the first sentence of section 21 of the Second Liberty Bond Act (31 U.S.C. 757b) shall be temporarily increased by \$398,000,000,000.

Repeal; effective date.

SEC. 2. Effective on the date of the enactment of this Act, the first section of the Act of October 4, 1977, entitled "An Act to increase the temporary debt limit, and for other purposes" (Public Law 95-120), is hereby repealed.

31 U.S.C. 757b note.

SEC. 3. The last sentence of the second paragraph of the first section of the Second Liberty Bond Act (31 U.S.C. 752) is amended by striking out "\$27,000,000,000" and inserting in lieu thereof "\$32,000,000,000".

Domestic Finance**Exhibit 9.—Statement by Assistant Secretary Altman, February 6, 1978, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, on the public debt limit**

I am pleased to be here today to assist you in your consideration of the public debt limit. The present temporary debt limit of \$752 billion will expire on March 31, 1978,

and the debt limit will then revert to the permanent ceiling of \$400 billion. Legislative action by March 31 will be necessary, therefore, to permit the Treasury to borrow to refund securities maturing after March 31 and to raise new cash to finance the estimated deficits in the budget, as submitted to Congress by the President last month.

In addition, to permit the Treasury to continue borrowing in the long-term market, it will be necessary to increase the \$27 billion limit on the amount of bonds which we may issue without regard to the 4 1/4-percent interest rate ceiling on Treasury bond issues.

Finally, we are repeating our earlier request for authority to permit the Secretary of the Treasury, with the approval of the President, to change the interest rate on U.S. savings bonds if that should become necessary to assure a fair rate of return to savings bond investors.

Debt limit

Turning first to the debt limit, our estimates of the amounts of debt subject to limit at the end of each month through the fiscal years 1978 and 1979 are shown in the attached tables. The tables indicate that the debt subject to limit will increase to \$778 billion on September 30, 1978, and to \$868 billion on September 30, 1979, assuming a \$12 billion cash balance on those dates. These are the debt estimates and cash balances assumptions included in the President's January budget proposals. The usual \$3 billion margin for contingencies would raise these amounts to \$781 billion on September 30, 1978, and \$871 billion on September 30, 1979. Thus the present debt limit of \$752 billion would need to be increased by \$29 billion to meet our financing requirements through the remainder of fiscal 1978 and by an additional \$90 billion to meet the requirements in fiscal 1979.

Our \$781 billion estimate of the debt subject to limit on September 30, 1978 (which includes the \$3 billion margin for contingencies) is \$6 billion higher than the \$775 billion approved in the second concurrent resolution on the Federal budget for fiscal year 1978, which was adopted by Congress on September 15, 1977.

The \$90 billion increase in FY 1979 reflects the administration's current estimates of a fiscal 1979 unified budget deficit of \$60.6 billion, a trust fund surplus of \$13.9 billion, and a net financing requirement for off-budget entities of \$12.5 billion. The trust fund surplus must be reflected in the debt requirement because the surplus is invested in Treasury securities which are subject to the debt limit.

The relevant debt of off-budget entities consists largely of obligations which are issued, sold, or guaranteed by Federal agencies and financed through the Federal Financing Bank. Since the Federal Financing Bank borrows from the Treasury, we are required to increase our borrowing in the market by a corresponding amount. This, of course, adds to the debt subject to limit.

Bond authority

I would like to turn now to our fiscal 1979 need for an increase in the Treasury's authority to issue long-term securities in the market without regard to the 4 1/4-percent statutory ceiling on the rate of interest which may be paid on such issues. To meet our requirements next year, the Treasury's authority to issue bonds (securities with maturities over 10 years) should be increased by \$10 billion from the current ceiling of \$27 billion to \$37 billion.

The 4 1/4-percent ceiling predates World War II but did not become a serious obstacle to Treasury issues of new bonds until the mid-1960's. At that time, market rates of interest rose above 4 1/4 percent, and the Treasury was precluded from issuing new bonds.

In 1971, Congress authorized the Treasury to issue up to \$10 billion of bonds without regard to the 4 1/4-percent ceiling. This limit has since been increased a number of times, and in the debt limit act of October 4, 1977, it was increased from \$17 billion to the current level of \$27 billion.

The Treasury, to date, has used almost \$20 billion of the \$27 billion authority, including the \$1 1/4 billion bond auctioned last week, which leaves the amount of unused authority at about \$7 billion. While the timing and amounts of future bond issues will depend on prevailing market conditions, \$10 billion increase in the bond authority would permit the Treasury to continue its recent pattern of bond issues throughout fiscal year 1979. Thus, the Treasury would be able to make further progress toward achieving a better balance in the maturity structure of the debt and reestablishing the market for long-term Treasury securities. We believe that such flexibility is essential to efficient management of the public debt.

Savings bonds

In recent years, Treasury has recommended frequently that Congress repeal the 6-percent ceiling on the rate of interest that the Treasury may pay on U.S. savings bonds. Prior to 1970 the ceiling had been increased many times, but the current 6-percent statutory ceiling was enacted by Congress in 1970. As market rates of interest rose, it became clear that an increase in the savings bond interest rate was necessary to provide investors in savings bonds with a fair rate of return.

Mr. Chairman, we do not feel that an increase in the interest rate on savings bonds is necessary today. Yet, we are concerned that the present requirement for legislation to cover each increase in the rate does not provide sufficient flexibility to adjust the rate in response to changing market conditions. The delays encountered in the legislative process could result in inequities to savings bond purchasers and holders as market interest rates rise on competing forms of savings.

Furthermore, Treasury relies on the savings bond program as an important and relatively stable source of long-term funds. On that basis, we are concerned that participants in the payroll savings plans and other savings bond purchasers might drop out of the program if the interest rate were not maintained at a level reasonably competitive with comparable forms of savings.

Any increase in the savings bond interest rate by the Treasury would continue to be subject to the provision in existing law which requires approval of the President. Also, the Treasury would, of course, give very careful consideration to the effect of any increase in the savings bond interest rate on the flow of savings to banks and thrift institutions.

Debt limit procedure

Mr. Chairman, I would also like to take this opportunity to suggest that your committee consider a more effective procedure for controlling the size of the public debt.

We do not think that the present statutory debt limit is an effective way for Congress to control the debt. In fact, the debt limit may actually divert public attention from the real issue—control over the Federal budget. The increase in the debt each year is simply the result of earlier decisions by the Congress on the amounts of Federal spending and taxation. Consequently, the only way to control the debt is through firm control over the Federal budget. In this regard, the Congressional Budget Act of 1974 greatly improved congressional budget procedures and provided a more effective means of controlling the debt. That act requires congressional concurrent resolutions on the appropriate levels of budget outlays, receipts, and public debt. This new budget process thus assures that Congress will face up each year to the public debt consequences of its decisions on taxes and expenditures.

Moreover, the statutory limitation on the public debt occasionally has interfered with the efficient financing of the Federal Government and has actually resulted in increased costs to the taxpayer. For example, when the temporary debt limit expired on September 30, 1977, and new legislation was not enacted on the new debt limit until October 4, Treasury was required, in the interim, to suspend the sale of savings bonds and other public debt securities. The suspension of savings bonds sales, in particular, resulted in considerable public confusion, and indignation, as well as additional costs

to the Government. The cost of printing and distributing notifications to about 40,000 savings bonds issuing agents was \$16,775. A much greater, but incalculable, cost is the loss of public confidence in the savings bond program and in the management of the Government's finances.

Accordingly, we believe that the public debt would be more effectively controlled and more efficiently managed by tying the debt limit to the new congressional budget process. We simply put this proposal on the table, Mr. Chairman, for you and the other members of the subcommittee to consider in the hope that we can work together to devise a more acceptable way to control the debt.

Public debt subject to limitation, fiscal year 1978, based on budget receipts of \$400 billion, budget outlays of \$462 billion, unified budget deficit of \$62 billion, off-budget outlays of \$12 billion
[In billions of dollars]

	Operating cash balance	Public debt subject to limit	With \$3 billion margin for contingencies
<i>1977</i>		ACTUAL	
Sept. 30.....	19.1	700.0	
Oct. 31.....	7.7	698.5	
Nov. 30.....	5.5	709.1	
Dec. 31.....	12.3	720.1	
<i>1978</i>			
Jan. 31.....	12.5	722.7	
		ESTIMATED	
Feb. 28.....	12	738	741
Mar. 31.....	12	747	750
Apr. 19.....	12	750	753
Apr. 30.....	12	740	743
May 31.....	12	753	756
June 21.....	12	753	756
June 30.....	12	746	749
July 31.....	12	756	759
Aug. 31.....	12	772	775
Sept. 30.....	12	778	781

Public debt subject to limitation, fiscal year 1979, based on budget receipts of \$440 billion, budget outlays of \$500 billion, unified budget deficit of \$61 billion, off-budget outlays of \$12 billion
[In billions of dollars]

	Operating cash balance	Public debt subject to limit	With \$3 billion margin for contingencies
<i>1978</i>		ESTIMATED	
Sept. 30.....	12	778	781
Oct. 31.....	12	789	792
Nov. 30.....	12	801	804
Dec. 31.....	12	806	809
<i>1979</i>			
Jan. 31.....	12	809	812
Feb. 28.....	12	824	827
Mar. 31.....	12	837	840
Apr. 18.....	12	841	844
Apr. 30.....	12	828	831
May 31.....	12	846	849
June 20.....	12	852	855
June 30.....	12	839	842
July 31.....	12	848	851
Aug. 31.....	12	864	867
Sept. 30.....	12	868	871

Exhibit 10.—Statement by Assistant Secretary Altman, June 27, 1978, before the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs, on extension of the authority of Federal Reserve banks to purchase public debt obligations directly from the Treasury

I welcome this opportunity to assist in your oversight of the authority of Federal Reserve banks to purchase directly from the Treasury up to \$5 billion of public debt obligations. As you know, the most recent extension of this authority expired on April 30, 1978. On April 19, 1978, this subcommittee favorably reported House Joint Resolution 816, to extend this authority to April 30, 1979. The resolution was adopted by the House of Representatives on May 1, but the Senate has not yet acted.

The purpose of the direct-purchase authority is to facilitate the efficient management of the public debt. It was first granted in its present form in 1942, and it has been renewed for temporary periods on a number of occasions. The authority has lapsed, however, on five occasions in recent years—from July 1 until August 14, 1973; from November 1, 1973, until October 28, 1974; from November 1 to November 12, 1975; from October 1 until November 7, 1977, and the current period.

Borrowings from the Federal Reserve System under this authority have been for very short periods, the average length being from 2 to 7 days. Only twice in the past 35 years has the Treasury had to draw funds in this manner for periods exceeding 13 consecutive days. I have appended a table which lists the instances of actual use. Borrowings under the authority are subject to the public debt limit, and its use is reported in the Daily Treasury Statement, the weekly Federal Reserve Statement, and in the Federal Reserve Board's Annual Report to the Congress.

The existence of the direct-purchase authority provides us with a margin of safety which permits us to let our cash balance fall to otherwise unacceptably low levels preceding periods of seasonally heavy revenues. This, in turn, results in balances that are not as high as they otherwise would be during the periods of high revenues that follow, allowing the public debt to be kept to a minimum and thus reducing interest costs to the Government. Moreover, there is always the possibility that unforeseen swings in our cash flows may suddenly deplete our cash balance and require a sudden borrowing.

The direct-purchase authority is available to provide an immediate source of funds for temporary financing in the event of a natural emergency on a broader scale. While this has never happened, it is conceivable that financial markets could be disrupted at a time when large amounts of cash had to be raised to maintain governmental functions and meet the emergency. Consequently, the direct-purchase authority has for many years been a key element in the Treasury's financial planning for a national emergency.

I want to emphasize that the direct-purchase authority is viewed by the Treasury as a temporary accommodation to be used only under unusual circumstances. The Treasury fully agrees with the general principle that our debt obligations should be floated in the market and that purchases of Treasury obligations by the central bank should normally be made through that same public market. The Treasury agreed also that the direct-purchase authority should not be considered a means by which the Treasury may independently attempt to influence credit conditions by usurping the authority of the Federal Reserve to engage in open market operations in Government securities. In that connection, it is important to emphasize that any direct recourse by the Treasury to Federal Reserve credit under this authority is subject to the discretion and control of the Federal Reserve itself.

Direct borrowing from Federal Reserve banks, 1942 to date

Calendar year	Days used	Maximum amount at any time (millions)	Number of separate times used	Maximum number of days used at any one time
1942.....	19	\$422	4	6
1943.....	48	1,302	4	28
1944.....	None	—	—	—
1945.....	9	484	2	7
1946.....	None	—	—	—
1947.....	None	—	—	—
1948.....	None	—	—	—
1949.....	2	220	1	2
1950.....	2	180	2	1
1951.....	4	320	2	2
1952.....	30	811	4	9
1953.....	29	1,172	2	20
1954.....	15	424	2	13
1955.....	None	—	—	—
1956.....	None	—	—	—
1957.....	None	—	—	—
1958.....	2	207	1	2
1959.....	None	—	—	—
1960.....	None	—	—	—
1961.....	None	—	—	—
1962.....	None	—	—	—
1963.....	None	—	—	—
1964.....	None	—	—	—
1965.....	None	—	—	—
1966.....	3	169	1	3
1967.....	7	153	3	3
1968.....	8	596	3	6
1969.....	21	1,102	2	12
1970.....	None	—	—	—
1971.....	9	610	1	7
1972.....	1	38	1	1
1973.....	10	485	3	6
1974.....	1	131	1	1
1975.....	16	1042	4	7
1976.....	None	—	—	—
1977.....	4	2,500	1	4

NOTE.—Federal Reserve direct-purchase authority expired on Apr. 30, 1978.

Exhibit 11.—Statement by Assistant Secretary Altman, April 3, 1978, before the House Budget Committee, on the administration's urban policy proposals

I am pleased to appear today to discuss with you certain of the President's urban policy initiatives. The administration has worked hard this past year to analyze social, economic, and fiscal conditions in American cities, the effectiveness of existing Federal policies and programs aimed at cities, and, then, to determine the need for new program initiatives. The culmination of this process was announced by the President last Monday. His urban policy proposals are worthy of your support, and we join with the other departments in urging you to include the related funding in the first concurrent budget resolution.

The President's message presented the conceptual framework of his urban policy. Over this next month we will be drafting legislation on the various program initiatives in consultation with the Congress. So today I will not describe the specific details of initiatives, but I will address the general thrust of three components of the President's urban policy proposals: The National Development Bank, supplementary fiscal assistance, and the tax proposals—the industrial revenue bonds, the differential investment tax credit, and the employment tax credit. These initiatives address the following principles of the President's urban policy:

- Involving all levels of government and the private sector.
- Leveraging significant private sector resources.
- Increasing access to opportunities for disadvantaged people.
- Providing flexibility to respond to diverse needs of all cities and communities while recognizing that certain localities will require strategic targeting of resources.

The National Development Bank

It is clear to us that a crucial cause of urban decay has been the decline of the private sector employment base in central cities. This has resulted in a smaller tax base and higher fiscal strain for city governments. While fiscal and monetary policies are effective instruments for improving the overall level of economic activity, we have learned that they are not precise enough tools to address the interrelated problems of slow growth, chronic economic decline, and the resulting high levels of unemployment among certain groups in many of our cities. We believe, therefore, that new Federal incentives for the private sector to expand job opportunities in distressed areas should be undertaken.

The National Development Bank represents a long-range economic development strategy to rebuild the private economies of distressed areas. Its key objective is to help create permanent jobs.

This strategy includes a set of financing incentives to influence businesses to remain and expand or to locate in distressed areas. The effect of these incentives would be to improve business and job opportunities, by lowering one element of the costs of doing business—the cost of capital.

The package of incentives includes:

1. A program of “up-front” capital grants involving up to 15 percent (or a maximum of \$3 million) of an eligible firm’s capital costs for rehabilitation or fixed-asset expansion. EDA and HUD grants would be used.
2. In coordination with the grants, a program of loan guarantees to cover 75 percent of the remaining capital costs at interest rates representing a slight premium above Treasury rates. In special circumstances the bank could subsidize the interest rate down to 2.5 percent. The business or project could only receive this package of a grant and loan guarantee if it obtained the balance of its needed financing from private sources.
3. An increase in the limit from \$5 to \$20 million of tax-exempt or taxable industrial revenue bonds that can be issued in an economically distressed area.
4. A new secondary market for (a) private loans made directly to eligible small- and medium-sized businesses to finance capital expenditures, and (b) the private loans made to businesses receiving Federal financing assistance through the Development Bank.

A “private market test” will place the initial credit decision not in the Federal bureaucracy, but in the private market. This test will differentiate between economically viable projects which can provide permanent private sector jobs and those which will fail. It will also help ensure that the bank will be financially self-sustaining. Hence, we think that the bank can leverage significant private sector investment in distressed areas with relatively small Federal exposure.

Successful local economic development requires public and private cooperation and careful planning at the local level. We have designed this Development Bank as a catalyst for promoting public and private sector cooperation in distressed areas and one which will leave maximum flexibility for economic development planning at the local level.

This proposed Development Bank, Mr. Chairman, is the result of an intense analysis of current Federal economic development programs and a series of consultations with mayors, Governors, academicians, economic development practitioners, and representatives of the business, labor, and financial communities. It will not duplicate existing Federal programs but, rather, fill a gap among Federal tools aimed at local economic development. Specifically, there is no major Federal program involving truly long-term

financing incentives to affect business locational decisions. Mr. Chairman, our combination of long-term financing incentives are strong enough to influence locational decisions. They can reduce long-term business borrowing costs significantly and impact job creation. Local practitioners have confirmed that it is a proposal which can be combined with other resources to seriously attack the continuing losses of private investment and jobs.

A crucial question in considering this proposal, of course, is why the Federal Government should influence locational decisions at all. We think that the answer is clear. For years, through a variety of programs, the Federal Government has directly and indirectly encouraged certain developmental patterns. It is only logical that rebuilding distressed areas must be an object of Federal policy.

The costs of doing nothing are too high—they include the tremendous human suffering and capital waste of permitting these areas to continue to decline. They include increased costs for welfare, health and unemployment compensation for the unemployed—those who cannot move to find new jobs in growing areas. They include the inefficient use of scarce national economic resources which flow into new areas to build new private facilities and public infrastructure while the old and valuable infrastructures are underutilized.

Supplementary fiscal assistance program

Let me turn now to discuss the fiscal relief component of President Carter's urban policy—our proposed supplementary fiscal assistance program. This would replace the expiring antirecession fiscal assistance program (frequently called countercyclical revenue sharing), and would use the \$1.04 billion already contained in the President's fiscal 1979 budget for the countercyclical program.

The new program, Mr. Chairman, would provide relief to local governments experiencing fiscal strain because of underlying and long-term economic decline. We are recommending it because there are a series of local governments which cannot withstand the impact of losing their current countercyclical funds. These are not governments, however, which are experiencing temporary recession-induced fiscal strain. Instead, their fiscal difficulties reflect shrinking urban revenue bases caused by the long-term outmigration of taxpayers, investment, and jobs or by underdevelopment.

During the past year, the Treasury Department studied carefully the fiscal conditions of our largest municipalities. Indeed, as part of this effort, some of you may be familiar with a report we made available to Congress concerning the fiscal impact on these municipalities of President Carter's 1977 economic stimulus program. In that report, we developed an index of "municipal fiscal strain" and ranked the 48 largest municipal governments according to that index. It became clear to us that certain local governments are experiencing considerable fiscal strain. Their revenues are stagnant, and the combination of inflation, high local unemployment, and high concentrations of low-income persons are exerting upward pressure on their expenditures. The loss of countercyclical funds would require these "high strain" localities to implement severe fiscal austerity programs, which would have highly negative effects on the provision of municipal services to their citizens. These high-strain localities are precisely those who are least able to afford the loss of monies available under the current countercyclical programs. Many simply would be unable to balance their budgets without it. Their only choices would be to cut expenditures or raise taxes by the amounts of countercyclical funds lost. Yet, in these areas, taxes already are at high levels and raising them further would be counterproductive to economic redevelopment. Concerning service reductions, many of the largest cities would be forced to cut services such as police and fire which are vitally needed. In addition, they are already experiencing high unemployment levels, and further layoffs could only worsen their economic plight.

Tax proposals

Industrial development bonds. Let me now address the three tax portions of the President's urban policy. As part of the Development Bank proposal, the President has recommended changes in the small issue exemption governing the use of tax-exempt industrial development bond (IDB) financing. Under current law, small issue IDB's can be issued on a tax-exempt basis for financing investment in depreciable property or land

by private business firms. The use of such tax-exempt financing within any county is limited to the first \$1 million of any project or, alternatively, to \$5 million if total capital expenditures by the firm over a 6-year period, beginning 3 years before the date of bond issue and ending 3 years after, do not exceed \$5 million.

In the tax reform program, the administration proposed that the use of tax-exempt small issue IDB's be repealed except for distressed areas and that for such areas the \$5 million limit be increased to \$10 million with the capital expenditures limitation applying at this higher level. The original IDB proposal reflected the concern of this administration that preferential tax-exempt financing be channeled to areas of most urgent need.

The current proposal extends the IDB recommendations in the tax reform package. The increase of industrial development bond financing to \$10 million in the tax program will be further increased to \$20 million. The urban policy IDB proposals leave intact the recommendations in the tax reform program to remove tax-exempt industrial development bond financing in areas which do not qualify as distressed. Thus, while the dollar limitations are liberalized, there is still a strong commitment to limit the use of tax-exempt IDB financing to those areas of the country which are having difficulty in attracting private capital. Also these IDB's will be eligible for the administration's taxable bond option proposed as part of the tax reform program. Under the taxable bond option, State and local governments will have the choice of issuing tax-exempt or subsidized taxable bonds. The Federal subsidy on taxable bonds will be 35 percent of the taxable rate for bonds issued during the first 2 years and 40 percent thereafter. The urban policy IDB's may also be issued on either a tax-exempt or a subsidized taxable basis.

Differential investment tax credit. In addition, the administration is proposing, on a 2-year trial basis, a program of a differential investment tax credit for private investment (including the construction and rehabilitation of industrial buildings) for the improvement of distressed areas. These tax credits would be administered by the Commerce Department except that the income tax system would be employed as a clearing mechanism for final payment to the investor. Authority to grant the additional 5-percent investment credit would total \$200 million for each of the next 2 years.

To become eligible, a company would apply to the Commerce Department for a "certificate of necessity" basing its request on financing need and employment potential for the particular project in the distressed area. The certificate would be attached to a firm's tax return, thus making the firm automatically eligible for the additional 5-percent investment tax credit for the specified amount of the project.

This program would be similar to that which was used and administered by the Defense Production Board during World War II and the Korean war. The Treasury Department would be responsible to audit the firm's net tax liability and not its eligibility for the certificate of necessity.

Employment tax credit. The administration proposes a targeted employment tax credit that would substitute for the new jobs tax credit in the present law that is scheduled to expire at the end of this year. A tax credit for employment is desirable because of persistent problems of structural unemployment, but the existing jobs credit addresses the unemployment problem in a very unfocused and uncertain way. That credit has been available for the employment of workers generally and only for firms whose employment is growing. The credit is uncertain in application because an employer needs to predict the rate of growth of his unemployment tax base to the end of the year in order to judge whether a credit will be allowed. In the case of slow-growing industries and regions, the credit is denied to most employers simply because the demand for their products does not justify an increase of the wage base by more than 2 percent over the previous year. No employment incentive is provided to large employers that expect to grow by more than about 50 employees in a year.

Preliminary results from a recent survey of taxpayers conducted by the Census Bureau for an interagency task force show that less than 3 percent of employers report any conscious effort to increase their employment in response to the credit. These preliminary results also suggest that at least 80 percent of the dollar amount of the credit will be received by employers who report no conscious effort to increase employment.

The administration proposal would focus the employment incentives of the tax credit on the most serious structural unemployment problem: The high incidence of

unemployment among disadvantaged youth and handicapped workers. The categories of individuals who would be aided under this proposal have a recent rate of unemployment of about five times that of the remaining labor force. This proposal would not discriminate against slow-growing or declining firms nor against firms with rapidly expanding employment opportunities. It would, however, require that all of the benefits be targeted at a demonstrated special problem area of unemployment. As compared with the present jobs credit, this proposal would provide a larger dollar amount of incentive to employ each worker over a 2-year period, but at less than one-half of the total revenue cost of the present program in a typical year.

According to the administration proposal, a tax credit would be allowed to employers of eligible handicapped and disadvantaged individuals for 2 full years.

The major identifiable source of structural unemployment is minority and disadvantaged youth. Most other groups within the labor market do not suffer from pervasive structural unemployment. There are approximately 2.3 million young Americans between the ages of 18 and 24 who live in low-income households. The recent unemployment rate among this group is 26 percent; and this does not count the large number of such persons who wish to work full time but can find only part-time work or who have not been seeking work because they believe it is futile.

This program will provide strong incentives for employers to offer employment opportunities to those disadvantaged young people who have found it most difficult to gain the important experience of working in the private sector. Because the tax credit is continued for up to 2 years for each employee, there is an incentive for employers to retain these employees long enough for them to gain sufficient work experience and training to become a part of the regular work force. Therefore, this program will provide the necessary extra help to bring into our country's work force many young persons from low-income backgrounds, who might otherwise be denied entrance into the regular private job market.

I appreciate this opportunity today to present the broad outlines of some of the urban initiatives. We look forward to working with you and the other Members of Congress to achieve the President's urban policy goals.

Exhibit 12.—Statement by Assistant Secretary Altman, October 12, 1977, before the Senate Committee on Energy and Natural Resources, on the financing of an Alaska natural gas transportation system

I am pleased to have this opportunity to assist you in your consideration of the President's decision on an Alaska natural gas transportation system, and, in particular, the financing aspects of the decision.

The Treasury Department has participated in the Alaskan gas decision process from its initial stages. Among other activities, the Department led an interagency task force, which on July 1, 1977, delivered a public report to the President on financing a transportation system.

The President has designated the Alcan system to transport Alaskan gas across Canada for delivery to consumers in the lower 48 States. The President's report discussing the reasons for that decision was forwarded to Congress. It included a detailed discussion of the financing issues. Let me begin, Mr. Chairman, by summarizing the discussion of financing contained in that report.

The President observes that "the Alcan project will be one of the largest—if not the largest—privately financed international business ventures of all time." Obviously, the amount of financing required for such an undertaking is enormous and raising it is a complex task. Indeed, certain financing issues still remain unresolved. My central conclusion, however, is that the Alcan project can be privately financed, assuming equitable participation of those parties who will benefit directly from its construction.

Federal regulation

The Treasury Department has consistently argued that an Alaska natural gas transportation system could be privately financed given a proper Federal regulatory climate. The President's decision, with the accompanying terms and conditions, would

eliminate much of the potential uncertainty of Federal regulation and ensure that such regulation will be conducive to both an efficient project and a private financing.

To be specific, the President has recommended a modified form of incremental pricing for Alaskan gas to assure marketability to consumers. He has recommended the creation of an Alaska Natural Gas Office directed by an appointed Federal Inspector to coordinate the Government's involvement in construction of the project and to ensure the project proceeds efficiently. He has prepared an agreement with the Government of Canada which largely eliminates binational regulatory problems. The President has recommended establishing a rate of return on equity which discourages cost overruns. He has discouraged the use of new and controversial tariff arrangements that would be subject to time-consuming litigation with uncertain results. Finally, the President has recommended that the field price to the producers of Alaskan gas be established in accordance with his national energy plan, thus eliminating a lengthy price proceeding before the Federal Energy Regulatory Commission and subsequent litigation.

By adopting these recommendations, the Carter administration expects to resolve much of the uncertainty which earlier characterized the Federal regulatory environment for this project. This should eliminate what had been perceived to be a major risk of the project. In effect, the President's recommendations go far to encourage an economically viable Alaskan gas project, which is the key to a private financing.

One of the issues mentioned above, the form of the tariff paid by gas consumers, is particularly central to financing the project privately. The project applicants originally requested a novel form of tariff referred to as the "all events, full cost of service" tariff. This tariff would have reimbursed the project company for its costs, including the return on and of equity, under any and all possible circumstances, including noncompletion. It was argued such a tariff was necessary to induce sufficient private lending for this project.

Alcan's financial advisers have recently concluded that such a tariff will not be necessary. Alcan is prepared, instead, to finance its project with a more conventional tariff commencing only after the project has been completed. Such a tariff would assure that the project's debt would be serviced upon completion and should satisfy lenders that principal and interest payments on the project's debt will be met.

Essentially, our anticipation of an economically viable project coupled with this assurance of debt service leads me to believe that the Alcan project can be financed in the private sector.

Alcan financing plan

Alcan's financing plan, which is included in the President's report, estimates the total capital requirements of the project at \$9.7 billion in escalated dollars, most of which is to be raised over a 3-year period beginning in 1980. Of this total, 22 percent will represent equity investments and 78 percent will be in the form of debt capital. Alcan expects approximately 82 percent of this \$9.7 billion total (\$7.9 billion) to be raised in the United States and the remaining 18 percent (\$1.8 billion) to be raised in Canada.

The U.S. and Canada private capital markets combined represent the largest and most resilient capital markets in the world and have the inherent capacity to supply these amounts. As an example, Alcan plans to raise approximately \$5.5 billion during 3 years in the U.S. corporate long-term debt market. Overall long-term borrowing by nonfinancial corporations in that market is projected to reach \$300 billion this year. In 1982, the final year of Alcan's borrowing, it is projected to increase to \$466 billion. Alcan's borrowings would represent only 1.2 percent of this total.

The Alcan financing plan should be viewed as tentative because several important issues must be resolved before funds will be committed to it. These currently unresolved issues include—

1. The final determination of the field price of Alaskan gas;
2. The completion of sales contracts for the gas;
3. The final determination of the rate of return that will be allowed on the equity investment in the project.

A small group of the largest U.S. insurance companies will provide the bulk of the U.S. debt capital required. Accordingly, their perceptions of the risks will be critical.

At this initial stage, we cannot be sure how these key lenders will assess the risks or even which risks they will perceive as dominate, e.g., the risks of marketability and noncompletion. It will take more than a year before we will know with certainty whether the financing can be arranged.

Participants in a private financing

One important aspect of our conclusion on the private financing is that the parties who benefit from the project can and should participate in its financing. The major and direct beneficiaries of this project are natural gas transmission corporations, the producers of North Slope natural gas, and the State of Alaska. Their participation will increase the overall private financeability by reducing the amounts which must be raised on the strength of the project's credit alone. I will discuss each of these parties briefly.

Natural gas transmission and distribution corporations. Natural gas transmission and distribution corporations comprise the Alcan consortium and they must provide the necessary equity for the project as well as the equity portion of any cost overrun financing. The strength of this sponsoring consortium, therefore, is a key element of the financing. Our analysis shows that the firms currently involved in the Alcan project have the capacity to provide these required equity investments. Furthermore, we expect that the consortium will continue to expand and eventually will include a large portion of the entire natural gas transportation industry. In addition, the Alcan project has the advantage of the substantial equity investment of Canadian transmission corporations, which will total at least \$800 million.

Producers of Alaskan natural gas. The owners and producers of Alaskan natural gas are major U.S. energy companies. This group is primarily composed of Exxon, Atlantic Richfield, and the Standard Oil Co. of Ohio. These companies will benefit substantially from the sale of their natural gas reserves and obviously require a transportation system to sell them.

These three companies had total assets of \$51 billion in 1976 and net income in excess of \$3 billion. They clearly have the capacity to participate in the financing of a transportation system, especially as full returns from their North Slope oil and related pipeline investments are realized. These companies have demonstrated varying degrees of interest and have not yet agreed to participate in the project. It seems in their interest, however, and they should be encouraged to do so. We think that financial participation by the producing companies can be structured so as to avoid anticompetitive practices, a continuing concern of the Department of Justice. This issue is specifically addressed in the report which has been forwarded to you with President Carter's decision.

The State of Alaska. The State of Alaska will realize substantial revenue in the form of royalty payments and taxes from the sale of North Slope gas. The State will also benefit from use of the pipeline for natural gas distribution and resulting commercial development within the State.

The State of Alaska can use a portion of its revenues from the sale of Alaskan oil to assist in the financing of this project. Originally, the State offered to assist in the financing of the El Paso project by guaranteeing \$900 million of project debt. Similar State of Alaska support for the Alcan project is considered advantageous and is encouraged.

Federal Government financial assistance

Possible Federal Government support to the project, viz., loan guarantees or insurance, has been evaluated intensively by the Treasury Department because certain parties earlier claimed that it was necessary. These parties asserted that Federal financing support was necessary to finance the project in the uncertain regulatory environment which then existed. They argued that only such assistance would assure lenders of repayment in the event the project was not economically viable and only this would assure their participation. In particular, the Arctic Gas consortium, which withdrew earlier, claimed that financing assistance by both the Canadian and United States Governments was required for the financing of their project. In addition, the El Paso proposal incorporated approximately \$1.5 billion in loan guarantees under the

existing Maritime Administration shipbuilding program. On the other hand, no Federal financial assistance has been requested for the Alcan project.

Alcan's investment banking advisers do not believe that Federal financing assistance is necessary for the Alcan project. The administration shares this conclusion. In addition, the administration believes that Federal assistance to this project would be undesirable for several important reasons.

1. Federal financial support substitutes the Government for private lenders in the critical risk assessment function normally performed by the private lenders.
2. Financial assistance also reduces incentive for efficient management of the project.
3. Serious questions of equity would result from the transfer of project risks to taxpayers, many of whom are not gas consumers or will not receive additional gas supplies as a result of the Alaskan project.
4. A subsidy in the form of lower interest rates yields an artificially low price for the gas.
5. Other large energy projects might not be undertaken without similar Federal assistance.

The Government of Canada also opposes Canadian governmental financial assistance to a binational project.

Transfer of financial risks to consumers

The issue of a new mechanism by which gas consumers bear some or all of the financial risks of this project also has received careful study by the executive branch. The most frequently discussed mechanism for consumer support would entail a consumer financial guarantee by means of an all-events tariff with noncompletion arrangements. The noncompletion features would provide for a consumer guarantee of at least debt service in the event of noncompletion.

The Alcan sponsors and financial advisers have stated that the Alcan project can be financed without such a consumer guarantee prior to completion and without Federal financial assistance. The administration has concluded that the bearing of financial risks by consumers prior to completion is unnecessary for this project. Furthermore, the administration believes that consumer guarantees are undesirable for many of the same reasons that Federal financing assistance is undesirable.

Conclusion

The Alcan project is the largest construction project ever contemplated by private enterprise. The requisite financing is uniquely large, complex, and most difficult. Let me emphasize, however, that the administration currently believes that this project can be financed privately—that is, without Federal financing assistance or consumer guarantees. We encourage appropriate and equitable financial participation by the parties benefiting directly from the project. In conclusion, I urge congressional approval of the President's decision recommending the Alcan project.

Exhibit 13.—Statement by Assistant Secretary Altman, August 1, 1978, before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, on the proposed National Development Bank

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

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

2. Many areas of this country, urban and rural, have not fully participated in this recent growth. Particularly during the 1970's, certain areas have lost population, jobs, and important parts of their tax base.
3. These trends are costly for those places. They experience high unemployment, unused public facilities, a growing concentration of less skilled and less educated groups, and increasing welfare and other social support costs. At the same time, their fiscal bases shrink, and their ability to maintain an appropriate level of social services becomes strained.
4. Land, construction, and operating costs in distressed cities are disproportionately high and have led American businessmen to invest elsewhere. Furthermore, small and medium-sized businesses already located in distressed urban and rural areas frequently cannot obtain long-term financing to expand or rehabilitate.
5. In the past, the Federal Government has influenced, directly and indirectly, these business and job location trends.
6. The National Development Bank represents a private jobs strategy. It is aimed at increasing private investment and related jobs in distressed areas. We believe that a new economic development tool of this type is needed. It does not presently exist.
7. Specifically, the National Development Bank will provide a combination of grants, loan guarantees, and interest subsidies to reduce financing costs for business in distressed areas. These reduced financing costs will relate to acquiring, constructing, and rehabilitating facilities. The combination of Development Bank incentives can lower the cash invested in such projects, on a present value basis, by over 60 percent.
In addition, the bank also will provide a liquidity facility to increase the flow of private credit to small and medium-sized companies located there.
8. It would be inefficient to give the bank's powers to existing agencies. This would mean building a separate long-term, private financing staff in each agency—two or more staffs instead of one.

Chronic economic distress

Numerous rural and urban areas are experiencing chronic economic distress—low levels of investment, a lack of jobs, loss of population, poverty, and a shrinking tax base. The health of most central cities has declined relative to the suburbs. The cities of the Northeast and Midwest have not shared in the growth of the South and West. And many rural areas in all parts of the Nation continue to be isolated from growth.

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

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

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

Urban distress

The characteristics of chronic distress in urban areas can be highlighted by comparing the economic indicators for distressed places with those of healthy places
Employment and unemployment.—It is well known that many of our larger cities have

not shared in national growth. During the period 1970 to 1975, overall growth in employment was 7.8 percent. In contrast, in St. Louis, employment fell during that period by over 19 percent, and in New York City by 16 percent.

Central cities showed major declines in manufacturing jobs between 1970 and 1975. Jobs lost, largely through ordinary attrition, were not being replaced. In addition, looking at the 10 American cities with the largest number of headquarters of "Fortune 500" companies in 1956, we find that the number of headquarters had declined from 293 to 236 in 1971. In large measure, the cities' loss has been the suburbs' gain.

Looking at the unemployment side of the equation, we again see clear geographical disparities. One study has compared the average unemployment rates of 14 declining cities with those of 8 growing cities. On an unweighted basis, the rate of unemployment in the declining cities was 41 percent greater in 1976 than in the growing cities. Within regions, there are further disparities between central cities and their suburbs.

Investment.—The imbalance among different regions and cities is also highlighted by differences in investment per employee. According to a recent Urban Institute study, the average capital investment per production employee during 1970–76 was 66.7 percent greater in a group of growing cities as compared to distressed cities. For the same distressed cities, the ratio of wages to value added per production worker was 35 percent less favorable than in the group of growing cities.

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

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

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

Rural distress

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

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

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

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

Is it appropriate for the Government to influence locational decisions?

The foregoing demonstrates that there is a need for action. Nevertheless, some argue that the Federal Government should not "distort" the locational decisions of private

firms and that such programs merely subsidize inefficiency. We do not find these arguments convincing. Let me explain.

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

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

Efficiency.—Efficiency cannot be measured by looking at the economics of a particular business that is offered the incentives. We must also take into account the overall social costs of permitting deterioration to continue in economically distressed areas. The costs of public medical services, welfare, police and fire protection, among other things, rise as these places decline. The expense levels experienced by economically distressed cities, for example, is higher than those in the suburbs and other cities. If the bank's incentives create new permanent jobs in an area, there can be substantial savings in many of these costs. In addition, declining investment causes the revenue base of distressed areas to shrink sharply, while expenses rise. These localities are forced to increase their tax rates or reduce services. Most have tried the former course, which increases the disincentives to new investment.

Federal economic development programs¹

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

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

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

Why use capital incentives?

The most important disincentive to new investment in economically distressed areas is higher costs—land acquisition, construction, property taxes, labor, insurance, security, transportation, and the like. The bank's programs respond directly to the higher costs of land acquisition and construction by providing significant cash flow savings in excess of 60 percent of the cost of capital. They respond indirectly to higher

costs of operations because the savings from the bank's financial assistance will partly offset higher costs of operation.

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

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

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

The foreign experience

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

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

Structure and relation to other Federal programs

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

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

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

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

We propose establishing the bank as an independent agency in the executive branch under the direction of the President of the United States. Its Board will be composed of the Secretaries of the Departments of Housing and Urban Development, Commerce, and Treasury. The Board will have the power to exercise all of the powers granted to the Bank, including the powers to issue regulations, fix policy, and review investments.

It may, of course, delegate those functions where appropriate.

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

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

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

The Bank's Program

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

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

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

Powers. The bank will have five basic tools at its disposal, which may be used singly or in combination: Equity grants, loan guarantees, interest subsidies on guaranteed loans, interest subsidies on taxable development bonds, a liquidity facility to increase the flow of credit to economically distressed areas.

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

Eligible projects

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

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

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

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

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

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

To accommodate some of its operations, the manufacturer is considering an old plant in the city that had been vacant for the past 10 years. It needs \$25 million to prepare

the facility. A local bank has been involved in the city's negotiations with the firm and is likely to help finance the project if National Development Bank aid is also provided.

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

A 9 1/2-acre site has recently become available for approximately \$1 million. The city would like to purchase the land for the two companies. A combination of local capital and combined local and National Development Bank incentives could persuade the companies to use the site.

Financing assistance provided by the bank

The bank will offer a unique combination of long-term financing incentives, which in each case will be conditioned on a substantial commitment from private sector lenders—either private institutions or the public markets. Specifically, no grant will be made or loan guaranteed unless at least 25 percent of the long-term debt associated with the project is provided by a private financial institution or the public credit markets. This "private market test" is intended to differentiate between projects which, if financed, have a reasonable chance of long-term economic viability and those where the risk of loss is too high to attract any private capital, even when three-quarters of the total debt is guaranteed by the bank. Economic viability is important not only to protect against waste of government funds and credit but also to help assure the permanence of the new jobs and the investment.

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

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

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

These grants are a crucial part of the bank's incentives, representing approximately 45 percent of the savings that a total package of bank financing can offer to a company. A grant will substitute for an equivalent amount of equity investment, reducing sharply the amount of cash that a company must invest at the front end of a project. We propose that the bank have authority to provide \$1.65 billion in grants over the first 3 years of its life.

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

Loan guarantees.—The bank may guarantee up to 75 percent of the long-term loans incurred to finance the eligible capital costs of a project. The amount guaranteed for each project may not exceed \$15 million.

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

Before guaranteeing any debt, the bank must find that there is a reasonable prospect of repayment. The bank thus retains responsibility for its own credit decisions.

Nevertheless, the fact that at least 25 percent of the long-term debt has been extended by a private financial institution or by the public credit markets will help to confirm the bank's judgment. The guarantee will apply to taxable debt issued by local development authorities or by the business itself.

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

Interest subsidies on guaranteed loans.—The Federal guarantee will have the effect of lowering interest costs to the business on the portion of the long-term debt which is guaranteed. The rate must be approved by the bank and will bear a relationship to the rates carried by other U.S. guaranteed debt securities, which are just above the rates applicable to Treasury securities.

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

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

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

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

We have proposed \$934 million in budget authority for interest rate subsidy commitments in fiscal years 1979, 1980, and 1981. The total subsidy payable over the full life of the taxable development bonds will be counted against the bank's budget authority in the year of the commitment.

Liquidity facility.—Our extensive consultations revealed that banks and other financial institutions are reluctant to make the large, long-term commitments which a bank project may require because of the impact on their liquidity. In addition, many medium-sized and small businesses have difficulty in securing long-term financing because traditional long-term lenders, such as insurance companies and pension funds, prefer to deal with larger companies. The bank's liquidity facility addresses this need. By providing liquidity and some incentives to lenders, it will increase the flow of long-term capital to distressed areas.

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

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

The private financial institution will continue to service each loan. Let me emphasize that the bank will have full recourse to the selling institution in the event of a default, which would also require forfeiture of any unamortized premium. The Development Bank may require the seller to provide collateral to secure its obligation to repurchase

the loan. We have proposed budget authority of \$3 billion for the liquidity facility in fiscal years 1979, 1980, and 1981.

Definition of distressed areas

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

We believe that we have arrived at a fair and effective formula. It is the product of months of effort to choose criteria that reflect economic distress in an appropriate way. These factors take into consideration the absolute wealth of a community, the level of unemployment, and three growth factors over a 5-year period. In combination, they provide a good profile of chronic economic decline. A list of eligible areas prepared on the basis of current information has been requested by the chairman and has been furnished for the record.

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

Distressed areas will be defined by the boundaries of local governments and will include the unincorporated areas within county jurisdictions. To be eligible, an area must exhibit three of the following four conditions: An unemployment rate above the national average for the most recent 5-year period; a population growth rate below the national average for the most recent 5-year period; a growth rate in total employment below the national average for the most recent 5-year period; an increase in absolute dollars in per capita income less than the national average for the most recent 5-year period. In addition, no area is eligible if, in the most recent year for which data is available, its per capita income is 125 percent or more of the national average.

We have developed separate national averages for standard metropolitan statistical areas (SMSA) and non-SMSA areas. This feature makes the bank's eligibility standards sensitive to the differences between urban and rural economies. It allows urban areas to be judged against other urban areas and rural areas to be compared to other rural areas.

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

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

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

Each year the bank will publish a list of eligible areas. Once the bank determines that an area is eligible, it may provide financial assistance to projects in that area during any time in the next 2 years, even if the bank determines during the second year that the area is ineligible.

Local development authorities

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

community development policies and for assessing the economic value of the project to the community. It must also concur in the purchase of any loans by the liquidity facility.

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

Only one local development authority will be designated in each area. Units of State or local government with wider responsibilities (i.e., counties and States), however, can carry out specific projects in the economically distressed area, even if the State or county is not the designated authority, provided that the elected officials of the eligible locality agree. If the municipality itself does not act as the local development authority, then the municipality must redesignate one every 2 years.

Summary of proposed funding

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

National Development Bank guarantee and budget authority, outlays
[In millions of dollars]

	1979	1980	1981
Formation of bank, initial organizing expenses and operating expenses:			
Budget authority.....	25	25	25
Outlay.....	5	17	23
Loan guarantee authority pursuant to title VII—subject to appropriations control.....	(2,175)	(2,900)	(2,900)
Reserve for contingencies to honor guarantees, pursuant to section 706:			
Budget authority.....	543.75	725	725
Outlay*.....	46	166	272
Interest rate subsidies for guaranteed loans pursuant to section 801:			
Budget authority.....	1,035	1,380	1,380
Outlay.....	9	73	144
Interest rate subsidies for long-term debt (taxable development bonds) pursuant to section 802:			
Budget authority.....	234	324	376
Outlay.....	2	21	43
Title IX of the Public Works and Economic Development Act, as amended, for grants pursuant to title IX:			
Budget authority.....	275	275	275
Outlay.....	70	255	275
Title I of the Housing and Community Development Act, as amended, for grants pursuant to title IX:			
Budget authority.....	275	275	275
Outlay.....	8	109	211
Loan purchases to carry out the purposes of title X:			
Budgetary authority.....	810	1,095	1,095
Outlay.....	-0-	-0-	-0-
Reserve for contingencies to honor guarantees, pursuant to section 1009:			
Budget authority.....	202.5	273.75	273.75
Outlay.....	18	65	104
Less: Recoveries.....	-11	-47	-83
Net outlay effect.....	7	18	21
Total:			
Budget authority.....	3,400.25	4,372.75	4,424.75
Outlay.....	158	706	1,072
Less: Recoveries.....	-11	-47	-83
Net outlay effect.....	147	659	989

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

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

Exhibit 14.—Other Treasury testimony published in hearings before congressional committees

Secretary Blumenthal

Statement before the Senate Committee on Banking, Housing, and Urban Affairs, on New York City's fiscal condition, December 14, 1977.

Statement before the Subcommittee on Economic Stabilization of the House Committee on Banking, Housing, and Urban Affairs, on the future Federal relationship to the financing of New York City, March 2, 1978.

Statement before the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Senate Committee on Finance, on the future participation of pension funds in the financing of New York City, March 7, 1978.

Assistant Secretary Altman

Statement before the Subcommittee on Transportation and Commerce of the House Committee on Interstate and Foreign Commerce, on H.R. 8882, amending the Regional Rail Reorganization Act of 1973, October 4, 1977.

Testimony before the Subcommittee on Financial Institutions of the Senate Committee on Banking, Housing, and Urban Affairs, on S. 1010, creation of a Consumer Cooperative Bank, January 26, 1978.

Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, on the Federal Financing Bank, January 30, 1978.

Testimony before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, on the public debt limit, February 6, 1978.

Statement before the Subcommittee on HUD-Independent Agencies of the House Appropriations Committee, on the administrative expenses of the Office of New York Finance, March 22, 1978.

Statement before the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance, and Urban Affairs, on H.R. 7800, the Solar Energy Act, April 25, 1978.

Economic Policy

Exhibit 15.—Excerpt from remarks by Secretary Blumenthal, October 19, 1977, before the annual convention of the American Bankers Association, Houston, Tex., on the economic plans of the Carter administration

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The essential first step, I think, is for the administration to spell out for you—in full detail—our economic plans for the next several years. You have a right to know where we are heading and why. We are now formulating those plans, on a methodical, multiyear basis. The plans will emerge over the next several months as the tax reform program is presented and as the fiscal year 1979 budget cycle reaches its culmination.

I hope you will participate in the planning process—with advice and candid criticism. Allow me to open that dialog this morning. I will do so by sharing with you the basic principles that I hope, and fully expect, will guide the administration in formulating its long-term economic strategy.

The first principle is that the private sector is the key to the health of the U.S. economy. We must limit government intervention in the economic process both in purpose and magnitude. Let me be specific:

We should not allow the percentage of GNP accounted for by public spending to

exceed 21 percent in the long run. This is in line with the average rate over the past decade.

We should not allow Federal income taxes to take an ever-increasing share of the incomes of individual taxpayers. The average share has traditionally fluctuated between 10 percent and 12 percent. It is now at 13 percent and rising. We should cut taxes as inflation automatically increases that share. As for marginal rates, no taxpayer, in my judgment, should be forced to turn over more than half of each additional dollar he acquires through effort or investment.

As growth and employment reach their full potential, the Federal budget should move into balance. We must not allow the budget deficit to become a permanent feature on the economic landscape.

We should move boldly to develop genuine private sector jobs—jobs with a future—for the thousands of minority and teenage workers now unemployed in our great cities. Public service jobs and government training programs are necessary, short-term expedients, and we have moved conscientiously to use these tools. In the long run, however, the only effective solution is to integrate those currently unemployed fully into the private sector. We at Treasury are pressing hard to orient our emerging employment and urban programs toward imaginative private sector solutions. We ask your advice and help in this vital work.

Our *second* principle is that government must concentrate on increasing the rate of private capital formation. This means relieving the tax burden on profits and keeping regulatory meddling to a minimum.

To achieve and then sustain a full-employment economy, we must allocate a significant share of our real output—on the order of 12 percent—to investment in new tools of production for our growing labor force. We have been running at a rate of less than 10 percent.

As a result, we face an alarmingly low level of productivity growth. Productivity growth in the 1960's was over 3 percent per annum. In the 1973-76 period, it was less than 1 percent. If we allow these trends to continue, we will be forfeiting our children's opportunity for prosperity, full employment, and price stability.

Our *third* principle is that government policy must provide a stable, predictable environment for business planning. A chief cause of lagging investment is uncertainty. The only antidote for private sector uncertainty is steadiness and calm by the public sector.

I do not believe we know enough to engage in fine tuning. Even if we did, it is clear to me that our important economic woes are long term and chronic in character. They will not yield to the quick fix.

We should set our macroeconomic policies according to the significant long-term trends and swings in the economy. We must learn to ignore month-by-month ups and downs that yield neither to our understanding nor to our control.

Our *fourth* principle is that government must learn to work with, not against, the business sector in moving the economy away from high inflation and high unemployment. These are goals we all share.

After the last decade, the government is in no position to lecture the private sector on the subject of economic health. We are all caught in the trap of stagflation. We can free ourselves only by finding a mutual understanding of our dilemma, and by working together to fashion the most promising solutions.

As a former businessman, I know that business confidence requires candid communication between government and the private sector. We cannot promise you that we will always agree or that our policies will always be right. But we can and do promise that we will consult thoroughly with you in formulating them.

Our *fifth* principle is that government must manage the domestic economy in concert with the needs and demands of our unique role in the world economy. Though far from ideal, our recent economic performance—in terms of balanced growth, employment, and inflation—has been considered exemplary by many of our industrial allies and by much of the international investment community. The importance of the dollar in the international system requires that we maintain that reputation.

A strong and stable dollar is essential both to the United States and to the world at large.

As you know, we now have a substantial trade deficit. But a depreciation of the dollar is not required by that deficit; nor would a depreciation of the dollar erase that deficit.

The solution rests in enacting an effective energy program; in maintaining a healthy, growing, noninflationary U.S. economy; and in moves by other countries in a position to do so to stimulate their economies and to remove restrictions on trade where they exist.

We believe that the best foreign exchange policy for us—and the one that in the long run provides the greatest benefit for all countries—is to allow exchange rates to reflect underlying economic and financial conditions, and to permit rates to adjust to changes in those underlying conditions.

Rates in relation to some countries may fall; in relation to others they may rise, since underlying conditions will differ from country to country, in varying patterns. If disorderly conditions develop in the foreign exchange markets, we will continue our policy of intervening in the market to counter such conditions.

While our trade account has been in deficit, our international balance of payments generally is healthy. We continue to earn a large surplus in services and, not surprisingly, to attract substantial capital inflows. These are sources of strength for the U.S. dollar which can be expected to continue.

Our *sixth* and final principle is that we must balance boldness and patience in attacking the major, structural problems that threaten our long-term prospects for prosperity.

This has been a year of many bold new initiatives. I know that the very pace of innovation has aggravated uncertainty in the business sector, and that we have been accused of impatience.

You should know that the pace will now begin to moderate. The bulk of our policy agenda is now before the Congress and the Nation. It is now a time chiefly for consolidation, rather than innovation.

But our boldness has, in my judgment, been justified by the magnitude of the problems we face. We have acted, not for the sake of action, but as a precaution against the huge risks posed by doing nothing. Our boldness has been in the service of prudence.

Energy is the best example. We will this year import \$45 billion of oil, about half of what we will consume. Thus our dependence on foreign sources is rapidly escalating. Unless we act now, we will effectively cede sovereignty over our economic destiny.

The impact of our dependence on our growth, inflation, and unemployment rates has already been substantial. It could easily become incalculable.

On April 20, President Carter proposed a comprehensive, fair, and balanced program to rescue our economy from that fate. The program aimed to cut our oil imports by 4.5 million barrels a day by 1985—a reduction in our trade deficit at today's prices of some \$23 billion a year.

That program now hangs in the balance. The world looks on, astonished, as we flirt with the possibility of doing nothing and taking the consequences. I can imagine no more dangerous a course for our economy. Without a comprehensive energy program, we simply cannot chart a plausible course for growth, investment, and inflation. The whole world knows this. The American people now have only a few days to learn it.

Each of the three major elements of the President's program is in jeopardy: The crude oil equalization tax, the oil and gas consumption tax, and the gas guzzler tax. Most of the projected reduction in oil imports was to be achieved by these taxes.

The crude oil equalization tax would raise the price of crude oil produced in the United States up to the world price level. This would eliminate the present unwise subsidy to imports granted by U.S. price controls.

The proposed oil and gas consumption taxes on industrial uses were also designed to reduce imports by taxing the use of oil and gas, while providing a rebate of the tax to those firms converting to coal.

The gas guzzler tax imposed a graduated tax, increasing over time, on new models failing to meet specific fuel economy standards.

Taken together, these three taxes were projected to reduce U.S. oil imports by 3 million barrels a day by 1985, with a savings to our balance of payments of \$15.3 billion. New taxes are never popular. But these taxes are fair, reasonable, and necessary. The

revenues raised would be broadly and equitably returned to the American people. The practical alternatives to these taxes are few and unpalatable.

The President has charted a responsible and prudent course for the Nation on energy. For your own sakes, and for the sake of our country's economic future, I urge you to support that program.

We are applying the same prudent approach to every major policy that we now face:

In stabilizing the international monetary system, we have already helped develop the Witteveen Facility to promote balance of payments adjustments by IMF member nations.

In meeting the challenge of foreign import competition, in steel and other industries, we are developing a responsible policy that protects U.S. manufacturers from unfair competition, that keeps down pressure on domestic prices, without provoking retaliation that could lead to another trade war.

In developing a solution to the difficult problem of social security funding, we are working with Congress to minimize any adverse impact that a solution would have on our economic recovery.

And in welfare reform, we are working for passage of a major streamlining of assistance programs to reduce waste, to encourage those able to work, and to provide adequate help to those in genuine need.

Moreover, we are now drawing up two very basic economic documents—our 1979 Federal budget and a reformed income tax code. In both, you will see in clear figures the firm direction of our policies.

The budget forthcoming in January will be the first full budget written by this administration—the first that expresses our fundamental approach, instead of a revision of the previous administration's effort.

We will have in this the tough decisions needed for effectively setting priorities; the results of the first zero-base budgeting applied across the board; 5-year projections for spending; and an overall spending pattern that reflects our most urgent macroeconomic needs.

Our tax reform measures will form the other half of our fiscal approach to today's economic challenges. When the final decisions are made, I am confident that you will find a substantial, permanent reduction of business and individual taxes, a reduction that can help stimulate business investment for new jobs and greater productivity.

With those two documents in hand, this administration will have completed the formative phase of our efforts. The basic shape of our policies will be formed; the bold initiatives will be in better focus; and, with your help, we will begin realizing the long-term progress we all seek.

Exhibit 16.—Remarks by Assistant Secretary Brill, April 6, 1978, before the conference on "The Midyear Economic Outlook" of the Conference Board, San Francisco, Calif., on economic policies to reduce inflation

Economic policymaking in a democratic society involves an intricate balancing among contending objectives. Every objective is, in itself, worthy. Economic growth is a legitimate objective for an expanding population with ever-rising aspirations. So are: The achievement of more equitable distribution of the fruits of growth, enlarged employment opportunities to bring the disadvantaged into the mainstream of American economic life, repair of our deteriorated urban centers, preservation of our environment, better medical care—the list is endless.

All worthy, all achievable—but not all at once. As wealthy as this Nation is in terms of natural resources, advanced technology, and a skilled work force, it can make only moderate progress on all these objectives simultaneously.

Nevertheless, this should be a period in our economic cycle when the rate of progress on many fronts could be accelerated. There is slack in the system; we are not close to straining our labor or capital resources. Despite the significant achievement last year of creating over 4 million new jobs and reducing the number of unemployed by 1.2 million, we still have 6 percent of labor force unemployed. And despite a real growth

in output of 5 3/4 percent, there is still about one-sixth of industrial plants idle. Why can't we move faster toward satisfying the whole range of legitimate social and economic objectives?

In my judgment, the principal barrier is our recent history of inflation and the current widespread expectation of accelerating inflation. The roller-coaster experience of the past decade (soaring inflation followed by deep recession) has apparently made us a nation of risk averters. Private investment opportunities now require a much higher premium to induce the required capital inflow. The payback time horizon for research and for new investment embodying research results has been so shortened as to threaten our technological superiority, and government initiatives are limited and debilitated by inflation.

Even when the economy has slowed, we have been locked into an unacceptably high rate of inflation. During the second half of the sixties and into the early 1970's, the inflation rate—as measured by the GNP deflator—averaged over 4 1/2 percent per year, two and a half times as rapid as in the first half of the sixties.

Prices soared in 1973 and 1974, in response to food shortages, the oil situation, and the surge in raw materials demands during the worldwide investment boom. In 1974, added impetus to prices came from "catchup" efforts after the removal of wage and price controls.

As the worldwide economic contraction set in in 1975, cost and price advances began to subside from the peak rates of 1974. The pattern of unwinding continued into 1976, though the decline reflected principally further easing in farm and food prices and some federally mandated rollbacks in energy prices early in the year. Throughout 1976, and again during 1977, the underlying rate of inflation—as measured by the rise in consumer prices excluding food and fuel—averaged around 6 percent, up about one-half from the pace of the late 1960's and early 1970's. Similarly, wholesale prices—other than for farm products, foods, and energy—rose at a 6-percent rate during both 1976 and 1977. Basically, the inflation unwinding process stopped at 6 percent.

It is bad enough to be unable to bring down the rate of inflation below 6 percent even with unemployment in the 7- to 8-percent range. It is more disturbing that as significant improvement has taken place in the unemployment picture, signs have emerged that the inflation rate is accelerating. To be sure, recent price figures are distorted by temporary factors such as adverse weather and the coal strike, but it does appear that the underlying rate of price rise has moved up to at least the 6 1/2-percent range as unemployment has dipped to 6 percent.

This is not a viable relationship. We cannot tolerate the waste of resources—nor the social and economic tensions—implied by a 6-percent level of unemployment. But neither can we succeed with programs to encourage fuller employment of resources if high inflation persists or accelerates.

This is not a matter of lack of will, or of demons lurking at the central bank. The fact is that inflation and inflationary expectations induce economic behavior in the private sector perverse to the success of stimulatory efforts. With the scars of 1973-74 still fresh in executive suites, the prospect of accelerating inflation no longer brings forth the "build now before costs go up" reaction. More often, the reaction is to delay expansion in fear that inflation will inevitably result in recession; who wants to initiate an investment project today—at today's high costs—that might come on stream just as the economy noses dives? Similarly, consumers appear to respond negatively to their anticipations of inflation; buying now to beat the price rise is not a common reaction, except perhaps in the area of housing. It all adds up, to me, to the simple conclusion that the economy can't get where we want it to go if the path it takes is inflationary.

To find a safer route requires, first, an analysis of the nature of contemporary inflationary forces. What kind of inflation do we have? I find it easier to stress what kind we do not have. We do not have an excess demand inflation with "too much money chasing too few goods." We do not have a wage or profit inflation, with one group or sector carving out exorbitant gains. Instead, we have what for want of a better term I will describe as "tail-chasing" inflation. Let me explain the need for this new analytical category.

Ultimately, the rate of growth of real income is dependent upon the rate of growth of output per unit of input. This sets the limits. Beyond this, one sector can gain at the

expense of another only by a shift in relative factor shares, brought about by market forces or by exercise of market or political power. The shares of the "pie" available to labor and capital are also limited by redistribution of shares from the private to the public sector and from the producing to the nonproducing elements of society—retirees, welfare recipients, and others. Such redistribution means a smaller share to those currently engaged in the production process. But the limits for all are set by the rate of growth in productivity.

Unfortunately, the rate of growth in U.S. productivity has slowed down perceptibly in the last decade. From 1950 through 1968 private nonfarm productivity expanded by about 2.6 percent annually. From 1968 through 1977 it rose by about 1.4 percent per year—roughly one-half as much. Even after cyclical adjustment, a wide disparity remains. The causes of this slowdown in productivity growth are complex but seem to center around a slower growth in capital per worker in recent years. Whatever the cause—or causes—the fact is that the pie to be shared has grown more slowly over the past decade than the rate of growth earlier in the postwar period.

Moreover, during recent years, a larger share of the pie has been going to those not participating in the production process. Total government transfer payments to individuals have risen from 6 1/2 to 7 percent of national income in the early 1960's to the 13- to 14-percent range in recent years.

In the division of the remainder of the pie, neither labor nor capital has measurably benefited. The share of labor compensation in the gross product of the corporate sector has a slight upward tilt over the postwar period, but if supplements to wages are subtracted to leave only wages and salaries, this is converted to a slight declining trend. For the other factor of production—capital—profits adjusted to put the cost of inventories and capital consumed in the production process on a replacement-cost basis have represented a much lower share of corporate gross product in the 1970's than in the earlier postwar decades.

What is clear, then, is that neither labor nor capital has been able to gain, relatively, during this last inflationary decade. This is not only true in relative terms; neither labor nor capital has made much progress in absolute terms. The tail-chasing process has speeded up and has thrown off ever higher money wages and profits, but forward progress in real terms has slowed down to the vanishing point.

First, take the case of labor. Employee compensation per man-hour rose by 95 percent in the 1968–77 period, exceeding the 51-percent gain in the 1959–68 period. But that is almost all tail chasing. Corrected for inflation, real compensation per man-hour rose only 12 percent between 1968 and 1977—just a little more than 1 percent a year and well below the 27-percent gain of the earlier period. And, because of a decline in hours worked, real compensation per week rose only about 8 percent between 1968 and 1977—less than 1 percent a year.

Second, take the case of capital. Corporate profits after tax, as reported under current accounting conventions, rose by 122 percent between 1968 and 1977, exceeding the 65-percent gain between 1959 and 1968. Correction for inflation requires several adjustments to the reported figures. A first step is to adjust inventories and capital consumption allowances to a replacement-cost basis. This cuts the profit increase about in half, and leaves a rise of 52 percent in the 1968 to 1977 period. If these adjusted profits are then expressed in dollars of constant purchasing power, there was actually a decline of 11 percent in real profits during the 1968–77 period. This contrasts with a rise of 61 percent on the same inflation-adjusted basis in the previous period. Can anyone doubt that both labor and capital would be better off by a return to lower rates of inflation?

The crucial question is how we phase down to lower rates of inflation. Granted that no one is gaining much from the tail-chasing process, how do we slow down the process without slowing down the economy? If demands were pressing on resource availability, the answer would be relatively simple: Turn loose the conventional tools of stabilization policy and let fiscal/monetary restraint bring demands into better balance with supply. But the situation in which we now find ourselves, with demands inadequate but prices buffeted by everyone's desire to catch up with rising costs and prices, and all highly sensitized by a decade of inflation, is not easily amenable to conventional tools of stabilization.

There is a sense in which we are prisoners of the past. Inflation has now continued for a decade in this country at rates that are much higher than most of our previous experience. As a result, markets have adjusted to some considerable degree, building on an expectation, too often validated, that inflation is more likely to continue than to stop, and more likely to accelerate than to decelerate.

This leaves markets exceedingly vulnerable to any signs of intensification of inflationary pressures. The tangible signs of a rise in the rate of inflation would lead to higher rates of interest. Given the state of expectations, an effort by the monetary authorities to prevent or reverse such an inflation-induced rise in interest rates could be self-defeating. The markets' interpretation of a significantly faster rate of monetary expansion would only push prices and interest rates up all the more rapidly. This would be tail chasing with a vengeance.

I might note that monetary policymakers were once accused of "money market myopia"; i.e., resting policy too heavily on movements of interest rates. Perhaps today, financial market participants can be charged with "aggregates astigmatism"; i.e., too much preoccupation with jiggles in the monetary aggregates. Whether the contemporary preoccupation is sound economics or not—and I'm afraid my biases show—it has to be reckoned with in the formulation of policy. In markets, perception becomes reality. As a result, policy approaches which might once have been open to us are no longer available after a decade of inflation. Instead, our economic and financial policies must be shaped so as to reduce inflationary expectations, not to magnify them.

Since no major group is currently benefiting from the inflation process and since we all stand to lose in the long run, the sensible course is to chase our tails a little more slowly. In that way—and perhaps only in that way—the current inflationary process can gradually be slowed down and inflationary expectations reversed.

This was, and is, the compelling logic underlying the deceleration strategy outlined earlier this year by the President in his economic message. The strategy rests on the hypothesis that the rate of wage and price escalation can be reduced in every market, that businessmen assured of some moderation in the rate of cost increases can moderate their price increases accordingly, and that labor negotiators assured of moderation in the rise in the cost of living can temper their wage demands. In other words, if we can all "cool it" in concert, everyone will benefit.

Because this program is voluntary, rather than mandatory or coercive, and because it does not rely on a single standard of wage and price behavior, it has been dismissed by some as probably ineffective. We disagree. In light of the foregoing analysis of the inflation process—the process in which wages have been vainly chasing prices which have been vainly chasing wages, in an escalating cycle with no one the victor for long—we think the self-interest of all participants in the success of the program will be evident and a powerful force in achieving some abatement of inflationary pressures.

Exhibit 17.—Statement by Deputy Assistant Secretary Karlik, April 25, 1978, before the Subcommittee on International Economic Policy and Trade of the House Committee on International Relations, on the International Investment Survey Act of 1976

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 carry out the provisions of the act mandating portfolio investment surveys, we agree that section 9 needs amending. We plan to hire approximately the same number of persons to carry out the forthcoming surveys as Treasury was authorized to employ in 1974. Given a staff of this size, up to 35 persons, the authorization contained in the 1976 act is inadequate. More importantly, Treasury is requesting that, beginning with fiscal year 1979, administrative expenses for the purpose of conducting international economic affairs that are presently being financed from the Exchange Stabilization Fund be budgeted just as other administrative expenses are, and that expenditures for these purposes be authorized and appropriated. My appearance before you today is, of course, an essential initial step in that process.

I would like to briefly explain our survey plans. The coverage of the surveys is in part dependent upon the amount of funds authorized. The more elaborate the surveys, the higher the costs. We believe the act provides sufficient flexibility to select the survey coverage which is the most practical, efficient, and least burdensome on the public.

Basically, three approaches to coverage are implied by three variant definitions of "portfolio investment." These definitions are: (1) The market definition, essentially stocks and bonds; (2) the balance of payments definition, which covers other long-term debt in addition to stocks and bonds (essentially the coverage of the 1974 survey of foreign portfolio investment); and (3) the definition contained in the act, which added short-term items such as bank loans and deposits, short-term corporate claims and liabilities, and Treasury bills and certificates.

The monthly and quarterly data collected by the Treasury International Capital (TIC) surveys provide information on levels outstanding for all financial instruments except stocks and bonds and certain obscure financial items. The TIC reports give us relatively good figures on the levels of foreign portfolio investment, except for securities. In the case of securities, we have monthly reports on transaction flows, but not on levels of foreign investment.

We plan to collect in the benchmark survey only information on levels of foreigners' securities market holdings—stocks and bonds—and to supplement these reports with data on ownership of other financial instruments collected in the existing monthly and quarterly TIC surveys. We believe this approach meets the analytic requirements of most potential users of the data and, at the same time, results in a minimum burden to the public and in significant cost savings.

We assume the same staff will be able to conduct simultaneously a survey of foreign portfolio investment in the United States as of December 31, 1978, and a feasibility study of U.S. portfolio investment abroad. Since an outward survey would confront many unknowns, we plan to undertake a study in 1979 of the cost and feasibility of doing an outward survey. Once that study is complete, we can then present to you our conclusions and recommendations.

In the light of these survey plans, which have been discussed with the staffs of this committee and also of the House Committee on International Relations, and also considering the problem created by the prospective loss of authority to finance these surveys from the Exchange Stabilization Fund, when these international economic activities of the Treasury become subject to normal budgetary procedures, the funding authorized under the International Investment Survey Act of 1976 is inadequate. We therefore request that to fulfill Treasury's responsibilities in conducting surveys of foreign portfolio investment, authorizations be granted in the amount of \$1.4 million for the fiscal year ending September 30, 1979, and for fiscal years 1980 and 1981 in the amount of such funds as may be necessary.

Exhibit 18.—Remarks by Secretary Blumenthal, May 8, 1978, before the Financial Analysts Federation, Bal Harbour, Fla., on capital formation

Today's subject for discussion, capital formation, raises some of the most vexing and important economic problems facing the country.

Like college football, economic policy has too many candidates for the "number one" position: Inflation, unemployment, growth, poverty—a parade of problems—each vying for priority attention. In this spirited rivalry, capital formation often gets shoved to one side. In the popular mind, it is too often labeled a "business issue" and for that reason assumed to be of only parochial concern.

This is unfortunate, for the subject, despite all its technicalities, boils down to questions of overriding public importance:

Are we saving enough?

Is our financial system adequately tapping those savings and presenting them in optimal form to those wishing to make productive use of them?

Is the resultant real investment sufficient to our future needs, both in volume and in composition?

Unless we are doing each of these things—saving enough, passing those savings optimally through the financial system, and then investing them wisely—we are going to find ourselves in serious, long-term trouble.

I wish I could say with confidence that we are doing each of these things and doing them well. But my conclusion is exactly the opposite. In my judgment, this economy shows dangerous signs of underinvestment and misinvestment. As with every important issue in economics, the evidence is much more fragmentary and murky than we'd like. But the record here cannot be explained away. What it says is that we are not laying an adequate foundation for our future prosperity.

Let me begin with the evidence on savings. For some time now, American households have been saving no more than 6 percent of their disposable income. We are, in that basic respect, the quintessential "consumer society." This—we are told by all prophets—is where every other successful nation is heading, or wishes to head. I wonder. Our 6 percent looks very strange in international comparisons. The Canadians save 10 percent of personal disposable income, the British 14 percent, the Germans 15 percent, the French 17 percent, the Japanese 25 percent. These are not comforting figures.

Of course, they do not tell the whole story. The low savings rate of American consumers has traditionally been balanced by the relatively high savings rate of American business. By international standards, our business sector finances an exceptionally large share of its capital formation through internal cash flow.

The problem is that, while our personal savings rate has remained low, the financial self-reliance of our business firms has apparently suffered a secular decline. In the mid-1960's, the flow of internal funds just about matched the fixed and variable capital expenditures of our business firms. By 1977, however, internal funds stretched to cover only about 80 percent of capital spending.

Whether we look at personal savings or business savings, whether we compare ourselves internationally or to our own past experience, we arrive at the same conclusion: We are not setting aside enough of today's income for tomorrow's growth. We are skimping on our future.

The growing dependence of our business firms on external financing leads me to the second area of inquiry: the fitness of our financial system. As business looks increasingly to the financial markets to fund its investment, those markets assume central importance to our prospects for capital formation. We have, of course, exceptionally well developed capital markets, the most sophisticated and efficient in the world. These markets clearly do an excellent job of tapping savings. But do the markets make those savings available in optimal form to businesses wishing to make real investments?

Again, the evidence is disquieting. More and more, what the capital markets offer is loans. By contrast, what is needed, more and more, is equity financing.

The capital structure of American enterprise increasingly reflects this questionable tilt in the financial system. The ratio of debt to equity for manufacturing companies has risen from about 25 percent in the early 1960's to 40 percent at the end of last year.

This piling up of fixed claims makes our businesses much more vulnerable to the swings of the business cycle, in the extreme case by heightening the risk of bankruptcy. An increasing reliance on debt reduces the willingness and ability of companies to venture into untested markets and new technologies.

The problem is greatest for new companies, and for small- and medium-sized ones trying to market new ideas and new technology. For these enterprises, the relative shortage of equity financing translates into an absolute shortage of any kind of capital. They never get started, or they die young, or they sell out swiftly to larger, established concerns.

What these financial trends mean no one can say with certainty. But I find it hard to argue with commonsense: the fall-off in equity capital, it seems to me, can hardly help but encourage a trend toward dominance by larger companies, a corporate sector abnormally skittish about economic fluctuations, and a dearth of new, small companies dedicated to testing, generating, and spreading technological innovations.

I turn now to real investment in plant, equipment, and productive processes. This is the crux of the matter.

The record here is particularly grim.

Consider the period 1960-74, before the last recession. In the United States, nonresidential fixed investment averaged 13 1/2 percent of national output. The average was 18 percent for the larger OECD countries. It was 20 percent for West Germany, 25 percent for Japan. As one might expect, these differentials in investment contributed to sharp differentials in average real growth rates over the period: For the United States, 3.8 percent; for Germany, 4.6 percent; for Japan, 9.7 percent.

Last year, of course, the situation reversed itself. We grew considerably faster in real terms than most OECD countries. Our rate of growth in real investment, about 8 percent, also outpaced that in many of those countries. But I see little to suggest that this relative success of ours, in climbing out of the 1974-75 recession, portends a long-term recovery of our growth prospects. For that to occur, a genuine sea change is needed in the trend of private investment.

The task before us is truly enormous. The administration estimates that, to bring this recovery along a safe and balanced path to full employment and to prepare for the massive capital needs we will face in the 1980's, real fixed investment in productive facilities must rise by about 10 percent annually. That is markedly more than last year. It is very substantially more than recent trends. Looking at the 1970's as a whole, the annual increase in real investment has been less than 2 percent. We are very far behind schedule. Unless we begin catching up, and quickly, we will pay a serious price in the 1980's.

Our recent investment experience stands in sharp contrast to the 1960's. During those 10 years, productive capital per worker was growing at about 3 percent. In the last 5 years, it has been virtually stagnant. As a consequence, the growth in productivity (output per worker) has fallen off by about 25 percent since the 1960's. If this trend persists, we will fail to build plants and to supply tools fast enough to keep our labor force adequately employed. At the same time, we will ensure that every wage increase is inflationary and that each major increment of output runs into inflationary bottlenecks. In a word, we will ensure a future of stagflation.

Quite apart from the volume of investment, we have serious problems concerning its composition. There is not time today to explore in any depth whether we are making the right investments, in the right kind of enterprises and in the right sectors. But I do want to mention briefly two of these structural issues.

One is that we are now devoting a very sizable chunk of our private investment to meeting government regulatory standards. This investment will, in many cases, produce needed social benefits: Cleaner air, purer water, a healthier populace. But, like every other desirable product, these things come at a cost, and in some of these areas we may well be reaching a breaking point. Investment in environmental capital now accounts for about 9 percent of investment outlays in the manufacturing sector. If you exclude those mandated expenditures, investment as a share of value added has actually declined in the manufacturing sector since 1966.

My other major concern about the composition of our investment relates to advanced technology. The stakes here are exceptionally high. In international trade, we depend very heavily on our exports of R. & D.-intensive manufactured products. Indeed, in manufactured products that are not R. & D.-intensive, our trade balance is negative. Unfortunately, our investment patterns are doing far too little to preserve our comparative edge in high-technology products. As a share of GNP, R. & D. spending declined in the United States by more than 25 percent between the mid-1960's and the mid-1970's. Scientists and engineers, as a share of the population, have also declined while that ratio has increased in the Soviet Union, West Germany, and Japan. The number of U.S. patents granted to foreign residents has doubled. Our acquisition of foreign patents has declined.

These are mere straws in the wind, but it seems quite clear to me that the wind is blowing strongly in the wrong direction. Our technological supremacy is not mandated by Heaven. It can disappear. Unless we pay close attention to it, and invest in it, it will disappear.

All this leads me to the big questions: Why has capital formation, in nearly all its aspects, reached such a sorry state in this country? And what can we do about it?

One hears all sorts of sociological explanations: Americans have lost their spirit or nerve; our entrepreneurs have become less entrepreneurial; the genius for invention has

fled away, across the Pacific; some sort of cultural exhaustion has crept in, foglike, from across the Atlantic.

Such theories are entertaining, but I don't believe them.

In my judgment, investment is lagging for the simple reason that it has become less profitable. The rational investor, before he leaps, looks to expected real returns and to the probability of getting them. This vista of return and risk has been deteriorating.

After-tax rates of return on capital, reflecting the replacement cost of capital, have declined from around 8 percent in the mid-1960's to between 3 and 3 1/2 percent in recent years. That's a very substantial fall-off. As a percent of corporate product, profits have declined from more than 11 percent in the mid-1960's to around 8 percent in recent years. We are underinvesting because it no longer pays enough to invest enough.

At the same time that real returns have fallen, the riskiness of investment has substantially increased. The sources of uncertainty have been many and powerful. The 1970's brought back the business cycle with a vengeance, and then twisted the cycle so as to give us both unemployment and inflation simultaneously. Government added to the shock by controlling wages and prices. These controls eventually disintegrated, but memories of them have lingered on. All through this period, the Government applied layer after layer of complicated new regulations, some cost effective, some clearly not. Perhaps more important, the very process of regulation introduced bureaucratic delays and costly confusions into nearly every productive enterprise in the Nation. For many businesses, particularly small and new ones, the gap between a productive idea and a foreseeable profit widened into a forest of red tape.

So the sources of our plight are many, but they come down to a simple diagnosis. Profits are too low, and they are too uncertain.

How do we turn this situation around?

The most important thing is to assure that the fact of, and the causes for, our plight receive the highest level of attention within the Federal Government.

I have made today a number of international comparisons of a statistical nature. But the most important comparison cannot be quantified. It concerns the atmosphere of relations between government and those responsible for private capital formation. In the case of most of our major trading rivals, these relations are close, supportive, and understanding. In the United States, this has not been the custom. The public and private sectors have viewed each other with a certain, prickly mistrust. This has had consequences across the board. The most important consequence is that government has a very imperfect knowledge of what it can do—and what it must refrain from doing—in order to promote capital formation.

President Carter is acutely aware of this problem and has elevated the issue of private capital formation to a high level of administration concern. The White House is conducting an important Presidential review of technological innovation in the American economy. The President has also established a Cabinet-level task force on national export policies, to report within the next few months. The need to increase investment has dominated many meetings of the Cabinet Economic Policy Group, which sets our overall fiscal policies.

Given my own deep concerns, I have now established a permanent Treasury task force, at the highest levels, to examine the financial aspects of capital formation and what can be done about the shortage of equity finance. This group will reach beyond the Treasury and integrate, for the first time, the expertise and policy views of the several executive and independent agencies that regulate, and operate in, the Nation's capital markets. What the Federal Government does in and to the financial markets very substantially determines their vigor and efficiency. This task force will give us, finally, a means to analyze and coordinate those Federal actions in a coherent fashion.

Much of this work is in an early stage. There is a great deal about the problems of capital formation that we simply do not know. But already some things are clear enough.

The first is that government must work to reduce the uncertainties and risks which its own mistakes have injected into the investment process.

Above all, this means controlling inflation. Inflation is now, indisputably, the chief threat to our continued prosperity. Bringing it to heel is item one on the administration's economic agenda, overriding all other concerns.

Public attention now centers on a possible reacceleration of wage and price increases. Preventing a reacceleration is obviously essential. However, it is also not enough. I am firmly convinced that private investment in this country will remain suboptimal until we bring down the rate of inflation. Inflation raises construction costs ahead of prices, squeezes profits, generates high interest rates, and—most importantly—creates pervasive uncertainties. In such a climate, this economy cannot and will not build adequately for the future.

To reduce the cost and riskiness of investment, we must also rethink our approach to government regulation. Before we add further layers of regulation, for whatever purpose, we owe it to our future prosperity to undertake a meticulous audit of the economic trade-offs. Last month, the President put in place, through Executive order, a stringent interagency procedure to assure that just such an analysis takes place, in the case of every new executive branch regulation. I personally hope we can move toward a genuine zero base regulatory budget—a system of accounting and control to assure that the costs of existing regulations are weighed against the social gains expected from them. In the meantime, we need a significant streamlining of regulatory procedures to bring a measure of certainty, clarity, and commonsense to the daily interaction of government and industry.

By acting on inflation and overregulation, we can reduce the abnormal, economy-wide risks that are retarding investment.

The chief drag on investment, however, is low profitability, an inadequate real rate of return on capital. For this problem one of the important remedies has to be tax policy.

In constructing the tax package for this year, we consulted exhaustively with all sectors of the business and financial communities and conducted a very thorough examination of the structure of capital income taxation. We reached several major conclusions, shared by nearly everyone we consulted.

The key conclusion was that, to increase investment, it is vital to increase the profitability of American industry. This means cutting business taxes—to boost the real rate of return, to provide an increased cash flow, and to improve the ratio of equity to debt on corporate balance sheets.

The second conclusion concerned the way taxes should be cut on capital income. We were advised, by virtually every segment of the business and financial communities, that the simplest, most balanced, most effective—and most popular—way to reduce taxes was through broad and general reductions in corporate tax rates.

President Carter listened carefully to that advice, and he adopted it. To accommodate a major tax cut for investment within the bounds of fiscal prudence, he squeezed Federal spending to the smallest real increment in 5 years, freeing up revenues to cut the tax burden on capital income by more than \$7 billion.

The strategy of the business cuts mirrors the preferences of the business and financial communities. The corporate tax rate would fall by four points. For most small business, this means a full 10-percent reduction in taxes. In addition, the package would embed the 10-percent investment credit permanently into the tax law and would substantially liberalize its coverage. Finally, for small business, we provided liberalized and greatly simplified procedures for depreciation.

Obviously, there are other ways to cut taxes on capital income. In taxation, nothing is simple. We gave careful study to such issues as the special tax rate on capital gains, the double taxation of dividends, the distinction between earned and unearned income, and the problem of inflation adjustments in the tax system. The complex structure of taxes on capital income offers virtually endless opportunity for innovation and tinkering.

But the advice we received, uniformly, was to stay away from any such tinkering this year, to keep our package simple, and thereby minimize delay and uncertainty. To alter the intricate structure of capital income taxation is not a job for a short legislative session. Each of the structural issues is technically difficult and politically controversial on its own, and the issues are so closely related to each other that it is not only irresponsible but virtually impossible to alter one piece of the structure without dealing with many other pieces at the same time.

For the longer term, a thorough review of this structure is clearly in order. I personally would like to see the double taxation of dividends receive very close attention in any

such study. But this, of necessity, requires reconsideration of the capital gains issue and also a review of the present distinction between earned and unearned income in the individual tax system.

Obviously, there is no time in this Congress to undertake such an effort. A detour into these structural issues can only endanger the broad consensus needed to enact the President's program of deep, general corporate and individual rate cuts. If that should happen, the prospects for urgently needed, long-term investment would be seriously prejudiced. That is why the administration is strongly resisting any and all efforts to open up the structural issues of capital income taxation.

This has been a very rapid tour of a very complicated and controversial subject. At almost every stage, I'm afraid, my conclusions have been rather somber.

The facts are inescapable: We are not saving enough; our financial system is providing insufficient equity capital; we are not investing nearly enough in productive plant, equipment, and technological innovation; profits are too low, and they are too uncertain.

We must turn this situation around. I am convinced we can do so. The President not only appreciates the problem; he has oriented his entire fiscal policy toward solving it, and he is mobilizing the full resources of the Government to subject every aspect of the issue to expert scrutiny. We in the Treasury are fully dedicated to this effort.

What is now essential is that the Congress and the country also understand the dimensions of these problems. Your program today is an important step in that direction. I congratulate you on your prescience and thank you for the opportunity to participate.

Exhibit 19.—Other Treasury testimony published in hearings before congressional committees

Assistant Secretary Brill

Statement before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations, on the International Investment Survey Act of 1976, September 21, 1978.

Enforcement and Operations

Exhibit 20.—Statement by Assistant Secretary Davis, January 31, 1978, before the Subcommittee on Alcoholism and Drug Abuse of the Senate Committee on Human Resources, concerning warning labels on alcoholic beverage containers

I appreciate being able to appear before you today, and I welcome the opportunity to provide you with information on the issue of warning labels for alcoholic beverages, particularly relating to the fetal alcohol syndrome. Accompanying me today are Rex D. Davis, Director of ATF; Stephen Higgins, Assistant Director; Marvin Dessler, Chief Counsel of ATF; and Catherine Milton, my special assistant.

First, I would like to describe my role in relation to the Bureau of Alcohol, Tobacco and Firearms. The Secretary of the Treasury has all powers and responsibilities for all Treasury employees including ATF. However, by Treasury Order 221, the Secretary delegated to the Director of the Bureau of Alcohol, Tobacco and Firearms the Secretary's authority under the Federal Alcohol Administration Act. This is the act which establishes the responsibility for regulating the alcoholic beverage industry. Another Treasury order, No. 190, however, gives me as Assistant Secretary of Treasury the responsibility to supervise and oversee the Bureau in all policy and operations.

The Federal Alcohol Administration Act (FAA Act), which was enacted into law in 1935, contains a section on labeling, section 205(e). This section prohibits any alcohol to be sold or shipped in interstate commerce unless the alcoholic products are labeled properly according to regulations issued by the Secretary of the Treasury.

While under this provision ATF has been given broad authority in the labeling area, some have suggested that, because warnings for health purposes are not explicitly enumerated in the statute, ATF cannot act in this area. It is clear, however, from the language of the act and the legislative history that ATF has been given wide labeling authority aimed at protecting the consumer from a variety of evils. For example, one section forbids statements found to be likely to mislead the consumer; and another section states that labels should provide the "consumer with adequate information as to identity and quality of the products." Under these provisions, numerous regulations relating to labeling have been issued by the Secretary of the Treasury. Nevertheless, prior to making a judgment on the statutory authority of ATF to require health warnings, we intend to await the presentation of all legal arguments which may be made in connection with the rulemaking proceedings discussed below.

Fetal alcohol syndrome warning proposal

As for the specific proposal for a health label to be placed on alcoholic beverages warning women about the consumption of alcohol during pregnancy, ATF has issued an advance notice of proposed rulemaking which was published January 16, 1978, in the Federal Register. This notice followed a November 15, 1977, letter from Dr. Donald Kennedy, Commissioner of the Food and Drug Administration, requesting the Bureau to initiate action for the placement of warning labels on containers of alcoholic beverages because of the potential health hazard to the fetus if a woman consumes too much alcohol while pregnant. After holding discussions with FDA and reviewing their materials and consulting with the Office of Science and Technology Policy, we decided to issue an advance notice of proposed rulemaking. We felt that this course would enable us to get the maximum amount of information in the most efficient manner so that the best judgment can be made as to the appropriate course of action. ATF drafted the advance notice and it was published on January 16, 1978. The notice allows a 60-day comment period. Rather than describe in detail the substance of that notice, I will describe two important points.

First, the scientific evidence presented thus far has suggested that damage to the fetus can occur at early stages of prenatal development, even before the woman is aware she is pregnant. Second, some studies have indicated that consumption of 3 ounces of 100 percent alcohol (an equivalent of six drinks) produces a risk of damage to the fetus. Thus, a woman who one time engages in excessive drinking may endanger the fetus. If these two facts are true, then the problem is much broader than one of merely warning problem drinkers or alcoholics. It means that all women of childbearing age must be made aware of the potential dangers. Any proposal must take these facts into consideration.

In reviewing the comments and deciding on the best course of action, we intend to concentrate on a number of matters. First, we need to review all the available medical evidence. Then we need to consider whether labeling is the most effective way to warn women of the danger or whether alternatives are better. For example, it has been suggested that doctors should be the ones to provide the necessary warning. Others have questioned whether this issue should be dealt with separately or as part of a broader program to warn women as to the variety of dangers they face when pregnant, including such things as aspirin, alcohol, and any other dangerous commodities. Finally, if we decide that a warning label is required, we will look to the comments to provide guidance on exactly what the label should say. It is our hope that the comments we receive will enable us to answer these and other questions.

We take the responsibility in addressing this problem most seriously. In order to assure, therefore, that the proper expertise is applied to this issue, I have asked ATF to consult in evaluating the comments it receives with FDA, the National Institute of Alcohol Abuse and Alcoholism, and the Office of Science and Technology Policy. These consultations would focus particularly, though not exclusively, on the medical comments. If the need arises, we are prepared to seek additional scientific and medical advice. In addition, we are determined to evaluate the comments as expeditiously as possible.

General health warning proposal

You have also asked our views on the proposal to require a generalized warning label on certain alcoholic beverages indicating that their consumption may be hazardous to health as well as habit forming. We are concerned that use of such generalized warnings may reduce the significance attached to warning labels generally. By reserving this remedy for more specific dangers, all warnings may have more meaningful impact on those who read them. We therefore doubt that a showing has been made that the proposed warning would be effective. We would be happy, of course, to reevaluate this view if additional information is presented which would make that showing.

In closing, I would like to say that there has been, we know, publicity about disputes between ATF and FDA on various matters. It is my firm belief that in the future cooperation with FDA—with its obvious expertise—is important so that we both can assure that the best interests of the consumer are protected. While agreement between agencies may not always be possible, we plan on actively seeking FDA's advice and working together constructively.

Exhibit 21.—Statement by Assistant Secretary Davis, April 19, 1978, for the Library of Congress Forum, "Terrorism: Information as a Tool for Control"

I appreciate the opportunity to join you in this forum. Its topic, "Terrorism: Information as a Tool for Control," is timely. It poses only hard issues; it invites intelligent analysis; and it requires resolution.

My function today is to address the implications of this issue, and its resolution, for a democratic society. In doing so I speak not as an official presenting a particular administration position. Rather, I address this topic as a citizen molded by his own experiences; as someone who matured during the age of assassinations in the 1960's; who was a law student during the Columbia riots; who was a Federal prosecutor; who was an investigator of the events of Watergate; who was a defense lawyer for those suspected of wrongdoing; and who now has responsibility for protective and enforcement activities at the Treasury Department. My goal is to discuss the risks we face as we consider various policy choices. I am afraid, however, that I will bring no specific answers to the issues raised by this forum. Instead, my only hope is to articulate a perspective which will help clarify what we should do, and what we must avoid.

My perspective on this question is really a simple one. It is neither unique nor novel. First, terrorism, and the various alternative responses to it, plainly do have implications for our democratic society. Second, no ultimate policy choice is without its own costs. A more effective antiterrorist program may well involve programs with the potential to infringe in varying degrees on the rights of particular citizens; having no antiterrorist program, however, may ultimately infringe on the rights of us all. A balance must thus be struck.

Third, and finally, it appears unrealistic to expect that terrorism will simply go away, thereby removing the burden of decision from us. Rather, all should recognize that we must, in an open and rational process, make the hard choices involved.

At the end of this forum my first observation is, I am sure, clear to all: Acts of terrorism themselves do present a threat to democratic processes. This is true almost as a matter of definition. The terrorist act by its nature seeks to coerce a particular result not by logic or by the ballot, but by the force of arms and the threat of violence. It would hardly be consistent with democratic traditions to allow policy determinations to be dictated by the need to secure the release of a terrorist's captive or to prevent a threatened act of terror. And, of course, the assassination of an elected leader is the ultimate denial of our democratic rights.

But the danger really runs much deeper. Terrorist acts, particularly if of a continuing nature, can produce a siege mentality which affects the manner in which people exercise their rights. In the height of the violence in Northern Ireland, for example, how many—citizens and officials alike—had the courage to express their unvarnished views? In a country where terrorism flourishes, citizens may fear to attract attention to themselves by becoming involved in public affairs, or even by expressing views on controversial issues. Tolerating terrorism thus has the potential to inhibit us all from exercising our basic freedoms. Tyranny by government must be fought against:

Allowing a tyranny dictated by the terrorist is unconscionable. We must recognize this danger and never allow it to happen.

If terrorist acts are themselves a threat to democratic processes, how are we to avoid them? Other democratic countries have come up with various answers to this question. Laws have been passed outlawing or subjecting designated groups to special restrictions, allowing unrestricted searches and electronic surveillance against terrorists, suspending judicial protections, authorizing preventive detention, forbidding the articulation of support for specified organizations, and allowing the expulsion of suspected terrorists.

Are laws such as these the answer for this country? The answer to that is, I believe, simply—no. I suppose we might feel differently if we always knew in fact exactly who was a terrorist, exactly who had committed acts of violence, and exactly who would really commit such acts. It is not hard to act against the known “bad guy.” Our constitutional system, however, is not so naive. We know that in reality this kind of perfect knowledge is impossible. To find the guilty, police must question and investigate those who, in reality, are innocent. Those we suspect of evil may, in fact, be innocent. It is because there really is no way always to know with certainty who is a terrorist and who is not a terrorist, but instead a legitimate dissident, that we cannot simply cede away basic constitutional protections. We cannot allow ourselves to overreact and create a system of suppression which turns the fanciful accusations of our critics into reality.

But it is equally dangerous to our democratic future if we rest on this conclusion and do nothing. If we are inattentive to the need for protection now, we may be faced by an intolerant public later. The more terrorism appears to threaten us, the more it touches us directly, the greater will be the sense of crisis. There is danger, therefore, which we must recognize, that if we wait too long, intense public alarm and emotion will produce misunderstanding of what measures must be taken, thus causing excessive, and likely misdirected, reactions.

To say that we must both not overreact or fail to act does not, I am afraid, provide much of a solution. What, then, are the areas where the hard choices must be made—the areas where we must allow something, but not everything? The issue is the hardest, I believe, in three areas, areas that are being actively considered in one aspect or another by both the Congress and the executive branch. Each of these areas relates to the ability of the Government to secure information about prospective terrorist actions, an ability which, I am sure you have heard, would clearly assist us in preventing terrorism.

First, the issue has been raised as to how should we define a terrorist. If we are to grant additional authority in this area, this will be among the most critical issues. Do we want to include something like the Red Brigade in Italy?—plainly yes. What about the Congress of Racial Equality (CORE) in the early 1960's?—plainly no. What about the Black Panthers, now and 10 years ago, the SLA, the PLO, the Weather Underground, the FALN, or the militant antiwar groups from the late sixties and early seventies? The answer is plainly not the same for all these groups. The challenge is to develop a definition which authorizes the gathering of intelligence about the violent terrorist, but minimizes the license given to collect information about those groups whose violence only is in the force of their rhetoric.

Second, we must determine when should we allow investigation. One possibility being actively considered is to allow such investigation only for past or presently occurring crimes. This surely minimizes the risk of abuse, but is it where the balance should be set? If information about future violent acts is so keyed to their prevention, is there no standard which we can divine which allows the collection of intelligence in some circumstances where there is an articulable basis for reasonably believing that someone may commit terrorist acts directed against our citizens, or against our officials? This is a question which is in the process of being answered. We should not, I believe, lightly answer “no” to it and, thereby, reject attempting to find such a standard.

Third, we must decide what techniques may be used to gather evidence. Abusive and ruthless techniques against terrorists can become abuses against the innocent. A clear and common understanding must thus be developed as to how we may investigate. Informants, electronic surveillance, and the like may be appropriate in some cases. It must be clear to all, however, what those cases are, and what they are not.

The resolution of all these issues plainly impacts on the nature of our democracy. Privacy of the individual is a fundamental precept of our form of government: It is also an essential element for successful planning and execution of terrorism. This conference thus recognizes what should be a key lesson for us all: When debating privacy legislation, we must consciously consider the impact on our ability to detect and combat terrorism, as well as other similar criminal activities; when considering antiterrorism legislation, we must consider the impact on the privacy and freedom of our citizens. When we are done, those who seek maximum security likely will think we have done too little and those who seek absolute protection for citizen privacy likely will feel we will have gone too far. Hopefully, that will mean we have struck the right balance, and done the right thing.

Exhibit 22.—Statement by Assistant Secretary Davis, May 3, 1978, at the 35th annual convention of The Wine and Spirits Wholesalers of America, Las Vegas, Nev., on "Liquor Regulations: Current Issues and Future Options"

When I received the invitation to address you I wondered whether I really should accept. I must confess that it is not wholly consistent with my self-image to fly to Las Vegas, with all its glamour, in order to make a speech. But on reflection, I decided that it was important that I accept. I was concerned that there was confusion as to what was transpiring in Washington. It was time, therefore, that communications stopped taking place by rumor. It was time that you stopped learning about ideas by leaks—leaks which are often incomplete and inaccurate. I therefore decided to accept your invitation and to speak directly to a topic I believe is of interest to all of us: "Liquor Regulations: Current Issues and Future Options."

There are many matters being considered in Washington which will affect all of us. Regulatory reform, ingredient labeling, health warnings, and wine labeling—all are issues about which you are concerned; all are issues which affect the American public at large. My goal here today is not to announce decisions on any of these issues. None have yet been made. Each alone is probably sufficiently intricate to warrant more discussion than the time allotted to me here. Rather, my hope is to provide you with some insight about our perspective and to highlight some of the issues which must be addressed in the months ahead.

Probably the most significant long-range issue confronting us today is regulatory reform: Should changes be made in the manner in which the liquor industry is regulated? Should changes be made in the substance of those regulations, both those imposed by statute and those the result of agency rules?

I cannot answer these questions today with any precision. I can, however, say that they plainly require serious study and resolution. This has been clear to me from the day I assumed my responsibilities last summer. It was revealed by the multitude of liquor-related issues described in the briefing book given me on the day I arrived. It was accentuated by a mere reading of the Federal Alcohol Administration Act and some of the relevant regulations.

The volume of regulation and control—covering trade practice rules, production methods, advertising, labeling, tax collection, and so on—impressed me then. It continues to impress me as various issues reach my desk on a regular basis.

Another thing struck me immediately in addition to the complexity of the regulatory requirements—the apparent competition among regulatory agencies. FDA, FTC, ATF, whatever their initials—they all appeared to have a regulatory claim over you. And their assertions of authority, it was clear, were not always coordinated.

This, then, is what I perceived when I surveyed the situation: An agency—ATF—working hard to administer a detailed and complex regulatory scheme; the appearance of jurisdictional jealousies; and a regulatory scheme based on a statute passed 43 years ago as we emerged from Prohibition. The need for careful study of the liquor regulatory scheme was clear. And that is what we are doing.

Now, I have already said that our study has not yet produced any answers. What I would like to share with you are some of the underlying conceptions which will

contribute to those answers. I do not think you will find these conceptions particularly novel; they are also plainly easier to recite in a speech than to implement in practice. I hope, however, that they will assist you in understanding our goals.

The first underlying premise is that simplicity is a critical goal of any scheme. When I was a trial lawyer, I used to observe some of my colleagues develop highly ingenious theories of proof, which involved the use of detailed and complex evidence. Such theories worked well in the office; they generally failed in the courtroom. Their complexity made them unintelligible to the jury, and thus unpersuasive to them.

So, too, with regulatory schemes. What is imaginative and logical in the office may fail in real life. As the language of regulation becomes more detailed and complex, inconsistency and confusion are likely to follow. The result will soon be that of a system that ceases to be understandable to the regulated, or helpful to the consumer. Simplicity is thus an essential—though admittedly highly illusive—goal.

Our second premise is that destructive competition among enforcement and regulatory agencies is bad. I say this so often that some of my colleagues in Washington, I think, are tired of hearing me use this refrain. But as a prosecutor I have observed the impact of this kind of competition firsthand—it is not beneficial to anyone; it causes investigations to be more difficult and causes a loss in necessary public confidence. So, too, with the regulatory world—destructive competition helps no one, neither the regulated nor the consumer.

If destructive competition is bad, how are we to avoid it? As a general matter, we try to do so simply by coordinating our efforts where we have overlapping responsibilities. It is important also, however, that the lines of responsibility be drawn as clearly as possible. For us this means looking at the responsibilities of various agencies—ATF, FTC, FDA, and the Justice Department—and seeing if the lines of authority really are clear. Now as you know, this raises a significant issue. There is one school of thought which believes that liquor is not a special commodity; that FDA, the FTC, and the Justice Department should exercise fully their responsibilities over this industry; that there is no need for a single agency dedicated solely to liquor. Others feel equally as strongly that the opposite is true.

This is obviously a core issue. From any perspective one of the strongest arguments in favor of continuing the single agency concept is the dedicated manner in which the men and women of ATF have carried out their responsibilities and the expertise concerning the liquor industry which they have, as a group, developed. We certainly should not recommend a change in the single agency concept unless we were convinced it would mean real improvement. In any event, it will be important no matter what specifically is proposed, or not proposed, that ultimately responsibility, and thus accountability, for all aspects of regulatory enforcement is as clearly defined as possible.

The third underlying premise is the need to develop a better definition of criminality as it applies to conduct in the liquor industry. We are increasing our reliance on the criminal sanction in appropriate cases, particularly where there is no voluntary disclosure. And, as you know, the Federal Alcohol Administration Act makes a wide variety of conduct criminal, but only slightly criminal. That is, those who violate many of its provisions may be called criminals, but the potential jail sentences are virtually nonexistent.

This, I believe, leaves all in an uncomfortable position. The notion that particular conduct is criminal is a serious one: We should not lightly ascribe this characterization to particular acts. It should be reserved for conduct that society truly intends to condemn. We should recognize also that the criminal sanction is not the only alternative for a government seeking to regulate conduct. Civil penalties, license suspensions, and injunctive relief: all can be effective enforcement tools.

Thus, one key thing that must be considered is to review the conduct now proscribed by the FAA; to define that which is really criminal and to provide real criminal penalties for that conduct and define that which is not and for it provide other sanctions.

Finally, any analysis of this question must have one additional underlying premise: A recognition of the unique history of liquor as a product. It is the only product banned by one constitutional amendment and allowed by another. It is a product which produces for various levels of government an extraordinary amount of revenue; yet it

is a product which also has always been understood to have important health implications for those who overuse it. While it is not clear whether all these qualities have specific logical significance, it is clear that it is part of the reality of understanding your industry, and its concerns, as well as the concerns of the public.

The issues of regulatory reform are not simple. Their resolution will involve examining regulations we have issued, as well as the underlying statutes. That will take time! There is no certainty that it will be decided to make major proposals.

At the same time, however, issues exist which must be decided under the existing framework. What, for example, should we do about the various labeling issues? I would like to spend a few minutes describing what we view as some of the considerations involved in an analysis of these issues.

Labeling is undoubtedly one of those regulatory issues which always seem to be with us. We are struggling with some aspects of it right now. How should one address such issues? Plainly there are a variety of factors present. They often point in opposite directions. All, however, must be considered and balanced.

First, the value of the proposal must be analyzed—will it assist the consumer, will it avoid deception, will it deter some questionable processing? Regulation can provide a positive benefit to society. It can, however, be an unnecessary burden when it becomes an end itself. Both of these truisms must be remembered.

Second, the cost of any proposal must be considered. We recognize that by adding to industry's costs, we inevitably are adding to the prices we all must pay. While the cry of increased cost cannot be allowed to become a claim that defeats all proposals, it is one that plainly cannot be ignored. And it must be considered at two levels—in determining whether to impose a requirement and, also, how any requirement should be implemented. We sometimes forget that if we put in the effort and remain flexible, regulations can be designed in a way to minimize their cost while still accomplishing basic goals.

Third, and finally, we must consider the appropriateness of imposing particular requirements. This issue has legal aspects; it also has highly philosophical implications. There are many different views as to the appropriateness of government intervention in private conduct. It is, I believe, important to assure that our citizens have adequate information to make reasonable choices in the consumer market. At the same time, there plainly is some point at which a requirement becomes too detailed, too intrusive. We undoubtedly will not always agree when that point has been reached. It is important that decisionmakers, however, always remember that such a limit exists as they wrestle with particular issues.

These, then, are some of the issues confronting us. Issues of regulatory reform are never simple. Those involving the determination of appropriate requirements always involve honest conflicts. One thing, I hope, is clear. We understand that wisdom does not reside in Washington alone. Policy—if it is to be both wise and workable—must be the product of many minds and many ideas. On all the issues I have discussed today—and those others that may arise—we want your views; we want the views of other interested individuals and groups, both business and consumer. We cannot always agree with everyone. Hopefully, however, by learning all we can and trying to act rationally, we can minimize our mistakes and improve the quality of what we try to do.

Exhibit 23.—Statement by Assistant Secretary Davis, May 4, 1978, before the Subcommittee on Crime of the House Judiciary Committee, on proposed firearms regulations

I very much appreciate the opportunity to discuss with you today various proposed regulations designed to reduce the criminal misuse of firearms. With me is Rex Davis, Director of the Bureau of Alcohol, Tobacco and Firearms (ATF).

I believe that these hearings are very timely. We are in the midst of a comment period on these regulations; this period will close on May 22. It is, therefore, an important time for us all to take steps to make certain that those interested in these matters have an accurate understanding of what is being proposed. I am not certain, however, that is

currently the case. Much of the debate we hear, and the comments we receive, claim that these regulations would create a national registration system or complain that they represent an attempt to prevent the sportsman or law-abiding citizen from acquiring or keeping a firearm. These regulations would do neither. They create no registration system. They add no new restrictions on the ability of private citizens to purchase firearms. They usurp no congressional prerogatives. They involve only what Congress has authorized and what the public has a right to expect—that we seek ways to enforce our current laws more effectively. They are aimed at identifying the criminal who uses a weapon, and those individuals who are his sources of supply. Hearings such as these will assist in removing some of the confusion which has been created by some private interest groups concerning the scope of these regulations.

At the outset I would like to set out some of the underlying premises and general goals involved in proposing these regulations. Our basic goal, of course, is to strive to improve the manner in which we enforce existing firearms laws. In doing so one of our principal premises is recognition of the fact that the explicitly stated purpose of the Gun Control Act of 1968 was “to provide support to Federal, State and local law enforcement officials in their fight against crime and violence* * *”. One of the principal ways we can do this, of course, is to trace weapons found at crime scenes or otherwise used in crimes.

Another of our operating premises is that violent crime continues to be a serious problem and that firearms continue to be used in many of these crimes. In 1976 over 12,000 murders, 190,000 robberies, and 120,000 aggravated assaults were committed with firearms. Approximately 12,000 people were killed in that year alone with firearms. From 1967 to 1976, over a thousand police officers were shot down in the line of duty. Last year 94 police officers were shot and killed in the line of duty. As the agency charged with responsibility for enforcing our firearms laws, the Treasury Department believes that it should take those steps it can to seek to provide our police officials—and particularly those at the State and local level—with increased capabilities to meet this growing problem.

Our third operating premise is a belief that we have to try to develop an approach which involves something other than simply adding an endless number of agents to the Federal payroll. ATF's Concentrated Urban Enforcement program, Project CUE, for example, involved the assignment of over 200 additional personnel to only 3 cities at a cost of over \$8 million. It is unrealistic to suggest, however, that we will be able to add similar numbers of agents to all our cities. What is needed, therefore, is a program which impacts not just selected cities, but which provides benefit to all parts of our country. What is also needed is a program which minimizes the need for additional resources by providing a basis for more effective targeting of those resources we have.

And finally, another of our premises is to concentrate our efforts on the lawbreaker, not the law-abiding citizen. Information must be available so we can track down the criminal, without affecting those who obey our laws.

It is with these thoughts in mind that proposed new regulations were drafted. They are designed to—

- Increase significantly the ability of ATF to trace firearms used in crime;
- Provide ATF with essential information to identify unusual flows of firearms to particular areas or dealers so that resources can be meaningfully targeted;
- Allow a more organized effort against the problem of stolen firearms which are used in so many crimes;
- Assist State and local governments who are seeking to deal with the problem of street crimes.

By taking these steps we hope to enhance the ability, first, to apprehend those who use firearms in crime and, second, to identify—and, where possible, stop—sources of firearms which are entering the illegal market. The ultimate beneficiaries of these proposals will include State and local police officials, law-abiding gun owners, and the public at large.

The proposed regulations can provide us with these improved capabilities without putting new restrictions on the ability of citizens to acquire firearms, without adding to the burdens of firearms ownership, and without creating any national file or registry

of citizen purchasers or owners of firearms. These regulations would help take weapons from the criminal; they would not make it easier to take weapons from our law-abiding citizens.

Now I would like to summarize for you specifically what these regulations, if implemented, would require. While the package of regulations published on March 21 has a number of provisions, the three principal aspects would require the following:

1. That licensees—not private citizens—promptly report to ATF all thefts and losses of firearms by manufacturers, wholesalers, and dealers;
2. That quarterly reports be made to ATF of all commercial transactions between licensees, that is, from manufacturers or importers to wholesalers, from wholesalers to retailers, from retailers to other retailers; and
3. That each firearm manufactured or imported into the United States contain a unique serial number.

These proposed regulations do not place any requirements on individual citizens. Rather, they only affect licensees who are engaged in the business of manufacturing, importing, or selling firearms. In addition, and given the statements of some, we cannot be too clear on this point: These regulations do not require the name or address of citizen purchasers or owners of firearms to be reported to ATF; they do not require purchasers or owners to register their firearms; and they do not create a "national registration system." We have not suggested such requirements in these proposals and we have no intention of issuing regulations which would involve such requirements. Any decision to impose such requirements should require legislative action by the Congress. This is simply not a first step to gun registration. Nothing in these regulations would make it easier for Congress to adopt such a program.

While some have questioned the authority of the Department to issue these regulations, it could not be more clear that the Secretary was given full authority by the Congress to impose these requirements. Section 923 paragraph (g) of title 18, chapter 44 specifically provides:

(g) Each licensed importer, licensed manufacturer, licensed dealer, and licensed collector shall maintain such records of importation, production, shipment, receipt, sale, or other disposition, of firearms and ammunition at such place, for such period, and in such form as the Secretary may by regulations prescribe. Such importers, manufacturers, dealers, and collectors shall make such records available for inspection at all reasonable times, *and shall submit to the Secretary such reports and information with respect to such records and the contents thereof as he shall by regulations prescribe.* [Emphasis supplied.]

Authorization for the unique serial number is found in section 923 paragraph (i) of the act. In addition, section 926 gives the Secretary of the Treasury general authority to issue regulations. These regulations therefore represent no more than an attempt by the Treasury Department to faithfully enforce a law passed 10 years ago by Congress. We believe it is long past time such an effort was made.

I would now like to explain in more detail how the information secured by these proposals could be used. The first way would be to enhance our ability to trace firearms used in crimes. To understand the benefits which would accrue, it is necessary to understand how the current tracing system works, and what its drawbacks are.

While in a crisis case, such as an assassination or mass murder, ATF can trace a firearm very quickly, it is misleading to assume that the isolated exceptional case is at all typical. The average case takes weeks, not minutes.

Under the current system, after receiving the request for a trace, ATF must call the manufacturer or importer and various wholesalers before ultimately contacting the retailer. Studies have indicated that there are an average of three commercial transactions before the gun is sold to the retailer. Of course, in each instance, ATF must await the answer from one licensee before contacting the next one. Once the retailer is finally identified, ATF or the law enforcement agency who requested the trace then contacts that retailer to find out the name and address of the individual who purchased the firearm. Under current rules, retailers are required to keep names and addresses of purchasers of firearms. These regulations would not change this.

This trace by telephone system, despite the efforts of ATF, simply does not meet the needs of our law enforcement agencies, Federal, State, or local. Last year ATF attempted only 62,498 traces, 55 percent of which were for State or local officials. The Bureau actually lacks the capacity to expand this number of traces and is forced into the extraordinary position of not encouraging law enforcement officials to seek its assistance in tracing guns used in crime. When one considers the large numbers of robberies, assaults, murders, narcotics cases, rapes in which firearms are used, this inability to trace a firearm is unacceptable. This creates a gap in the nation's efforts to fight crime.

Attempting a trace is not, however, completing it, and the current system makes success difficult to achieve. In fact, in 1977, of the 62,498 traces attempted, 45 percent were incomplete. In 10,000 of these failures, the inability to complete the trace was caused by the unavailability or incompleteness of the records that the licensees were required to keep at their premises. Records are often reported lost or destroyed and it is impossible to complete the trace.

Even when we can complete a trace, the current system often produces unfortunate delays in doing so. There are three categories of traces: Urgent, expedite, and routine. Where urgent, the goal is to complete the trace in 24 hours, where expedite, in 4 working days, and where routine, in 7 working days. Approximately 76 percent of all traces are routine, 19 percent expedite, and 7 percent urgent. Even these rather long time limits are often not met: As of April 5 there was a backlog of 23 urgent requests, 177 expedite requests, and 390 routine requests. Our best estimate is that the *average* urgent trace took 2 days; the average expedite took 8 days; the average routine case took 11 days. When there are difficulties with retail or wholesale records these averages can double or triple. This delay becomes even more distressing when it is only commonsense that the speed with which police receive evidence may determine whether they can solve the crime. Thus a fast and successful trace can be the difference in determining whether or not local police are able to apprehend a murderer, a rapist, or a robber.

Ideally, we should trace any gun used in a crime or found at a crime scene. Where a suspect has been apprehended, such a trace could identify possible criminal associates, provide leads as to how the gun got into the criminal market, supply additional evidence to assure successful prosecutions, and solve earlier thefts of firearms. Where the gun, but not the suspect, is in custody, tracing can provide at least an assist in identifying the criminal. But, as you can see, our capability to do this is plainly insufficient.

These regulations promise to correct this situation. If the proposed system were in effect, ATF could skip the intermediate steps and not bother the manufacturer, wholesaler, and so on. They would have this information already and within hours or even minutes be able to identify the final retail seller. The problem of incomplete or unavailable records would be diminished. The service would be fully available to State and local, as well as Federal, law enforcement officials. An important part of the assistance Congress wanted us to provide when it enacted the 1968 Gun Control Act would thus finally be available.

In addition to enhancing its tracing ability, these regulations, as I mentioned at the outset, would also provide information necessary for ATF to more effectively develop strategies of enforcement and target its resources. As you are probably aware, there are approximately 170,000 individuals who are licensed by ATF to engage in the business of manufacturing, importing, distributing, or selling firearms. Under Federal firearms law, ATF has the responsibility to regulate the interstate commerce of firearms, ensure that licensees are complying with the law, and identify those diverting weapons illegally. However, as you know, under current regulations there is no requirement that copies of the record of transaction with other licensees be sent to ATF. The Bureau therefore lacks the ability to target their inspection or investigative resources so as to focus their attention on dealers where there is reason to believe they may be engaged in illegal commerce or the selling of firearms on a regular basis to criminals. Instead, for example, inspections inevitably must be on a more random basis than is desirable.

These regulations will change this situation. They will provide ATF with essential information to identify unusual flows of firearms. ATF could then assign its inspectors and agents to investigate those areas or dealers who are receiving firearms in quantities that may not be explainable by the demands of normal legal business. With such information to guide its efforts, the average law-abiding dealer would be bothered less by the Government. Those possibly abusing their license and selling into the criminal market would, however, receive more attention, as they should.

There is another benefit to this proposal, one not usually associated with reporting requirements. Ultimately it will reduce the recordkeeping burden now placed on licensees. Currently it is necessary to require that records of firearms transactions be maintained indefinitely. This is essential if firearms traces are to always be possible. Under these proposals, however, this would no longer be necessary. ATF would have the information it needs. Record retention requirements could then be reduced, easing the burden on our licensees.

Also, once the system is fully operational, licensees would probably have to respond to fewer requests from ATF to assist in traces.

Other aspects of these proposals would also assist our enforcement efforts. A unique serial number would include in one number all that is necessary to submit for a firearms trace; would avoid confusion for the street officer seeking to determine what information or numbers he must submit; would end the duplication in numbers used by different manufacturers; and would simplify the computerization of this information. This change is long overdue.

The theft reports would enable ATF and local police to address more effectively the problem of stolen firearms. As you may know, it has been estimated that stolen weapons are used in 20 percent of all crimes committed with firearms. Though there is some voluntary reporting, under current regulations there is no requirement that a licensee report a theft or loss of a firearm. Without knowledge of a theft, however, there is no way local or Federal law enforcement can investigate the incident. Thus, law enforcement in some cases also is unaware of the problem until the firearm is used in a crime. Knowing when a gun was stolen would help identify the criminal who uses it in a crime. In addition, with more complete information on firearms thefts, vulnerabilities in the distribution process would be identified, so that methods to remove them could be developed.

The regulations proposed on March 21 also include other provisions. One would require members of the military to obtain authorization prior to importing weapons for their personal use. Civilians must do so now. The other proposals seek to simplify and revise certain procedures relating to the importation and transportation of various weapons. In addition, they would require licensees to supply information when needed by ATF over the telephone. Most do so on a voluntary basis now.

The comment period for these regulations is scheduled to close on May 22. We are, of course, interested in the arguments and information these comments will provide. We know, for example, the advantages of requiring a unique serial number; we need to obtain a better notion as to the costs to industry, as well as any suggestions for alternatives. So, too, with the other proposals. We welcome all comments so that the most meaningful decisions on this matter can be made.

We have, of course, already received many comments. Support has come from the National Conference of Mayors and the League of Cities; the International Association of Chiefs of Police (IACP), which has 11,000 members; the Police Executive Research Forum, comprised of the police chiefs of 50 cities; the Police Foundation, which did an extensive 2-year study of the problem of firearms abuse; and various police chiefs. We also have letters from individual police chiefs in support. The NRA and the firearms lobby have opposed the regulations even though they are aimed at tracing firearms used in crimes and do not affect, in any way, law-abiding gun owners and purchasers.

We expect many additional comments. They will take time to sort and analyze. A final decision will be based upon this analysis. Because of this process there is no possibility that implementation could be earlier than sometime in 1979. Whenever they are implemented, we will have to come to Congress for the necessary funds. If implemented in their current form, it is our estimate that the costs will be approximately

\$4.1 million. The administration's fiscal year 1979 budget submitted to the Congress contains no funds with which to implement the regulations.

In sum, we have proposed these regulations as part of an effort to use our current firearms laws more effectively in the fight against crime. They take no really dramatic steps; they create no national registration system; they usurp none of Congress' authority. Rather, they are simply an attempt to do what all—both pro- and anti-gun-control people—have urged us to do to enforce existing laws more effectively and to direct our attention at the criminal misuser of firearms.

Exhibit 24.—Press release, June 9, 1978, concerning revocation of ban on melting 1-cent coins

The Treasury Department announced today that the regulations prohibiting the exportation, melting or treating of one-cent pieces have been revoked. [31 CFR Part 94—Coin Regulations]

The ban on the exportation, melting or treating of one-cent coins was imposed by the Secretary of the Treasury in April 1974. The restrictions were placed into effect primarily because high copper prices at the time made it potentially profitable to melt one-cent coins for their metal content or to export them. Violations of the regulations carried a statutory penalty of up to \$10,000 and/or 5 years imprisonment.

Because of changed economic conditions, including stabilized copper prices and the large inventory of one-cent coins maintained by the Government, the Department has determined that the prohibitions are no longer necessary. The revocation became effective on June 7, 1978.

Exhibit 25.—Statement by Assistant Secretary Davis, July 20, 1978, before the Subcommittee on Courts, Civil Liberties, and the Administration of Justice of the House Committee on the Judiciary, concerning H.R. 214, the Bill of Rights Procedures Act

I appreciate the opportunity to appear before you today in order to present the views of the Department of the Treasury concerning H.R. 214, the Bill of Rights Procedures Act. While I will refer to the other titles, the focus of my testimony will be on title I of this bill. This title would substantially affect the manner in which Government agencies may obtain access to bank, credit, and telephone toll records. It would create a legally recognized right of individuals, corporations and other associations in any such records which pertain to them, but are in the possession of third parties. The general approach taken by this title would be to bar Government access to these records until the individual or association has an opportunity to object to their production and whenever such an objection is interposed, until the Government prevails in a judicial proceeding.

The issues of Government access and privacy raised by this title have been matters of controversy for some time. This is largely due to the fact that they appear to bring into confrontation two highly desirable goals: The need for a system of government which enables its citizens to be and feel free from unnecessary official scrutiny, and the need for a system of justice which protects our citizens against violence, assassination, corruption, fraud, and other criminal activities in as effective and efficient a manner as possible.

Because of legitimate and deep concerns over achieving this latter goal, the executive branch has in earlier administrations simply opposed virtually all proposals such as those contained in title I. We no longer do so. The Treasury Department has spent much time in recent months discussing this issue and, along with the Department of Justice, we are prepared to support legislation incorporating the principles of title I, although we believe that certain amendments are essential in order to place the law enforcement-privacy goals in proper balance. We have not, however, come to this position because

we believe that adoption of our proposal will be cost free for our enforcement-type activities; we recognize, as you should, that it has the potential for a certain amount of investigative delay and loss and will put some added burdens on our courts and prosecutors. We are prepared to support this course of action instead because we believe it responds to a genuine need to provide added safeguards against the erosion of the privacy of our citizens, while meeting the essential needs of our law enforcement and regulatory agencies.

As Assistant Attorney General Heymann has previously told this subcommittee, the Justice and Treasury Departments recently have had occasion to offer draft legislation incorporating our position to another committee considering legislation similar to title I. A copy of that draft has been submitted to this subcommittee for its consideration. Before discussing the principal provisions of this proposal, however, I would like briefly to articulate with more specificity some of the underlying, and in part competing, principles and concerns which Treasury sought to balance in developing its position on this matter.

First, as I mentioned previously, we accept the validity of the need to provide protection for financial records. It is necessary to develop more clearly stated rules governing access to financial records. In the mere adoption of rules greater discipline is introduced into the record acquisition system, reducing intrusions into private records which are only of marginal value to investigators. Also, we recognize that whatever rules are established, some instances of abuse are possible. It is thus desirable that any proposal provide an opportunity for those instances to be identified and remedied.

Second, and certainly central to consideration of this issue, is a desire in selecting the appropriate rules to minimize any genuine risk to the performance of the missions of Treasury's various agencies. Treasury currently has agencies with diverse responsibilities. Protecting the President and Vice President of the United States, as well as visiting heads of state; guarding against smuggling and customs fraud; enforcing our tax laws; regulating national banks; administering laws concerning blocked assets and economic sanctions; regulating the liquor industry; and enforcing laws involving dumping, currency transactions, counterfeiting, forgery, and the illegal use of firearms and explosives are just some examples. Many of these responsibilities have special needs. As an example, in protecting the President, speed without notice to those involved is often critical. For all, however, it is important that any proposals recognize that undue delay may mean lost leads and diminished momentum. Similarly, in all cases, care must be taken that procedures to regulate access do not mean that in actual practice there is no access to information which is legitimately needed. Also, it is necessary to consider the reality of many criminal investigations—the risks of flight and illegal obstruction of inquiries and the danger to individuals in particular situations.

Third, we believe it appropriate to minimize the impact of these proposals on the criminal justice system as a whole. The trial and pretrial stage—when a case is actually pending—has generally been the time when questions about the investigative phase were litigated. Therefore, the extent to which there is more routine judicial intervention in this earlier stage adds to the burdens being placed on an already congested judicial system. Opportunities to litigate and generate delay in the investigative phase also may lengthen further a process which many believe already takes too long for all involved. Additionally, at a time when we are striving to enhance interagency cooperation and avoid duplicative efforts, it seems desirable that an approach be avoided that routinely mandates repetitive investigations or otherwise unnecessarily complicates our criminal justice system. We are not unmindful of the fact that adding too much to the burden on the various aspects of the criminal justice system runs the risk of lessening the speed and quality of justice felt by the many who get caught up in that system.

These, then, briefly were some of the underlying concerns which we considered and which we urge this subcommittee to consider. I would now like to highlight some aspects of the proposal which we support. Assistant Attorney General Heymann has already articulated many of the key issues and we join in the statement he submitted to you last week.

Challenge procedures

Among the most important aspects of the Justice-Treasury proposal is a modification of the challenge procedures from those contained in H.R. 214. We strongly believe that generally investigations require speedy access to records. This is necessary, among other reasons, so that leads can be pursued in a timely fashion before evidentiary trails become more difficult to follow or disappear; so that investigative momentum can be maintained; and so that the large volume of matters involved can be handled in an efficient fashion. In order to accommodate this need we have offered several suggestions.

Initially we believe that the time period in which a customer may act to prevent access should be relatively short and that a time limit should be established by which the judge must decide the matter. Also, it is important that appeals by customers from adverse rulings should not be allowed during the investigative phase. To do so would generate an opportunity for delay which could stymie particular investigations. Instead, we believe it sufficient to allow appellate remedies to be pursued after the completion of the investigation. Our proposals contain provisions implementing these proposals.

An additional major change in this aspect of our proposal would be to place on the customer the initial requirement of going forward to prevent the government from gaining access to the customer's record. H.R. 214, in the case of administrative subpoenas and summonses, would enable someone to prevent access simply by objecting to the Government agency. This is the same general approach taken in the Tax Reform Act of 1976. While experience under that statute is still insufficiently complete to provide much guidance, it does appear so far that this approach invites the interposition of frivolous or casual objections which accomplishes no more than the generating of delay and adding to the Government's workload. We would require more of a customer who wishes to object to government access. In essence we suggest that a customer be required to file with the appropriate court a simple affidavit and motion to quash setting forth the basis for the objection to the access. Of course, once the customer makes a showing that access may be improper, the Government should have the burden of proving that access to the records is being sought for a legitimate law enforcement purpose.

Other provisions in our proposal would toll relevant statutes of limitations while challenges are being processed, require recordkeepers to process requests during the notice period, and authorize *in camera* showings by the Government. These suggestions are designed to avoid provisions designed to enhance privacy from being misused simply to generate delay or obtain otherwise unauthorized criminal discovery.

Access through process requirement

A principal aspect of H.R. 214 would prohibit all access to financial records except by legal process and thereby eliminate any ability to obtain "informal" access to such records. What this proposal fails to consider, however, is that many investigative agencies which have legitimate need for access to such materials in various of their investigations have no summons authority. If such a rule were adopted, the impact on Treasury agencies would be substantial. The Secret Service totally lacks summons power; the Bureau of Alcohol, Tobacco and Firearms has it only for tax and Federal Alcohol Administration Act cases, not for firearms or explosives investigations; Customs has it for most, but not all its investigative jurisdiction as does the Office of Foreign Assets Control; and the IRS lacks it for its critical internal affairs anticorruption efforts.

If the requirements of H.R. 214 are unchanged, many necessary inquiries—ranging from forgery to threats on our elected leaders to bribery of IRS employees—would be seriously impeded. An available alternative would, of course, be the earlier use of grand jury procedures where it is necessary to obtain access to financial records. We believe that to force such reliance on the grand jury is unwise. It invites abuse of the grand jury system; it means that minor matters which would otherwise be resolved without a grand jury inquiry will be forced into that system; it will adversely impact the ability of investigative agencies to organize their workload and would place added and

unnecessary burdens on both prosecutors and the grand jury. Additionally, the grand jury is not available where the inquiry is civil and not criminal.

If H.R. 214, or similar legislation, is adopted, either necessary administrative summons power should be conferred on agencies needing it or an alternative procedure must be created. The Justice-Treasury proposal chooses the latter alternative. We urge that there be a formalization of "informal" agency access by requiring the use of written requests by agencies that lack summons power. These requests would be issued under regulations promulgated by agency heads and would be subject to the notice and challenge provisions of this legislation.

Of course, third-party recordkeepers would not be required to produce records pursuant to a written request; they would instead be permitted to do so. Like the Justice Department, however, our support for this procedure is based upon our belief that recordkeepers, who would not be liable for good-faith reliance on government representations, would be prepared to cooperate with legitimate inquiries.

Exceptions

While accepting the general concept contained in H.R. 214, we believe that certain exceptions are necessary from the notice and challenge provisions. These exceptions are of two kinds: First, from only the prenotice provisions, and second, from the requirements of notice altogether.

We believe that delayed notice is required in several general situations. The first relates to emergency situations where immediate access is required if injury to person or property or flight is to be avoided. This exception is particularly important where the matter relates to an ongoing crime such as the kidnapping situation referred to by Assistant Attorney General Heymann in his testimony. In these situations no impediment to immediate access should be allowed and notice can be provided after the fact.

We also are concerned that in certain other circumstances provision be allowed for notice to be delayed until after access is obtained. This exception should operate in those circumstances where there is reason to believe that giving notice would (1) endanger life or physical safety, (2) cause flight from prosecution, (3) cause the destruction of evidence, (4) result in witness intimidation, or (5) otherwise jeopardize an investigation, trial, or ongoing official proceeding. In these circumstances the Government agency seeking the delay would be required to seek a court order authorizing it to do so. We feel strongly, however, that the opportunity for delayed notice where these showings can be made is important since in the everyday world of criminal investigations the potential for these consequences is real. While generally we agree that delays under this provision should be for specified time periods, in one circumstance we believe it important that the court have the authority to grant indefinite delays. This circumstance involves disclosures of records obtained by the Office of Foreign Assets Control in the course of its investigation. In these cases the owner of the account may be a foreign national of, for example, Vietnam or Cambodia and notification to the owner may also mean that the involved government may learn of its existence, subjecting the owner or those associated with the owner to risks of physical reprisal. If the court finds such a risk exists, delay should be indefinite.

In some circumstances, we believe that it is unnecessary to require even delayed notice. One such situation is where the information being sought is only the name, address, account number, and type of account of any customer or ascertainable group of customers associated with a financial transaction. This exception thus covers only what is on the account signature card; if information about actual transactions in the account is sought, the notice provisions would fully apply.

This exception is intended to reach two kinds of situations. First, it would cover those situations where a forged check or other instrument has been processed by the financial institution. In these circumstances the fact of the criminality is apparent but this account information is necessary to pursue the inquiry. This would involve a relatively large number of routine inquiries now made by letter to banks during the course of the many forgery investigations by the Secret Service. To impose the notice requirement in this situation would, we believe, unnecessarily complicate this relatively simple process without materially enhancing the privacy interests involved.

This section would also reach circumstances where the Government had information that an illegal transaction had taken place, but it did not know the particular account involved. Thus, for example, upon learning that a large amount of cash generated by a criminal activity had been deposited in a particular bank, the Government would be able through use of process or formal written request to identify the account involved. Again, however, in order to examine transactions in the account the Government agency would have to comply with the notice provisions.

Another exception in our proposal to the notice requirement is when access to records is sought by the Secret Service for the purpose of conducting its protective responsibilities, or when access is in connection with conducting foreign counter or positive intelligence activities. We believe that in these circumstances even after the fact notice would be very harmful to the execution of these responsibilities. In these circumstances, the agency involved would certify to the financial institution that grounds for an exception exist and the institution would be prohibited from notifying its customer that access has been obtained.

Finally, we believe that this title need not apply when the records are being sought in an inquiry or proceeding directed at the financial institution itself. This would involve "redlining" or other similar investigations. In such a circumstance any conceivable privacy right of the customers involved is clearly outweighed by the burden and cost of giving hundreds or thousands of customers notice, standing, and an opportunity to litigate in a case where their interest in the underlying case is highly speculative.

Miscellaneous provisions

As I noted above, we support the various modifications reflected in Mr. Heymann's testimony and in the draft legislation submitted to this committee. In particular, we share the Justice Department's belief that information lawfully obtained may have legitimate uses apart from the purposes for which it was originally obtained. It is, we believe, unnecessary and would add unneeded burdens to require each agency to resubpoena the same records. We believe, therefore, that this committee should not amend the Privacy Act in this legislation. We are particularly concerned that H.R. 214 as drafted would prohibit the routine referral of investigative matters from investigative agencies to the Justice Department for prosecution, would inhibit the conducting of joint investigations, and would prevent the transfer of information even when it contains evidence of a crime within the investigative jurisdiction of another agency. We also believe that this proposal should not prohibit the bank supervisory agencies from exchanging information with other bank supervisory agencies since all share a common responsibility.

Our proposal also adds to the list of supervisory agencies the Secretary of the Treasury with respect to the Bank Secrecy and Currency and Foreign Transactions Reporting Acts. Under these laws, the Secretary is required to monitor the compliance of financial institutions with the requirements of those statutes. Thus, in that instance, the Secretary has responsibilities equivalent to the bank regulatory agencies themselves.

Finally, we concur with the views previously expressed by the Justice Department concerning the penalty provisions of title IV, the uncertainty as to the desirability of including telephone toll records in the current legislation, the exclusion of the grand jury, and the limiting of this proposal to natural persons and not to corporations and other legal entities. Similarly, we also share their view that Congress should not be excluded from the provisions of this bill as is now the case under title V.

Titles II and III

Title II of H.R. 214 refers to mail covers. We concur with the views expressed by the Department of Justice on this issue. We believe, however, that the statute should include as a basis for mail covers investigations conducted by the Secret Service in connection with its protective responsibilities.

Title III relates to electronic surveillance conducted pursuant to 18 U.S.C. 2510 et seq. As to these matters, the Treasury Department is considering whether to seek an

added amendment to 18 U.S.C. 2516 to include certain statutes enforced by the Customs Service. No decision has yet been made on this point by the Department.

Title III also includes an amendment to section 2516 which would regulate supervisory observing of employees. The Internal Revenue Service does do some monitoring of this type. We believe that this telephone monitoring is essential to the IRS to ensure quality control of service to the public by taxpayer service and collection personnel. Where telephones are clearly marked as subject to monitoring and monitoring policy is known to employees through written training materials, their privacy interests are adequately protected. We are concerned that requiring duplicative special consents by employees would be impracticable because employees might unreasonably withhold such consents and frustrate our quality control program. The language of the bill should thus be clarified to eliminate the implication that any notice other than that contained in the training materials is required.

We have no position on the other issues raised by this title.

Exhibit 26.—Statement by Assistant Secretary Davis, July 25, 1978, before the Subcommittee on Aviation of the House Committee on Public Works and Transportation, on explosives tagging

I very much appreciate the opportunity to appear before this subcommittee in order to discuss the explosives tagging provisions of H.R. 13261, an "Act to Combat International Terrorism." With me today are Mr. J. Robert McBrien, my special assistant for matters involving terrorism and intelligence, and Mr. A. Atley Peterson, Special Assistant to the Director of ATF for Research and Development. Mr. Peterson, who has served as Chairman of the Advisory Committee on Explosives Tagging since 1973, will present more specific testimony on how tagging works.

If adopted, this legislation would provide Treasury with the necessary authority to require that all nonmilitary explosives carry unique elements—taggants—which permit identification and detection. Identification taggants would remain intact after a bomb explodes and enable the type of explosive used to be identified and traced. Detection taggants would enable the presence of a bomb to be established before it exploded.

While we have proposed certain modifications to the provisions of H.R. 13261, the Treasury Department strongly urges the adoption of explosives tagging legislation. It would provide us with critical tools in the battle against terrorists and others who use explosives illegally: It would help us apprehend the bomber, and it would help save lives and preserve property by preventing explosions from taking place. Our proposed changes, however, would explicitly require that taggants be safe, available, and technologically acceptable before we may require them to be inserted in explosives.

Bombing is a particularly vicious and indiscriminate crime, and it is a clearly deliberate act of violence. One does not, in a moment of intense anger, grab his bomb from a closet and blow up his spouse or neighbor. The bomber actively 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. At the same time, the consequences of the bomber's action are severe: 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.

The Treasury has, therefore, been working in recent years to determine whether explosives taggants could be developed to assist in the investigation and prevention of bombings. A technical advisory committee, including all Federal agencies interested in explosives control and the Institute of Makers of Explosives, the Sporting Arms and Ammunition Manufacturers' Institute, the International Association of Bomb Technicians and Investigators, the American Society of Industrial Security, the Airline Pilots Association, and representatives from various universities, was created in 1973. In addition, because of the importance of technical expertise in this area, Aerospace Corp. was retained in order to provide technical systems management. While Mr. Peterson's statement includes more detail on the technical status of the program, as a general matter we are ready to tag the cap-sensitive explosives—that is, the dynamites, water

gels, and slurries—for identification. If the facility for manufacturing those taggants was built, we could begin the identification tagging today. But it will not be constructed until the taggant manufacturer knows that it will have customers, and the explosives manufacturers will become customers only by Congress passing legislation which requires that they use taggants. We believe that the production facility will be finished and producing taggants within 12 to 18 months after the law is enacted. It also appears that the availability of sufficient numbers of taggants is the only technical constraint on identification tagging of most high explosives.

If this legislation were to pass, the expected implementation date for identification tagging of other explosives is: Black and smokeless powders, June 1980; detonators, September 1980; cast boosters, September 1980; fuse and detonator cord, January 1981.

Progress is also being made in the detection tagging area. Our experts believe that pilot detection tagging can begin in late 1979 for dynamites, water gels, and slurries. Testing should have been completed by then since much of the applied research and advanced development are already in process.

For other detection tagging we have projected the practical readiness for national implementation as follows: Black and smokeless powders, March 1980; high explosives and detonators, April 1980; fuse and detonator cord, September 1981.

It is clear that the addition of identification taggants to commercial explosive materials or their boosters will better enable law enforcement authorities to trace the explosive material from a bomb scene to its last recorded owner and, hopefully, to its ultimate user. The chances of solving more bombing crimes will be improved when identification tagging is introduced. In addition, many valuable investigative hours now necessarily spent attempting to identify the last legal owner of the explosives involved can be saved.

From Treasury's perspective, the vital issue as to identification tagging is whether the crimes solved and the deterrence established will be worth the effort and costs of requiring the identification 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 concludes, and we believe, that the value and cost-effectiveness of identification tagging is clear.

With tagging, bombers can only lose. And we believe the costs for the manufacturers, dealers, and users of explosive materials will be entirely reasonable. An inflation impact study was conducted by Aerospace Corp. in March 1977. It found that the tagging program would not have a major inflationary impact.

The possible price increases in explosives as a result of tagging for identification were estimated at merely 1 1/4 cents per pound of explosive; and while research on detection tagging is still continuing, we believe it will be less. Ultimately, when identification and detection taggants are combined into one microunit, there should be more cost reduction.

If identification tagging is a real benefit to law enforcement, a successful detection tagging program is critical. The bomb is intrinsically a weapon of terror. Bombing is a crime that is carried out secretly and without warning. A bomb is small and lightweight. It can be hidden easily. Through a time delay mechanism or a motion-activated detonator, it can be concealed (or mailed) and then abandoned by its creator. The bomber can choose his explosive device, select his target, and plant his bomb. But once he has left it, every passerby becomes a random target as it explodes without warning.

The need, therefore, is to develop the ability to detect the presence of a bomb before it explodes. Substantial progress in developing a working capability to tag explosives so that they may be detected before exploding has recently been made. And it is this part of the tagging program from which the greatest direct benefits to the public safety can be expected. With detection taggants added to explosive materials and 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 predetonation 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—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.

I would now like to discuss some of the points that have been raised during hearings. Initially, it has been suggested by some industry representatives that the Federal Government should buy the tagging materials and distribute them to the explosives manufacturers. There has also been a suggestion that the Government should bear the liability for any adverse results of explosives tagging.

It is the Treasury Department's belief that the Federal Government should not interpose itself in the commercial chain and create an artificial and unnecessary "middleman" between the producers of taggants and their customers, the manufacturers of explosive materials. The function of Treasury's Bureau of Alcohol, Tobacco and Firearms with respect to the explosives industry should be to develop the requirements and to monitor the execution of the tagging programs. The BATF function clearly should not be that of an unnecessary, bureaucratic intruder in the marketplace. We believe either role—that of distributor of taggants or insurer of manufacturers—should be reserved for private enterprise where it will be accomplished as guided by normal market forces and business management interests. Any involvement of the Federal Government in this middleman role is unnecessary and would create an unfortunate precedent. In addition, the problem of administering a program in which the Government is liable for a defective explosive caused by a taggant only cannot be overestimated. Establishing this causal connection would be extremely difficult and accomplish little other than increased legal fees for attorneys. We sincerely hope the subcommittee will not add any requirements of this sort to H.R. 13261.

In hearings on this issue certain groups have sought to eliminate black and smokeless powders from the coverage of the tagging program. Mr. Chairman, we believe that this attempt should be strongly resisted. The issues raised are not real; they are based on fancy, not fact. As discussed below, black and smokeless powders are used in a substantial percentage of bombings. When used they kill; they injure; they destroy property. The failure of the Congress to include these two forms of explosives would serve as an invitation to the terrorist and the criminal to rely more and more on these unexplainably excluded powders. The entire intent of the tagging program would be undermined.

Those urging this exception have raised two principal arguments opposing the use of taggants on black and smokeless powders. First, it has been argued that we are seeking to impose tagging requirements for black and smokeless powders before it is safe and feasible to do so. That is not true.

The Senate antiterrorism bill, S. 2236, contains language to ensure that tagging will be safe to users and weapons alike and will not be imposed prematurely. That is in subsection 12(t) of S. 2236. We drafted that language for the Senate bill, and it is the amendment which we most strongly urge be adopted for H.R. 13261. We are committed to the standards set by that provision; we *will* adhere to them; and even if they were not in the legislation, they would still be applied. Taggants for each class of explosives should not be required until the all-around safety, performance quality, and environmental impact of the tagged explosive are established through rigorous research and testing. In addition, a tagging requirement should only be imposed if the taggant itself has the requisite longevity, survivability, and uniqueness to accomplish its task. The tests conducted to date, which have been carried out by the explosives manufacturers themselves, have established that the identification taggants will be safe indefinitely.

It is because tagging technology and the readiness and adequacy for implementation varies according to the type of explosive that we have recommended in all Treasury testimony that tagging legislation should include greater discretionary authority and flexibility for the Secretary in determining what explosive materials should be tagged and when. But as soon as these conditions are met for each class of explosives, it is important that we have the authority to require the inclusion of these taggants as soon as possible. Maximizing the safety of our people requires no less.

The second major aspect of this false issue regarding black and smokeless powders is the charge that Treasury is seeking to achieve gun control through ammunition control. Again, that is not true. We are well aware of the controversy the notion of gun control generates. This is not a gun control issue, and you should not allow yourselves to be deceived into believing it is.

We stated during our Senate testimony, and reaffirm today, that we are not seeking to require the introduction of taggants into small caliber, commercially produced, fixed ammunition. The contents of commercially manufactured fixed ammunition are rarely found in bombs and are generally impractical for the bomber to use.

It is not appropriate, as some have done, simply to refer to black and smokeless powders as "propellant powders." The impression conveyed by this expression is that black and smokeless powders are used only to fire bullets and that somehow they lose their character as a favorite implement of bombers and acquire innocence by being used to propel ammunition. That is not true.

The fact is that the same type of 1-, 2-, and 5-pound cans of black and smokeless powders used by some sportsmen and musketry enthusiasts are the sources of the second most commonly used explosive fillers in bombs. Black and smokeless powders *are* explosives; they blow up.

Let us examine the facts. We have prepared brief comparison tables in order to demonstrate clearly that our information on the use of black and smokeless powders in bombs is not mere conjecture; and, indeed, agrees conservatively with information developed by the FBI.

The incidence of black and smokeless powder bombs in 1977 has been monitored by BATF and the FBI separately. Since the reporting of bombing crimes on a nationwide basis is not perfect, there are some differences in their final data and the FBI reports a higher percentage of incidents involving black or smokeless powder bombings. If all reported bombings are used as a basis, including incendiary devices and the unidentified explosives, BATF reports show black powder use at 12.4 percent and smokeless at 7.4 percent—a 19.8-percent total. FBI data reports 15.6 percent for black powder, 17.8 percent for smokeless, to equal a total of 33.4 percent of bombings.

If we calculate the percentages for reported bombings only when the explosive is identified, we find: Black powder equals 18.2 percent (FBI) to 22.5 percent (BATF) and smokeless powders account for 13.5 percent (BATF) to 20.5 percent (FBI); these total to 36.0 percent (BATF) and 38.7 percent (FBI). If we exclude incendiary devices from these data and use only "explosive bombs," we have BATF reporting 31.3 percent for black powder, and 18.7 percent for smokeless powder, a total occurrence in 1977 bombings of 50 percent. The comparable FBI statistics are: 24.2 percent, 27.3 percent, and a total of 51.5 percent.

The incidence of death and injury from bombings was calculated on the basis of BATF data by MSA for the period April 1975 through July of 1977. In that study, black and smokeless powders accounted for 18.8 percent of the 388 recorded injuries. That equals 73 injuries.

Among the 78 fatalities, black and smokeless powders were responsible for 19.3 percent of the deaths, that is, for 8 deaths. BATF's latest statistics, covering January 1976 to May 1978, show that black and smokeless powders are responsible for 12 percent of the bomb deaths in that time and 20 percent of the bomb injuries.

The MSA study also examined the types of targets of bombings and the explosives used against them. Black powder accounted for, among other bombings, 27.2 percent against schools, 12.9 percent against private residences, 8.5 percent against vehicles, 6.4 percent against transportation facilities, and 10.4 percent against Federal, State, and local government. Smokeless powder accounted for: Schools, 14.7 percent; private residences, 10.3 percent; vehicles, 10.4 percent; transportation facilities, 6.4 percent; Federal, State, and local government, 13.3 percent.

Black powder was not used against law enforcement agencies but smokeless powder was used in 12.5 percent of those bombings.

As these various figures show, the truth about black and smokeless powders is that they constitute a very major part of the bombing crime problem. While they certainly

do not carry the explosive force of dynamite and other high explosives, they are a significant part of the bombing problem. Black and smokeless powders are found, along with other explosives, in the bomb factories of domestic terrorists and other criminals. FBI figures reflect that in 1977, 90 percent of the domestic terrorist incidents in the United States took the form of bombings. BATF investigators believe that every known terrorist group in this country has, at some time or another, used black and smokeless powders. Just recently an Associated Press story of July 13 described a case in which New York police uncovered what was reported to be an FALN—the Puerto Rican terrorist group—bomb factory. Among the explosives found on the scene was black powder.

The proportionate use of black and smokeless powders in bombs is very significant. Only 400,000 pounds of black powder are commercially available to the public each year out of 600 million pounds of cap-sensitive explosives. The mathematics are simple: Black powder represents only 0.067 percent of the total available commercial explosives, but it is used in 12 to 16 percent of the bombings. Thus, its use in crime is several hundred times greater than its proportional availability.

Smokeless powder is very similar. It represents only 0.83 percent of the total cap-sensitive commercial explosives available (5 million pounds out of 600 million pounds). Yet smokeless powder is used in 7.4 (BATF) to 17.8 (FBI) percent of bombing crimes. Again, its criminal use is very many times greater than its proportional availability.

Mr. Chairman, as I said above, if black and smokeless powders are not included within the taggant program, if, as in subsection 12(u) of H.R. 13283, a nearly identical bill, they are excluded from tagging, then the explosive materials used in a major proportion of current bombings will not only escape these safeguards, but the criminal-terrorist will also be provided with an obvious alternative to those explosives which can be traced or detected through taggants. We do not believe this result can be justified to the American people.

It is our view that this legislation should require the insertion of taggants in all types of cap-sensitive commercially available explosive materials which are used in crimes. The Secretary would then have the authority, applying the standards in the proposed language, to impose the specific requirement for each class of explosives within a reasonable time after the taggant for that class has been successfully tested and is available. The Secretary would exempt those classes of explosives not yet ready for tagging.

Mr. Chairman, the benefits of tagging are clear. It will not, however, provide a panacea, instantly solving the problem of explosives crime. Identification tagging will help solve some bombings, not all. Detection tagging does not mean that all bombs will immediately be detected. Together, however, they will meaningfully advance our ability to deal with the bombing problem, and may deter some from using this deadly instrument. Those would be major advances.

One thing is clear, however: 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 critical, 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 is ready to be tagged now; others will be shortly. We therefore urge that this legislation be passed during this session. We can then 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.

The Treasury Department deeply appreciates the attention which the subcommittee and you, Mr. Chairman, are giving to the problems of bombings by terrorists and other criminals and the tagging of explosives to help fight this severe crime problem. We believe that all responsible Americans share a desire for all explosive materials commonly used in criminal and terrorist bombings, when operationally feasible, to be required to contain both identification and detection taggants.

We will gladly work with the subcommittee to achieve a final version of H.R. 13261 which will accomplish our mutual goal of a workable scheme for requiring the tagging of explosive materials for identification and for detection.

Exhibit 27.—Excerpt from statement by Under Secretary Anderson, August 7, 1978, before the School for Bank Administration, Madison, Wisc., entitled "The Bank Secrecy Act: Challenge for American Banking"

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Although the act gave Treasury extremely broad powers to require recordkeeping and reporting of financial transactions, the Department has chosen a moderate course, striving to accomplish the goals of the statute without imposing unnecessary burdens. The regulations apply mainly to the banking and securities industries and set standards which reflect prevailing industry practices. They include the following provisions:

- Banks, savings and loans, securities brokers, dealers in foreign exchange, agents of foreign banks, and other institutions are required to retain the original or a copy of: Each extension of credit in excess of \$5,000 except for those secured by real estate, and records of instructions for the transmission of credit, funds, currency or other instrument, check, or securities of more than \$10,000 out of the United States.
- Banks and bank-type institutions such as savings and loans and credit unions must also retain a variety of records for each deposit or share account, especially those pertaining to transactions with foreign financial institutions.
- Also, securities brokers supervised by the SEC must obtain a signature card or similar document establishing trading authority over an account and make a reasonable effort to obtain a social security number for each account.

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

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

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

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

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

Overall responsibility for coordination and compliance with the regulations remains in my office.

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

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

Last year, the Miami Herald credited these reports with helping to identify a widespread drug operation in the Miami area. One of the transactions was in excess of \$900,000, and most of it was in denominations of less than \$100. Some of the deposits involved such large volumes of currency that it took three tellers 3 or 4 hours to count the money. Someone familiar with the investigation commented that the currency had to be converted into some other form because otherwise "you'd need a DC-6 to fly it to your holding bank."

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

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

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

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

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

Customs makes several hundred seizures of currency and monetary instruments each year under a variety of circumstances. In one case last month, agents seized some currency that a traveler had concealed in his wooden leg.

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

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

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

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

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

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

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

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

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

Part of the problem has been that Treasury needs to improve its analysis of the reports. We recognize that and have established a Reports Analysis Unit in our Office of Law Enforcement. With improved computerization and collation of the reports, we should be more sensitive to the data and better able to identify persons who habitually deal in relatively large amounts of currency, as well as banks which file an unusual number of reports or no reports at all.

The other part of the job is to develop greater awareness of banks' responsibilities under the act. Last year, one of the major New York banks was fined \$222,500 in connection with the failure to report 445 currency transactions amounting to several million dollars. The case came to light as the result of a narcotics investigation. Several

bank employees admitted receiving commissions on drug-related transactions which involved the exchange of \$1.8 million in small bills for larger bills, and no reports were filed. The activity took place at several branches of the bank. It is my understanding however, that no senior executives were implicated and that the internal auditors were unaware of the situation.

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

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

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

Exhibit 28.—Statement by Assistant Secretary Davis, September 14, 1978, before the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs, on the problem of arson for profit and Treasury's investigative role

I am pleased to have this opportunity to appear before you today on behalf of the Department of the Treasury to discuss the growing problem of arson for profit and the role of the Treasury Department in investigating those incidents. With me is John Krogman, Acting Director of the Bureau of Alcohol, Tobacco and Firearms; and William E. Williams, Deputy Commissioner of the Internal Revenue Service.

There can be no doubt as to the seriousness of the arson-for-profit problem. It has been characterized as the Nation's fastest growing crime; its cost is felt in human suffering as well as in extraordinary economic effects such as the loss of homes, businesses, and jobs; and it is a difficult crime for law enforcement to successfully detect, investigate, and prosecute. The impact of arson has not fallen on any single State or part of our country alone, but has affected all of our major urban areas in various degrees. The National Fire Prevention and Control Administration has informed us that there were approximately 150,000 arsons committed in the United States in 1976, and that the direct losses were estimated at approximately \$1 billion. In addition, we believe that there is evidence that in various areas arson serves as a source of income to organized crime.

Currently, the Treasury Department's role in the investigation or apprehension of those engaged in arson for profit lies with the Bureau of Alcohol, Tobacco and Firearms (BATF). The responsibility of the Bureau is to investigate violations of the Federal firearms and explosives statutes which prohibit the possession of many of the explosive and incendiary devices which are commonly used by arsonists. Therefore, BATF has statutory jurisdiction to investigate arsonists who employ certain proscribed devices to commit arsons. In addition, the Internal Revenue Service, whose mission is the administration and enforcement of our internal revenue laws, has the authority to investigate individuals or entities who fail to report their profits from arsons. As you can see, the Bureau of Alcohol, Tobacco and Firearms has a direct role to play in dealing with this problem, while, on the other hand, the Internal Revenue Service has a much more indirect responsibility in the arson area.

The Federal statutes which currently direct themselves at arson are the National Firearms Act, 26 U.S.C. 5801 et seq. (title II of the Gun Control Act of 1968), and title XI of the Organized Crime Control Act of 1970, 18 U.S.C. 841 et seq. Violations of both of these statutes may be punishable by fines of \$10,000 and/or imprisonment for up to 10 years. Justice Department officials will be appearing before this subcommittee and will be offering their views as to the effectiveness of these statutes as they relate to arson, as well as some other statutes which might be applicable such as those involving racketeer-influenced and corrupt organizations and mail fraud.

Arson, like many other crimes, involves a blending of Federal, State, and local jurisdictions and responsibilities. The Treasury Department believes that, at its core, arson is primarily a State and local crime. These entities have the basic responsibility to maintain public safety within their respective boundaries and, obviously, the

Treasury Department does not have the resources to actively investigate more than a small percentage of the arsons which are committed each year.

This does not mean, however, that we believe there is no Federal role in the arson area. To the contrary, the Treasury Department believes that organized and direct Federal involvement is necessary, and we have acted to provide it. BATF has already provided substantial assistance in attacking this problem and is currently directing its arson investigative activities to those instances where there is organized criminal involvement, white collar crime, and arson-for-hire rings which cross State lines in carrying out their illegal activities. We have also been committed to providing technical support and assistance to State and local law enforcement authorities.

In the past the Treasury Department has attempted, within its limited resources, to play an active role in combating arson and arson-related crimes, predicated upon ATF's enforcement of the Federal firearms and explosives laws. As the members of the subcommittee may know from the GAO report, the number of ATF arson cases cannot accurately be measured without great difficulty because what is now reported as an arson or arson-related offense, until January 1978 was reported as a violation of the Federal firearms and explosives laws. I am able to report, however, that between January and July 1978, ATF had 163 active arson-for-profit schemes under investigation nationwide, 75 of which were being conducted by ATF arson task forces.

I am also able to report that in cases where direct ATF investigative involvement at the State and local levels was precluded for jurisdictional reasons, the Bureau always stood ready to furnish technical and investigative assistance. For instance, during 1976 and 1977, ATF's 4 forensic laboratories provided technical assistance in over 2,000 arson cases and investigative assistance in 606 cases.

As the problem of arson grew, the Treasury Department in the past year has sought to develop new and more effective strategies within the Department to combat it. We have also recognized the need for a coordinated Federal effort and have initiated programs with other Federal law enforcement agencies.

I would like to share some of these initiatives with the subcommittee:

In January 1977, an ATF arson task force was established in the Philadelphia, Pa., area consisting of personnel from BATF, the FBI, the Postal Inspection Service, and Philadelphia police and fire investigators. This task force was created to assist local law enforcement authorities in arson investigations where violations of the Federal firearms and explosives laws were suspected. The task force was very effective and has led to the convictions of three individuals who had employed professional arsonists to burn down commercial structures for the purpose of defrauding insurance companies. The task force has also investigated nine other cases, three of which are now awaiting prosecution, and six others awaiting grand jury action.

In the fall of 1977, my office had discussions with the Justice Department concerning the feasibility of establishing arson task forces in the 23 Department of Justice primary and satellite strike force locations. The purpose of these task forces is to develop cases against organized crime and racketeering figures who are believed to be involved in arson schemes, and to assist State and local authorities in the investigation and prosecution of significant arson-for-profit cases.

During this same period of time, ATF investigative personnel met with officials of the Criminal Division's Organized Crime and Racketeering Section to develop specific investigative standards and guidelines to be used in determining when an arson-related organized crime or white collar crime should be investigated. The purpose of setting these guidelines is to ensure that the limited Justice Department and ATF resources would be utilized in the most effective manner by investigating only those cases where there was a reasonable likelihood of successful prosecution.

On February 1, 1978, the task force concept was approved. Beginning in March, ATF began training special agents in arson investigations and since then has trained 120 special agents. The special agents chosen for these assignments all underwent intensive instruction in the detection and investigation of arson-for-profit schemes at the Federal Law Enforcement Training Center in Glynco, Ga. Since then, ATF, in cooperation with the Department of Justice, also has held a seminar in arson investigative techniques for special agents in charge.

In January 1978, we also met with representatives of the Commerce Department's National Fire Prevention and Control Administration to offer our assistance at the

National Fire Academy in the training of State and local law enforcement and firefighting personnel in the detection and investigation of arson. Previously such training had been provided by ATF on only an ad hoc basis at the district level. Final arrangements for ATF participation have been made, and it is expected that ATF will begin assuming teaching duties at the Academy within the immediate future.

Because we have recognized the obvious interest that insurance companies have in halting the growth of arson and their wide experience in investigating this crime, we recently enlisted their cooperation in combating arson-for-profit schemes. For instance, in April and June 1978, ATF met with representatives of the Insurance Crime Prevention Institute and the Property Loss Research Bureau in order to obtain information regarding major arson-for-profit schemes, and to make arrangements for the future exchanges of information regarding detection techniques. Representatives of both organizations have pledged their full cooperation in support of the ATF arson task force projects. In the case of the Insurance Crime Prevention Institute, there were also arrangements made for ATF to participate on a limited basis in the instruction of new investigators.

Treasury recognizes that further initiatives will be required if the Federal effort against arson-for-profit schemes is to be fully effective, and as our experience grows we are prepared, within our resource capability, to undertake them. For instance, we know that there must be a better and more efficient procedure for sharing information on suspected arsonists with Federal, State, and local authorities. Studies to develop these procedures are now underway.

While we continue to believe that primary responsibility in this area should remain with the State and local authorities, we are committed to continuing our role in this area. However, we caution against heightened expectations that the Federal Government alone will be able to provide sufficient resources to attack this problem. It can only be successfully addressed by a coordinated Federal-State effort. This is a reflection of the fact that Federal resources, law enforcement and others, are not unlimited. This is particularly true of the Bureau of Alcohol, Tobacco and Firearms, whose proposed 1979 budget was severely reduced by the Congress. Nevertheless, we are determined to try to do what we can to try to meet this problem, even though our primary actor, BATF, may have less people to meet all its responsibilities.

Tax Policy

Exhibit 29.—Statement of Secretary Blumenthal, January 30, 1978, before the House Ways and Means Committee, on the President's tax program

I am pleased to appear before you today to discuss one of the President's highest legislative priorities for 1978—a significant revision of our Nation's tax laws. Last year, the administration thoroughly studied the present tax system. The President himself had extensive personal involvement. This study reaffirmed our view that the tax system should be made more equitable and simpler for the average taxpayer.

In recent months, it has become apparent that tax reform should be combined with substantial tax reductions. The continued growth of the economy requires tax cuts to sustain the purchasing power of individuals. And businesses must have adequate incentives and resources to modernize facilities and to create permanent jobs for American workers.

Therefore, the President submitted to Congress on January 21 a tax package that will attain three overall goals: Tax reduction for individuals, improvement of the tax structure, and increased incentives for business investment. The specific proposals to secure these objectives are closely interrelated: The gross tax cuts of \$34 billion are partially financed by \$9 billion in revenue-raising structural changes. Enactment of the tax reductions and incentives without the structural changes would result in an excessive drain on tax revenues and a serious distortion in the allocation of the tax burden. For this reason, the President offers his proposals in the form of a balanced tax program, and we urge Congress to consider these recommendations as an integrated package.

The President's tax package consists of the following elements:

- Net income tax reductions for individuals of \$16.8 billion, comprising gross tax cuts of \$23.5 billion and revenue-raising structural changes of \$6.8 billion.
- Net income tax reductions for businesses of \$5.7 billion, reflecting gross business cuts of \$8.3 billion combined with \$2.6 billion of structural reform.
- Excise and payroll tax reductions of \$2.0 billion.

This program will achieve major structural reform, but we have not attempted to correct all the inequities nor to simplify all the complications in the Code. What we seek through the President's proposals is enactment of structural changes that are urgently needed, but will not disproportionately consume the time of the committee. It is critical that a program of tax reform and reduction be passed in 1978, and we have devised a tax package that reflects the importance of expeditious action. Most of the reforms involve provisions with which this committee is familiar; and, in fact, many of the administrations's recommendations have been approved by the committee in recent congressional sessions. We believe our tax package can be fully considered and adopted this year.

The remainder of my statement will outline the principal features of the package. A detailed technical explanation is being submitted for the convenience of the committee and other witnesses. In addition, I have attached to this statements exhibits that contain revenue estimates and other statistical data.

The Importance to the Economy of a Balanced Program of Tax Reductions and Structural Changes

The economic importance of the tax program is emphasized after a review of our economy's recovery to date. When the President assumed office 1 year ago, our Nation's economy was making only a halting recovery from recession. The unemployment rate for December 1976 was 7.8 percent, with 7.5 million Americans out of work. In 1976, the economy operated at approximately \$120 billion below its high employment potential.

After surveying the economic situation in January 1977, the President offered a 2-year economic recovery package as one of his first official acts. Enactment of that stimulus program has had a favorable impact on economic conditions. The unemployment rate dropped almost 1 1/2 points during 1977 to a level of 6.4 percent as of the end of the year. Over 4 million more people are employed now than were employed 1 year ago, and a record 58 percent of the working age population now holds jobs. The real gross national product—the Nation's combined output of goods and services, adjusted for inflation—has grown at a rate of 5 3/4 percent from the fourth quarter of 1976 to the fourth quarter of 1977.

For the most part, the economic performance for 1977 has been encouraging. Nevertheless, an unemployment rate of 6.4 percent is still too high. This administration will not be satisfied as long as millions of Americans are jobless and billions of dollars of productive capacity of the business sector remain idle. It is imperative that steady economic recovery be sustained.

However, there are impending forces that threaten the recovery. In 1979, social security tax liabilities will be increased over 1977 levels by \$4 billion due to previously scheduled rate increases and by an additional \$7 billion due to changes enacted in 1977. Many individuals also face the prospect of bearing an "automatic" income tax increase, as inflation pushes taxpayers into higher rate brackets even though real purchasing power of incomes may remain constant. A combination of these and other tax increases would cause Federal receipts to assume an unacceptably large share of our Nation's gross national product. The result would be a significant slowdown in economic growth toward the end of this year, with the rate of real growth falling to about 3 1/2 percent in 1979. Unemployment would remain above 6 percent and, by the end of 1979, would be moving upward.

These developments must be averted by sound fiscal policy. The President has submitted a budget for fiscal year 1979 that will reduce the ratio of Federal spending to the gross national product from 22.6 percent to 22 percent. This administration is determined to release sufficient resources through income tax reductions to enable the private sector to take the lead in sustaining a strong economic recovery.

Therefore, a carefully fashioned, net tax reduction of \$25 billion is the centerpiece

of the administration's economic program. These tax cuts will maintain consumer purchasing power by offsetting both the scheduled social security tax increases and the impact of inflation on effective tax rates. The ratio of personal taxes and employee and self-employed social security taxes to personal income in 1979 will be brought down to the 1977 level, 14 percent. Without the proposed tax cut, the ratio would rise at least 1 full percentage point. At the same time, business tax reductions will provide incentive for investment to meet expanding demand and to furnish the tools of production for a growing labor force.

Together with the programs outlined in the President's budget message, this tax package should assure that our economy will grow at a 4 1/2- to 5-percent pace through 1979, with unemployment declining to about 5 3/4 percent by the end of 1979. Five million new jobs will be created—about 1 million more than would be created in the absence of a tax cut.

Yet, in fashioning a tax program that ensures steady and sustainable economic growth, we have been wary of providing excessive "stimulus." Enlarging the net reduction substantially beyond the \$25 billion level would put at serious risk the balanced, steady character of our economic recovery. The average recovery in the postwar period has lasted 4 years and has typically been destroyed by the appearance of rapid inflation or radical imbalances between the various sectors or elements in the economy. We are now in the third year of this recovery; and, as I have indicated, it is proceeding in a remarkably smooth and balanced fashion. We have experienced solid economic growth. There has been a steady reduction in the rate of unemployment. The inflation rate, while far too high, is not accelerating.

If the recommended net tax cut were significantly increased, an appropriate economic balance might well be upset. Private sector confidence in our ability to manage the Federal budget would be eroded, for we could make no progress in reducing the deficit. Financial markets would tighten, thereby blunting the effects of our proposed tax incentives for job-creating investments and injuring the housing sector. Finally, we would damage our chances of getting better control over inflation. A \$2 billion tax cut is required to maintain the momentum of economic recovery, but the risks associated with a larger net tax reduction are simply not worth taking.

Proposals to Provide a Tax System That is More Equitable, Simpler, and Less Burdensome for Individuals

Although the tax program is a central element of this administration's economic policy for the years ahead, it should not be assessed solely in macroeconomic terms. In devising the program—both reductions and structural changes—we have kept in sharp focus the tax system's impact on individual taxpayers. That system directly involves 130 million Americans annually in a process that has an important bearing not only upon their financial well-being, but also upon their perception of the quality of the Federal Government.

Unlike some systems in which a government determines the amount of tax due and sends the taxpayer a bill, the first formal determination of income tax liability occurs when an individual files his tax return. The withholding system and IRS auditing procedures assist the tax collection process. But in the end, the tax structure relies upon the honesty, trust, and diligence of individual citizens who are asked to calculate the share of the burden of public support.

In many ways, the tax system reflects our highest national ideals. It represents the active participation of Americans in the affairs of their government. And it reflects mutual trust between that government and its citizens.

However, if our system of self-assessment is to remain successful, it is essential that the tax structure be considered fair by taxpayers and that average Americans understand how their tax liability is computed. Accordingly, our tax program has been structured to address the important needs of individual taxpayers:

- The tax system should not claim too large a share of personal income incentives to work and invest must not be impeded by an onerous tax burden.
- The income tax burden should be allocated fairly among taxpayers. Individuals with similar levels of income should have similar tax liabilities, and the proportionate tax burden should vary among income classes in accordance with ability to pay.

- Tax calculations and return preparation should be comprehensible for average taxpayers.

I. Reducing the tax burden for individuals

The President recommends a gross tax reduction for individuals of \$23.5 billion, with offsetting structural reforms of \$6.8 billion. When both the reductions and reforms are considered, the typical family of four at the \$20,000 income level will save \$270, a 12.4-percent reduction in income tax liability. Commencing October 1, 1978, that family's withholding rates will be reduced so that it will then experience an increase in take-home pay and purchasing power.

The recommended tax reduction is needed to maintain the standard of living of American taxpayers. Without an income tax cut, scheduled increases in the social security tax will reduce the take-home pay of workers. In 1979, the family of four with one earner at the \$20,000 income level will bear an additional payroll tax liability of \$261 due to the combination of social security tax increases enacted prior to this Congress and the financing package that was enacted last year. I commend the members of this committee for facing up to the challenge of restoring the financial integrity of the social security system; large infusions of revenue were urgently needed to ensure social security benefits for future generations. Congress determined to accomplish that objective entirely through the payroll tax. Consequently, unless income taxes are reduced, payroll tax increases will drain purchasing power of American workers, stall the economic recovery, and impose a very onerous burden on low- and middle-income families.

The President's tax program will provide the necessary tax relief. For most taxpayers, there will be a net reduction in combined income and payroll tax liability through 1979 even after the scheduled social security tax increases are considered. Tables 1 and 2 compare the combined income and FICA taxes under 1977 law and the proposed law for 1978 and 1979. Included in the calculations are the FICA tax increases resulting from legislation enacted prior to 1977 as well as the increases contained in the Social Security Amendments of 1977. The tables assume a four-person, one-earner family with wage income at various levels. Our recommended income tax cuts will completely offset the increase in social security taxes for families with wage income up to \$25,000 in 1978 and \$20,000 in 1979. A substantial offset will result even above those levels. Only 16 percent of families have wage income of more than \$25,000 a year and 23 percent have wage income of more than \$20,000 a year. Tables 3 and 4 present similar information for a four-person, two-earner family, assuming that each spouse earns one-half of total family income; under these assumptions, the proposed income tax reductions for 1978 and 1979 will offset the social security tax increase up to \$30,000 of total family income.

In proposing this substantial income tax relief, the administration recommends a more equitable allocation of the tax burden. The President is committed to the principle that the net tax reductions should be focused on those individuals who need tax relief the most—low- and middle-income Americans. Through a combination of substantial tax cuts and needed reforms, the administration's program provides sizable tax reductions for low- and middle-income individuals who now shoulder a disproportionately large portion of the burden of public support; lowers taxes for most high-income taxpayers as well; and raises the tax liability of some persons who now use unjustified tax preferences to escape paying their fair share of taxes.

Over 94 percent of the income tax relief is provided to families making less than \$30,000, but typical families in every income class through \$100,000 will experience a tax cut. The net tax reductions are proportionately largest at the low end of the income scale. For example, families earning between \$5,000 and \$10,000 will have their taxes reduced by 22.6 percent. The percentage reduction is 9.7 percent for the \$20,000 to \$30,000 income class. In the income classes over \$100,000, some persons will have a tax reduction while those now using tax preferences may have an increase; overall for this group, the tax program will result in a modest tax increase of 3.7 percent. Stated in dollar terms, the typical family earning \$20,000 a year will save \$270 in taxes; on the average, a family at the \$100,000 income level will pay \$590 more.

In short, the administration's tax package will reduce the share of the total income

tax burden for each income class through \$30,000, thereby resulting in a decrease from 60.8 percent to 57.6 percent in the aggregate individual income tax liability that fall on those low- and middle-income taxpayers. Under current law, the effective rates of tax range from 0.2 percent for individuals with incomes under \$5,000 to 30.0 percent for persons making over \$200,000 annually. The tax program will have the effect of reducing effective tax rates for all income classes through \$100,000, with a new range of effective tax rates from -0.4 percent (reflecting the refundable earned income credit) to 31.7 percent.

Rate cuts.—The gross tax reduction for individuals will be accomplished primarily through a sizable cut in tax rates that will benefit every taxpayer. The proposed rate schedule for joint returns will range from a tax bracket of 12 percent for the first \$1,000 of taxable income to a rate of 68 percent on taxable income exceeding \$200,000. (These taxable income figures and all others I will discuss do not include the "zero bracket amount.") For single taxpayers, the 12-percent rate will apply to the first \$500 of taxable income and the 68-percent rate to taxable income over \$100,000. The present rate schedule covers a 14-percent to 70-percent span. A comparison of the old and new schedules is contained in tables 5 and 6.

This new rate schedule will provide the largest rate cuts in the middle-income brackets. For example, the marginal rate for each taxable income bracket from \$12,000 through \$24,000 on a joint return will be reduced by 5 percentage points whereas the marginal rates in income brackets above \$44,000 are generally reduced only 1 or 2 percentage points. Nevertheless, high-income taxpayers will also derive substantial benefits from these rate cuts—benefits that must be borne in mind when assessing the impact of the per capita credit proposal and the recommendations that will broaden the income base subject to taxation.

Per capita tax credit.—As a part of the substantial tax relief provided to low- and middle-income families, we propose a new tax credit of \$240 for each dependent. This credit will replace the current \$750 exemption for each family member and the general tax credit, which is now equal to the greater of \$35 per dependent or 2 percent of the first \$9,000 of taxable income. The existing tax benefits for family members vary directly in proportion to income level. A family of 4 in the 50-percent tax bracket now enjoys a tax savings of \$1,680 for dependents while a family earning \$10,000 save about one-third of that amount. By contrast, the \$240 credit will provide a tax saving of \$960 to a 4-member family regardless of income level. Due in large part to the new credit, the tax-free level of income for a family of 4 will rise to \$9,256 under the tax program as compared to \$7,200 under current law.

Although the per capita credit is being proposed in combination with a restructuring of tax rates, it may be helpful for the committee to know the credit's "break-even level" if presented as an isolated change. For a 4-person family with less than \$20,200 of income, the new \$240 credit will provide greater tax savings than the existing personal exemption and general tax credit, assuming no changes were made in the tax rate schedule. At that level of income, the family is neither better off nor worse off. The tax would be \$2,580 under either the \$240 credit or under existing law.

	Current law	Proposed law (assuming current law) rate schedule
Adjusted gross income.....	\$20,200	\$20,200
Less personal exemptions.....	3,000	—
Taxable income*.....	17,200	20,200
Tax before credits.....	2,760	3,540
General tax credit.....	180	—
Per capita credit.....	—	960
Tax after credits.....	2,580	2,580

* The example assumes the taxpayer has no itemized deductions in excess of the zero bracket amount. If the taxpayer had average itemized deductions equal to 23 percent of income, the break-even point would be \$22,078 of income.

I want to emphasize, however, that families above \$20,200 of income are not going to be worse off under the administration's proposal. The proposed rate schedules have been designed to offset the tax increases that would occur at high income levels if a \$240 credit simply replaced the existing personal exemption and general tax credit. What we achieve with the \$240 credit and the new rate schedule are: Equity—the credit for family members is worth the same regardless of the family's level of income; and simplification—one credit will replace the existing combination of a deduction and alternative credits. And these improvements in the tax system are accomplished without providing tax increases for families above the so-called break-even level.

Adoption of the per capita credit will also facilitate additional tax reductions the President may recommend to adjust for congressional action on the national energy plan. In April, the President proposed that Congress pass the crude oil equalization tax and rebate the proceeds to the American people on a per capita basis. This action is essential if we are to protect the real incomes of consumers. If the final energy bill includes the full rebate of the net proceeds of the crude oil tax, no further Presidential action will be required. However, if the final bill contains a rebate provision only for 1978, as provided in the House version, the President intends to recommend that the individual tax reductions proposed in his message to Congress be increased by the net proceeds of the crude oil tax.

II. Tax equity and simplification for individuals

The rate cuts and the per capita credit I have described will help achieve a more equitable and simpler tax structure. But those tax changes cannot stand alone. The \$23.5 billion of tax relief provided by these measures would have to be scaled down considerably in the absence of revenue-raising structural changes. Steady, noninflationary economic growth can be sustained only if we keep the net revenue loss of the entire package—including individual and business reductions—at approximately \$25 billion.

The structural changes are focused in part on serious inequities in the tax laws. Without such changes, tax relief simply cannot be focused effectively on those persons who are now bearing a disproportionately heavy tax burden—especially middle-income taxpayers. A tax program that provides large-scale relief to taxpayers would be inequitable if the benefits were fully shared by those already avoiding payment of their fair share of tax liability.

The proposed tax cuts are also closely interrelated with the administration's efforts to promote tax simplification. For many middle-income persons, the major source of complexity in the tax laws relates to itemized deductions. Average Americans are forced to assemble detailed records for tax purposes and to grapple with complicated tax forms and instructions in order to prepare a schedule for itemized deductions.

Changes in itemized deductions are essential if the tax system is to be simplified for middle-income taxpayers. We are recommending such changes. But we are also recommending substantial rate reductions in the middle-income classes—cuts ranging from 3 to 5 percentage points in each taxable income bracket from \$8,000 through \$44,000—that will more than offset the tax increases that would otherwise result from the proposed itemized deduction changes.

Changes in itemized deductions.—The administration's proposals continue the simplification efforts that began last year. In the Tax Reduction and Simplification Act of 1977, Congress worked with the administration to enact changes in the standard deduction that have increased the percentage of nonitemizers from 69 percent to 77 percent. We now recommend additional steps that will increase the percentage of nonitemizers still further, to 84 percent of all individual taxpayers. The changes we propose will enable over 6 million Americans to switch to the simple, flat standard deduction that was recently enacted and thereby avoid vexing recordkeeping requirements.

These proposals can accomplish drastic tax simplification without creating significant controversy. The recommended changes curtail deductions that add complexity and inequity to the tax system without advancing major objectives of public policy.

(1) State and local taxes. The special deduction will be eliminated for general sales taxes, personal property taxes, gasoline taxes, and miscellaneous taxes but

retained for State and local income and real property taxes. Most itemizers determine the amount of deductions for their State sales and gasoline taxes by reference to published tables that provide nearly uniform deductions and result in a relatively small tax benefit. Due to the fact that the tax benefit is so slight for itemizers and the fact that there is no benefit at all for the 77 percent of individuals claiming the standard deduction, deductibility is not a major factor for State and local governments in determining the rate of tax to impose.

This committee has already voted in connection with the energy bill to eliminate the deduction for gasoline taxes—a decision supported by the recognition that the deduction runs counter to our national goal to conserve energy. We propose that the committee renew that decision and also terminate the deduction for general sales taxes, personal property taxes, and miscellaneous taxes.

(2) **Political contributions.** We also recommend simplification of the presently confusing scheme of deductions and credits for political contributions. Under current law, a taxpayer can elect to claim an itemized deduction for the first \$200 of contributions. In lieu of the deduction, he may claim a credit for one-half of his political contributions, with a maximum credit of \$50. We propose that the political contribution deduction be repealed while the credit is retained. As a result, whatever incentive a tax subsidy provides for political contributions will be equally available to itemizers and nonitemizers and will not rise with the income level of the taxpayer.

(3) **Medical and casualty expenses.** Twelve lines on schedule A for form 1040 are devoted to computation of the deduction for medical and dental expenses. The form reflects a tax provision that is unnecessarily complicated and that results in recordkeeping and record-searching burdens for millions of taxpayers. Currently one-half of the first \$300 of health insurance premiums is deductible outright for those who itemize. Other medical expenses are deductible to the extent they exceed 3 percent of adjusted gross income, with this latter category of deductibility including the remaining portion of health insurance premiums and medicines and drugs in excess of 1 percent of adjusted gross income.

Another six lines on schedule A relate to a deduction for damage to property from a casualty such as a theft or fire. A casualty loss may be deducted only if it exceeds \$100 and is not reimbursed by insurance.

We propose that the deductions for medical and casualty expenses be combined in a new "hardship expense" deduction. This new deduction will apply only to medical and casualty expenses in excess of 10 percent of adjusted gross income. In the case of casualty losses, the excess over \$100 per casualty will be included in the computation. Medical insurance premiums, drugs, and medicines will be treated the same as other medical expenses. In this manner, tax return preparation will be simplified greatly, and the deduction will be available only to taxpayers whose ability to pay has been significantly affected by medical and casualty expenditures that can truly be considered "abnormal" in the light of the current relationship between medical and casualty costs and income.

Tax shelters.—The members of this committee are familiar with the basic concept of a tax shelter. Although shelter devices can assume a wide variety of forms and include a great diversity of activities, they share a common characteristic: "paper" losses generated by shelters are used by high-income individuals to reduce taxable income from other sources. Typically, shelter investments are made not because of anticipated economic productivity, but in anticipation of the various tax preferences that are packaged together by shelter promoters to provide optimum tax writeoffs. This draining of investment dollars into shelter activities creates economic distortions and harmful legitimate profit-seeking businesses.

Due in large part to tax shelter devices, there is now a wide disparity in effective tax rates among individuals with similar economic incomes. This phenomenon is especially prevalent in the upper income brackets. For example, some taxpayers with income exceeding \$200,000 effectively pay only 1 or 2 cents in taxes for every dollar of income received; other individuals are taxed at effective rates of about 60 percent.

Data recently compiled by the IRS graphically illuminate the disturbing impact of tax shelters. Through the use of tax preferences, thousands of affluent Americans are reporting poverty-level income for tax purposes. In 1976, tax preference items were enjoyed by 16,000 taxpayers statistically classified as having adjusted gross income below \$10,000. But these individuals are not members of the low-income class; on the average, each of them claimed \$35,000 of preference income. Our tax system needs significant improvement if it is to approach the objective of providing equal tax treatment for equals.

Congress is to be commended for its recognition of tax shelter abuses in 1976 and its innovative and forceful reform efforts in this area. The Tax Reform Act of 1976 contains important provisions designed to curtail shelter activities. The principal methods used in that legislation were revisions of the minimum tax on certain tax preference items and the adoption of an "at risk" rule that denies deductibility for certain paper losses that exceed an individual's cash investment and indebtedness for which he has personal liability.

Unfortunately, the 1976 amendments—significant as they are—have not ended shelter abuses. In fact, tax shelter activity may have increased during 1977. The National Association of Securities Dealers reports that over \$1 billion of shelters were publicly offered by its members during the first 9 months of 1977—a 30-percent increase over offerings for a similar period in 1976. And there is some evidence that unreported shelter deals may have increased even more dramatically.

The explanation for this high level of post-1976 shelter activity is simple. Promoters have adapted their operations to provide shelters in forms that were not substantially affected by the 1976 Act. The Internal Revenue Service is waging a vigorous campaign against tax shelter gimmicks, but it must be given stronger weapons.

The administration is not proposing any radically new approaches to this problem. Rather, in the light of experience, we are recommending that Congress build upon the efforts that led to reforms in 1969 and 1976. Flagrant tax shelter abuses must be curtailed.

In the administration's program, we are proposing several different methods of continuing the attack on tax shelters.

(1) Elimination of certain tax preferences. Some of our recommendations eliminate or limit directly a tax preference that makes shelter investments attractive. An example of this approach is our recommended reform of real estate depreciation. Shelter investments in such real estate projects as shopping centers and office buildings are attractive, in large part, due to the fact that depreciation may be claimed for tax purposes that far exceeds a realistic measurement of actual economic decline. Real estate shelters, in contrast to other major shelter investments, were left virtually untouched by the 1976 act. As a result, they have become even more popular.

Exceptions from the general rule will be granted until 1983 for new multifamily and used low-income housing, which will be permitted to use a 150-percent and 125-percent declining balance method, respectively. New low-income housing will remain eligible for a 200-percent declining balance method until 1983, and for 150 percent thereafter. In the interim period, the administration intends to analyze tax and nontax subsidies for housing. Our objective is to determine the need for subsidizing particular segments of the housing market and the most efficient means of providing needed subsidies.

In addition to reform of real estate depreciation, the elimination of two other shelter preferences is proposed. The administration recommends that the earnings of most deferred annuities, purchased for shelter purposes, be taxed currently to the purchaser. Also, we propose an extension of the 1976 act's accrual accounting rule relating to large corporate farms; under our proposal, accrual accounting will be required for most farming syndicates and the current exemption for large "family-owned" farm corporations (with gross receipts exceeding \$1 million) will be eliminated.

(2) Extension of "at risk" rule. Another administration proposal is designed to deal with a common shelter financing technique—the use of nonrecourse loans

to enable a shelter investor to obtain tax writeoffs greatly exceeding his own investment. "At risk" rules were enacted in 1976 to limit this abuse, but coverage was extended only to partnerships and certain specified activities of individuals. Action should be taken now to curtail the extensive shelter activities that have arisen in situations not expressly covered by the 1976 act; recent shelter promotions project tax writeoffs as high as \$170,000 for \$25,000 cash investment in such items as books, television programs, and lithographic plates. We recommend that the "at risk" rule be extended to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons.

(3) Restricting use of limited partnership as shelter vehicle. The attractiveness of the limited partnership as a shelter vehicle will be limited by the reform program. New limited partnerships with more than 15 limited partners will be treated as corporations for tax purposes so that shelter losses may not ordinarily be passed through the partnership to reduce the taxable income of the limited partners. An exception will be made for partnerships formed before 1983 to engage in the construction and operation of residential real estate, with the exception continuing after 1982 for new low-income housing as long as it remains eligible for accelerated depreciation. By 1983, the administration will have made recommendations to Congress as to what form of subsidy is appropriate to our housing needs.

(4) Auditing partnerships. We also propose that the Internal Revenue Service be authorized to implement tax audits of partnerships and to determine tax issues at the partnership level rather than being forced to proceed against each partner individually.

(5) Strengthening the minimum tax. Finally, the benefits available through excessive use of tax preferences will be restricted through a tightening of the minimum tax provision. In its current form, the minimum tax is imposed at a rate of 15 percent on the amount of certain tax preference items enjoyed by a taxpayer. However, the total amount of tax preferences can now be reduced by the greater of \$10,000 or one-half of an individual's regular tax liability before the minimum tax is applied.

We propose to eliminate the offset of one-half of regular tax liability so that the minimum tax will attack tax shelters more directly and effectively. High-income individuals will no longer be able to use their taxes on nonpreferred income to avoid the minimum tax on excessive preference income. On the other hand, those individuals with modest preference income will still be totally exempted from the minimum tax by the \$10,000 preference offset, and the minimum tax will not be applied to capital gain realized on the sale of a personal residence.

Termination of alternative tax for capital gains.—The current deduction for the long-term capital gains of individuals generally has the effect of taxing such gains at a rate that is one-half of the rate for ordinary income. During our intensive study of the tax laws, this capital gains preference was carefully studied. The study also included such matters as the partial integration of corporate and shareholder taxes and drastic rate reductions for investment income.

These aspects of the tax system are both controversial and relatively unexplored. Full consideration of the issues raised would require extensive congressional debate. Therefore, in order to expedite consideration of tax legislation this year, the program does not involve these matters.

We do propose in this tax package to eliminate what is left of the 25-percent alternative tax for capital gains. The effect of the current provision is to grant taxpayers in the highest income brackets an additional tax preference over and above the special capital gains deduction. Through the alternative tax, individuals above the 50-percent tax bracket can take advantage of a 25-percent tax ceiling on the first \$50,000 of capital gains.

The alternative tax cannot be said to benefit the middle-class investor. Its benefits accrue exclusively to persons with taxable income exceeding \$52,000 (if filing a joint return) or \$38,000 (if filing a single return)—less than 1 percent of all taxpayers. And for those families with taxable income in excess of \$200,000, the benefit is greatest

all. Those wealthy investors can use the alternative tax to exclude nearly 65 percent of \$50,000 of capital gains each year from taxation; by contrast, a family with income of \$50,000 a year can exclude only one-half of capital gains, and most workers are taxed on every cent of their wages and salaries.

This committee has voted on prior occasions to terminate this inequitable and complicating provision. I urge the committee to repeat such action this session.

Unemployment compensation.—We recommend that the current tax exemption for unemployment compensation benefits be phased out as an individual's income rises above \$20,000 for single persons or \$25,000 for married couples. Under the administration's proposal, 50 cents of unemployment compensation will be taxed for every dollar of total income (including unemployment compensation) received in excess of these income ceilings.

Dollars received as unemployment benefits are just as valuable as dollars received in any other form. Therefore, a continued exemption at middle- and high-income levels violates the tax policy principle that persons should be taxed in accordance with ability to pay. In the 1976 Act, Congress repealed the sick pay exclusion for workers at higher income levels on the grounds that sick pay is a substitute for wages and should generally be taxed in the same manner. This rationale should now be extended to unemployment compensation.

Reforming the tax treatment of unemployment benefits is especially important in view of the serious abuses that can be caused by the preference. In many cases, the unemployment compensation system serves not to relieve hardship but to discourage work for taxable income. For example, an individual can receive a substantial income every year through stock dividends and the salary from his 9-month job, take a winter vacation, and collect untaxed unemployment benefits. There is no reason we should continue to permit such persons to "beat the system" at the expense of their neighbors who work throughout the year for taxable wages.

Fringe benefits unavailable to rank-and-file workers.—The major tenet of tax equity—that tax liability be based on ability to pay—should also be considered by this committee as it examines certain employee fringe benefits. Application of the principle in its pure sense requires that compensation be taxed to an employee regardless of the form that compensation assumes. A worker who receives cash wages that he uses to provide benefits for his family should not ordinarily be taxed more heavily than the employee who receives those benefits directly from his employer.

Yet, the tax laws now contain numerous exceptions for various employee benefits. For example, if an employer establishes a medical insurance plan for his employees, the premium payments by the employer are deductible while neither the premiums nor the benefits are taxable to the employee. Favored tax treatment is also conferred upon certain pension plans, group life insurance plans, and employee death benefits.

Again, the administration is not proposing a radical departure from the current treatment of fringe benefits. Instead, we recommend congressional action to ensure that these tax preferences benefit rank-and-file workers as well as corporate management. Preferential tax treatment for these fringe benefits can be justified only as a means of ensuring that a wide range of employees are protected against such contingencies as illness, disability, retirement, or death. We should move closer to fulfilling that objective.

Accordingly, the President recommends the following proposals:

(1) Medical, disability, and group life insurance plans. The full tax exemption for employer-established medical, disability, and group life insurance plans will be denied if those plans discriminate in favor of officers, shareholders, and higher paid employees. Preferential treatment is now available to pension plans and group legal plans only if nondiscrimination standards are met. The tax laws should require similar nondiscriminatory treatment for workers in the case of these other types of employee benefit plans.

(2) Integration of social security and private pension benefits. Although there is now a nondiscrimination requirement for qualified retirement plans, such plans are permitted to cover only employees who earn amounts exceeding the social security wage base. When Congress established new nondiscrimination standards

in the Employee Retirement Income Security Act of 1974 (ERISA), this issue of proper integration of social security and private pension plans was expressly left unresolved.

In view of the fact that the social security wage base will rise to \$29,700 by 1981 under the recently enacted social security financing legislation, it is especially important that Congress act now to address this question left open by the 1974 ERISA legislation. It is unfair to grant tax preferences for private pension plans that exclude all low- and middle-income employees. We recommend that a new integration formula be enacted so that no qualified pension plan can provide benefits beyond social security for highly compensated employees unless all workers receive substantial coverage under the plan.

(3) **Employee death benefits.** We propose the repeal of the current exclusion for the first \$5,000 of payments made by an employer on account of the death of an employee. These death benefits typically represent deferred wages that would have been paid to a high-income employee, and they should not be given preferential tax treatment.

Entertainment and other expenditures for personal consumption.—For many average taxpayers, the inequity of current tax law is demonstrated most vividly by the treatment of entertainment expenses that are claimed as business deductions. The deductibility of entertainment expenses is a significant revenue item; approximately \$2.2 billion a year are lost to the Federal Treasury through the deductibility of expenditures for items such as theater and sports tickets, country club dues, yachts, hunting lodges, first-class air fare, and business meals. However, the recapture of a large revenue loss is not the only consequence of reforms the President recommends in this area. Of greater significance will be the effect on the morale of average taxpayers, who are now forced to subsidize the untaxed personal consumption of some of the most affluent Americans.

Some persons have become accustomed to living luxuriously on tax-deductible dollars. One individual deducted 338 business lunches in 1 year, skipping Thanksgiving Day but not the Friday, Saturday, or Sunday of Thanksgiving weekend. A surgeon deducted \$14,000 a year for maintaining a yacht where he allegedly “talked shop” with other doctors. And, another wealthy professional claimed a deduction of \$17,000 for the cost of entertaining associates at his home, at a country club, at sporting events, at restaurants, and at a rental cottage.

Yet, in spite of the disturbing impact on average Americans of such tax-deductible extravagance, some persons would have us believe there is really no tax preference involved—that reform in this area represents an antibusiness attitude without a sound basis in tax policy. These persons argue that business bears part of the cost of deductible entertainment expenditures and that business can, and should, determine which expenditures are nonproductive. Under this line of reasoning, entertainment expenses are viewed as being analogous to business expenditures for advertising or research, and any attempt to limit deductibility is seen as an interference with business decisionmaking.

This argument is dead wrong. Entertainment expenditures, unlike expenditures for advertising and research, confer untaxed personal benefits to the participants. Preparing or reading an advertisement is not comparable to dining at an elegant restaurant, sailing on a yacht, or attending a Sunday football game. Entertainment is more closely analogous to wages; they both provide personal benefits to employees. However, the tax collector withholds a portion of wages before they can be spent for personal consumption while entertainment benefits are now received tax free by employees.

Ideally, the preference for business meals and other entertainment expenditures would be eliminated by taxing the participants, but such an approach would obviously be very complex and disruptive. What we propose instead is to deny a deduction for entertainment expenditures to the extent they provide the participants with untaxed personal benefits. This is the approach Congress used in 1962 when business deductions for gifts were limited.

The President's recommendations are based on sound theories of tax law and public finance. Economists tell us that an employer's entertainment expenditures are wage

substitutes. Tax lawyers tell us that the law should deny the employer a deduction where compensation, in whatever form, is untaxed to the employee. Internal Revenue Service agents describe problems in trying to enforce a law that often becomes a test for a taxpayer's imagination and ingenuity. And, as the Secretary of the Treasury, I am concerned about the loss of billions of dollars in Federal revenue.

However, this issue will not be decided on such academic grounds. Nor should it. The general public realizes there is something wrong here. For example, Mr. Fisher has sent me the results of a poll which canvassed 22,000 of his constituents. This question was posed: "Would you favor or oppose elimination of business expense deductions for items such as lunches, club and other membership fees, and the first-class portion of air fares?" Over 72 percent said they would favor elimination of the deduction.

Public irritation will become increasingly evident as the "expense account" issue is debated in Congress. I doubt that Congress would appropriate direct Federal expenditures to subsidize elegant restaurants and the affluent individuals who dine there. There is no reason to permit these governmental subsidies to be provided indirectly through the tax system.

The President's proposals address this public concern. Let me describe them briefly.

(1) Tickets and certain other entertainment expenses. No deduction will be permitted for purchases of tickets to such events as theater performances and athletic contests. A deduction will also be denied for the expenses of maintaining facilities such as yachts, hunting lodges, and swimming pools, and for fees paid to social, athletic, or sporting clubs.

(2) Meals. Fifty percent of currently deductible business entertainment expenses for food and beverages will remain deductible, and 50 percent will be disallowed. A substantial portion of business meal expenses represents the cost of personal consumption that must be incurred regardless of the business connection. The 50-percent disallowance represents an approach that approximates the actual personal benefit involved and provides a reasonable, simple answer to the problem.

(3) Foreign conventions. There will be a modification of the rules in the 1976 act relating to the deductibility of foreign convention expenses. Current law now effectively permits taxpayers to deduct the expenses for two foreign vacations a year—as long as those vacations are packaged with the label of a "convention." We recommend that the two-convention rule be stricken. In its place will be a rule that denies deductibility for foreign convention expenses unless factors such as the purpose and membership of the sponsor make it reasonable to hold the convention outside the United States and possessions. This proposal will eliminate abuses while easing restrictions on conventions held in foreign countries for legitimate business reasons.

(4) First-class air fare. The 1976 act denied a deduction for first-class flights to foreign conventions. The President recommends that this rule be extended to tickets for domestic business travel. Although business travel constitutes a legitimate cost of producing income, the business purpose is served by purchasing a ticket at coach fare. Private extravagance should not be publicly supported through the deductibility of first-class air fare.

Municipal Financing

Interest on debt obligations issued by State and local governments is exempt from Federal income tax. There is also a current tax exemption for certain "industrial development bonds" that are issued by State and local governments for the benefit of private borrowers. In order to qualify for tax-exempt status, industrial development bonds must be issued to provide financing for certain facilities such as pollution control equipment, sports arenas and convention halls, airports, industrial parks, and the facilities (such as hospitals) of private, nonprofit organizations. There is also a "small issue" exemption for certain industrial development bonds where the amount of the bonds sold does not exceed \$1 million or the total capital expenses of the facility being financed do not exceed \$5 million.

This current structure for State and local bonds creates two problems. First, the present system is a very inefficient means of providing a Federal subsidy to State and

local governments; less than three-fourths of the revenue loss to the Federal Treasury actually accrues to State and local governments through lower borrowing costs. Second, the exemption is a major source of tax avoidance by wealthy individuals and by commercial banks, which retain for themselves the portion of the Federal revenue loss not accruing to State and local governments.

In the administration's tax program, we are recommending measures that will address both of these weaknesses in the current structure. A more efficient subsidy will be made available to State and local governments to reduce their borrowing costs below what a tax exemption alone can provide; and, at the same time, the equity of the tax system will be improved. Yet, our program retains the autonomy of State and local governments over the financing of their projects and preserves the freedom of State and local governments to issue tax-exempt bonds in whatever amounts they choose. It does not restrict State and local discretion to determine the governmental purposes for which subsidized financing is used.

Taxable bond option.—State and local governments will be given the option of continuing to issue tax-exempt bonds or of issuing taxable bonds which will receive a subsidy from the Treasury for a fixed percentage of the interest costs. The choice will be entirely a matter for State and local governments to decide. For bonds issued in 1979 and 1980, the subsidy will be equal to 35 percent of the interest costs, with the subsidy level rising to 40 percent for bonds issued after 1980.

This proposal is not intended to be a step toward elimination of the tax exemption, nor a movement to exert more Federal control over State and local decisionmaking. The taxable bond option is not an interim proposal, but a reasonable long-term solution to the problems of tax policy and public finance that have plagued the municipal bond area. A sizable tax-exempt market will remain; in fact, we project that 75 percent of State and local bonds will continue to be issued in tax-exempt form after an initial adjustment period of perhaps 5 years during which 40 to 50 percent of new issues might be taxable. It is our firm conviction that the addition of a taxable bond option to a tax-exempt market, which currently applies to a limited class of investors, will prove to be an enormous benefit for State and local governments. Borrowing costs on municipal debt will be reduced by about 15 percent whether bonds are issued in tax-exempt or taxable form.

Termination of exemption for pollution control bonds, bonds for the development of industrial parks, and private hospital bonds.—There will no longer be an exemption for interest on industrial development bonds for pollution control or for the development of industrial parks. The exemption will also be removed for bonds issued to finance construction of hospital facilities for private, nonprofit institutions unless there is a certification by the State that a new hospital is needed.

These activities are essentially for the benefit of private users. The tax exemption in such cases serves little or no governmental purpose but increases the supply of bonds in the tax-exempt market. The cost of municipal financing is raised as a result.

Municipal financing is injured particularly by the abundance of pollution control bonds in the marketplace. I will describe later our proposal to liberalize the investment tax credit for pollution control facilities so that Federal assistance in bringing existing plants into compliance with environmental standards can be provided in a manner that is much more efficient and less disruptive of the tax-exempt market.

Small issue exemption for economically distressed areas.—The existing "small issue" exemptions will be retained only for economically distressed areas; and, with respect to those areas, the \$5 million exemption will be raised to \$10 million.

Option for certain industrial development bonds.—Industrial development bonds that continue to enjoy tax-exempt status will be eligible for the taxable bond option with the same interest subsidy applicable to general obligation bonds of State and local governments.

Reduction and Reform of Business Taxation to Encourage Efficiency and Productivity

The business portion of the tax program is designed to encourage the productive investments needed to satisfy consumer demand, to create permanent jobs, and to move toward greater price stability. The President has recommended gross business tax reductions of \$8.3 billion in 1979 in a form that will provide efficient incentives for

investment in productive facilities and will apply equitably to a wide spectrum of businesses, affecting every industry and benefiting both small and large firms. Tied integrally with these gross cuts are business tax reforms that will eliminate tax preferences that have proved to be wasteful and inequitable. As in the case of individual tax reductions, the business cuts have been combined with reforms in order to ensure that Federal tax revenues are focused where relief is needed—both to make the tax system more equitable and to provide the maximum benefit to our economy.

I. Business tax reductions

Increased incentives for business investment are essential if we are to maintain a strong economic recovery. In recent years, the growth of our productive capital stock has not kept pace with the expansion of the economy or of its labor supply. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the fourth quarter of 1977 was still 3 percent below its previous peak reached in the first quarter of 1974.

The portion of our gross national product devoted to investment must be increased in the years ahead. As we look to the long-term needs of the economy, we must depend upon private businesses to provide permanent jobs for a growing labor force while meeting the goals of our national energy plan and providing a cleaner environment and safer workplaces. Vigorous business investment will also prevent capacity bottlenecks and price pressures that might otherwise occur as consumer demand increases.

The real income of workers can grow steadily over the years only if businesses increase productivity with investments in new machinery and more efficient plants. By providing substantial, permanent tax incentives for business expansion, the administration's tax program will help to create an atmosphere that is conducive to a continued economic recovery led by the private sector.

Corporate rate cut.—The President recommends a sizable rate cut for both small and large corporations. Effective October 1, 1978, the corporate tax rate will be reduced from 20 percent to 18 percent on the first \$25,000 of income, from 22 percent to 20 percent on the next \$25,000, and from 48 percent to 45 percent on income exceeding \$50,000. The highest rate will be reduced an additional point, to 44 percent, on January 1, 1980. These rate reductions will reduce corporate taxes by \$6 billion in 1979 and by \$8.5 billion in 1980.

The corporate rate cut will provide an impetus to capital formation in a simple and straightforward manner. The cash flow of businesses will be increased significantly; for a business with \$100,000 of taxable income, \$2,500 more in after-tax earnings will be available in 1979 and an additional \$3,000 in 1980 to provide internal financing for needed capital expenditures. The reduced tax rate will also increase the anticipated after-tax profits on investment projects and will thereby encourage businesses to increase capital spending. This increased after-tax return on corporate investments will stimulate external financing by making corporate stock more attractive to public investors.

Liberalization of the investment tax credit.—Needed business investments will also be encouraged by improvements in the investment tax credit. The President recommends that the credit be made available to a wider range of taxpayers and for a broader scope of investments. In addition, the present 10-percent rate will be made permanent—rather than reverting to the 7-percent level that is now scheduled to apply after 1980—so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

In addition to proposing that the 10-percent credit be made permanent, the President recommends the following extensions of the investment credit:

- (1) Application to industrial structures. The investment credit should be extended to utility and industrial structures as well as machinery and equipment. The current ineligibility of structures is based in large part upon the investment patterns that existed when the credit was first introduced in 1962; at that time, investment in equipment was lagging behind the investment in nonresidential

structures. Also, structures were then eligible for depreciation allowances that were even more favorable than those available today.

We are now confronted with a different set of circumstances. In contrast to the investment patterns in the early 1960's, a particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures; investment in structures reached its peak almost 4 years ago and is now 11 percent below that level. The tax preference for depreciation of structures has been reduced through the operation of the "recapture" rules and the minimum tax. In view of these developments, it is important that the investment credit be changed to remedy the existing tax bias against structures and to encourage balanced industrial expansion.

We recommend that the investment credit be available both for the construction of new utility and industrial structures and the rehabilitation of existing structures so that the proposal will have no anti-urban bias. Eligibility for the credit will provide five times more tax savings for investments in structures than does the current provision for accelerated depreciation. By combining our investment credit proposal with the repeal of accelerated depreciation for structures, we will provide a tax incentive that is stronger, more efficient, and much simpler.

The President recommends that this provision apply to construction costs incurred after December 31, 1977. In the case of new structures, there will be an additional requirement that the facility be placed in service after that date.

(2) Application to pollution control facilities. Currently, only one-half of the full investment credit can be claimed by a taxpayer who selects special 5-year amortization for pollution control equipment installed in pre-1976 plants. This restriction should be removed.

We propose that pollution control equipment placed in service after December 31, 1977, be allowed to qualify for the full 10-percent credit even if rapid amortization is claimed under the provisions of existing law. As in the case of industrial structures, our recommendation will provide tax relief in a form that is more efficient and straightforward than current government tax subsidies; this proposal will permit the tax exemption to be removed for pollution control bonds without increasing the costs of compliance with environmental standards.

(3) Increase in tax liability ceiling. The investment credit will be made more fully available to businesses with relatively high investment needs and low taxable incomes. Currently, the investment credit claimed during any taxable year cannot generally exceed \$25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a 3-year carryback and a 7-year carryforward). The President recommends that the tax liability ceiling be raised to 90 percent of all tax liability, with no firm being able to use investment credits to eliminate its entire tax liability.

Revision and simplification of regulations under the asset depreciation range (ADR) system.—The asset depreciation range (ADR) system provides substantial tax benefits to businesses through generous depreciation allowances. However, certain complexities in the ADR regulations discourage most businesses from electing ADR and impose administrative burdens on those businesses that do use ADR.

The President proposes that legislation be enacted expressly to permit the Treasury Department to issue regulations that will simplify the ADR system. Included among the simplifications will be the termination of the annual reporting requirement.

Proposals focused on small business.—The President's tax cut proposals will provide significant relief for small businesses. Reductions in individual and corporate tax rates will increase the net earnings of small businesses whether conducted in the form of a sole proprietorship, a partnership, or a corporation. For example, a small corporation with profits of \$50,000 will experience a tax reduction of about 10 percent in 1979 because 2 points of the 4-point corporate rate cut have been targeted to small businesses and made fully effective as of October 1, 1978. The resulting increase in cash flow will enable small firms to expand their facilities and compete more effectively.

In addition to these general tax reduction recommendations, the administration's program contains three proposals designed specifically to aid small companies. First,

the Subchapter S rules that treat certain small corporations as partnerships will be simplified and liberalized. Second, a new, simple table for equipment depreciation, tantamount to a streamlined ADR system, will be authorized for small businesses. And third, risktaking will be encouraged by doubling the amount of a small corporation's stock (from \$500,000 to \$1 million) that can qualify for special ordinary loss treatment and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

II. Curtailment of business tax preferences that are wasteful and unfair

The business incentives I have discussed total \$8.3 billion. Revenue-raising reforms (including those relating to entertainment expenditures) will offset that gross reduction by \$2.6 billion. To understand the importance of the reforms, the President's tax proposals should be viewed in the context of a tight Federal budget for fiscal year 1979. This Presidential budget is the first that reflects the results of a zero-based review of all Federal expenditures; projected Government spending for fiscal year 1979 has been held to \$500 billion through a process that demands that Federal dollars be spent most productively and efficiently.

On the other side of the Federal ledger, the President's tax program reflects the same concern for an efficient allocation of resources. The \$8.3 billion of increased incentives is desirable only in combination with reforms that eliminate inequitable and inefficient business tax preferences that contribute little to our efforts to sustain economic growth and create jobs for American workers. We must not leave the careful budgeting process half completed; the same scrutiny that is used in allocating Federal outlays must be used in examining tax expenditures.

Tax treatment of financial institutions.—Viewed in this light, it is imperative that the tax treatment of financial institutions be modified. Financial institutions do not pay income taxes on the same basis as other taxpayers. Commercial banks, savings and loan associations, and mutual savings banks can reduce taxable income by special bad debt deductions that do not reflect actual loss experience. Credit unions are provided an even greater preference; they are completely exempted from taxation.

The preferred tax status of financial institutions is based largely on outmoded concepts regarding the nature of these businesses. Commercial banks, mutual savings banks, and savings and loan associations were permitted to deduct artificially inflated reserves for bad debts supposedly to protect the banking system from catastrophic losses that were prevalent decades ago. However, since the 1930's, the Federal Government has acted to protect commercial banks and thrift institutions and their depositors from financial crises. These protections include deposit insurance, regulatory restrictions on bank practices, and the availability of the Federal Reserve discount window. Also, financial institutions are eligible for special 10-year carryback and 5-year carryforward provisions so that large losses in any one year can be used to reduce taxable income over a broad span of years. The excess bad debt deductions seriously distort the measurement of a financial institution's income, and that distortion cannot be rationalized on the grounds that the preference is needed to protect the banking system.

Likewise, the exemption for credit unions is an anachronism. Credit unions were exempted from taxation in the days when these institutions were small entities with close bonds among the members and few powers to provide extensive financial services. Today, many have expanded to a point where they are functionally identical to and compete directly with savings and loan associations and commercial banks.

The administration recommends changes that will recognize the contemporary practices of financial institutions and will bring the tax treatment of commercial banks, savings and loan associations, and credit unions more in line with the taxation of other businesses.

(1) Commercial banks. Commercial banks may now claim bad debt deductions that greatly exceed their actual losses. Under legislation enacted in 1969, this special bad debt deduction is scheduled for elimination after 1987. The

administration proposes that the effective date for repeal be accelerated so that beginning in 1979 banks, like other businesses, will base their bad debt reserves on their own experience in the current and 5 preceding years.

(2) Mutual savings banks and savings and loan associations. Mutual savings banks and savings and loan associations are generally entitled to deduct 40 percent of their net income (this percentage is scheduled to apply in 1979) as a bad debt reserve. The tax program will reduce the percentage to 30 percent over a 5-year period.

(3) Credit unions. We recommend that credit unions be made taxable on the same basis as mutual savings banks and savings and loan associations, with this change imposed gradually over a 5-year phase-in period.

Domestic international sales corporation (DISC).—The so-called DISC provision is another example of a wasteful tax expenditure that should be eliminated. In 1971, the Code was amended to add a special tax program to shield export income from taxation. This program grants tax benefits for exports channeled through a company's specially created subsidiary, usually a paper organization, known as a domestic international sales corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of eligible DISC income is deferred as long as these profits are invested in export-related assets.

When DISC was enacted, Congress wisely included a provision for an annual study by the Treasury Department to evaluate DISC's impact. Those studies have demonstrated that DISC is a very inefficient and wasteful export subsidy. The most recent Treasury study indicates that DISC may have contributed only \$1 to \$3 billion to U.S. exports in 1974—an increase of less than 3 percent in total exports—at a tax revenue cost of \$1.2 billion. In the long run, even these increased exports are probably offset by rising imports that result from the operation of the flexible exchange rate system. DISC helps exporters with large profit margins and does nothing for, and may even disadvantage, our import sensitive industries. Independent experts believe that DISC may have had no lasting effect on our balance of payments.

If Government support is to be provided for exports, tax dollars should be expended more efficiently. In this regard, it is significant to note that the President's budget for fiscal year 1979 provides for a \$2.2 billion increase between 1977 and 1978 in authorizations for direct loans by the Export-Import Bank and for another \$800 million increase in 1979. Likewise, the Export-Import Bank's guarantee and insurance authorizations are increased by \$1.8 billion in 1978 and by \$1.7 billion in 1979. The Bank will use these funds to provide financial support for exports, targeted on areas of greatest need for this assistance. By contrast, DISC tax benefits are claimed without regard to whether there is any need for them or whether any real export improvement occurs through them.

Congress recognized the wasteful nature of DISC in 1976 when the Tax Reform Act limited its applicability. However, DISC continues to cost U.S. taxpayers over \$1 billion per year, with well over one-half of DISC benefits realized by only 2 percent of the DISC's. While the 1976 changes reduced the cost of this wasteful program, we seriously doubt that those changes made the program more cost effective.

We recommend the elimination of one-third of DISC benefits in 1979, two-thirds in 1980, and all DISC benefits in 1981 and later years. However, our proposal will not affect past earnings; accumulated DISC income will remain tax deferred as long as it continues to be invested in export-related assets.

Foreign tax deferral.—Domestic corporations now pay a U.S. tax on the earnings from operations that they conduct directly overseas such as through a foreign branch. However, domestic corporations can avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. The U.S. tax is usually deferred until dividends are paid by a subsidiary to its domestic parent, and then U.S. tax liability is offset by a tax credit for foreign income taxes paid on those remitted earnings. The President recommends that this deferral privilege be phased out over a

3-year period. At least one-third of a foreign subsidiary's earnings will be taxed to the U.S. parent in 1979, at least two-thirds in 1980, and all the subsidiary's earnings after 1980.

The fundamental problem with current law is that it makes the tax consequences of foreign investment depend upon the form of an investment, rather than its substance. Deferral is an artificial concept that causes the taxation of U.S. taxpayers to depend upon whether a foreign corporate charter has been placed as a screen between the foreign income and the U.S. taxpayer. In 1969, Congress revised the corporate surtax exemption provisions so that a commonly owned business enterprise would be taxed at the same rate, whether it operated under a single corporate charter or under multiple charters and regardless of the business reason for the use of multiple charters. We propose that Congress act in a similar manner to prevent the interposition of foreign corporate charters from affecting the level of U.S. taxation.

You will undoubtedly hear some persons argue that the termination of deferral will cause U.S. multinationals to lose their competitive position in world markets. The vast majority of investment is made in response to real market forces rather than the lure of the deferral preference. And consequently, when deferral is terminated, these overseas investments will continue to be made—and to be competitive—because they are governed not by tax consequences but by basic investment factors such as large and growing markets overseas, high consumer incomes, and a substantial demand for U.S. products.

In some countries, our tax deferral, in combination with their low tax rates, may provide an artificial tax incentive for U.S. investment. Elimination of deferral may restrict that insignificant portion of U.S. investment overseas that is now tax induced. But in such instances, there is no reason to favor a distortion of normal market forces that may work to the detriment of overall U.S. investment.

In short, the primary impact of deferral is to grant a tax preference to firms doing what prudent business judgment would dictate in the absence of deferral—investing in profitable foreign markets. There is no sound reason to continue this preference. The substantial business incentives recommended by the President will help ensure that U.S. multinationals have ample after-tax funds available to make the productive investments necessary to remain competitive in world markets. Terminating deferral represents only a small offset to the gains that businesses will realize through other provisions in the tax package. The administration has proposed a program of business taxation that is generous and fair and does not depend upon the formalistic structure of international business operations.

Special Tax Reductions Proposed to Reduce Costs for Consumers and Businesses

Finally, we propose two tax reduction measures—outside the income tax system—that will assist our efforts to attain price stability.

Repeal of excise tax on telephone services.—The present 4-percent excise tax on amounts paid for telephone services is now being phased out at the rate of 1 percentage point a year, with full repeal scheduled as of January 1, 1982. The administration's program will completely repeal this tax as of October 1, 1978. This action will reduce the cost of living directly. It will also lower consumer prices indirectly through a reduction of the business cost associated with telephone services.

Federal unemployment insurance tax.—We also recommend a reduction in the Federal unemployment insurance tax to reduce the payroll costs of employers. On January 1, 1977, the unemployment insurance tax rate rose from 0.5 percent to 0.7 percent of an employer's taxable wage base. This tax increase was instituted in order to replenish general revenue funds that have been loaned to the unemployment insurance trust fund during recent periods of high unemployment. We remain committed to sound financing of unemployment compensation; a National Committee on Unemployment Compensation will soon be appointed to study the long-term financing issue. Pending that study, we believe that the proposed tax cut can make a significant contribution to our efforts to fight the immediate problem of inflation. The President's tax program will reduce the tax rate to the 0.5-percent level as of January 1, 1979.

Conclusion

The President's recommendations would effect important changes in our Nation's tax laws. These proposals are presented in the form of a balanced package of tax reductions and reforms that should be manageable in one congressional session. Action this year is vital. The sustained growth of our economy requires tax reductions for individuals to maintain their purchasing power, and for businesses to encourage investment in new facilities.

Tax reforms, designed to promote equity and simplification, are carefully integrated with the proposed tax cuts. Reforms finance a major part of the gross tax reductions. In the absence of offsetting reforms, we must either reduce the cuts substantially or face a budget deficit for fiscal year 1979 that expands well beyond the fiscal year 1978 figure; neither of these alternatives is acceptable.

Moreover, the tax reforms enable us to target the net tax relief where it is needed most. Substantial reductions can be provided to individuals heavily burdened by current tax liability without passing along an unwarranted tax cut to those persons already avoiding the payment of their fair share. Likewise, the merging of tax reform with the proposed business cuts produces investment incentives that are potent, efficient, and equitable.

Our efforts in developing this package have been assisted greatly by the consultations we have had with members of this committee. That relationship will become even more important in the weeks ahead as this committee and the administration work together to fashion tax legislation. The American people deserve prompt enactment of a tax reform and reduction program, and we must meet that challenge.

TABLE 1.—1978 combined income tax and FICA tax burdens—four-person, one-earner families

Wage income	Present law tax			1978 proposed tax			Change in tax		
	Income ¹	FICA ²	Total	Income ¹	FICA ³	Total	Income	FICA	Total
\$5,000	—\$300	\$292	—\$8	—\$300	\$303	\$3	0	\$11	\$11
10,000	446	585	1,031	192	605	797	—\$254	20	—234
15,000	1,330	877	2,207	1,166	908	2,074	—164	31	—133
20,000	2,180	965	3,145	2,042	1,071	3,113	—138	106	—32
25,000	3,150	965	4,115	3,025	1,071	4,096	—125	106	—19
30,000	4,232	965	5,197	4,150	1,071	5,221	—82	106	24
40,000	6,848	965	7,813	6,748	1,071	7,819	—100	106	6
50,000	9,950	965	10,915	9,855	1,071	10,926	—95	106	11
100,000	28,880	965	29,845	28,640	1,071	29,711	—240	106	—134

¹ Assumes deductible expenses equal to 23 percent of income.

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

³ Calculated under present law rate and base for 1978 (6.05 percent and \$17,700), employees' share only.

TABLE 2.—1979 combined income tax and FICA tax burdens—four-person, one-earner families

Wage income	Present law tax			1979 proposed tax			Change in tax		
	Income ¹	FICA ²	Total	Income ³	FICA ⁴	Total	Income	FICA	Total
\$5,000	—\$300	\$292	—\$8	—\$300	\$306	\$6	0	\$14	\$14
10,000	446	585	1,031	134	613	747	—\$312	28	—284
15,000	1,330	877	2,207	1,072	919	1,991	—258	42	—216
20,000	2,180	965	3,145	1,910	1,226	3,136	—270	261	—9
25,000	3,150	965	4,115	2,830	1,404	4,234	—320	439	119
30,000	4,232	965	5,197	3,910	1,404	5,314	—322	439	117
40,000	6,848	965	7,813	6,630	1,404	8,034	—218	439	221
50,000	9,950	965	10,915	9,870	1,404	11,274	—80	439	359
100,000	28,880	965	29,845	29,470	1,404	30,874	590	439	1,029

¹ Assumes deductible expenses equal to 23 percent of income under present law.

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

³ Assumes deductible expenses equal to 20 percent of income under proposal.

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

TABLE 3.—1978 combined income tax and FICA tax burdens—four-person, two-earner families¹

Wage income	Present law tax			1978 proposed tax			Change in tax		
	Income ²	FICA ³	Total	Income ²	FICA ⁴	Total	Income	FICA	Total
\$5,000	-\$300	\$292	-\$8	-\$300	\$303	\$3	0	\$11	\$11
10,000	446	585	1,031	192	605	797	-\$254	20	-234
15,000	1,330	877	2,207	1,166	908	2,074	-164	31	-133
20,000	2,180	1,170	3,350	2,042	1,210	3,252	-138	40	-98
25,000	3,150	1,463	4,613	3,025	1,513	4,538	-125	50	-75
30,000	4,232	1,755	5,987	4,150	1,815	5,965	-82	60	-22
40,000	6,848	1,931	8,779	6,748	2,142	8,890	-100	211	111
50,000	9,950	1,931	11,881	9,855	2,142	11,997	-95	211	116
100,000	28,880	1,931	30,811	28,640	2,142	30,782	-240	211	-29

¹ Assumes that each spouse earns 50 percent of total family income.² Assumes deductible expenses equal to 23 percent of income.³ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 (\$16,500), employees' share only.⁴ Calculated under present law rate and base for 1978 (6.05 percent and \$17,700), employees' share only.TABLE 4.—1979 combined income tax and FICA tax burdens—four-person, two-earner families¹

Wage income	Present law tax			1979 proposed tax			Change in tax		
	Income ²	FICA ³	Total	Income ⁴	FICA ⁵	Total	Income	FICA	Total
\$5,000	-\$300	\$292	-\$8	-\$300	\$306	\$6	0	\$14	\$14
10,000	446	585	1,031	134	613	747	-\$312	28	-284
15,000	1,330	877	2,207	1,072	919	1,991	-258	42	-216
20,000	2,180	1,170	3,350	1,910	1,226	3,136	-270	56	-214
25,000	3,150	1,463	4,613	2,830	1,533	4,363	-320	70	-250
30,000	4,232	1,755	5,987	3,910	1,839	5,749	-322	84	-238
40,000	6,848	1,931	8,779	6,630	2,452	9,082	-218	521	303
50,000	9,950	1,931	11,881	9,870	2,808	12,678	-80	877	797
100,000	28,880	1,931	30,811	29,470	2,808	32,278	590	877	1,467

¹ Assumes that each spouse earns 50 percent of total family income.² Assumes deductible expenses equal to 23 percent of income under present law.³ Calculated under prior law rate for 1977 (5.85 percent) and prior law base for 1977 (\$16,500), employees' share only.⁴ Assumes deductible expenses equal to 20 percent of income under proposal.⁵ Calculated under present law rate and base for 1979 (6.13 percent and \$22,900), employees' share only.

TABLE 5.—*Individual tax rate schedule for joint returns*

Taxable income bracket ¹	Present law		Tax proposal	
	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket
		Percent		Percent
0-\$500	0	14	0	12
\$500-\$1,000	\$70	14	\$60	12
\$1,000-\$2,000	140	15	120	14
\$2,000-\$3,000	290	16	260	16
\$3,000-\$4,000	450	17	420	17
\$4,000-\$8,000	620	19	590	18
\$8,000-\$12,000	1,380	22	1,310	19
\$12,000-\$16,000	2,260	25	2,070	20
\$16,000-\$20,000	3,260	28	2,870	23
\$20,000-\$24,000	4,380	32	3,790	27
\$24,000-\$28,000	5,660	36	4,870	32
\$28,000-\$32,000	7,100	39	6,150	36
\$32,000-\$36,000	8,660	42	7,590	39
\$36,000-\$40,000	10,340	45	9,150	42
\$40,000-\$44,000	12,140	48	10,830	44
\$44,000-\$48,000	14,060	50	12,590	48
\$48,000-\$52,000	16,060	50	14,510	48
\$52,000-\$54,000	18,060	53	16,430	51
\$54,000-\$62,000	19,120	53	17,450	51
\$62,000-\$64,000	23,360	53	21,530	51
\$64,000-\$76,000	24,420	55	22,550	54
\$76,000-\$88,000	31,020	58	29,030	57
\$88,000-\$90,000	37,980	60	35,870	57
\$90,000-\$100,000	39,180	60	37,010	60
\$100,000-\$110,000	45,180	62	43,010	60
\$110,000-\$120,000	51,380	62	49,010	62
\$120,000-\$130,000	57,580	64	55,210	62
\$130,000-\$140,000	63,980	64	61,410	64
\$140,000-\$150,000	70,380	66	67,810	64
\$150,000-\$160,000	76,980	66	74,210	65
\$160,000-\$175,000	83,580	68	80,710	65
\$175,000-\$180,000	93,780	68	90,460	66
\$180,000-\$200,000	97,180	69	93,760	66
\$200,000 and over	110,980	70	106,960	68

¹ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by \$3,200.

TABLE 6.—Individual tax rate schedules for single returns

Taxable income bracket ¹	Present law		Tax proposal	
	Tax at low end of bracket	Tax rate on income in bracket	Tax at low end of bracket	Tax rate on income in bracket
	Percent		Percent	
0-\$500	0	14	0	12
\$500-\$1,000	\$70	15	\$60	13
\$1,000-\$1,500	145	16	125	15
\$1,500-\$2,000	225	17	200	15
\$2,000-\$3,000	310	19	275	18
\$3,000-\$4,000	500	19	455	19
\$4,000-\$6,000	690	21	645	20
\$6,000-\$8,000	1,110	24	1,045	20
\$8,000-\$10,000	1,590	25	1,445	22
\$10,000-\$12,000	2,090	27	1,885	23
\$12,000-\$14,000	2,630	29	2,345	25
\$14,000-\$16,000	3,210	31	2,845	25
\$16,000-\$18,000	3,830	34	3,345	29
\$18,000-\$20,000	4,510	36	3,925	29
\$20,000-\$22,000	5,230	38	4,505	33
\$22,000-\$24,000	5,990	40	5,165	33
\$24,000-\$26,000	6,790	40	5,825	38
\$26,000-\$28,000	7,590	45	6,585	38
\$28,000-\$32,000	8,490	45	7,345	41
\$32,000-\$36,000	10,290	50	8,985	46
\$36,000-\$38,000	12,290	50	10,825	50
\$38,000-\$40,000	13,290	55	11,825	50
\$40,000-\$44,000	14,390	55	12,825	51
\$44,000-\$48,000	16,590	60	14,865	57
\$48,000-\$50,000	18,990	60	17,145	58
\$50,000-\$52,000	20,190	62	18,305	58
\$52,000-\$54,000	21,430	62	19,465	60
\$54,000-\$60,000	22,670	62	20,665	60
\$60,000-\$62,000	26,390	64	24,265	60
\$62,000-\$64,000	27,670	64	25,465	63
\$64,000-\$70,000	28,950	64	26,725	63
\$70,000-\$76,000	32,790	66	30,505	63
\$76,000-\$80,000	36,750	66	34,285	66
\$80,000-\$88,000	39,390	68	36,925	66
\$88,000-\$90,000	44,830	68	42,205	66
\$90,000-\$100,000	46,190	69	43,525	67
\$100,000 and over	53,090	70	50,225	68

¹ The zero bracket is not shown in this table. To include the zero bracket, increase all taxable incomes shown by \$2,200.

TABLE 7.—*Summary of revenue effects of income tax reductions, tax reforms, and telephone excise and unemployment insurance tax reductions*
[\$ billions]

	Fiscal years				
	1979	1980	1981	1982	1983
Individual income tax:					
Tax reductions.....	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms.....	4.2	7.4	8.9	10.6	12.3
Net change.....	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation income tax:					
Tax reductions.....	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms.....	1.1	3.0	4.3	5.0	5.2
Net change.....	-5.1	-6.5	-6.8	-6.8	-7.6
Telephone excise and unemployment insurance tax reductions.....	-1.6	-2.0	-1.6	-1.2	-1.1
Total.....	-25.0	-26.6	-28.6	-30.8	-34.9

TABLE 8.—*The effect of tax proposals on calendar year tax liability*
[\$ millions]

Provisions	Full year 1976	Calendar year					
		1978	1979	1980	1981	1982	1983
\$240 credit and reduced tax rates.....	-17,305	-6,067	-23,538	-26,583	-30,272	-34,732	-40,110
Itemized deduction changes:							
Repeal gasoline tax deductions.....	582		862	983	1,121	1,277	1,456
Repeal sales tax deductions.....	1,672		2,477	2,824	3,219	3,670	4,184
Repeal miscellaneous tax deductions.....	384		569	649	739	843	961
Deduction for medical and casualty expenses.....	1,396		1,909	2,119	2,352	2,611	2,898
Repeal political contributions deduction.....	2		2	4	2	3	3
Repeal capital gains alternate tax.....	113		140	151	162	174	187
Individual real estate tax shelters.....	320		61	181	296	407	514
Taxation of unemployment benefits.....	275		212	207	204	204	214
Tax interest element of annuity contracts.....	320		12	26	40	57	80
Minimum tax change.....	229		284	306	329	353	380
Taxable bond option (individual).....	255		197	592	1,080	1,666	2,218
Extend 10 percent investment tax credit to structures (individual).....	-36	-47	-54	-65	-73	-79	-86
Limit individual tax credits to 90 percent of tax before credits.....	38		52	58	64	71	79
Tax qualified retirement plans and employee death benefits.....	30		32	32	33	33	34
Corporate real estate shelters.....	180		40	118	194	265	335
Corporate family farm accounting.....	30		40	25	10	5	7

TABLE 8.—*The effect of tax proposals on calendar year tax liability—Continued*

[\$ millions]

Provisions	Full year 1976	Calendar year					
		1978	1979	1980	1981	1982	1983
Bad debt reserves:							
Commercial banks	196		227	232	232	23	—
Mutual savings bank and savings and loans			37	85	145	221	316
Credit unions	82		22	50	83	123	171
Entertainment expenses.....	1,125		1,476	1,633	1,771	1,932	2,107
Taxable bond option (corporations).....	—24		—15	—47	—79	—113	—150
Phase out DISC over 3 years.....	852	193	664	1,228	1,513	1,613	1,751
Phase out deferral of tax on foreign source income	523		88	280	768	830	897
Corporate tax rate deduction.....	—5,718	—1,349	—5,965	—8,516	—9,228	—10,010	—10,764
At risk limitation (corporations).....	10		14	10	8	5	6
Increase investment tax credit limit to 90 percent	—71		—882	—576	—114	—194	—205
Extend 10 percent investment tax credit to structures (corporations).....	—1,055	—1,100	—1,389	—1,649	—1,869	—2,074	—2,268
Nondiscrimination rule for health and group term life plans.....	29		32	33	34	35	36
Full investment tax credit for pollution abatement facilities	—90	—142	—93	—107	—127	—115	—144
Total individual.....	—11,725	—6,114	—16,783	—18,516	—20,704	—23,442	—26,988
Total corporate.....	—3,849	—2,398	—5,704	—7,201	—6,659	—7,454	—7,905
Subtotal tax reform..	—15,574	—8,512	—22,487	—25,717	—27,363	—30,896	—34,893
Repeal telephone excise tax	—	—355	—1,200	—900	—500	—	—
Reduce unemployment payroll tax rate.....	—	—	—850	—900	—950	—1,000	—1,050
Total	—15,574	—8,867	—24,537	—27,517	—28,813	—31,896	—35,943

TABLE 9.—*The effect of tax reform proposals on fiscal years receipts*
[\$ millions]

Provisions	Full year 1976	Fiscal year				
		1979	1980	1981	1982	1983
\$240 credit and reduced tax rates.....	-17,305	-22,544	-25,669	-29,166	-33,394	-38,497
Itemized deduction changes:						
Repeal gasoline tax deductions.....	582	603	947	1,080	1,230	1,402
Repeal sales tax deductions.....	1,672	1,734	2,720	3,100	3,535	4,030
Repeal miscellaneous tax deductions.....	384	398	625	712	812	926
Deduction for medical and casualty expenses.....	1,396	1,336	2,056	2,282	2,533	2,812
Repeal political contributions deduction.....	2	1	3	3	3	3
Repeal capital gains alternate tax.....	113		140	151	162	174
Individual real estate tax shelters.....	320	9	93	228	361	448
Taxation of unemployment benefits.....	275	151	208	205	204	211
Tax interest element of annuity contracts.....	320		12	26	40	57
Extend 10 percent investment tax credit to structures (individual).....	-36	-55	-61	-72	-81	-82
Minimum tax changes.....	229		284	306	329	353
Taxable bond option (individual) ¹	225	30	301	783	1,381	1,873
Limit individual tax credits to 90 percent of tax before credits.....	38	7	58	64	71	74
Tax qualified retirement plans and employee death benefits.....	30	5	34	35	35	33
Corporate real estate shelters.....	180	18	75	152	226	296
Corporate family farm accounting.....	30	18	33	18	8	6
Bad debt reserves:						
Commercial banks.....	196	102	229	232	138	13
Mutual savings banks and savings and loans.....	82	17	59	112	179	264
Credit unions.....	82	10	35	65	101	145
Entertainment expenses.....	1,125	664	1,547	1,695	1,843	2,011
Taxable bond option (corporations) ¹	-24	-7	-29	-61	-94	-130
Phase out DISC over 3 years.....	852	249	807	1,551	1,771	1,675
Elimination of deferral of tax on foreign source income.....	523	40	174	500	796	860
Corporate tax rate reduction.....	-5,718	-3,953	-7,078	-8,827	-9,570	-10,339
At risk limitation.....	10	2	14	10	8	5
Increase investment tax credit limit to 90 percent.....	-71	-397	-744	-368	-150	-199
Extend 10 percent investment tax credit to structures (corporations).....	-1,055	-1,725	-1,506	-1,748	-1,961	-2,161
Nondiscrimination rule for health and group term life plans.....	29	14	32	33	34	35
Full investment tax credit for pollution abatement facilities.....	-90	-184	-99	-116	-122	-128
Total individual.....	-11,725	-18,325	-18,249	-20,263	-22,779	-26,183
Total corporate.....	-3,849	-5,132	-6,451	-6,752	-6,793	-7,647
Subtotal, tax reform.....	-15,574	-23,457	-24,700	-27,015	-29,572	-33,830
Repeal telephone excise tax.....	—	-955	-1,050	-700	-250	—
Reduce unemployment payroll tax rate.....	—	-600	-900	-900	-1,000	-1,100
Total.....	-15,574	-25,012	-26,650	-28,615	-30,822	34,930

¹ Outlays associated with the proposal are \$99 million in 1979, \$495 million in 1980, increasing to \$222 million in 1983.

TABLE 10.—*Expanded income and tax liability under present law and tax proposals (personal only)*
[1976 levels of income]

Expanded income class	Number of returns	Expanded income	Present law		Administration proposal	
			Tax liability	Effective tax rate	Tax liability	Effective tax rate
		<i>\$ millions</i>	<i>\$ millions</i>	<i>Percent</i>	<i>\$ millions</i>	<i>Percent</i>
Less than \$5,000.....	25,474,000	57,557	141	0.2	- 251	- 0.4
\$5,000-\$10,000.....	20,109,000	149,590	8,227	5.5	6,368	4.3
\$10,000-\$15,000.....	16,106,000	201,036	18,071	9.0	15,361	7.6
\$15,000-\$20,000.....	11,824,000	205,086	23,009	11.2	20,148	9.8
\$20,000-\$30,000.....	9,907,000	237,041	32,778	13.8	29,593	12.5
\$30,000-\$50,000.....	3,347,000	124,836	22,017	17.6	20,971	16.8
\$50,000-\$100,000.....	985,000	67,484	16,492	24.4	16,344	24.2
\$100,000-\$200,000.....	198,000	27,371	8,084	29.5	8,261	30.2
\$200,000 and over.....	49,000	21,573	6,476	30.0	6,838	31.7
Total.....	87,998,000	1,091,573	135,293	12.4	123,633	11.3

Tax Reform Program: Effective Individual Tax Rates -- Taxes as a Percent of Expanded Income. 1976 Level of Income.

Effective tax rate (percent)

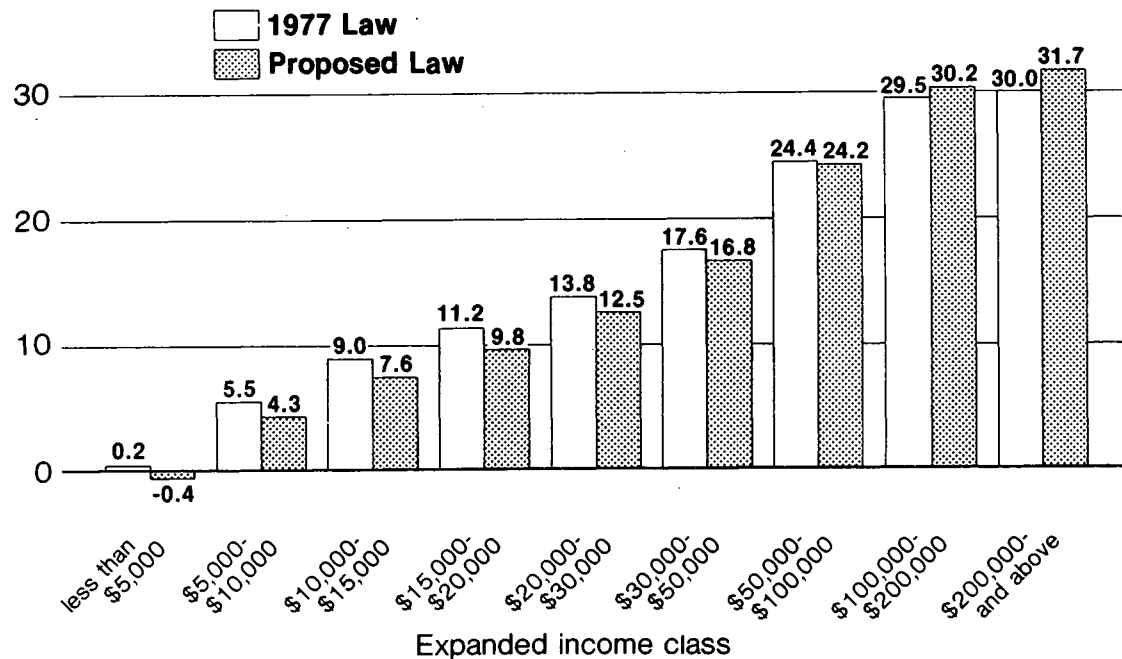


TABLE 12.—*Income tax liabilities: present law and administration proposal
(personal income only)*
[1976 levels of income]

Expanded income class	Present law		Administration proposal		Tax change	
	Tax liability	Percentage distribution	Tax liability	Percentage distribution	Tax liability	Change as percent of present law tax
	\$ millions	Percent	\$ millions	Percent	\$ millions	Percent
Less than \$5,000.....	141	0.1	— 251	— 0.2	— 392	— 278.0
\$5,000—\$10,000.....	8,227	6.1	6,368	5.2	— 1,859	— 22.6
\$10,000—\$15,000.....	18,071	13.4	15,361	12.4	— 2,710	— 15.0
\$15,000—\$20,000.....	23,009	17.0	20,148	16.3	— 2,861	— 12.4
\$20,000—\$30,000.....	32,778	24.2	29,593	23.9	— 3,185	— 9.7
\$30,000—\$50,000.....	22,017	16.3	20,971	17.0	— 1,046	— 4.8
\$50,000—\$100,000.....	16,492	12.2	16,344	13.2	— 148	— .9
\$100,000—\$200,000.....	8,084	6.0	8,261	6.7	177	2.2
\$200,000 and over.....	6,476	4.8	6,838	5.5	362	5.6
Total.....	135,293	100.0	123,633	100.0	— 11,660	— 8.6

TABLE 13.—*Burden table: Single returns*
[1976 levels of income]

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
				Percent
Less than \$10,000.....	\$217	\$181	— \$36	— 16.4
\$10,000—\$15,000.....	1,595	1,519	— 76	— 4.8
\$15,000—\$20,000.....	2,768	2,591	— 177	— 6.4
\$20,000—\$30,000.....	4,236	3,917	— 319	— 7.5
\$30,000—\$50,000.....	8,254	7,660	— 594	— 7.2
\$50,000—\$100,000.....	18,465	17,889	— 576	— 3.1
\$100,000—\$200,000.....	42,015	41,714	— 301	— .7
\$200,000 and over.....	161,723	167,760	6,037	3.7

TABLE 14.—*Burden table: Joint returns, no dependents*
[1976 levels of income]

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
				Percent
Less than \$10,000.....	\$168	\$95	— \$73	— 43.6
\$10,000—\$15,000.....	1,104	983	— 121	— 11.0
\$15,000—\$20,000.....	2,084	1,906	— 178	— 8.5
\$20,000—\$30,000.....	3,615	3,308	— 307	— 8.5
\$30,000—\$50,000.....	6,921	6,535	— 386	— 5.6
\$50,000—\$100,000.....	17,020	16,647	— 373	— 2.2
\$100,000—\$200,000.....	40,403	40,956	553	1.4
\$200,000 and over.....	132,121	137,140	5,020	3.8

TABLE 15.—*Burden table: Joint returns, one dependent*
[1976 levels of income]

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
				<i>Percent</i>
Less than \$10,000.....	\$65	—\$38	—\$103	—157.8
\$10,000—\$15,000.....	1,024	824	—200	—19.5
\$15,000—\$20,000.....	1,922	1,696	—226	—11.7
\$20,000—\$30,000.....	3,392	3,063	—329	—9.7
\$30,000—\$50,000.....	6,709	6,327	—382	—5.7
\$50,000—\$100,000.....	16,938	16,625	—313	—1.8
\$100,000—\$200,000.....	41,993	42,264	271	.6
\$200,000 and over.....	121,583	125,202	3,620	3.0

TABLE 16.—*Burden Table: Joint returns, two dependents*
[1976 levels of income]

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
				<i>Percent</i>
Less than \$10,000.....	9	—\$79	—\$88	—975.6
\$10,000—\$15,000.....	867	589	—278	—32.1
\$15,000—\$20,000.....	1,739	1,461	—278	—16.0
\$20,000—\$30,000.....	3,117	2,780	—337	—10.8
\$30,000—\$50,000.....	6,287	5,979	—308	—4.9
\$50,000—\$100,000.....	16,336	16,088	—248	—1.5
\$100,000—\$200,000.....	40,885	41,087	202	.5
\$200,000 and over.....	127,666	130,473	2,807	2.2

TABLE 17.—*Burden table: Joint returns, three dependents*
[1976 levels of income]

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
				<i>Percent</i>
Less than \$10,000.....	—\$41	—\$81	—\$40	—97.7
\$10,000—\$15,000.....	693	367	—326	—47.0
\$15,000—\$20,000.....	1,562	1,218	—344	—22.0
\$20,000—\$30,000.....	2,867	2,514	—353	—12.0
\$30,000—\$50,000.....	5,872	5,609	—263	—4.5
\$50,000—\$100,000.....	15,924	15,785	—139	— .9
\$100,000—\$200,000.....	40,417	40,827	410	1.0
\$200,000 and over.....	126,915	130,397	3,483	2.7

TABLE 18.—*Burden table: Joint returns, four dependents*
[1976 levels of income]

Expanded income class	Average tax present law	Average tax under proposal	Average tax change	Percentage change
				<i>Percent</i>
Less than \$10,000.....	—64	—70	—6	—9.9
\$10,000—\$15,000.....	526	177	—349	—66.3
\$15,000—\$20,000.....	1,375	985	—390	—28.3
\$20,000—\$30,000.....	2,590	2,248	—342	—13.2
\$30,000—\$50,000.....	5,720	5,521	—199	—3.5
\$50,000—\$100,000.....	16,529	16,593	64	.4
\$100,000—\$200,000.....	42,090	42,707	617	1.5
\$200,000 and over.....	127,755	131,298	3,543	2.8

Exhibit 30.—Statement of Acting Assistant Secretary Lubick, April 7, 1978, before the House Ways and Means Committee, on integration of the corporate and individual income tax

INTRODUCTION

There is widespread agreement that changes in our tax laws are needed to strengthen and maintain the current economic expansion and to assure the future productivity of the economy. In particular, changes are needed to stimulate business investment.

One technique suggested by many for achieving these goals is integration of the corporate and individual tax systems. Under present law, income earned from activity conducted in corporate form is subject to taxation twice if distributed to shareholders. First, the income is taxed at the corporate level at rates up to 48 percent. In addition, if the after-tax income of a corporation is distributed to individual shareholders as dividends, it is subject to a second tax at rates of 14 to 70 percent. Integration would eliminate or reduce one of these levels of tax.

During his 1976 campaign for the Presidency, President Carter called for an end to the double taxation of corporate dividends. Over the past year, the Treasury has studied integration extensively. We have analyzed the economic effects of the present tax laws and considered a number of possible integration systems in great detail. One approach which we developed and considered carefully was substantially similar to the proposal which Chairman Ullman has introduced.

As you know, we ultimately decided not to recommend an integration proposal. Instead, the President proposed other incentives for business, principally in the form of individual and corporate rate cuts and liberalization of the investment credit. The rate cuts will benefit both small and large businesses and will reduce corporate taxes by \$6 billion in 1979 and \$8.5 billion in 1980.¹ The individual rate cuts will benefit unincorporated businesses. Needed business investment also will be encouraged by improvements in the investment tax credit. The present 10-percent rate will be made permanent rather than reverting to the 7-percent level that is now scheduled to apply after 1980. In addition, the ability of taxpayers to utilize the investment credit will be increased, and the credit will be made available for a broader range of investments.²

In my testimony today, I would like to explain why the President ultimately decided not to recommend corporate integration and instead proposed these other forms of business tax relief.

There are two broad reasons underlying this decision. First, integration is a fundamental structural reform of our tax system and raises a wide range of policy issues. There must be an opportunity for the implications of these issues to be considered by the administration and Congress, as well as by the various groups in our society which will be affected. Given the pressing need for a tax bill this year, we simply did not feel that there was sufficient time for these issues to be adequately considered. I will devote the major portion of my testimony to describing these issues. Second, due to the fact that the form of integration affects the competitive position of some sectors of the business community vis-a-vis others, we found an absence of broad business support for any single plan. The business community in general favored other forms of business tax reductions such as those which we have included in our program.

I would like to mention, however, two factors which did not underlie the decision. First, the administration did not conclude that integration should be rejected because of undesirable economic effects. We believe integration has merit and deserves further study. Second, the administration did not conclude that integration is technically infeasible. In fact, we concluded that a plan of integration could be made to work technically and even could allow various collateral simplifications of the tax system to be adopted.

¹ Under the proposal, effective Oct. 1, 1978, the corporate tax rate will be reduced from 20 percent to 18 percent of the first \$25,000 of income, from 22 percent to 20 percent on the next \$25,000, and from 48 percent to 45 percent on income exceeding \$50,000. The maximum rate will be reduced by an additional point, to 44 percent, on Jan. 1, 1980.

² The principal changes in the investment credit are (1) extension of its application to industrial structures, (2) extension of its application to pollution control facilities which are subject to rapid 5-year amortization, and (3) increase, generally from 50 to 90 percent, in the amount of tax liability which may be offset by the investment credit.

PROPOSALS WHICH SHOULD BE CONSIDERED IN CONJUNCTION WITH INTEGRATION

Before describing policy issues raised by integration itself, I would like to discuss certain changes in the tax laws which we believe should be considered at the same time as integration.

The administration considered integration in conjunction with two related proposals: Reduction of the top individual marginal rate to a rate which approximates the top corporate rate, and taxation of capital gains as ordinary income.³ These proposals are linked to integration for two reasons.

First, they relate to the basic structural elements involved in the taxation of income from corporations. We believe integration should be considered only as part of a more general reform of the tax treatment of corporate income that would move toward taxing all income once at appropriate individual marginal rates. Integration for dividends does not remove the incentive for high-bracket taxpayers to accumulate income within corporations. For these taxpayers corporations provide a form of tax shelter. Even with integration they can save taxes by accumulating money within a corporation rather than paying currently one tax on the earnings at their appropriate marginal rate. This tax shelter effect can be eliminated only by reducing the maximum individual rate to approximately the top corporate rate and taxing capital gains as ordinary income.

Second, a very substantial portion of the tax reduction resulting from integration is distributed to wealthy individuals since these are the individuals who own the most stock. In other words, integration as an isolated proposal is regressive. For the same reason elimination of the capital gains preference is progressive and therefore is an appropriate revenue offset to integration.

We continue to believe that integration should be considered only in conjunction with these other proposals.

POLICY CONSIDERATIONS RAISED BY INTEGRATION IN GENERAL

I would like to turn now to policy considerations raised by integration proposals in general. Many specific advantages have been claimed for corporate integration in comparison to other methods of stimulating capital formation. At the same time, some of these claims have been challenged both by tax professionals and by representatives of private groups. I would like to describe the claimed advantages and the areas of uncertainty which we believe require further study.

The following four arguments have been raised in favor of integration proposals to reduce the double tax on dividends, such as the one introduced by Chairman Ullman:

- (1) Integration would reduce the bias against equity financing and in favor of debt that characterizes the present tax system;
- (2) Integration would promote better use of scarce capital resources by reducing a bias against investment in the corporate sector and against industries with high dividend payout ratios;
- (3) Integration would improve the capital market by reducing the current bias in favor of corporate retentions relative to distributions; and
- (4) Integration would give relatively more benefits to low-income taxpayers and so be less regressive than other forms of stimulus to capital formation.

Encouraging corporate equity financing

Under present law, corporations, in computing taxable income, are allowed a deduction for interest but not for dividends. This means that a corporation pays interest with pretax dollars and pays dividends with after-tax dollars. Thus, corporations are encouraged to finance their operations with debt instead of equity. The proportion of debt in the corporate financial structure has increased over the past 15 years, giving rise to concern about increased corporate vulnerability to business risks such as cyclical downturns.

Many economists believe that reducing the double tax on dividends would encourage a greater relative use of equity financing. However, some recent economic research has challenged this traditional view. According to this research, the bias of the current system is only against raising new equity and is not against corporate reinvestment in

³ In connection with its consideration of integration, the administration also considered repeal of the \$100 dividend exclusion allowed to individuals under current law.

retained earnings. Since most corporate investment currently is out of retained earnings, the bias of the present system may be narrower than is generally believed. If this is so, it may be more cost effective to provide relief from double taxation solely for dividends on newly invested equity capital.

In any case, it should be noted that the corporate tax cuts proposed in the President's tax program will also reduce the relative costs of equity financing by reducing the "corporate" portion of the double tax. The relative effectiveness of integration and corporate rate cuts in encouraging new investments in corporate equity remains an open question.

Reducing the bias against investment in the corporate sector

Another reason advanced for adopting integration is to correct a bias against investments in the corporate sector. Corporate income distributed to shareholders is taxed twice. Income from investments in unincorporated enterprises is only taxed once. For nontax reasons, the corporate form of organization is more prevalent in some industries than in others. Because of the double taxation of corporate income, owners of industries organized in corporate form such as basic industries incur substantially higher tax on capital income than owners of industries conducted in noncorporate form such as real estate. Such differentials in tax rates result in inefficiency in the use of capital. Relatively too much investment is channeled to unincorporated enterprises because choices among investments are affected by tax considerations.

The administration agrees that gains in economic efficiency could be realized from reduction of the double tax on dividends. However, moving towards equalization of rates of tax on capital income will cause some industries and firms to receive much bigger tax reductions than others and will change the relative value of investments as between industries. We believe that these consequences should be carefully considered by Congress and affected groups within the society.

Reducing the bias against distributions

Another reason advanced for adopting integration is to reduce the bias of current law against corporate distributions. Retained corporate earnings are taxed once, whereas distributed corporate earnings are taxed twice. Accordingly, it is argued that corporations are encouraged to retain earnings. Of course, retained earnings are reflected in higher share prices, and a selling shareholder is taxed on this appreciation. However, tax on this appreciation is deferred until the shareholder sells the stock and appreciation is taxed at capital gains rates.

Corporate integration, it is argued, will reduce this bias against retention, thus reducing the advantage of large and established firms which can generate capital internally. These corporations will be forced to compete in the open market for investment funds, and new enterprises will be able to compete for these funds. The stock of capital within the economy thus will be distributed with greatest efficiency.

There are two issues relating to this claimed advantage of integration which deserve substantially more consideration and debate. First, the extent to which the current tax system actually discourages distributions has not been resolved. It is open to question on both theoretical and empirical grounds. For example, while some econometric research suggests that dividend payout ratios should increase because of integration, dividend payout ratios appear to have remained roughly constant in European countries that have integrated. Further analysis is required before one can confidently predict the effect of integration on distributions. Second, even assuming that dividend payout ratios would increase because of integration, there is substantial disagreement as to whether this result is good or bad for the economy. In contrast to the favorable arguments presented above, some experts argue that if shareholders receive more dividends they will increase consumption, thereby reducing funds available for business investment. Also, raising capital in equity markets involves substantial transactional costs. Retention of earnings, of course, does not involve these costs. By this line of argument, tax reductions designed to stimulate capital formation should not encourage shareholder pressure on corporations for increased distributions.

Progressivity relative to other forms of business tax reduction

The final argument in favor of integration is that it is less regressive than other techniques for reducing the tax burden on capital income. Integration through dividend

relief in effect reduces the corporate tax on taxable income distributed to shareholders. Integration results in shareholders receiving relatively more income, which is then taxed at each shareholder's marginal rate. In contrast, at least a portion of the benefits of a corporate tax rate cut will be retained by corporations and thus will not be subject to current tax at individual marginal rates. Thus, integration is relatively less regressive than a system which reduces the tax on all corporate income, whether or not distributed.

In the absence of other tax changes, the relative progressivity of reduction of the double tax on dividends, compared to other forms of business tax relief, would be an important consideration. While the administration is not proposing integration at this time, the business tax cuts in the tax program are balanced by provisions that limit deductions used mostly by the wealthy and provisions that provide substantial tax cuts for lower and middle-income families. If integration is adopted in addition to the other elements of the administration's program, it would distort in favor of wealthy taxpayers the distribution of tax reductions which the administration's program is designed to achieve.

POLICY ISSUES RAISED BY INTEGRATION—DEVELOPMENT OF A SPECIFIC PROPOSAL

In developing an integration proposal, we became aware of the fact that resolution of technical issues often involved significant policy judgments. Various categories of corporations and shareholders could receive significant relative advantages or disadvantages depending on how these issues were resolved. As the specifics of a proposal developed, we found that various businesses and shareholder groups became concerned with the effects of integration and many advocated instead the business tax cuts which the President ultimately recommended. We became convinced that if integration were to be proposed, these issues should not be left to the draftsmen, but should be fully explored with Congress and affected groups within the society.

I would like to describe some of the more significant issues which we identified.

Form of integration proposal

Integration can take one of two basic forms. It can treat the corporation like a partnership and tax all income to the shareholders currently, regardless of whether or not the income is distributed. This is generally referred to as full integration. Alternatively, it can provide relief from double tax only to the extent corporate income is in fact distributed. This is referred to as partial integration or dividend relief. Chairman Ullman's proposal takes the latter form; that is, it provides relief from double tax only to the extent corporate income is in fact distributed as dividends. The Treasury Department concluded that full integration was infeasible because of its administrative problems. We agree with Chairman Ullman that partial integration is technically feasible.

There are various mechanisms which can be utilized to achieve partial integration. All of them are similar in that economically they provide relief by reducing or eliminating the corporate tax on income which the corporation distributes to its shareholders. It is possible, however, to formulate partial integration either as a reduction of the corporate tax or as shareholder relief. If partial integration takes the form of relief from corporate tax, the corporation receives a deduction for dividend which it pays, a credit against its tax liability on account of dividends which it pays, or a lower rate of tax on distributed earnings. If partial integration takes the form of shareholder relief, shareholders include in income all or a portion of the tax which the corporation paid on income distributed as dividends and take a credit against their individual tax liability for such amount. Significant short-term consequences flow from the form utilized.

If integration takes the form of a reduction of the corporate tax, the tax saving resulting from integration will be received in the first instance by the corporation. This means that the corporation will have more cash and may be able to retain some of the integration tax savings for internal generation of capital. On the other hand, if integration takes the form of shareholder relief, the tax savings of integration initially will be in the hands of the shareholders. The corporation will be able to obtain benefit from integration for the internal generation of capital only if it can convince its shareholders that on account of this change in law it is appropriate for the corporation

o reduce the level of its cash distributions. Thus, the form in which integration is proposed may have an important impact on the extent to which corporations in the short run are able to capture at least a portion of the integration benefits for internal capital formation. In the long run, the choice between corporate tax reduction and shareholder relief may not affect the retention rate.

A second significant impact of the form involves the calculation of corporate income or financial accounting purposes. If integration takes the form of reduction of corporate tax, corporations probably will be able to report lower tax costs and consequently higher after-tax profits. If integration, on the other hand, takes the form of shareholder relief, corporations will probably have to report the same tax costs as they do today. An integration system which resulted in higher reported profits for financial accounting purposes could have a wide range of psychological effects from stock pricing to wage increases for employees.

Another important impact of the form involves our treaty obligations with foreign countries. Frequently, under these treaties the United States agrees not to withhold more than a specified amount from dividends paid to residents of the treaty country. If integration takes the form of reduction of the corporate tax, it may be argued that we are in violation of treaty obligations if the benefits of integration are denied to foreign shareholders. If, however, integration takes the form of shareholder relief, there is a stronger argument that we have not violated treaty obligations if foreign shareholders are denied the benefits of corporate integration. Because of this factor, European countries which have adopted integration have chosen the shareholder relief form.

treatment of tax preferences

Development of an integration proposal also requires major policy decisions with respect to the treatment of tax preferences. Tax preferences are created by special provisions included in the Internal Revenue Code to encourage taxpayers to undertake activities which are deemed to be socially desirable. In general, preferences are of four types: (1) Credits such as the investment credit; (2) artificial deductions such as percentage depletion; (3) accelerated deductions such as rapid amortization of pollution control facilities; and (4) exclusions from gross income such as interest on state and local government obligations.

Under present law, corporate tax preferences give rise to economic income which is not subject to corporate tax. This income, however, is taxed to shareholders if distributed as dividends.

Insofar as preferences already serve to eliminate the corporate tax, integration may provide no benefit unless the favorable treatment of the preferences is preserved when corporate income is distributed to shareholders. An example of this preservation under present law is the treatment of tax-exempt interest earned by mutual funds. Under certain circumstances, tax-exempt income retains its tax-exempt character when distributed to shareholders of the mutual fund. If the preference were not "flowed through," the mutual fund shareholders would be taxed on the income when distributed.

If preferences are not flowed through, integration will provide a greater benefit to corporations in those industries which currently have fewer preferences and consequently pay relatively high effective rates of tax relative to economic income. Thus, integration could have an effect on the competitive position of different industries in attracting capital investment. The treatment of preferences thus presents a fundamental question: Should integration be limited to relieving double taxation only to the extent that a corporate tax is actually paid, or should it attempt to pierce the corporate veil and pass through the benefit of corporate tax preferences to shareholders? Chairman Ilman's proposal does not pass tax preferences through to shareholders.

In the event that the decision is made not to flow through the benefit of preferences, it will be necessary to provide some rules to determine the source of any dividend distributions. A corporation with preferences has, in effect, two pools of income: income with respect to which tax has been paid (after-tax taxable income) and preference income with respect to which no tax has been paid. There are three options for determining the source of dividends: All distributions may be treated as first coming

out of after-tax taxable income until such income is exhausted; all distributions may be treated as first coming out of preference income until such income is exhausted; or distributions may be deemed to be partially out of each pool, presumably on a pro rata basis. Treating after-tax taxable income as distributed first will provide the greatest benefit to industries with relatively high levels of preference income and distribution while treating preference income as distributed first will provide the least benefit.

Chairman Ullman's proposal treats distributions as coming first out of after-tax taxable income. Also, to some extent his proposal allows shareholders the benefits of integration even when their corporation has distributed all of its after-tax taxable income and is making distributions out of preference income. (This results from the fact that under the proposal the amount which a corporation is permitted to add to its shareholder credit account for a taxable year exceeds the maximum amount of shareholder credits the corporation could have declared for such taxable year if it distributed all of its fully taxed income.) In other words, his proposal provides tax relief even when the distributed income has not incurred any corporate tax. This treatment makes preferences more valuable to a corporation than they are under current law. Under current law, corporate preference income is not subject to corporate tax. Under Chairman Ullman's proposal, preference income can, in effect, give rise to a refund of corporate tax paid on other income. This treatment is most serious during the proposal's 10-year phase-in period. To a lesser degree it continues to be present even after the proposal is fully phased in.⁴

⁴ For example, assume corporations X and Y each earns \$100 of taxable income on which each pays \$48 of corporate tax and in addition corporation Y earns \$20 of preference income on which it pays no corporate tax. Assume further that each corporation has a sole shareholder in the 40-percent tax bracket to whom it distributes all of its after-tax income.

Current law

X Corp.	
\$100	economic income
- 48	corporate tax on \$100
<u>52</u>	
Shareholder of X Corp.	
\$52.00	dividend income
- 20.80	tax (at 40% rate)
<u>31.20</u>	cash after tax

Y Corp.	
\$120	economic income
- 48	corporate tax on \$100
<u>72</u>	
Shareholder of Y Corp.	
\$72.00	dividend income
- 28.80	tax (at 40% rate)
<u>43.20</u>	cash after tax

The value to the shareholder of the \$20 preference income is \$12 (\$43.20 - \$31.20).

Ullman proposal fully phased in

X Corp.	
\$100	economic income
- 48	corporate tax on \$100
<u>52</u>	
Shareholder credit account	
<u>\$14.40</u>	$(\$48 \times .30)$
Shareholder of X Corp.	
\$52.00	dividend income
+ 10.40	gross up $(\$52 \times .20)$
<u>62.40</u>	
24.96	tax (at 40% rate)
- 10.40	credit
<u>14.56</u>	net tax
<u>37.44</u>	cash after tax $(\$52 \text{ dividend} - \$14.56 \text{ tax})$

Y Corp.	
\$120	economic income
- 48	corporate tax on \$100
<u>72</u>	
Shareholder credit account	
<u>\$14.40</u>	$(\$48 \times .30)$
Shareholder of Y Corp.	
\$72.00	dividend income
+ 14.40	gross up $(\$72 \times .20)$
<u>86.40</u>	
34.56	tax (at 40% rate)
- 14.40	credit
<u>20.16</u>	net tax
<u>51.84</u>	cash after tax $(\$72 \text{ dividend} - \$20.16 \text{ tax})$

The value to the shareholder of the \$20 of preference income is \$14.40 $(\$51.84 - \$37.44)$. As illustrated above, the value of preference is \$12 under current law. The Ullman proposal makes preferences more valuable. Even though the preference income is not taxed at the corporate level, the Ullman proposal provides tax relief when the preference income is distributed. As a result, the income is bearing less than one full level of tax.

Foreign tax credit

An issue similar to that presented by preferences arises with respect to the foreign tax credit. The United States generally taxes the worldwide income of its residents and domestic corporations. The United States, however, allows a credit against U.S. tax liability for taxes paid to foreign countries. The foreign tax credit is intended to insure that the tax law is neutral with respect to foreign and domestic investment. That neutrality has been a cornerstone of U.S. tax policy.

In designing an integration proposal, it is necessary to reexamine this policy of neutrality. Some argue that neutrality should be the basic principle underlying international tax policy. Neutrality is achieved when an enterprise pays the same total rate of tax on foreign profits as on domestic profits. This would require the integration of foreign corporate and domestic individual income taxes; that is, an individual would receive credit for corporate taxes irrespective of whether they were paid to the United States or the foreign country. Others, mindful of revenue considerations, point out that allowing a shareholder credit for foreign corporate taxes can be a significant revenue drain on the U.S. Treasury because it may require the refund to shareholders of taxes paid by the corporations to foreign treasuries.⁵ In addition, some argue that a flowthrough of the foreign tax could weaken our treaty bargaining leverage with other countries having integrated tax systems since those countries typically do not flow foreign taxes through to their shareholders.

Traditional practice within a classical system has given the source country the major portion of the tax revenue from foreign investment with only residual taxing rights accruing to the residence country. It is not clear how the tax revenue from foreign investment should be divided between the source and residence countries within an integrated system. Whether the revenue split should be 50-50 or something else is an open question. It is very clear, however, that giving more than 100 percent of the tax revenue to the source country is unacceptable. But this is precisely the effect that full flowthrough of foreign taxes to individual shareholders would often have.

There are a variety of possible solutions. Foreign corporate taxes could be allowed as a credit at the individual shareholder level, but limited to the individual shareholder's effective tax on his foreign source income. This would avoid the refund of foreign taxes by the United States, but would be administratively complex since each individual shareholder would be required to compute a foreign tax credit limit. Another possibility would be for the United States to allow a full credit at the shareholder level for foreign corporate taxes, but require the foreign "source" country to finance the credit. This would entail an EEC-type "clearing house" payment. A third possibility would be for the United States to deny a part or all of the flowthrough of foreign taxes but, like France, Germany, and the United Kingdom, soften the impact through favorable dividend ordering or tracing rules.

Special categories of shareholders

A number of major issues arise in connection with the treatment under integration of special categories of shareholders. The most important of these categories is tax-exempt institutions. Many integration proposals (apparently including that of Chairman Ullman) effectively exclude tax-exempt institutions from participating in the benefits of integration by denying these shareholders a refund of any corporate tax attributable to their dividends. It is frequently argued that this exclusion will reduce the revenue cost of integration.

Theoretically, a strong argument can be made that tax-exempt entities should be entitled to the benefits of integration. Such entities arguably are equivalent to taxpayers with a zero marginal tax rate. If tax-exempt entities do not receive the benefits of integration, then taxable shareholders with very low marginal tax rates will be left with

⁵ For example, assume a domestic corporation's only taxable income was \$100 earned in a foreign country which imposed a \$48 income tax, and that the corporation paid the remaining \$52 to its U.S. shareholder who had a 30-percent marginal tax rate. Under current law, the corporation will be allowed a \$48 foreign tax credit and will owe no U.S. tax. If the entire \$48 were treated as U.S. taxes paid under a system of integration which provided full dividend relief, the results would be as follows: The shareholder would gross his dividend up by \$48 (the taxes deemed paid by the corporation) and report \$100 of taxable income. The shareholder would incur a \$30 tax, offset by a \$48 credit, and so would receive an \$18 refund. The U.S. Treasury would be refunding taxes which were, in fact, paid to a foreign government.

more dividend income after tax than charities. This anomaly led a tax law professor to ask us: "At what rate of tax are tax-exempts tax exempt?" In other words, denying charities the benefits of integration is equivalent to subjecting them to tax.

The exact effect of denying the benefits of integration to tax-exempt shareholders is hard to predict. There is considerable concern that over a period of years the treatment might lead to a major shift of tax-exempt investors out of the equities market in favor of debt instruments at least with respect to new investments. Thus, as taxable and tax-exempt shareholders readjust their portfolios, the anticipated revenue savings would not be realized and there would be significant transactional costs. In addition, this shift in portfolios may undermine the positive impact on equity markets expected in connection with integration.

Also, denial of the benefits of integration to charities will cause these institutions, to the extent they continue to own corporate equity, to exert pressure on corporations to continue high levels of cash dividend payouts. (Taxable shareholders might be willing to accept lower cash payouts because they would be receiving tax credits as a result of integration.) This will tend to force corporations to pass the entire benefit of integration through to shareholders. Such a result has been a major concern of corporate managers.

In particular, tax-exempt pension trusts present difficult technical problems. It can be argued that it is appropriate to treat these trusts like other exempt organizations to the extent they receive dividends attributable to contributions made with pretax dollars. (Taxable income earned with respect to pretax dollars is mathematically equivalent to tax-exempt income earned with respect to after-tax dollars.) However, this argument is inapplicable to the extent these trusts receive dividends attributable to contributions made with after-tax dollars such as voluntary employee contributions. Any mechanism for allocating dividends between these sources would be extremely complex.

A second category of shareholders presenting special considerations are financial intermediaries. These include mutual funds and real estate investment trusts for which a dividends paid deduction form of integration is provided under current law. In addition, there are life and casualty insurance companies, both mutual and investor-owned, as well as commercial banks and other stock and mutual depository institutions. The tax treatment of these institutions has been developed over a period of many years and has been designed to insure that the tax system does not disrupt the competitive balance which exists among the different classes of institutions. Inclusion of these institutions in an integration program in such a way as to insure maintenance of the balance will require extensive study.

Transactions

Finally, there are a number of provisions under current law which, in effect, mitigate the effects of the present system of double taxation. These include the ability to liquidate a corporation, or make certain noncash dividend distributions, without recognizing unappreciated gain at the corporate level. These provisions introduce a substantial amount of complexity into the law and provide the impetus for much tax planning. These provisions should be studied in the context of an integration proposal since integration is intended to provide an overall solution to the problems of double taxation.

CONCLUSION

We believe that integration has considerable merit. As the discussion indicates, however, experts are divided on some of the potential effects of the proposal, and various segments of the business community are divided on the technical aspects of its implementation. We believe further analysis and debate of these issues is essential.

Exhibit 31.—Statement of Deputy Assistant Secretary Sunley, April 24, 1978, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on tax indexing

I appreciate this opportunity to appear before you and discuss the subject of indexation of the tax system. The recent surge of interest in indexation, or inflation adjustment of the tax system, obviously stems from the high rate of inflation we have

experienced for the last several years. If inflation were proceeding at a rate of only 1 or 1 1/2 percent as it did in the early 1960's, there would be much less concern with as complex an alteration of the tax law as indexation. On the other hand, if the rate of inflation were to accelerate and reach a level of 20 or 25 percent as in some other countries, I believe almost everyone would favor indexation. Thus, one factor in deciding whether we want to index the tax system is the projection of likely future inflation rates. If we expect a moderate rate of inflation, say 6 to 7 percent, we must then decide whether the complexities involved in going to an indexed system are worth the gains, or whether there are other forms of ad hoc adjustments which could achieve the same ends of automatic indexation, but which would involve much less tax complexity.

There are two separate issues in indexing the tax system: The definition of income and the proper tax treatment of income, once defined. I will begin by discussing the second issue, the tax treatment of nominal dollar amounts, because in this area proposals and recommendations have been most fully developed.

Fixed dollar amounts

As inflation occurs, the real value of fixed dollar amounts declines; and thus, since income taxes are computed from tax brackets and exemptions which are denominated in fixed dollars, tax liabilities and effective tax rates rise. To illustrate this result, consider a family consisting of a husband, wife, and two children, with an income of \$15,000. Their income tax based on 1977 rates would be \$1,385, or about 9.2 percent of income. Now, let's assume that inflation runs at a rate of 7 percent this rate, a bit higher than our current estimate but the average that we have experienced for the last several years, and assume further that this family's income increases by this same percentage. That would mean that their dollar income in 1978 would be \$16,050, but, of course, their real income, that is, their actual spending power, would not have increased at all above last year's level of \$15,000. Yet their income tax would rise to \$1,613 and more importantly, their effective tax rate, which had been 9.2 percent in 1977, would rise to 10 percent in 1978. If this high rate of inflation were to continue for 10 years, this family, even though it had experienced no increases in real income, would see its effective tax rate climb to 17.8 percent, almost double what it had been in 1977 if—and this is a big if—Congress did not make any income tax changes during the intervening period.

In this instance, what is true for an individual family is true for taxpayers as a whole. If we experience 10 percent inflation, individual income tax receipts rise not by 10 percent, but by something closer to 15 percent. In the technical jargon of economics, the elasticity of the income tax with respect to inflation is about 1.5; that is, tax receipts rise one and a half times as fast as the rate of inflation.

Since World War II, the rate of inflation has ebbed and flowed but the trend of prices has always been upward. Does this mean that the effective tax rate on individual income has been constantly rising over time? Not at all, because Congress has in fact taken frequent action to reduce individual taxes so that the individual income tax as a percentage of personal income has actually fluctuated in a rather narrow band. Since 1951, it has ranged from a low of 9.2 percent (in 1965), to a high of 11.6 percent (in 1969 when the 10-percent surcharge was in effect).

It is not just inflation which pushes taxpayers up into higher tax brackets. Because the real productivity of the American economy has been rising, in the absence of offsetting legislation, our tax bills would also have risen, given our progressive rate structure. This would have been true even if there had been no inflation. Thus, the fact that income taxes as a percent of personal income have not risen means that Congress, with its periodic tax cuts, has been offsetting not only the impact of inflation on tax rates, but also the impact of the growth of real per capita income. In fact, if Congress had not cut taxes periodically but instead had indexed the individual income tax for inflation on the basis of the Consumer Price Index in 1960, taxes would in fact have been higher in 1975 than they were under the actual 1975 law.

Thus, I think the question we should ask is not: Should we adjust the tax system for inflation? But rather, how should we adjust the tax system for inflation—by an automatic process called indexation or by periodic legislative readjustments?

Automatic indexation

I would like to discuss three issues concerning automatic indexation: The impact of inflation on the Government's share in the economy, the necessity of congressional oversight, and the impact of indexation on economic stability.

Many people favor automatic indexation because they believe that the Government will automatically increase its share of the total economy as inflation generates additional taxes. Thus, they believe the Government "benefits" from inflation. This view is mistaken. The historical record, mentioned above, shows that the response of the Federal Government to an upward trend in effective tax rates has not been to launch new expenditure programs, but rather to reduce taxes. The present proposed tax cuts illustrate this. Taxes are raised to pay for Government programs; Government programs are not expanded just to spend increased tax revenues. Automatic indexation by itself would lead to neither a smaller nor a larger Government sector.

Next, the argument is sometimes made that automatic indexing is desirable because Congress should not have to "be bothered with" an inflation adjustment every year. It is true that the automatic nature of indexation systems removes the need for frequent oversight by Congress, but this argument works both ways. The argument could be made, equally well, that encouraging the Congress to take a more frequent look at what is happening to the tax system may in itself be desirable. Also, even with indexation Congress would have to adjust taxes downward periodically to offset the impact of rising real per capita incomes.

The final argument, and one which I find very important, concerns the impact of automatic indexing on overall fiscal policy. Inflation represents an excess of purchasing power relative to the amount of goods and services available, and therefore tax increases are called for. Automatic indexation of the tax system, whatever its appeal on equity grounds, moves in the opposite direction. That is, under indexation, inflation would give rise not to tax increases but rather to tax cuts or at least, in real terms, no change in effective tax rates. Rather than give up its control over this aspect of fiscal policy, I feel the country would be better off if Congress continued with its existing ad hoc approach to tax increases and decreases.

There have been occasions when we would have been better off with an automatic tax reduction—1974 and 1975 might have been such occasions, given the increasing rate of unemployment. But in general, if all we know about the economy is that it has been experiencing inflation, economists would generally prefer to have taxes going up rather than going down. If the appropriate fiscal policy calls for a tax reduction Congress can provide that reduction.

Income measurement

Let me now turn to the second and much more difficult issue concerning indexation—that is, the definition of income and specifically the measurement of real income from capital. Ideally, the base of the tax system should be real income because that is the best measure of ability to pay. With reasonable price stability, nominal income provides a satisfactory approximation of real income, but under inflationary conditions, this is no longer the case. Particularly severe problems arise in four areas: Depreciation of fixed assets, inventory accounting, capital gains, and financed instruments.

Depreciation.—Generally, fixed assets are depreciated on the basis of their historical cost. It is easy to see that this is inappropriate in a period of inflation because the dollar value of depreciation allowances will be worth less, as time goes on, than the "real" value of the assets being used up. Unfortunately, while the problem is clear, the solution is not. There has been much controversy in recent years, both here and abroad, concerning the appropriate accounting for depreciation of fixed assets in a period of inflation. One possible approach would be to adjust depreciation for each asset based on replacement cost, which would involve calculating a separate price index for every kind of asset. Even aside from the great difficulties in adjusting for quality changes and technological innovations over time, it is clear that the sheer numbers and recordkeeping involved here would lead to a very cumbersome system. Moreover, such practice would allow real changes in relative values to escape taxation. Another possibility

would be to index on the basis of some measure of the general price level. Such a measure would refer not just to the prices of capital assets, but would be a reflection of the value of the dollar in broader terms.

Although current law does not contain an explicit depreciation adjustment to account for the effect of inflation, accelerated depreciation methods provide some offset for inflation. In fact, until the high inflation rates experienced in the last few years, the use of accelerated depreciation on a historical cost basis has generally meant higher depreciation deductions (and, hence, lower income taxes) than if the law permitted straight-line depreciation on a replacement cost basis. The Commerce Department has estimated the net effect of these adjustments (accelerated depreciation and replacement cost accounting) on Capital Consumption Allowances, which is the National Income and Product Account concept analogous to depreciation and amortization. For corporations, the net effect was positive (i.e., lower taxes) for the years 1962-73, while for the years since 1974, it has been negative. That is, for the last few years of high inflation, replacement cost depreciation on a straight-line basis would have meant lower taxes, whereas for earlier years historic cost depreciation on an accelerated basis meant lower taxes. (For sole proprietorship and partnerships, the net effect has been lower taxes ever since 1946.)

Inventory accounting.—In the area of inventories, the current LIFO (last-in, first-out) system of accounting is in fact a form of inflation adjustment similar to replacement cost depreciation. However, some have argued that it would be more appropriate to require FIFO (first-in, first-out) inventory accounting but to permit an adjustment to effect the change in the general price level from the time the item was put in inventory until the time it was removed from inventory and sold. Such a system would be much more complex than the LIFO method.

Capital gains.—One of the clearest areas in which inflation has an impact is capital gains. If an asset's market value increases due solely to inflation, the holder of that asset has really experienced no increased in wealth, yet he is required to pay a capital gains tax on the difference between the original purchase price and the sales price. In fact, his impact of inflation has been one of the key arguments in defending the present favorable treatment which capital gains receive in our tax system. The present 50-percent exclusion feature does indeed provide an offset for inflationary gains. However, in any given case it is usually either too much or too little; only rarely would inflationary gains amount to exactly 50 percent of the total gain. The proper taxation of capital gains under inflation depends on the way financial instruments are handled, as we shall see below.

Financial instruments.—If an individual earns an interest rate of 5 percent on a \$1,000 savings account, at the end of the year he would have \$1,050. Suppose, however, the rate of inflation has been 7 percent over the course of the year. This means that at the end of the year the individual has not gained from his investment, but is actually worse off, for he has less purchasing power than he did at the beginning of the year. His \$1,050 is actually worth only \$981 in terms of beginning-year prices, and even though he is experiencing this \$19 decline in real purchasing power, he must still include \$50 in his taxable income, and when he withdraws his deposit, he will not be allowed a tax deduction for his loss of purchasing power.

On the other hand, consider a debtor who is able to pay off his debt in deflated dollars: he actually benefits from inflation. Moreover, for tax purposes he may deduct all of his interest payments—even those which merely reflect inflation. Thus, inflation produces both gainers and losers in terms of real income, and this asymmetry poses real problems for any practical system of indexation. Suppose, for example, I purchased an asset for \$1,000 and financed it entirely by debt. Would I be helped or hurt by inflation? The answer is that if the holding period of the asset and the debt are the same, I have completely protected myself from the effects of inflation; any inflationary loss on the asset is exactly offset by a gain on the debt.

Market adjustments

We generally speak of the changes in value resulting from inflation as if they were always unanticipated, but this is not really the case. No one, for example, thinks that

the price level 12 months from now will be precisely where it is today. While we may not agree on an exact number, everyone anticipates some rise in prices, and lenders as well as borrowers, take this into account in deciding the terms of a loan.

If the real rate of interest, that is, the rate for stable prices, is 3 percent, lenders will not continue lending money at 3 percent when the rate of inflation is 5 percent—the lender will demand a higher rate of interest. How much higher depends on the lender's tax rate, for he will try to maintain his after-tax rate of return. Suppose a lender's marginal tax rate is 50 percent; that means that under stable prices, his after-tax rate of return was 1 1/2 percent. If inflation now rises to 5 percent, he will seek to raise the before-tax rate not just to 8 percent (i.e., 3 percent + 5 percent) but to 13 percent because after he pays taxes on 13 percent he will have 6 1/2 percent left, which in real terms (subtracting 5 percent for inflation) is the same as the 1 1/2 percent he was earning before inflation.

Thus, in this case the market rate of interest would adjust so that no inflation adjustment would be necessary for the lender. What about the borrower? If he is in the same tax bracket, no adjustment is necessary for him either. In the absence of inflation he had to pay 3 percent, but this was a deductible expense on his tax return, so his after-tax, real cost was 1 1/2 percent. Now he has to pay 13 percent interest but this, too, is deductible, so after taxes he pays only 6 1/2 percent, and he is repaying the loan in depreciated dollars, so his real cost is, again, 1 1/2 percent.

To the extent that market rates of interest adjust for anticipated inflation, then, it would appear that no tax adjustment for debt instruments is necessary. There are three qualifications to this, however. First, creditors and debtors may not be in the same tax bracket, so any rise in the rate of interest will have certain redistributive effects between them. Second, many people feel that the market does not fully adjust, that there are always lags and other discrepancies among nominal rates of interest, real rates of interest, and the rate of inflation. Finally, for many creditors there are institutional barriers which prevent them from adjusting their rate of return in response to inflation. Specifically, we have laws setting limits on the rate of interest which may be paid on savings in banks and other financial institutions. In some recent years, these limits have been less than the rate of inflation, which means that savings account holders have been unable to adjust the rate of interest they earn, and therefore have suffered an actual loss in the value of their assets while at the same time they have been forced to pay income tax on their nominal interest receipts.

In brief, there is currently no agreement among economists, accountants, and businessmen on just how an adjustment for financial instruments should be made. This uncertainty reflects both differences of opinion concerning how well the market adjusts rates of return to take account of inflation, and concern with the equity and practicality of handling inflation premiums. Some economists have argued that the interest deduction should be reduced by the amount of interest that is caused by inflation, i.e., the "inflation premium." This, of course, would require an estimate of how much the current nominal rate of interest is real and how much is just an inflation premium. Others have suggested that the full interest deduction should be permitted and the full amount of interest income taxed, but at the time debt is paid off, a gain or loss should be recognized to the extent that the debt is paid off with deflated dollars.

Financial accounting

Similarly, no consensus has yet emerged concerning the appropriate way of adjusting depreciation for inflation. The Securities and Exchange Commission has required certain large companies to provide supplemental accounting information concerning the cost of replacing productive capacity. The approximate amount of depreciation depletion, and amortization which would have been recorded under such a scheme provides a measure of replacement cost depreciation.

Another proposal for adjusting accounting data for inflation was made, somewhat tentatively, by the Financial Accounting Standards Board. The aspect of that proposal which drew the most attention was the inclusion in net income of changes in the purchasing power of net holdings of monetary assets. This turned out to be quite controversial, and the FASB subsequently withdrew its proposals for further study.

A study of the impact of indexed accounting for two groups of corporations was undertaken by Sidney Davidson of the University of Chicago and Roman Weil of the Georgia Institute of Technology. They recalculated the financial statements of the 30 firms included in the Dow Jones Industrial Average and the 24 utilities included in the Dow Jones Utility Average. All of the utilities would have had higher income and hence presumably higher taxes under the FASB proposed accounting rules, mainly because of the large amount of debt they owed. In the case of the industrial firms, 21 would have had lower taxes and 9 would have had higher taxes. Thus indexation is not an unmixed blessing from the point of view of corporate taxpayers.

It seems to us that until there exists a greater consensus within both the accounting profession and the business community concerning the best manner of adjusting financial and operating statements for inflation, it would be inappropriate for the Treasury Department to attempt to impose any particular "correct" method. Until the accounting profession has worked out the technical details of how to index income, and until the business community is prepared to use an indexed financial statement in reporting to their stockholders and creditors, Congress should not permit the business community to report to the Internal Revenue Service on an indexed basis.

Conclusion

What can we conclude from this review of indexation? As I stated at the outset, at rates of inflation above a certain level almost everyone would feel that indexation is desirable. I feel that our present and prospective inflation rates are not at that level. To introduce indexation into the tax system would mean substantially increasing the complexity of the present system, greatly increasing the recordkeeping requirements of individuals and firms, and making fairly arbitrary decisions in many areas of income measurement in which no consensus has emerged to date from economists, accountants, or businessmen. Until we know more, it would be a mistake to proceed too rapidly.

Comments on S. 2738

I have been asked to comment on bill S. 2738, which provides for indexation of certain provisions of the tax laws. This bill essentially calls for indexing the fixed dollar amounts defined in the tax code by adjusting them upwards at two-thirds of the percentage change in the Consumer Price Index. As I indicated in the first part of my testimony, this is a fairly straightforward form of adjustment and while it does mean the recalculating of a number of factors, it requires no action on the part of Congress or the executive each year in response to inflation. It does mean, however, that the amount of fiscal stimulus (in the form of tax cuts) provided each year will be determined by the rate of inflation in the previous year: the more inflation last year, the more stimulus this year. Moreover, it would make it more difficult for taxpayers to make accurate estimates of their tax liability and therefore make appropriate adjustments in their withholding rates.

The bill goes well beyond this simple form of indexation, however, and provides for a basis increase for capital gains. This basis increase would apply only to capital assets; no provision is made for adjusting financial instruments. Thus, the proposal encounters the difficulty which I mentioned of discriminating between leveraged and unleveraged investors, and between those investors capable of converting income into a capital asset and those unable to.

While a heavily leveraged taxpayer would receive a significant windfall from such a provision, many persons relying on fixed incomes would be relatively disadvantaged. The savings account depositor is a prime example. Because his savings account interest rate is limited by law, he is not in a position to obtain a real interest rate sufficient to compensate for his inflationary losses. Moreover, a fixed security like a savings account cannot increase in market value the way an equity can. Thus, while the equity holder might experience a rise in market value for his equity, only a portion of which would be taxed away, the holder of a bank deposit would see no rise in the value of his account. He would still be required to pay taxes annually on the full amount of his nominal

interest income while the owner of a capital asset could adjust his gain for inflation as well as postponing the tax on that adjusted gain until the asset is sold. Further, under S. 2738, only half of that real capital gain would be taxed at all! There is a patent inequity in a tax system that would insulate holders of real estate and stock from the impact of inflation while ignoring the plight of low-income taxpayers who tend to hold savings accounts.

Current law with respect to capital gains has demonstrated that taxpayers will strive to change an ordinary income transaction into a form qualifying for preferential tax treatment. An inflation adjustment for capital gains would place an even greater premium on such manipulative practices and open new avenues for tax gamesmanship. A clear example of this is the collapsible corporation, a device used for the conversion of ordinary business profits into capital gains. If an inflation adjustment is permitted with respect to stock, such collapsible corporations would retain substantial tax advantages unless a significant holding period were required before the inflation adjustment would go into effect.

If we attempt to restrict the categories of assets eligible for inflation adjustments, we would exacerbate problems involving corporate tax shelters. In the event corporate stock is eligible for an inflation adjustment which is denied most other assets, there will be pressure to incorporate scores of nonpreferred investments. For example, taxpayers might be motivated to incorporate savings accounts, jewelry, and antiques if the basis of those investments could not be adjusted independently. Another area of complexity in the tax law would have to be developed in order to prevent such abuses.

Finally, providing an inflation adjustment for capital gains as proposed in S. 2738 would add to the complexity of computing taxable gains. Currently, the amount of gain in a transaction is generally determined without regard to the length of time an asset has been held, once the holding period is such as to qualify as "long term." With an inflation adjustment mechanism such as S. 2738, however, the date of any change in basis becomes all important. Even in the simplest of transactions, a taxpayer will have to account for the date an asset was purchased as well as the amount paid for that asset, and this determination could create significant administrative problems in those instances where basis is carried over from one taxpayer to another or from one asset to another by transfer where no gain is recognized. Further, an investor adding to or withdrawing from his investment over time would have to calculate a separate inflation correction for each such action.

In brief, without the introduction of a comprehensive scheme of indexation throughout the tax law, a basis adjustment for capital gains might violate the neutrality standard and add new economic distortions to the tax laws. During periods of high inflation, the savings of individuals and businesses would tend to flow increasingly into those investments eligible for an inflation adjustment and away from "nonadjustable" investments. Once an inflation adjustable asset had been selected as an investment, there would also be a tendency for the investor to maintain that investment longer than would be desirable in the absence of the inflation adjustment.

There are many difficult conceptual as well as practical problems involved in correcting the measurement of income for the effects of inflation. Until we have made much more progress in this area, it would be a mistake to proceed in piecemeal fashion to provide an adjustment for only one form of income, namely, capital gains, while denying any adjustment for other, equally deserving, types of income which do not enjoy the preferential treatment already accorded capital gains.

Exhibit 32.—Statement by Deputy Assistant Secretary Sunley, May 22, 1978, before the Senate Committee on Banking, Housing and Urban Affairs, on tax-based incomes policy

I am pleased to appear today to discuss with you the potential for use of tax incentives to hold down wage and price increases. These imaginative proposals have recently been receiving increasing attention and I am happy to see that this committee is giving them a thorough hearing.

I will address my remarks here to the administrative problems of tax-based incomes policies such as those put forth by Arthur Okun and by Henry Wallich and Sidney Weintraub. A workable scheme must permit the Internal Revenue Service and businesses to determine the amount of tax benefit or penalty that a firm qualifies for or is subject to. As one might expect, finding solutions to the administrative problems often involves trade-offs with features that would otherwise be desirable on economic or political grounds.

Preliminary observations

The administrative problems of implementing a tax-based incomes policy depend crucially on five initial design decisions. First, the scheme may impose tax penalties on firms granting excessive wage or price increases, or it may provide tax reductions for firms or workers restraining price or wage increases. If the "stick" approach is taken, that is, penalties are imposed, then unincorporated businesses and small firms, which often employ only rudimentary accounting, can be excluded from the program. Limiting the penalties to larger corporations would greatly reduce administrative problems without seriously impacting the effectiveness of the program.

The "carrot" approach is politically attractive because it could probably provide tax reductions directly for workers as well as employers if wages did not rise above the threshold amount. But, providing tax reductions for workers raises some vexing administrative problems. Firms would have to inform workers on the W-2 form that they qualify for the tax break, or, following Okun's suggestion, they might adjust withholding in anticipation of qualifying for the tax break. If on audit it is found that the workers did not qualify, the Internal Revenue Service would have to collect from the firm, leaving the tax break for the workers intact. This solution is practical, but it seems to suggest that employees are responsible for successful wage restraint, while companies are to blame for any failure.

Furthermore, it would not be desirable to deny small business taxpayers and their employees the rewards for good behavior. A program that has universal coverage of all taxpayers would be much more costly to administer than one that covers only larger corporations. I conclude, therefore, that the "stick" approach involving penalties on firms is to be preferred on administrative grounds to the "carrot" approach involving tax breaks for workers.

The second initial decision with important administrative implications is whether the rewards and penalties apply over the full range of possible wage and price changes such as under the program proposed by Laurence Seidman, or whether they depend on the firm remaining above or below a threshold or "hurdle." Under a continuous program, higher prices and wages reduce the rewards or increase the penalties according to some formula. Continuous incentives are more efficient but also would require that for every firm the exact increase in wages or prices must be known.

In the "hurdle" approach, the rewards and penalties depend simply on whether a firm's wage increases are below, say, 5 percent per year. In this approach, IRS enforcement efforts can be concentrated on firms that are near the hurdle. Consequently, the "hurdle" approach is more attractive on administrative grounds.

Whether the program is a temporary or permanent one is the third initial design decision. If a tax penalty is imposed for only 1 year, it is likely to have very arbitrary effects among firms depending on when they customarily raise wages and prices. Complicated intrayear adjustments annualizing wage and price increases occurring during the year may be needed to reduce the arbitrariness of the program. Also, special rules or exceptions may be needed for multiyear contracts that provide future wage or price increases. A temporary program may result in firms and workers agreeing to compensatory wage increases or bonuses to be paid after TIP expires. The best way to avoid this problem is to indicate initially that a temporary program may very well be extended if it is successful in moderating inflation.

The fourth initial decision is whether the basic accounting unit for wage and price increases should be the plant, the corporate entity, or the conglomerate. In the case of a tax-based incomes policy applying only to wages, the basic accounting unit could also be the bargaining unit, or class of workers.

By far the simplest arrangement for administration is to have the basic accounting unit be the group of related corporations that file a consolidated tax return, and to have the basic time period be the accounting period of that group. Some corporations may be on a calendar year time period, and others on a fiscal year.

If the TIP penalties or rewards are to be applied directly to tax liabilities of employees, it may also be necessary to apply them to each bargaining unit or broad class of employees. Otherwise, one group of employees may be penalized for the greater demands or stronger market positions of another union or class of workers.

The fifth initial design decision is to specify the nature of the TIP penalty or reward. Most TIP proposals have been cast in terms of changes in the rate of the income tax. Thus, the Okun proposal would rebate a percentage of the income tax for firms and employees of firms that pass the hurdle, while Wallich and Weintraub propose a surtax on income for firms that fail the hurdle. Laurence Seidman has suggested a variable system with rebates for firms that do better than a specified standard and a surtax for those that do worse.

However, an economic case may be made for tying a wage restraint to the Federal payroll taxes. A payroll tax variant of TIP would then be directly related to a measure of labor cost rather than to capital income. Some approach other than altering the income tax rate should be proposed, if it is deemed important that businesses be subject to TIP, regardless of the amount of income tax currently paid. In 1973, 56 percent of corporate taxpayers paid no Federal income tax. A TIP that alters the income tax rate for the current tax year would have no consequence for such firms.

The most easily administered type of TIP incentive that would also apply to deficit companies is a credit or surcharge applied to one of the payroll tax bases. These incentives could be defined as additional income tax liabilities or credits so as not to affect the trust funds.

Having settled on (1) carrot or stick, (2) a hurdle or continuous formula, (3) temporary or permanent, and upon (4) the level of consolidation, and (5) the type of penalty or reward, any TIP program must specify rules to determine the extent of wage increases. If price increases are to be explicitly treated, these must also be defined. In each case, there are problems of defining the prior year base and measuring the increase over the base. The administrative problems are considerable, particularly in the case of prices, unless simplified procedures are adopted. These procedures would be somewhat arbitrary and could distort business decisions such as the choice between debt and equity or the choice between money wages and fringe benefits.

The measurement of wage increases

A comprehensive measure of pay increases would include all elements of labor compensation that can be reasonably valued in dollars. That is, the numerator of the hourly wage rate would be the sum of money wages and salaries, including overtime; the accruals of pension rights; profit sharing and other incentive awards; contributions to annuities and group insurance; commissions; bonuses; and any other valuable compensation. The denominator would be the annual total of man-hours worked. Such a thoroughgoing definition of wages is desirable unless there is some reason to promote the substitution of nonwage benefits for money wages.

All of the practical problems of measuring nonwage compensation are already encountered in defining and administering the income tax. For employees, the incentive to seek substitution of certain tax-exempt or unreported nonwage benefits such as reduced-rate merchandise or company-paid insurance already exists. For corporations, there is a strong incentive to avoid understatement of deductible labor costs since these directly reduce corporate tax liability; but, in many cases, fringe benefits that are not reported as income by employees are deductible to employers as business costs.

Under a hurdle-type TIP program, the payoff at the margin for reducing measured pay increases by increasing benefits that are not recognized as compensation may be very large. For some versions of TIP, if the wage hurdle is set at 6 percent, any device that allows a firm to reduce the measured increase from 6.1 percent will result in a tax rate reduction (or avoidance of a rate increase) on the entire income of the firm. Because of this "notch," firms that are near the margin of target wage increases would

have very strong inducement to underreport increases in compensation, even if the average rate of the TIP penalties or rewards is small. A similar potential notch problem would exist on the price side of TIP.

One set of wage measurement issues thus involves defining enforceable rules for measuring accruals of pensions and unfunded insurance benefits, for measuring the value of employee fringe benefits, and for estimating hours worked for those on salary or commissions. Another set of wage measurement issues is the adjustment of gross increases in hourly compensation for such considerations as year-to-year variations in the amount of overtime, changes in the skills mix, changes in the average length of service, explicit escalator clauses, and incentive awards.

Equity would suggest that a firm with above-average overtime in the current year should not be penalized under a TIP. This would require that an adjustment for overtime be made in both the base period and for the current year. Many firms, however, would not have records to support the amount of overtime pay in the base period.

It may also be unfair to penalize a firm for pay increases that result from adding more highly skilled employees, or for rewarding employees who complete training programs or surpass quotas. To the extent that employee incentive awards, increases for length of service, and promotions are intended to reflect increased productivity, these changes in compensation are already allowed for in setting the wage increase hurdle. But firms in a cyclical downturn may be caught by TIP if layoffs are mainly lower skill, lower pay employees. Actual shifts in the mix of employment toward higher paid classes will, of course, be penalized if TIP is based only on the change in aggregate hourly compensation.

TIP could also provide an incentive for firms to contract out for high-wage labor services. Suppose, for example, that a small construction firm, consisting of five laborers and two engineers, wishes to hire an additional engineer. Under a straight hourly wage hurdle with no adjustment for classes of workers, hiring the engineer outright could cause the firm to fail the TIP hurdle. Hiring the additional engineer as a consultant would allow the firm to qualify unless there were regulations to count consultants as employees.

During the 1971-72 wage controls, the meaning of the term "wage increase" was rather narrowly construed to mean increases in the regular compensation, not including over-time and bonuses, for a given job held by employees with the same length of service and quality of performance. This concept requires the specification of an index to adjust compensation per hour for changes in job definitions, longevity, and the mix of skills.

A wage index could take the form of a weighted average of hourly wages in each job classification or grade. But the specification of such an index adds significantly to the compliance and administrative burden as compared to a simple average hourly wage measure. It also puts heavy reliance on the job classification system of business organizations. If the coverage of the TIP program is to be nearly universal, most small employers would need to invent a classification system and all employers would be tempted to bend their classification systems to help achieve the specified standard. The promotion of a relatively high-paid secretary to administrative assistant can reduce the average wage in each category, giving the appearance of wage reductions. Such promotions would give more room for pay increases within grades without encountering the TIP penalty or foregoing the TIP reward.

The worst injustices resulting from shifts in the employment mix may be accommodated, without adding greatly to administrative burden, if a calculation of the average increase in hourly compensation defined to include all types of compensation were made separately for certain broad and recognizable classes such as (1) hourly rated employees, (2) salaried and commissioned employees, and (3) corporate officers or partners. The increase in these classes could then be averaged using the number of full-time equivalent employees of each class in the base period as weights.

Finally, Congress would need to decide whether exceptions should be allowed for low-wage employees and, especially, for wage increases mandated by increases in the minimum wage. Again, exceptions of this type that are attractive on equity grounds will complicate administration and compliance.

The measurement of price increases

Extending a tax-based incomes program to prices would increase the administrative problems severalfold. In the case of wages, there is a basic unit of labor, a man-hour, which can be adequately defined. Total compensation, somehow defined, can then be divided by total man-hours to obtain compensation per man-hour.

In the case of prices there is not a basic unit of output. Thus it is not possible to divide total sales revenue by total units of output to obtain price per unit of output. Instead, a price index must be created for each covered firm. This is not a simple task when there are some companies such as Dow Chemical that produce over 100,000 separate products.

What makes matters even more difficult is that a firm may have raised its price only because it was passing through an increase in the cost of purchased materials. Allowing a passthrough of cost increases is a simple concept, but it does raise a number of issues, particularly as to just what costs are going to be passed through and how purchased materials are to be priced. In general, firms should be permitted to pass through costs of inputs if the firm is a price taker. However, if the firm has some control over the price of the input, passthrough should not be permitted. But this would be a very tough judgment to make in developing a TIP program, and the rules would inevitably be more appropriate for some taxpayers than for others.

To determine whether there has been a price increase net of costs of materials, i.e., a value-added price increase, the firm must know last year's prices of purchased materials and output. Last year's price of a product very likely will be a weighted average of the prices at which the product was sold during the previous year, and special rules may be required for temporary special allowances offered during the base period. The firm would then measure this year's value-added using last year's prices and compare that with this year's value added measured using this year's prices. In short, the firm would construct a value-added price index using this year's quantity weights for both outputs and purchased materials. Constructing such an index would raise all the traditional problems involved in constructing a price index.

The first problem in developing a value-added price index is to define by statute or regulation what is a product or an input. For example, how many kinds of automobiles does General Motors sell in 1 year or how many kinds of steel does Bethlehem Steel produce? In the case of a drug store, are felt-tipped pens different from ballpoint pens? Just what is a separate product or input would have to be defined with sufficient clarity that the firm and the Internal Revenue Service can easily compute the value-added price index.

Closely related to the problem of new products is the problem of quality changes. This year's automobile is different from last year's. Some adjustment would have to be made for product improvement such as disc brakes, safety equipment, and more durable bumpers. Again, the statute or the regulations would have to provide specific rules for quality improvements that both businesses and IRS agents can easily follow.

An additional problem with constructing an index is that the base period may not be a "normal" year. Companies whose base period prices or wages were abnormally low will seek an exception or special relief. For example, the major firms in the steel industry raised prices just before the August 15, 1971, freeze. These firms thus had a high base-period price. The smaller firms in the steel industry had not raised prices. These firms, as a result, were doubly penalized since they purchase raw steel from the majors and sell finished products in the same market as the majors.

The problems of measuring average price increases arose during Phase II and later phases of the economic stabilization program. Unfortunately, the experience during the economic stabilization program gives little guidance for administration of a tax-based incomes policy since little auditing of company reports was ever done. Firms were essentially on an honor system, and the Cost of Living Council generally accepted the reports as filed.

I conclude that computing a value-added price index for each firm would involve considerable complexity for business. There is no easy way to define what are separate products or inputs or to handle new products, quality improvements, and the various issues surrounding cost passthrough. Sampling techniques could ease the administrative

burdens for large business but would be beyond the capabilities of a small retail firm with many different products. If it is desirable to apply a tax-based incomes policy to prices, consideration should be given to a scheme that does not involve the construction of an index.

Profit margin test

During wage and price controls, a profit margin limitation was employed as a supplemental device to allowable cost passthrough. It was assumed that a firm that had not increased its profit margin; i.e., the ratio of profits to sales, had not increased its prices excessively.

A profit margin limitation would solve many of the problems of a value-added price index. No special rules would be required for new products or quality improvements. All costs could be passed through including increases in wages. Presumably, a parallel portion of the tax-based incomes policy would provide a brake on excessive wage increases.

Firms would, however, have an incentive to increase expenditures for advertising and R. & D. so as to shrink profit margins. Unless the test was applied to "gross" profit margins; that is, profits before debt service, firms would have an incentive to substitute debt for equity financing. Base-year problems would also remain, though they would be mitigated since the base period could be an average of several prior years and not just the immediate preceding year. Special exceptions would have to be made for losses or very low profits in the base year. One possibility would be for the Government to publish minimum profit margins for specific industries based on industry averages.

The major advantage of a profit margin limitation is that the Internal Revenue Service could much more easily administer it. Sales revenue and profits, either net or gross, are concepts with which the Service has had long experience.

Like any excess profits test, a profit margin limitation would be a penalty on efficiency. It would also penalize industries that are becoming more capital intensive. But if some form of price controls are regarded as a necessary complement to a TIP for wages, the profit margin limitation is the most tractable version.

A tax-based incomes policy applying either to wages or prices may require a number of special rules relating to exports, coverage of particular industries, and corporate mergers and other reorganizations.

The objective of a tax-based incomes policy is to hold down domestic wages and prices. There is, however, no particular policy reason to be concerned about export price increases. Thus, firms should probably be permitted or required to disaggregate exports in determining the value-added price increase or the gross profit margin. This would require special regulations to allocate certain costs and profits.

As indicated at the beginning of my testimony, if a tax-based incomes policy provides tax benefits, all business taxpayers and even nonprofit organizations would want to be permitted to participate. If, however, tax penalties are to be provided, a number of exclusions that would greatly simplify the administrative complexities would be possible. An effective tax-based incomes policy could exclude new firms, unincorporated businesses, small corporations, and certain industries. There are very substantial administrative advantages to such exclusions.

Determining base period prices and wages would be a considerable burden on new firms, if they are included in the tax-based incomes policy. If the firm began midway through the year, an intrayear adjustment might also be required.

If anything more than the most perfunctory auditing were to be contemplated for small firms, the sheer magnitude of necessary paperwork for firms and for the IRS argues against including them. Precisely this kind of paperwork burden was encountered in administering Phase II controls, and this was eventually accommodated by the exemption of most firms having fewer than 60 employees.

Small firms are most likely to make use of the potential for contracting out in order to avoid the apparent wage increase from adding or replacing high-paid workers. Also, small corporations present significant opportunities to reduce salaries and increase corporate taxable income when the owners are also employees. This is particularly true when a small corporation is subject to only the 20- or 22-percent corporate tax rate.

In general, the proportion of cases for which some special relief from the rules may be needed is probably much larger for small firms. Large changes in skill mix, changes in the amount of overtime, and other such potentially variable elements in the calculation of the wage increase would be more likely where small firms are involved. Exempting the smaller firms would also exclude most sectors of the economy such as agriculture and small retailing where wages and prices are the most market sensitive. Excluding unincorporated businesses and Subchapter S corporations from TIP would avoid the necessity for special rules to distinguish labor compensation in the earnings of partners, proprietors, and shareholders that are active in management.

Conclusion

I conclude that tax-based incomes policies would involve significant administrative problems for the IRS and compliance problems for businesses. These problems can be reduced to a manageable size if the scheme is applied only to business taxpayers, limited to wages, if the hurdle approach is adopted, and if it does not apply to small companies. The administrative and compliance problems, however, still would be significant.

There would be a strong incentive for firms near the hurdle to pass the test by substituting forms of compensation that are not included or are undervalued in the wage index. Experience with wage measurement problems under the income tax suggests that opportunities for substituting forms of compensation that understate the true increase in labor cost cannot be fully closed off. Establishing the base period wage level is an added problem. Adjustments are required for firms that reorganize or add major new activities. Further adjustments may be demanded for year-to-year changes in the skills mix, overtime pay, or wage increases mandated by low or prior contracts.

If a parallel price restraint program is adopted, there are strong administrative reasons for preferring a profit margin limitation rather than an explicit price index.

The remaining administrative and compliance problems must be weighted against the expected gains from a tax-based incomes policy in moderating wage and price increases.

Exhibit 33.—Statement of Secretary Blumenthal, June 28, 1978, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, on capital gains taxation

I welcome the opportunity to appear before this subcommittee to present the administration's views on three bills before you: S. 3065, S. 2428, and S. 2608.

Each of these bills would reduce the tax on capital gains for selected groups of taxpayers. Each aims at objectives of capital formation and growth. These objectives are shared by the administration. But each bill has fatal flaws and either would not achieve its stated objectives at all, or would do so in an inefficient and inequitable manner. Accordingly, the administration strongly opposes all three bills.

I will devote the bulk of my testimony to S. 3065, the Investment Incentive Act of 1978. To say that this bill and its House counterpart have received extensive publicity is to engage in understatement. Suddenly, like flowers that bloom in the spring, the notion of reducing capital gains taxation is appearing everywhere as an all-purpose solution to the country's economic problems. Manifold and sweeping claims are made for this idea: It is advertised as a technique of middle class tax relief, or a measure to help homeowners. It is said that reducing capital gains taxes will substantially increase stock values. It is claimed that the Treasury will gain revenues by cutting these taxes. We are told that this is the best way to accelerate capital accumulation in the United States. Some even claim that other economies outperform us because they avoid taxing of capital gains.

This administration shares the goals espoused by the supporters of a capital gains tax reduction. We too wish to see stock prices rise. We too are concerned about Treasury revenues; and we are certainly as concerned as anyone about reducing the Federal deficit. We too are vitally interested in spurring capital accumulation and investment,

and believe that tax incentives are needed for this. We too are anxious to employ every reasonable device to improve our performance with respect to inflation, unemployment, and exports.

Our opposition to S. 3065, therefore, is based not on disagreement with its goals. Rather we are persuaded that this bill would not advance us toward these goals or would do so only in ways that are inefficient, inadequate, and unjust.

The tax reduction legislation that the administration has proposed this year would meet two broad objectives: *First*, relief for the average taxpayers of this country who are finding their incomes increasingly pinched by rising tax liabilities; *second*, a broad and significant increase in the after-tax return on capital, which will increase business investments by making them more attractive.

Mr. Chairman, a dispassionate and objective analysis of S. 3065 shows that this bill and others like it would achieve neither of these goals while wasting Treasury revenues urgently needed to achieve these critical objectives in an efficient and equitable fashion.

The facts about capital gains taxation under current law

Under current law, the net capital gain of an individual taxpayer is taxed at a rate equal to one-half of the taxpayer's rate on ordinary forms of income such as wages, salary, dividends, interest, and rent. Those persons in tax brackets above 50-percent need pay only the 25-percent alternative rate on the first \$50,000 of their net capital gains.

For corporations, net capital gains may be taxed at an "alternative" 30-percent rate instead of the maximum 48-percent rate on other income.

In addition to these basic provisions, the Tax Reform Acts of 1969 and 1976 introduced two elaborations.

First, the 1969 act imposed a "minimum tax" on those with very large amounts of capital gains income or other income benefiting from preferential provisions. After changes in the 1976 act, the minimum tax for individuals is 15 percent of preference income in excess of either \$10,000 or one-half of regular tax liability (whichever is greater). One-half of capital gain is considered "preference income." Therefore, if a taxpayer's only preference item is capital gain, the minimum tax applies only if total gains exceed \$20,000.

Second, the 1969 act reduced the maximum tax rate on earned income (wages and salaries) from 70 percent to 50 percent, providing massive relief to high-income individuals. For these persons, the amount of earned income eligible for this special "maximum tax" ceiling is offset by the amount of preference income, including the untaxed half of capital gains.

Now, what are the consequences of this structure of capital gains taxation? Who pays what?

In 1978, capital gains taxes will raise \$10.3 billion in revenue, \$7.8 billion from individuals and \$2.5 billion from corporations.

Let's look at the individual side of the equation, where public attention has been concentrated.

The average effective tax rate on capital gains in 1976 was 15.9 percent. (See table 1.) For most Americans with capital gains, the effective rate is quite low: For instance, 12.7 percent for those between \$20,000 and \$30,000 in adjusted gross income, 16.7 percent for those between \$30,000 and \$50,000. Up to \$200,000 a year, the effective rate is below 25 percent. Even for those over \$200,000 the average effective rate is only 27.4 percent.

Typically, therefore, the great majority of taxpayers pay taxes on capital gains at modest levels, considerably below the rate on ordinary earned or unearned income, and the progressiveness of the capital gains tax is quite moderate. The rate generally rises above 25 percent only where the taxpayer's income or gains are extraordinarily large, and even in these instances, the taxes are not at all extreme.

In the current debate, much has been made of the possibility—under the maximum and minimum tax provisions enacted in 1969 and 1976—that individuals may be paying a 50-percent tax or even more on their capital gains. The facts are much less alarming than the rhetoric. Capital gain, at all income levels, is still very much a preference item in our tax system.

TABLE 1.—*Income tax on capital gains—1976 levels*

Adjusted gross income class	Total capital gains	Tax liability	Effective tax rate on capital gains
	\$ millions	\$ millions	Percent
Less than \$5,000	2,697	34	1.3
\$5,000-\$10,000	2,872	110	3.8
\$10,000-\$15,000	3,571	269	7.5
\$15,000-\$20,000	3,418	326	9.5
\$20,000-\$30,000	5,281	672	12.7
\$30,000-\$50,000	6,105	1,019	16.7
\$50,000-\$100,000	5,537	1,234	22.3
\$100,000-\$200,000	3,613	898	24.9
\$200,000 and over	5,939	1,625	27.4
Total	39,034	6,187	15.9

More than 60 percent of all capital gains is taxed at 25 percent or less. Of all returns showing capital gains, only about 7 percent is taxed above 25 percent. Though in theory the tax rate could exceed 50 percent, this would require a very implausible composition of income, and in fact we have been unable to find even one case where this has happened. We have found fewer than 20 returns—out of 5.4 million returns with capital gains—taxed at more than 45 percent. The capital gains tax very rarely goes above 40 percent. Rates over 40 percent have appeared in less than five hundredths of 1 percent of returns with capital gains, involving less than four-tenths of 1 percent of gains.

In sum, the Tax Reform Acts of 1969 and 1976 increased capital gains taxes for very high income individuals with very large gains, but these measures did not introduce unreasonable marginal rates and they left capital gains in a clearly preferred status.

The facts about S. 3065

This bill is not a general measure to reduce capital gains taxes for everyone. Rather, it aims to reduce the capital gains rate for the highest income individuals with the largest amount of gains. As I have just noted, the overwhelming majority of taxpayers, realizing the great bulk of capital gains each year, pay substantially less than 25 percent on capital gains. This bill is not designed for this vast majority. Its relief is focused almost entirely on the small minority who now pay more than 25 percent.

The bill would do the following. It would remove all nontaxed capital gains income from the minimum tax, rather than exempting the first \$10,000 of untaxed gain (or one-half of regular tax liability), as under present law. It would eliminate the present capital gains offset against wage and salary income eligible for the maximum tax. It would extend the 25-percent alternative tax to an unlimited amount of gain, as opposed to the \$50,000 of gain eligible for this rate under present law. Finally, it would reduce the "alternative" rate on capital gains for corporations from 30 to 25 percent.

For these changes in the law, very expansive claims have been made. We have examined those claims closely. Few of them stand up against such analysis. At best, it can be said that some of the claims can be neither proven nor disproven. For the most part, however, the claims run flat against the available evidence.

The proponents say that S. 3065 constitutes broad-based tax reduction, in line with the so-called middle class tax revolt. The facts are otherwise. About 20 percent of the bill's benefits would go to corporations. For individuals, the bill's benefits are skewed heavily to the highest income taxpayers. Four-fifths of the bill's benefits go to those with incomes over \$100,000 a year. Mr. Chairman, this bill would provide lower taxes for less than one-half of 1 percent of the individual taxpayers in this country and would benefit only about 7 percent of the taxpayers that have capital gains.

This is in truth a millionaire's relief bill, and I mean income millionaires, whose assets are usually many times greater than that. Of those million dollar earners benefited by S. 3065, about 3,000 of them throughout the country, each would receive an average \$214,000 in tax reduction. For all million dollar earners the average relief would be \$145,000. By contrast, the average relief for those in the \$20,000 to \$30,000 class would be one dollar. (See table 2.)

TABLE 2.—*Distribution of individual tax reductions under S. 3065*
[1978 income levels]

Expanded income class	Average tax benefit	Percentage distribution of tax benefit
		<i>Percent</i>
Less than \$15,000	\$0.12	0.4
\$15,000-\$20,000 .....	.25	.2
\$20,000-\$30,000	1	.8
\$30,000-\$50,000	11	4.0
\$50,000-\$100,000	158	13.7
\$100,000-\$200,000	783	14.2
\$200,000-\$500,000	4,000	15.7
\$500,000-\$1,000,000	21,540	11.3
\$1,000,000 and over	145,302	39.7
Total	19	100.0

The bill's proponents assert that it would trigger a stock market boom. The studies said to show this result simply assume the fact, or rather they assume different facts. Bear in mind that the bill would reduce taxes on corporate stock gains by only \$500 million. Yet, one study assumes the bill would raise stock values by 40 percent, a rise of more than \$300 billion or 600 times the size of the tax cut; another study suggests only a 4- to 6-percent rise in stock values, which is still 60 times the size of the cut. A third study, which presumes total elimination of the capital gains tax, rather than the selective cuts in S. 3065, predicts a 20-percent rise in stock values. This is all the sheerest conjecture. The truth is that no one has any credible evidence or theory permitting a projection of the bill's impact on the stock market, and certainly there is no basis for the extreme assumptions that have dominated public discussion of the bill.

If we look at recent stock market behavior, it is difficult to avoid the conclusion that the effects of capital gains tax changes, if any, are wholly swamped by other stock market influences. The bill's proponents often suggest that the 1969 Tax Reform Act lies behind the stock market's doldrums during the 1970's. However, the stock market fell sharply in 1969, before the tax increases from the Reform Act took effect. Then the market rebounded sharply from 1970 through 1972—the same period during which the reforms were fully phased in. Then, as inflationary momentum accelerated in 1973, there was a huge fall in stock prices, though the tax law was not changed at all. (See chart.)

Analysis of stock market prices over the last 10 years shows no relationship between the capital gains tax and the market's level. The record does not show that the capital gains tax changes in the Reform Acts of 1969 and 1976 depressed stock prices. The assertion that repeal of those reforms would now raise stock prices is just that, an assertion, unsupported by evidence.

Proponents of S. 3065 have noted that it would provide relief for homeowners forced to pay capital gains taxes upon sale of their residences, in those instances where the gain cannot be rolled over into purchase of a new residence. This aspect of the measure we wholeheartedly support. The President's tax package provides nearly identical relief for homeowners.

A further claim of the proponents is that this bill would greatly spur capital formation. Accelerating the rate of capital formation—particularly industrial and technological investment—is a priority objective of this administration, but S. 3065 is not the way to go about it.

Why is this so? The test of a tax cut for investment is how generally and directly it reduces the tax burden on income from productive capital. In applying this test, it is important to keep in mind two facts. First, productive capital is taxed in many ways—by the corporate income tax, the individual income tax, the capital gains tax, et cetera. We don't have a single, unique tax on capital income; rather we have many taxes which together place a burden on capital. Capital gains tax is not the major tax on capital income. It accounts for only about 10 percent of the Federal tax burden on capital. (See table 3.)

TABLE 3.—*Tax liability on capital gain income compared with tax liability on all capital income*
[1978 levels; dollar amounts in billions]

Tax liability on all capital income:	
Corporate tax liability	\$63.8
Individual tax liability	36.8
Total	100.6
Tax liability on capital gain income:	
Corporate	2.5
Individual	7.8
Total	10.3
Capital gain tax as a percent of total taxes on capital income	10.2%

NOTE:—Total capital income consists of corporate profits, dividends, interest, rents, royalties, the portion of partnership and sole proprietorship income attributable to capital, and capital gains.

Second, the kind of capital we particularly need to accumulate is industrial and technological capital. Many types of assets, for instance, jewelry, antiques, speculative real estate, and the like, are of much less importance to our economy's ability to adapt, grow, and compete in international markets. The President's tax proposal takes these two important facts into account. Through broad-based reductions in corporate and individual income tax rates, and through a liberalization of the investment tax credit, the President's package would reduce the major taxes burdening capital income by about \$7 billion and would directly increase the profitability and cash flow of all productive enterprises. It is a package ideally suited to increasing the rate of formation of productive capital.

By contrast, S. 3065 is very poorly suited to this job. As I've noted, capital gains taxes constitute only about 10 percent of the Federal tax burden on capital income. Reducing the capital gains tax would therefore deal with only a very small corner of the problem. Furthermore, it is in many respects the wrong corner. Only about one-quarter of realized capital gains come from corporate stock. The rest are scattered over a range of assets having little or no role to play in the kind of investment boom this country needs. For instance, another quarter of the realizations is on real estate sales, 3.4 percent on livestock, 2.5 percent on commodities, 9.7 percent on installment sales, et cetera. (See table 4.) This bill would create windfalls on assets all over the landscape, but it would largely detour around the central objective, which is to reduce significantly and broadly the tax burden on income from productive investment. This bill takes a very inefficient approach to capital formation.

Standard & Poor's 500 Stock Index and Capital Gains Tax Changes 1955-1978

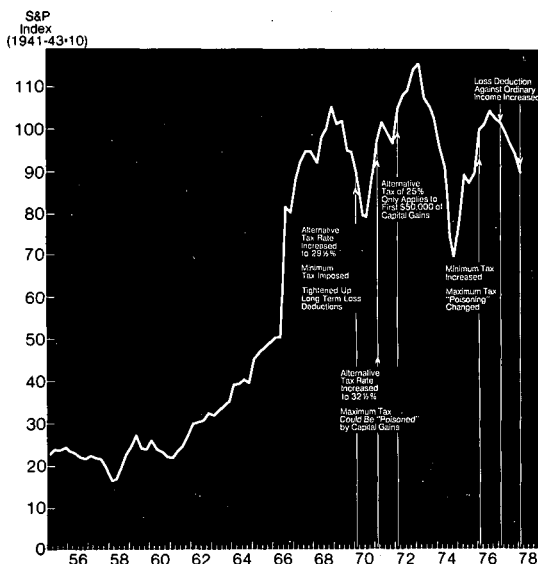


TABLE 4.—*Shares of capital gains and losses by asset type—1973*

Asset type	Gains only	Losses only	Gains and losses combined
		<i>Percent</i>	
Financial assets (stocks and bonds)	28.8	55.5	17.1
Partnership, fiduciaries, and small business corporations	8.5	7.2	9.0
Prior year installment sales	9.7	*	14.0
Liquidation distributions	2.6	4	3.6
Residences	10.8	—	15.5
Nonbusiness real estate	8.1	1.3	11.1
Timber .....	.5	*	.7
Retirement plan distributions	1.8	*	2.6
Commodities, including futures	2.5	8.2	*
Involuntary conversions	1.1	.5	1.4
Trade or business assets	3.7	1.1	4.9
Business and rental buildings	3.8	—	5.5
Livestock	3.4	.2	4.8
Farm land and property .....	.7	.3	.8
Other assets	14.0	25.1	9.1
Total	100.0	100.0	100.0
Memorandum:			
Corporate stock only	26.1	51.9	14.8

* Less than 0.05 percent.

This inefficiency is a fatal flaw for the simple reason that we do not have unlimited revenues available to stimulate capital formation. To keep the budget deficit in bounds, the administration believes next year's total tax reduction should not exceed \$20 billion. The bill before you would take up over \$2 billion of that amount. This would have to come at the expense of wage and salary earners, which would be clearly inequitable, or at the expense of the corporate income tax reductions, which would render the bill a much less effective vehicle for capital formation. The only other choice is to increase the budget deficit, which would be an inflationary and irresponsible course.

The proponents of S. 3065 try to avoid this dilemma by asserting that their bill, unlike the myriad other tax cuts promoted in the Congress, would in fact increase Treasury revenues.

The reasoning behind this assertion has never been made clear. As is often the case with this subject, we are dealing here with conjecture, not facts.

It is important, in assessing the revenue claims, to distinguish between three different time horizons: The very short term, the medium term, and the long term.

In the short term, the revenue impact of S. 3065 would turn on the so-called unlocking effect. With a cut in maximum capital gains rates, it is possible, at least in theory, that some taxpayers would sell assets that they had held for a very long time. Whether and how much this would occur no one knows. If it did happen, two results would follow. First, the wave of selling might well depress asset prices on the stock market and elsewhere. This would tend to reduce capital gains tax revenues. Second, the wave of selling would itself generate tax revenues. The net effect on revenues of these conflicting forces no one can predict. But one thing is clear: It would be a temporary, one-shot effect. The wave of selling would not repeat itself year after year.

In the medium term, any tax reduction will stimulate aggregate demand—investment and consumption—and therefore tend to increase GNP toward its potential level, creating a feedback of tax revenues to the Treasury. There is absolutely no reason to think that S. 3065 would create larger feedback effects than any other cut in capital income taxes. Indeed, such feedback effects are much less certain with capital gains taxes than with the corporate income tax cuts proposed by the President. Cutting corporate rates and liberalizing the investment tax credit would directly increase enterprise profits and cash flow, and thus real investment and tax revenues. The

advocates of S. 3065 hold out the hope—no more—that a capital gains tax cut would substantially boost stock values and that this in turn could trigger a large amount of new investment, with a consequent rise in tax revenues. But, as I have indicated, there is no perceptible relationship between capital gains taxes and the level of the stock market, and a capital gains tax cut of this size is most unlikely to affect the stock market substantially. Unfortunately, it is equally difficult to trace a causal relationship between the level of the stock market and the rate of increase of investment or GNP. Both points in the argument are thus very shaky. For the medium term, the revenue feedback effect of a capital gains tax reduction is anyone's guess.

In the long term—the most important perspective—tax revenues depend on the sustainable growth rate of the economy. In other words, the revenue feedback will be greater the more efficiently the tax cut boosts the long-term trend of investment in productive assets and enterprises. It is precisely here that S. 3065 is most seriously defective. It scatters its benefits over a wide array of assets, many of little productivity, and it misses entirely 90 percent of the tax burden on capital income. It is a very poor tool for increasing the economy's long-term rate of real growth, and its long-term revenue feedback effects would be commensurately modest.

Finally, I wish to say a word about the very loose international comparisons that have been made in the debate on this measure. Some proponents of S. 3065 have suggested that our economic performance—in areas of inflation, unemployment, and growth—has fallen short of that of Germany and Japan because we tax capital gains while they, assertedly, do not. This line of argument ignores certain important facts. First, the United States has over the past few years outperformed most other industrialized countries, including Germany and Japan, in terms of real growth and increases in employment. Our inflation record is less satisfactory, but is nonetheless superior to several countries; e.g., Italy, having no capital gains tax. Second, Japan does in fact tax capital gains. As for Germany, it instead uses an even more comprehensive tax on annual increases in wealth, whether or not realized; I doubt that the proponents of S. 3065 would prefer the German system to ours. What all this shows is that making simplistic international comparisons on a tax-by-tax basis is a very treacherous business.

In sum, Mr. Chairman, the claims made for S. 3065 do not stand up to scrutiny:

- The bill would not provide general or middle income tax relief but would instead narrowly focus its benefits on the highest income classes and would provide an unprecedented boon to millionaires.
- The bill has no realistic potential for creating a substantial rise in stock prices.
- The bill would not efficiently meet our urgent needs for more investment in productive enterprises.
- The bill would not gain us revenue but would instead use up revenue needed for far more efficient and equitable incentives for capital formation.

There are, of course, many variations of S. 3065 under discussion in the other Chamber. I will not deal with them in detail. Some of the proposals escape certain problems I have noted here. However, those involving an effective repeal of the minimum tax so far as capital gains are concerned have the same defects as S. 3065: They are very expensive, and they focus their benefits on a narrow class of extremely high income individuals, with the result that many of those persons would pay very little tax. As the President has indicated, this is an unfair and ineffective response to the need of American workers and businesses for genuine tax reduction.

Comments on S. 2428

I turn now to S. 2428, the Small Business and Farms Capital Preservation Act of 1978. This bill would extend to certain small businesses a tax-free rollover privilege similar to that available on the sale of a principal residence.

We believe such a rollover provision would be inequitable. Owners of businesses already enjoy enormous tax benefits. As a business grows and prospers, and its market value increases, the owners do not have to pay current tax on this appreciated value. A person receiving income in the form of wages, interest on a savings account, or stock

dividends must first pay taxes before setting aside funds for future use. The business owner increases his wealth with before-tax dollars, while the wage earner increases his wealth with after-tax dollars. In addition, the owner of a business, when he sells, has the advantage of preferred capital gains rates. Further, any bunching of income resulting from the tax deferral can be alleviated by income averaging, made available for capital gains by the Tax Reform Act of 1969, and by the use of installment sales.

S. 2428 would provide yet another valuable tax break to those who already benefit from a number of preferential provisions. This raises serious questions of fairness.

Apart from considerations of equity, this proposal would raise considerable problems of compliance and administration. Some problems occur now with the tax-free rollover privilege afforded taxpayers on their personal residences. Individuals are asked for more information and computations than are generally required, and such data must be retained for very long periods of time. The complexity would be aggravated substantially by the rollover contained in S. 2428. Recordkeeping and computation burdens could be monumental where a taxpayer has several qualifying asset sales and purchases with overlapping 1-year reinvestment periods.

The Congress has allowed the extraordinary rollover privilege for principal residences because of the peculiar social value of home ownership. We think it would be a major error in tax policy to begin extending this privilege, piece by piece. Very soon, other types and classes of taxpayers would be demanding this preference, and a wholesale erosion of the tax base would result.

Comments on S. 2608

This bill seeks correction for the appreciation of nominal asset values caused by inflation. It attempts this by excluding from taxable income a percentage of realized capital gains—a percentage that would increase with the length of time the asset had been held. The rationale is simple and understandable. It seems unfair to many that taxes should be paid on gains that are “paper gains” only, the product of inflation.

Unfortunately, there is no easy way to solve this problem. While S. 2608 is concerned with “illusory income” in the case of capital gains, the same issue arises with all types of income from capital and with debt. A balanced program of indexing income for inflation would require at least four adjustments:

- Taxpayers would increase the basis of capital assets by the rate of inflation.
- Owners of savings accounts and other interest-bearing obligations would deduct the loss resulting from the inflation-induced decline in their assets' real value.
- Businesses would be allowed to increase their basis in computing depreciation deductions and inventory profits.
- Debtors would report income whenever inflation reduced the real value of their indebtedness.

Obviously, an indexation system that included these four elements would be extremely complicated; but going only part way would create new inequities among taxpayers. For example, it is difficult to justify an inflation adjustment for owners of stock and real estate while ignoring the effect of inflation on the savings account depositor. Nor would a system be just that allowed the holder of debt-financed property to adjust the asset's basis for inflation while making no allowance for the fact that the debt was being repaid with cheaper dollars.

There is, however, a more fundamental problem with the notion of indexation. It deals with the symptoms and not the disease itself. Indexation is a response to high inflation rates, but the proliferation of indexation schemes tends to make those rates an accepted fact of economic life. These schemes tend to institutionalize the defect. Rather than accommodating to inflation, we should, in my judgment, bend all efforts to eliminate it.

Even if capital gains indexing were desirable, S. 2608 would not provide the proper means of implementing such a system. The most appropriate inflation adjustment would be to increase the basis of capital assets by the rate of inflation rather than to exclude a fraction of the gain from income during a period of inflation. This bill instead excludes from tax a larger proportion of gain the longer the asset has been held. The mechanism

should work in the opposite way. The absolute amount of the illusory gain does rise as the holding period lengthens; however, the absolute size of the real gain also rises. As a matter of fact it can be shown mathematically that the ratio of real to total gain on an asset will increase the longer an asset is held. Thus, the bill's system of graduation would be perverse.

Conclusion

We strongly oppose these three bills on the merits, as I have explained at length. But we also object to them for a broader reason. These bills approach the problem of capital income taxation in a partial and ad hoc manner. The various Federal taxes on capital income—the capital gains provisions, the corporate income tax, and the personal income tax on property income—make up an interrelated and complicated structure. The Treasury is now engaged in a far-reaching study of that structure, seeking to determine how it might best be rationalized in light of the capital formation problems our economy faces, and will continue to face, over the coming years. I am giving this study my closest personal attention. None of us is bringing rigid views on the taxation of capital gains into this exercise. But tinkering with bits and pieces of this structure of capital income taxation—as the bills before you do—will get us nowhere. The whole structure will become that much more complex, inequitable, inefficient, and incoherent. In the process, we will lose revenues critically needed for more efficient investment incentives. To deal properly with the capital gains tax, what is required is a thoughtful and comprehensive approach to capital income taxation generally.

For that task, the Congress needs more than the few months remaining in this very busy legislative session. The proper agenda for this year is to take relatively simple and efficient steps to cut capital income taxes across the board, as the President has proposed. There is no question that this would best serve the needs of the economy and the long-term interests of the American people.

Exhibit 34.—Statement by Secretary Blumenthal, August 17, 1978, before the Senate Finance Committee, on the Revenue Act of 1978

The committee begins consideration today of H.R. 13511, the Revenue Act of 1978. This bill, recently adopted by the House of Representatives, would reduce tax liabilities by \$16.3 billion in calendar year 1979. Of this amount, \$10.4 billion is attributable to personal tax relief, \$4.0 billion to business tax reductions, and \$1.9 billion to a cut in capital gains taxes.*

My testimony will assess the House-passed bill in light of the objectives outlined in the President's tax message last January. One goal emphasized by the President is to provide substantial tax relief for individuals, especially those persons in the low- and middle-income categories. Another objective is to furnish efficient investment incentives that encourage businesses to modernize productive facilities and to create permanent, meaningful jobs. We also believe that the income tax structure should be improved through reforms that make the system more equitable and simpler for average taxpayers.

H.R. 13511 takes some steps toward these goals, but there is substantial room for improvement. The size of the net tax reduction—about \$16 billion—is within a reasonable range of tax cuts that will maintain growth without increasing inflationary pressures. Moreover, the bill's split between personal and business relief is acceptable. But we do not like the distribution of the cuts among taxpayers. In my statement, I will describe ways in which we believe the relief can be distributed more equitably.

I will also suggest additional structural tax changes for the committee's consideration. We are pleased that the House adopted some of the tax reform proposals recommended by the President. The bill includes new tax shelter restrictions, simplification of the itemized-deduction schedule, elimination of the tax exclusion for unemployment benefits at high-income levels, and repeal of the special alternative tax ceiling on the

* These revenue figures do not include feedback revenues that might be generated through economic stimulus. The appendix to this exhibit describes the role of feedback effects in Treasury revenue estimating procedures.

capital gains of persons in the top rate brackets. We urge the committee to build upon these reforms now contained in H.R. 13511.

In this regard, the results of a recent Roper survey are illuminating. The survey, released last month, indicates that the American public considers tax reform the third most pressing national problem, ranking behind only controlling inflation and lowering the crime rate; and significantly, "tax reform" to the Roper respondents is equated much more frequently with tax fairness than with tax reduction. This timely expression of public sentiment should provide a useful guide for your deliberations.

The Economic Need for a Prudent Tax Reduction

Before turning to specific proposals in the House bill, let me discuss the size of tax reductions needed in 1979—an evaluation that must be made in the light of recent economic developments. In many ways, our economy has performed remarkably well over the past year and a half. The unemployment rate at the end of 1976 was 7.8 percent; that rate has now dropped to 6.2 percent in July. Almost 6 million more people are employed now than were employed at the beginning of this administration, and a larger percentage of the working-age population now holds jobs than ever before. In the fourth year of our recovery from recession, we are still experiencing a real growth rate of about 4 percent.

To maintain this recovery, tax policy must take account of several factors. In 1979, social security tax liabilities will be increased over 1977 levels by \$4 billion due to previously scheduled rate increases and by an additional \$7 billion due to changes enacted in 1977. Other tax increases will result as a higher cost of living pushes individuals into higher rate brackets without increasing real incomes. An income tax cut in 1979 will help to compensate for these factors and thereby to maintain adequate purchasing power to continue our economic growth.

Perhaps the most significant risk in the economic outlook is inflation. Over the first half of 1978, the Consumer Price Index has risen at an annual rate exceeding 10.4 percent. We believe that the inflation rate for the second half of this year will be substantially lower, by perhaps one-third, and that the annual rate will be more moderate in 1979 than in 1978. Nevertheless, inflation will continue to be a troublesome problem.

In recognition of the need to restrain accelerating inflationary pressures, the administration has called for a reduction in the size of the 1979 tax cut, from the \$25 billion figure recommended in January to \$20 billion. Moreover, we have urged Congress to trim an additional \$5 billion from Federal budget outlays for fiscal year 1979 in order to reduce the deficit for that year to \$43.5 billion. Budgetary restraint is essential.

Tax and budget policy must address another threat to continued economic recovery: sluggish business investment. Investment in new plant and equipment now accounts for only one-tenth of our Nation's real gross national product, a much smaller share than is needed to provide the tools of production for a full-employment economy in the 1980's. Manufacturing capacity has increased at an average annual rate of only 3 percent over the past 4 years, as compared to a 4 1/2-percent capacity growth rate during the postwar period through 1973. Incentives, in the form of business tax cuts, are needed to improve this disappointing record of business fixed investment and to avoid inflationary capacity bottlenecks in the years ahead.

We believe that the tax reduction contained in the House bill for 1979 represents generally an appropriate fiscal response to these economic concerns. The magnitude of the cut in H.R. 13511 is about \$1.2 billion less than that recommended by the administration.* Tax relief of this size would help maintain the economic recovery, without bloating the deficit and exacerbating inflation. We recommend that the Finance Committee adopt a tax cut of approximately the same magnitude.

A tax cut substantially larger than that in the House bill would create serious risks to our economic recovery, in particular the creation of inflationary pressures. Whatever temporary benefits might be obtained through lower tax burdens would be quickly negated by the resulting rise in prices and interest rates; increased after-tax incomes

* Using the same estimating assumptions, the tax cut in H.R. 13511 is \$18.8 billion, compared to the administration's \$20 billion recommendation. The administration did not count the expiration of the \$2.5 billion general jobs credit in its tax program as a revenue-raising provision. It was, however, accounted for elsewhere in the budget.

for individuals would be illusory, and the tax incentives for business investment and job creation would be undermined. These economic risks should not be taken. We ask this committee not to adopt a significant increase in the tax reduction now contained in H.R. 13511.

Personal Tax Changes

Tax relief for individuals

In fashioning the portion of the tax cut relating to individuals, the committee is urged to bear in mind a fundamental principle of tax equity: Taxes should be imposed in accordance with ability to pay. The tax program recommended by the President reflects that principle. We are convinced that tax reduction should be focused on individuals in middle- and low-income brackets; these are the persons most in need of relief from tax burdens. The tax bill adopted by the House does not adequately respond to this critical principle of tax equity.

H.R. 13511 would effect the tax cut through several changes. Individual rate brackets would be expanded by about 6 percent. The zero bracket amount (standard deduction) would be increased from \$3,200 to \$3,400 for joint returns and from \$2,200 to \$2,300 for single returns. The personal exemption would be raised from \$750 to \$1,000, with the general tax credit being eliminated. Rates would be cut in certain brackets.

In the abstract, these changes may appear to have merit. Yet, when one examines the impact of H.R. 13511 on specific taxpayers, the inequities become apparent. As H.R. 13511 was adopted by the House, a typical 4-person family with wage income of \$10,000 would receive an income tax reduction of only \$62—a cut one-fifteenth the size of the reduction provided to a family with salary 10 times as large. Relief for the typical 4-person family at the \$20,000 income level would be less than one-sixth of the tax cut enjoyed by a \$100,000 income family.

An examination of combined income and social security tax changes reveals the same disturbing pattern. For a family of four at the \$15,000 wage level, combined income and social security taxes would be reduced \$35 in 1979 in comparison to 1977 levels. The net income and social security tax reduction at the \$100,000 level would be \$485—a cut 14 times as large even though income is only 7 times as large.

Moreover, it is important to recognize that these figures, relating to personal income tax relief, do not present the bill in its full perspective. The comparisons I have just discussed do not include the impact of capital gains relief in H.R. 13511. The proposed capital gains tax changes for 1979 and the subsequent inflation adjustment for capital assets would provide capital gains relief amounting to nearly \$7 billion annually by 1983. Like any cut in capital gains taxes, this \$7 billion would be enjoyed primarily by persons in higher income brackets. As a result, the inclusion of capital gains cuts in the bill makes it especially important that the personal cuts be focused on middle- and low-income groups.

The administration recommends that the distribution of tax relief be altered to provide greater tax reductions than the House bill for all income classes through \$50,000. We would reduce some of the bill's bountiful tax cuts for persons in income classes above \$50,000 and increase cuts for taxpayers with incomes under \$20,000. The share of the total individual tax cut going to persons below \$20,000 should be increased from 25 percent to about 40 percent while the share for those above \$50,000 should be reduced from 24 percent to about 10 or 15 percent. This distribution of relief reflects much more accurately the tax principle of ability to pay.

As you know, the distribution of personal tax relief in the bill depends upon two factors: Rate changes and the size of the exemption or credit for dependents. Neither of these factors can be viewed in isolation. Changes in tax rates can be combined with an exemption or credit to produce virtually any degree of progressivity the committee desires.

We suggest that a \$240 credit for each dependent be combined with generous rate cuts in the middle-income brackets to achieve the recommended tax cut distribution—increased tax savings in the bill for all income categories through a level of about \$50,000. The new credit would replace the current \$750 exemption for each dependent and the general tax credit, which is equal to the greater of \$35 per dependent or 2

percent of the first \$9,000 of taxable income. By eliminating this complicated scheme of exemptions and alternative forms of credits, the \$240 personal credit would achieve the same simplification as the \$1,000 exemption in the House bill.

The \$240 credit would provide a more equitable tax differential for various family sizes than would the \$1,000 exemption in H.R. 13511. The members of this committee are well aware of the advantages of providing tax savings through a credit. Since the personal credit would be subtracted directly from tax liability, each additional dependent would furnish \$240 in tax savings to a taxpayer regardless of his income level. By contrast, a \$1,000 exemption would result in a \$700 tax benefit for each dependent in a top-bracket family and \$140 benefit for each dependent in the lowest bracket family.

In addition to equalizing the tax savings for dependents, the \$240 credit would raise the level of earnings at which an income tax begins to be imposed. For example, the tax-free level of income for a family of four would rise from \$7,200 under present law to \$9,200. This figure compares with a tax-free level of \$7,400 under the House-passed bill.

This committee now has the opportunity to review the tax rate schedules, the exemptions and credits that are proposed for 1979. I urge you to reject the House bill in these areas and to substitute a \$240 personal credit and a new rate schedule that direct greater relief to middle- and low-income families. A sense of fairness demands these changes to benefit the vast majority of American taxpayers.

Changes in itemized deductions

The House responded favorably to a number of personal tax changes recommended by the President. Among these proposals are changes in itemized deductions. I ask that you accept these provisions in order to continue the tax simplification effort that began last year.

In the Tax Reduction and Simplification Act of 1977, Congress worked with the administration to enact changes that incorporate the standard deduction in the tax tables, lessen the number of computations made by taxpayers, and simplify the total reporting and recordkeeping burden. As a result of these changes, approximately 40 percent of all individual taxpayers were able to file a short form 1040A for tax year 1977, and the number of lines on that form was reduced from 25 to 15. The error rate of taxpayers was decreased dramatically, from 9.1 percent to 6.5 percent for the long form 1040 and from 12 percent to 5.1 percent for form 1040A.

We hope to sustain this encouraging progress. Itemized deduction changes in the House bill would accomplish further tax simplification without creating significant controversy. The bill would simplify or eliminate a number of deductions that add complexity to the tax system and that do not advance any major objective of public policy.

1. *State and local taxes.* H.R. 13511 would eliminate the deduction for State and local gasoline taxes. We urge the committee to adopt this provision of the House bill.

The administrative problems associated with the gasoline deduction are large relative to the tax savings involved. Taxpayers using the standard deduction receive no tax benefit. The tax savings of a typical itemizer are calculated arbitrarily and amount to only about \$25. Most taxpayers use gasoline tax tables prescribed by the Internal Revenue Service and guess at the number of miles driven in a given year—a fact which must be known for proper utilization of the tables. Therefore, calculation of the gasoline tax paid is seldom accurate, and the Internal Revenue Service has no adequate way to check the mileage claimed by taxpayers.

In addition to creating these administrative problems, the deductibility of gasoline taxes represents bad substantive policy. Current law lowers the net price of gasoline by the value of the deduction, thereby encouraging the purchase of gasoline relative to other goods. Eliminating the deduction would advance the governmental policy of discouraging the consumption of energy.

We recommend that the committee also eliminate the special deduction for general sales taxes, personal property taxes, and miscellaneous taxes while retaining deductions for State and local income and real property taxes. State sales taxes, like gasoline taxes, are usually determined arbitrarily with reference to published tables that provide nearly

uniform deductions and result in a relatively small tax benefit. Since the tax benefit for itemizers is generally modest and since there is no benefit at all for the 69 percent of individuals claiming the standard deduction, deductibility is not a major factor for State and local governments in determining the rate of tax to impose. By extending H.R. 13511 to remove deductions for these other forms of State and local taxes, the committee could achieve further tax simplification; and tax increases could be avoided by using the revenue raised from these changes to provide larger rate reductions.

2. *Political contributions.* The House adopted the administration's proposal to simplify the confusing scheme of deductions and credits for political contributions. Under current law, a taxpayer can elect to claim itemized deductions for the first \$200 of contributions. In lieu of the deduction, he may claim a credit for one-half of his political contributions, with a maximum credit of \$50. The House bill would repeal the political contribution deduction while retaining the credit. As a result, the incentive of the tax subsidy for political contributions would be available equally to itemizers and nonitemizers and would not rise with the income level of the taxpayer.

3. *Medical and casualty expenses.* The current provision for medical deductions is unnecessarily complicated. Twelve lines on schedule A for form 1040 are devoted to computation of the deduction for dental and medical expenses. Currently, one-half of the first \$300 of health insurance premiums is deductible outright for those who itemize. Other medical expenses are deductible to the extent they exceed 3 percent of adjusted gross income, with this latter category of deductibility including the remaining portion of health insurance premiums and including medicines and drugs in excess of 1 percent of adjusted gross income.

The House has accepted the President's proposal to treat medical insurance premiums, drugs and medicines in the same manner. All of these expenditures would be subject to the same floor—in the House bill, 3 percent of adjusted gross income. This change would greatly simplify return preparation. However, for those who now itemize their medicines and drugs, the House bill would have the effect of reducing the overall floor from 4 to 3 percent. This change by itself would increase the number of itemizers.

The committee may wish to consider additional simplification measures in this area. Since normal medical expenditures average about 8 percent of income, the floor for medical deductions could be raised—perhaps to 5 percent of adjusted gross income. This would accord with allowing deductions for hardship cases, but leaving the normal amount of expenses as an element of the standard deduction. On the same theory, casualty losses, now deductible for amounts in excess of \$100, could be subjected to an additional floor of 5 percent of adjusted gross income. There is no reason the government should in effect insure property damage losses at a lower threshold than personal injuries or sickness. By substituting rate cuts for the lost deductions, over 1 million taxpayers would be able to switch to the standard deduction.

Unemployment compensation

The House also adopted the administration's recommendation that the current tax exclusion for unemployment compensation benefits be phased out as an individual's income rises above \$20,000 for a single person or \$25,000 for a married couple. Under the bill, 50 cents of unemployment compensation would be taxed for every dollar of taxable income (including unemployment compensation) received in excess of these income ceilings.

Dollars received from unemployment benefits are just as valuable as dollars received in any other form. Therefore, a continued exclusion at high- and middle-income levels violates the principle that a person should be taxed in accordance with ability to pay. In the 1976 act, Congress repealed the sick pay exclusion for workers at high-income levels on the grounds that sick pay is a substitution for wages and should generally be taxed in the same manner. This rationale should now be extended to unemployment compensation.

Reforming the tax treatment of unemployment benefits is especially important in view of the serious abuses that can be caused by the preference. In many cases, the unemployment compensation system serves not to relieve hardship but to discourage work. For example, some individuals receive a substantial income every year through investment income and a salary from a 9-month job; they take a winter vacation and

collect untaxed unemployment benefits. There is no reason we should continue to permit such persons to "beat the system" at the expense of their neighbors who work throughout the year for taxable wages.

Earned income credit

The House bill would extend and simplify the earned income credit—an important provision developed by the chairman of this committee to assist workers at lower income levels. Under H.R. 13511, the earned income credit would be made permanent rather than allowed to expire after 1978. In addition, there would be changes in the calculation and determination of eligibility for the credit. These changes would make the credit easier to compute and would enable the IRS to determine more readily those eligible individuals who fail to claim the credit.

Currently, taxpayer mistakes are caused by difficult computations and by eligibility criteria that differ from the criteria for determining filing status and claiming exemptions. The House bill would achieve substantial simplification through the elimination of calculations and the substitution of published tables for hand computations. In addition, the bill would make it possible to determine eligibility for the earned income credit from the information supplied in claiming dependent exemptions or head of household status. The administration has strongly supported these efforts, and we believe that enactment of the House bill would result in simplification for both the taxpayer and the Internal Revenue Service.

Deferred compensation arrangements

In order to provide similar tax treatment for persons in the same economic circumstances, the tax law generally requires income to be reported by employees regardless of the form in which compensation is received. It is thought that a person who receives cash wages and uses those wages to save for retirement, to purchase insurance, or to make other investments should not be taxed more heavily than the person who receives those benefits through arrangements with his employer.

As exceptions to this general rule, preferential tax treatment is now provided for various employee benefits, including certain pension plans, group life insurance plans, and medical insurance plans. The administration believes that a tax preference for employee benefits can be justified only as a means of ensuring that a wide range of employees are protected against such contingencies as sickness, disability, retirement, or death. Accordingly, the President's tax program recommended that tax-favored status be withheld from certain kinds of employee benefit plans that discriminate against rank-and-file employees.

Included in the President's recommendations was a nondiscrimination requirement for cafeteria plans. A "cafeteria plan" is an arrangement under which a participating employee elects the type of fringe benefits to which employer contributions will be applied on his or her behalf. H.R. 13511 contains a provision which is substantially similar to the President's proposal, and we urge that this committee retain that provision.

Other sections of the House bill would enable employees to defer taxation under certain plans that permit an employee to elect whether or not to receive a current cash payment. One type of plan covered by the House bill is an unfunded "salary reduction plan"; another type is a "cash or deferred profit-sharing plan." We believe that preferred tax treatment for these plans should also be based on a requirement of nondiscriminatory coverage. The Treasury Department is working on a detailed proposal in this area, and we will be happy to consult with the committee members in designing a fair and reasonable provision.

Tax shelters

Tax shelters are devices used by taxpayers to generate artificial paper losses to offset income from other sources. There are at least two undesirable byproducts of tax shelter activity. First, such tax avoidance by high-income persons is demoralizing to average

taxpayers bearing a substantial tax burden on all their income. Second, many shelter activities drain investment funds from productive enterprises into schemes designed primarily to generate tax losses.

In 1976, this committee received extensive evidence regarding tax shelter abuses. You responded with several tax changes. Tax shelter restrictions are among the most significant reforms contained in the Tax Reform Act of 1976.

Unfortunately, shelter gimmicks have now assumed forms intended by promoters to avoid the restrictions in the 1976 act. Tax shelter activity may have actually increased during 1977. The National Association of Securities Dealers reports that over \$1.8 billion of shelters were publicly offered by its members during 1977—a 50-percent increase over offerings in 1976. And there is some evidence that private shelter deals may have increased even more dramatically.

In an effort to combat the new shelter devices, the House adopted an extension of the current “at risk” rules recommended by the President. The “at risk” limitation denies deductibility for certain paper losses that exceed an individual’s cash investment and indebtedness for which he has personal liability. The 1976 act extended coverage only to partnerships and to a few specified activities of individuals. Under the House bill, the “at risk” rule would be broadened to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons. This important provision in H.R. 13511 should be retained.

The President has also recommended that the Internal Revenue Service be authorized to implement tax audits of partnerships and to resolve tax issues at the partnership level rather than being forced to proceed against each partner individually. H.R. 13511 now contains only minor portions of the President’s proposal: A civil penalty for late filing of partnership returns, and a very narrow version of a proposal to extend a partner’s statute of limitations with respect to partnership items. We would like to work with you to adopt additional portions of the administration’s partnership audit proposals.

Entertainment expenditures

Perhaps no proposal in the administration’s tax program has received as much public attention as the recommended limitation on deductions for entertainment expenditures. This attention is not surprising. For many average taxpayers, the unfairness of current tax law is brought home most vividly by the fact that a few taxpayers are able to spend before-tax dollars to purchase some of the items most taxpayers must buy with income that has already been taxed.

Allowing entertainment expenses to be deducted, without taxing the related personal benefits to the recipient, offends fundamental principles of tax policy because it seriously distorts income measurement. The effect is to provide these benefits partially at public expense. The Federal Treasury loses about \$2 billion each year on account of entertainment deductions—a revenue loss that must be recovered from other taxpayers.

The public resents this form of subsidization of personal luxuries through the tax system. The July Roper poll indicates that 69 percent of Americans believe that there should be no deduction for the “cost of membership in [a] club if [the] job requires entertaining customers and prospects.” Seventy-five percent thought there should be no deduction for the cost of theater and sporting tickets purchased to entertain business customers, and 76 percent of respondents would not allow a full deduction for business lunches.

H.R. 13511 now contains none of the restrictions on deductibility of entertainment expenditures recommended in the President’s program. We continue to believe that these proposals are in accord with sound principles of tax policy and, more importantly, address the overwhelming sentiment of the American public for reforms in this area. We urge that the Finance Committee take account of this attitude of average taxpayers and, at least, deny a deduction for the expenses of maintaining facilities such as yachts, hunting lodges, and swimming pools and for fees paid to social, athletic, or sporting clubs.

Business Tax Changes

Corporate rate reductions

Present law taxes the first, \$25,000 of corporate income at a 20-percent rate and the second \$25,000 at 22 percent; income over \$50,000 is taxed at a 48-percent rate (a normal tax of 22 percent plus a surtax of 26 percent). The House bill provides for a corporate rate schedule that is much more steeply graduated than the current rate structure. Under H.R. 13511, the corporate rate would be 17 percent on the first \$25,000 of corporate income, 20 percent on the second \$25,000, 30 percent on the third \$25,000, 40 percent on the fourth \$25,000, and 46 percent on corporate income exceeding \$100,000.

The corporate rate reductions in the House bill differ from the cuts proposed by the President. In the President's tax program, he recommended a reduction from 20 to 18 percent on the first \$25,000 of corporate income, a reduction from 22 percent to 20 percent on income between \$25,000 and \$50,000, and a reduction from 48 percent to 44 percent on income exceeding \$50,000. The administration believes that this proposal provides the best means of reducing corporate rates. In our view, the top marginal rate should continue to apply to corporate income in excess of \$50,000—the amount of the current surtax exemption. Certainly, the level of graduation should not be raised above that in the House bill.

A graduated corporate rate structure raises troubling questions of tax equity. It should be borne in mind that individuals are the ultimate taxpayers; therefore, the tax policy goal of progressivity has meaning only as it relates to the impact of the system on individuals. Viewed in this light, a steeply graduated corporate rate schedule is actually regressive.

The principal beneficiaries of the House provision are individual owners of closely held corporations—persons who are generally in higher income brackets than the owners of publicly held companies. Corporations whose shareholders are in lower personal income tax brackets tend to elect Subchapter S. In a group of tax returns studied by the Treasury Department, the average income of shareholders in closely held corporations exceeded \$50,000. By contrast, the average income of all individual shareholders receiving corporate dividends was about \$25,000.

Moreover, most of the corporate relief would be provided in corporate income brackets from \$50,000 to \$100,000, the brackets affected by increasing the surtax exemption above the current \$50,000 level. The proposed increase in the surtax exemption would provide no relief for small corporations with no taxable income or with taxable income of less than \$50,000. Only 10 percent of all corporations would receive any tax reduction from the increase in the surtax exemption. These corporations represent less than 1.5 percent of all business entities.

We fear that an unintended result of the House changes would be the aggravation of tax-shelter abuses by many high-income individuals. To many owners of closely held corporations, the corporate income tax—far from being an additional burden—is actually a relief from taxes which they would otherwise pay if all the income of their corporation were attributed directly to them. The sheltering of income at the corporate level would be made still more attractive if substantial capital gains tax cuts such as those in H.R. 13511 were adopted; capital gains tax reductions would increase the tax advantage of avoiding the receipt of annual dividends and postponing a shareholder's realization of corporate profits until he sells his stock. In short, potential for tax abuse might be increased significantly by the use of the close corporation—a device already advertised widely as the "ultimate tax shelter."

Investment tax credit

As part of his program to encourage business investment, the President recommended that the 10-percent investment tax credit be made permanent and be extended to a wider range of taxpayers and a broader scope of investments. Most of these recommendations were adopted by the House.

1. *Permanent investment credit.* The present 10-percent credit is now scheduled to revert to a 7-percent level after 1980. The House accepted the President's

recommendation that the credit be made permanent at a 10-percent rate so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures. We hope the Finance Committee will follow this course.

2. *Increase in tax liability ceiling.* Under current law, the investment credit claimed during any taxable year cannot generally exceed \$25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a 3-year carryback and a 7-year carryforward). The administration proposed that the tax liability ceiling be raised to 90 percent of tax liability in excess of \$25,000. We also recommended that a taxpayer be entitled to offset no more than 90 percent of the first \$25,000 of tax liability.

The House bill would phase in an increase in the tax liability ceiling, with a 90-percent ceiling to be applicable after 1981 for tax liability exceeding \$25,000. We support this provision in H.R. 13511 as a constructive step to make the investment credit more fully available to businesses with high investment needs and low profitability. However, to ensure that no firm will be able to use investment credits to eliminate its entire tax liability, we continue to recommend that the 90-percent ceiling also be applicable to the first \$25,000 of tax liability—a limitation not included in H.R. 13511.

3. *Eligibility for the rehabilitation of structures.* The House bill would allow the investment credit for investments made to rehabilitate existing structures such as industrial buildings, commercial buildings, and retail establishments. Present law generally limits the credit to expenditures made to purchase machinery and equipment. In our view, the extension of the investment credit to the rehabilitation of structures would encourage the renovation of buildings and would thereby assist in the redevelopment of decaying urban areas. For this reason, the administration generally supports this provision. However, there may be serious problems in defining those structures eligible for the credit and the type of investment that qualifies as a "rehabilitation" expenditure; we would like to consult with this committee in developing provisions that mitigate these definitional problems.

4. *Distressed area credit.* In the President's urban program, he recommended that an additional 5-percent credit be available for investments, certified by the Commerce Department, in economically distressed areas. Adoption of this proposal would furnish additional incentives for urban investment.

5. *Pollution control facilities.* Certain pollution control facilities can now qualify for special tax treatment under two separate Code provisions. These facilities can generally be financed through the issuance of tax-exempt industrial development bonds. In addition, pollution control equipment installed in pre-1976 plants is eligible for special 5-year amortization. However, if rapid amortization is elected, only one-half of the full investment credit can be claimed.

H.R. 13511 would generally permit pollution control equipment to qualify for the full 10-percent credit even if rapid amortization is claimed under the provisions of existing law. There would be an exception to this rule. To the extent pollution facilities were financed with tax-exempt industrial development bonds, a taxpayer could not combine a full investment credit with rapid amortization.

The administration originally proposed the extension of the full investment tax credit to pollution control facilities, but this recommendation was accompanied by a proposal (discussed below) to repeal the tax-exempt status of pollution control bonds. By coupling these two proposals, our intention is to provide tax relief that is more efficient and does not disrupt the market for State and local government bond issues. We will support the extension of the full investment tax credit to facilities being rapidly amortized only if tax-exempt financing for investments in pollution control facilities is repealed.

Industrial development bonds

Interest on debt obligations issued by State and local governments is exempt from Federal income tax. There is also a current tax exemption for certain industrial development bonds that are issued by State and local governments for the benefit of private borrowers. In order to qualify for tax-exempt status, industrial development bonds must be issued to provide financing for certain facilities such as pollution control

equipment, sports arenas and convention halls, airports, industrial parks, and the facilities such as hospitals of private, nonprofit organizations. There is also a "small issue" exemption for certain industrial development bonds where the amount of the bonds sold does not exceed \$1 million or the total capital expenses of the facility being financed do not exceed \$5 million.

The President's tax program recommends the termination of tax-exempt status for certain industrial development bonds. Our proposals would provide substantial assistance to State and local government financing efforts and would also improve the equity of the tax system. These important provisions are not included in H.R. 13511—an omission we consider to be a serious defect in the bill.

1. *Termination of exemption for pollution control bonds, bonds for the development of industrial parks, and private hospital bonds.* The administration recommends that there no longer be an exemption for interest on industrial development bonds for pollution control or for the development of industrial parks. We believe the exemption should also be removed for bonds issued to finance construction of hospital facilities for private, nonprofit institutions unless there is a certification by the State that a new hospital is needed.

These activities are essentially for the benefit of private users. The tax exemption in such cases serves little or no governmental purpose but increases the supply of bonds in the tax-exempt market. The cost of municipal financing is raised as a result.

Municipal financing is injured particularly by the abundance of pollution control bonds in the marketplace. In 1977, there was nearly \$3 billion of tax-exempt borrowing for pollution control, accounting for 6.6 percent of all tax-exempt financing and 86.2 percent of all industrial development bonds. Substituting a liberalized investment tax credit in place of tax-exempt financing for pollution control facilities would provide Federal assistance in bringing existing plants into compliance with environmental standards without undermining the ability of State and local governments to borrow funds.

2. *Small issue exemption for economically distressed areas.* Under the House bill, the small issue industrial development bond limit would be increased from \$5 million to \$10 million. We oppose this change. By increasing the exemption limit generally, this proposal would not improve the competitive position of depressed localities in seeking funds; it would serve only to increase the supply of tax-exempt bonds and to impair borrowing capacity for governmental purposes.

The administration recommends that the financial assistance be targeted. The existing small issue exemption should be retained only for economically distressed areas; and, with respect to those areas, we recommend that the \$5 million be raised to \$20 million.

Targeted jobs credit

In April 1978, the President announced his urban program to encourage employment of those individuals who have been experiencing the most difficulty in finding jobs. A targeted employment tax credit was proposed to replace the general jobs tax credit that will expire at the end of 1978. Under the administration's program, employers would earn a tax credit for employing disadvantaged youth and handicapped individuals.

As modified by the House, the targeted jobs tax credit would provide a maximum credit per employee of \$3,000 for the first year of employment and \$1,000 for the second year of employment. Eligible employees would include WIN registrants, vocational rehabilitation referrals, youths and Vietnam veterans eligible for food stamps, SSI recipients, general assistance recipients, and cooperative education students. Like the administration's proposal, the House bill would avoid discrimination by company size, industry and region; it places no absolute limitation on the amount of credit claimed by an employer and does not restrict the availability of the credit to companies that have employment growth.

The administration generally supports the targeted jobs credit contained in H.R. 13511. This proposal is very similar to the recommendation made by the President. The targeted jobs credit is urgently needed to provide job opportunities for economically

disadvantaged young people and for others who have not been reached by more general programs to encourage business expansion and to increase employment.

We believe it is especially important that these young people be aided in their efforts to find private employment before they are drawn into the welfare system. For other eligible groups, the incentives offered by the tax credit should be fully coordinated with Federal job placement programs to provide necessary assistance and information and to assure uniform eligibility standards. The administration would like to assist the committee in developing technical provisions to reflect these objectives more fully.

Small business proposals

We urge the committee to retain in H.R. 13511 two provisions recommended by the President to provide specific relief to small corporations. First, the Subchapter S rules that treat certain small corporations as partnerships would be simplified and liberalized. Second, risktaking would be encouraged by doubling (from \$500,000 to \$1 million) the amount of a small corporation's stock that can qualify for special ordinary loss treatment, by doubling (from \$25,000 to \$50,000) the amount of losses that can be claimed by any taxpayer with respect to such stock, and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

We do not support a provision in the House bill that increases the first-year depreciation allowances for certain businesses. Under the House bill, the maximum amount of first-year "bonus" depreciation that could be taken would be increased from \$2,000 to \$5,000, and this special provision would be limited, for the first time, to taxpayers with less than \$1 million of depreciable property.

This new "bonus" depreciation provision would add further complications to a system that is already confusing for many small businesses. Far more valuable assistance can be provided to small businesses by simplifying the depreciation calculations that must now be made. We repeat here our recommendation, outlined in H.R. 12078, for a new, simple table for equipment depreciation tantamount to a streamlined ADR system for small business.

Farm accounting

The Tax Reform Act of 1976 generally requires farming corporations to use the accrual method of accounting in order to match properly farming expenses with farming income. That act contains exceptions from the accrual accounting requirement for certain corporations. One of the exceptions is for corporate farms with annual gross receipts of \$1 million or less; another exception is for farms controlled by one family, without regard to size or the extent of public ownership.

The administration has recommended the repeal of the one-family corporation exception, so that large corporate farms would be subject to accrual accounting requirements regardless of whether they are family owned. We have also recommended an extension of the accrual accounting requirement to farm syndicates. There is no reason to permit multimillion-dollar corporations and tax shelter syndicates to utilize a cash accounting privilege designed for unsophisticated taxpayers.

In lieu of the administration's proposal, the House adopted an additional exception to the accrual accounting rules for certain farm corporations owned by two or three families. The stated purpose of the House provision is to avoid competitive advantages for one-family corporations now permitted to use cash accounting. We feel that the President's proposals provide the appropriate means of eliminating the competitive imbalances caused by the accrual accounting exceptions. However, if this committee decides not to adopt the President's recommendations in this area, we will not object to the additional exceptions in the House bill.

H.R. 13511 would also revoke an IRS ruling which requires farmers, nurserymen, and florists who use the accrual accounting method to inventory growing crops. On July 28 1978, the IRS issued Revenue Procedure 78-22, which allows any farmer, nurseryman or florist who is on the accrual method of accounting to change to the cash method. This revenue procedure should eliminate any undue hardship that may have been caused by the previous ruling. The House provision is not needed to provide relief, and we oppose its adoption.

Domestic international sales corporation (DISC)

In its tax program, the administration recommended that the large cuts in corporate tax rates be combined with the elimination of two costly tax preferences for firms conducting international business operations. One proposal would have phased out the foreign tax deferral provision, which permits domestic corporations to avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. Another proposal would have phased out the DISC tax preference. Neither of these proposals is contained in H.R. 13511.

I would like to discuss the DISC provision in some detail. The President's program would eliminate, over a 3-year period, the special tax benefits granted for exports channeled through a company's specially created subsidiary—a paper entity known as a domestic international sales corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of incremental DISC income is deferred as long as these profits are invested in export-related assets.

There are numerous problems with the DISC program. It is incredibly complicated; over 50 pages of fine print in the Internal Revenue Code and Treasury Regulations are devoted to describing this special tax program. DISC is inequitable; special tax benefits apply only to exporters who establish these paper subsidiaries, and well over one-half of DISC benefits is realized by only 2 percent of the DISC's. DISC is expensive; it costs U.S. taxpayers over \$1 billion per year in lost Treasury revenues. And there is little evidence that this enormous cost has resulted in a significant increase in exports.

We need to stimulate exports, but the current DISC provision is the wrong approach. If a DISC program is to be maintained, we would like to work with you to focus it more effectively. Many DISC benefits now go to exporters with large profit margins—companies that would obviously be exporting in the absence of any special tax incentive. The committee may wish to consider the elimination of the 50–50 rule that permits one-half of those large profits to be allocated to the DISC. Another possible restriction would place a dollar limitation on DISC benefits in order to target the relief to small companies that may experience difficulties entering the export market. These modifications would result in an export incentive that is much more cost effective and equitable.

Capital Gains

H.R. 13511 contains significant changes in the tax treatment of capital gains. Following a recommendation of the President, the House bill would repeal the special 25-percent alternative tax that now applies to the first \$50,000 of capital gains of high-income individuals. A one-time exclusion would be permitted for up to \$100,000 of gain on the sale of a principal residence. The bill would also eliminate capital gains as an item of tax preference for purposes of the individual and corporate minimum tax and as a preference offset to the amount of personal service income eligible for the 50-percent maximum tax ceiling. Capital gains in excess of \$20,000 would be subject to a new alternative minimum tax of 5 percent if that tax exceeded regular tax liability. Finally, in determining capital gains or losses, an inflation adjustment would be provided after 1979 for common stock, real estate, and tangible personal property. Taken together, these changes would reduce capital gains tax liabilities by \$1.9 billion in 1979, with that figure expanding to nearly \$7 billion annually by 1983.

If capital gains relief is provided, we recommend consideration of several modifications in the House-passed version of H.R. 13511:

- *First*, to limit tax avoidance by wealthy individuals, a reasonable alternative minimum tax on large capital gains should be adopted in place of the token micromini tax in the House bill.
- *Second*, the existing minimum tax on the capital gains of corporations should be retained.
- *Third*, the exclusion for residences might be altered to reduce the revenue loss.
- *Fourth*, the special inflation adjustment for certain capital assets should be eliminated.

I will discuss each of these modifications in some detail.

Adoption of a true alternative tax on capital gains

In attempting to provide relief for persons with significant capital gains tax liabilities, the House created an undesirable byproduct: H.R. 13511 would exacerbate the problem of tax avoidance by wealthy individuals making extensive use of tax shelters. Eliminating the current minimum tax provision would reduce the top rate on capital gains to 35 percent; that result appears to be the objective sought by the House. But the replacement of the current minimum tax with the new "micromini" tax also has the effect of reducing from 7 1/2 percent to 5 percent the maximum capital gains rate paid by individuals who have completely sheltered millions of dollars of capital gains from regular tax liability. A present minimum tax with a modest impact on sheltered capital gains would be diluted.

An example derived from actual tax files may help to illustrate the increased sheltering opportunities that would be available under the House bill. An individual with \$2,184,982 of capital gains uses \$1,095,057 of shelter losses to eliminate all regular tax liability; the regular tax that would normally be paid on one-half of capital gains (\$1,092,491) is offset completely by tax losses. Under current law, he would pay a minimum tax of \$160,984—an effective tax rate on capital gains of 7.4 percent. If the micromini tax in the House bill were adopted in place of the current minimum tax, this person's minimum tax liability would fall to \$108,249—a tax rate of less than 5 percent on capital gains exceeding \$2 million.

Viewed in the context of the other capital gains changes in H.R. 13511, there is no justification for an alternative minimum tax that is so insignificant. The current minimum tax rate was kept low because it affects unsheltered taxpayers; it can add several percentage points to an effective tax rate that is already substantial. If the current add-on minimum tax on capital gains is eliminated in favor of an alternative tax approach, a graduated alternative minimum tax can be adopted so that persons with very large capital gains would have to pay more than a token 5- or 7 1/2-percent tax.

Such a graduated true alternative tax is reflected in the amendment we supported on the House floor—an approach we commend to this committee. This amendment would affect only persons with ordinary losses exceeding ordinary income. For those individuals, the true alternative tax would simply require that ordinary losses be offset against capital gains before the special capital gains deduction (equal to one-half of total gains) is applied. This new limitation would never reduce the amount of the special capital gains deduction below \$5,000, nor would it apply in a manner to reduce the benefits of charitable deductions.

The true alternative tax approach would provide a much more reasonable minimum tax liability for the individual, described earlier, who has sheltered over \$2 million of capital gains from all regular tax liability. He would be required to pay tax on about one-fourth of his total capital gains. Rather than paying a micromini tax of only \$108,249 imposed under the House bill, this taxpayer's liability would be \$345,628 under the true alternative tax. The effective tax rate on \$2 million of capital gains would rise from 5 percent in the House bill to nearly 16 percent under the amendment.

Mr. Chairman, you and other members of this committee have played an instrumental role in developing a minimum tax concept—an effort to minimize the extent to which high-income taxpayers can use various preferences to eliminate all or most tax liability. The Treasury Department will release today its High Income Report for tax year 1976. This report will show that provisions in the Tax Reform Act of 1976 have succeeded in reducing dramatically the number of high-income, nontaxable returns; in 1976, the number of nontaxable returns for individuals with expanded incomes over \$200,000 fell by 75 percent, from 210 in 1975 to 53 in 1976. The number of nontaxable individuals with adjusted gross incomes over \$200,000 fell from 260 to 22, a decrease of over 90 percent.

The results of this report should not lead to complacency. There are still nontaxable returns with high economic incomes that, for various reasons, do not fit into the categories of "expanded income" or "adjusted gross income." Moreover, for every nontaxable high-income return, there are still 10 or more nearly nontaxable returns where income has been reduced by more than 80 percent by use of preferences, deductions, and tax credits.

We believe that the true alternative tax on capital gains represents a significant effort to continue the important work already performed by this committee in reducing large-scale tax avoidance. It begins to focus on the problem of the nearly nontaxable return. You may wish to expand the alternative tax concept to include preferences other than capital gains. Whatever course of action is selected, we believe it is critical to amend H.R. 13511 to avoid a serious setback to important minimum tax reform efforts.

Retention of minimum tax on capital gains of corporations

A corporation can now elect to have its capital gains taxed at a 30-percent alternative rate, as opposed to the top rate of 48 percent under the regular corporate schedule. The corporate alternative tax on capital gains is considered a preference item for minimum tax purposes. But unlike the individual minimum tax, the corporate minimum tax adds a very insignificant amount to the effective capital gains rate—a maximum increase of only 1.125 percentage points even if all a corporation's income is eligible for the capital gains preference.

Other provisions in the House bill would cause a corporate minimum tax on capital gains to be even less burdensome than it is now. If the corporate rate schedule in H.R. 13511 is enacted, the impact of a corporate minimum tax would be reduced still further to a maximum 0.717 percentage point addition to the capital gains rate. Moreover, by providing a 30-percent corporate rate on ordinary income between \$50,000 and \$75,000, the House bill would reduce the number of corporations that would elect the alternative capital gains tax and subject themselves to an additional minimum tax liability.

We see no reason for eliminating the corporate minimum tax on capital gains, as proposed in H.R. 13511. Even with the individual capital gains relief in the House bill, the maximum corporate rate on capital gains would still be more than 4 percentage points below the maximum individual rate. In our view, the elimination of the corporate minimum tax can be justified only if the alternative capital gains rate for corporations is raised to the maximum individual level—35 percent.

Reduction in revenue cost of exclusion for residences

The administration believes that capital gains relief should be provided for homeowners. In the administration's tax program, we recommended that the gain on sales of residences be excluded as a tax preference item for purposes of both the minimum tax and the maximum tax.

Additional homeowner relief may be appropriate. However, the \$100,000 exclusion in H.R. 13511 is extremely costly. It would result in an annual revenue loss of approximately \$700 million.

To provide significant capital gains tax cuts to homeowners at a reduced revenue cost, the committee may wish to consider excluding from taxation the gain attributable to the first \$50,000 of sales price on residences for persons aged 55 or older. This would represent an expansion of the exclusion in current law for gain attributable to the first \$35,000 of sales price for persons aged 65 and over. Under this approach, the revenue cost of homeowner relief would be reduced to approximately \$300 million.

Deletion of inflation adjustment

We believe that the Archer amendment, which would provide inflation adjustments for certain capital assets, reflects a serious mistake in the House. This provision is unfair, complicating, and very costly. It should be eliminated from H.R. 13511.

The Archer amendment is inequitable because it selects for inflation adjustments only one aspect of the tax law—the income of persons who already enjoy the benefits of the capital gains preference. It is difficult to justify an inflation adjustment for owners of capital assets while ignoring the effect of inflation on the savings account depositor. Nor is it fair to permit the holder of debt-financed property to adjust the asset's basis for inflation while making no allowance for the fact that the debt is being repaid with cheaper dollars.

These inequities are illustrated graphically by considering three hypothetical taxpayers:

- Taxpayer A has a \$100,000 certificate of deposit, which bears interest at the rate of 5 percent.
- Taxpayer B purchases a capital asset for \$100,000; he sells it for \$105,000 after it appreciates 5 percent in 1 year.
- Taxpayer C purchases a capital asset for \$200,000, financing the purchase with \$100,000 of debt bearing 5 percent interest; this asset is sold for \$210,000 after it also appreciates 5 percent in 1 year.

At the end of one year, each of these taxpayers has an additional \$5,000 in cash and is in the same economic position before taxes; however, the Archer amendment would result in disparate tax treatment. Assume an inflation rate of 5 percent. Taxpayer A has an additional \$5,000 of taxable income and receives no relief under Archer. Taxpayer B has no additional taxable income because the inflation adjustment equals his appreciation. Taxpayer C is in a better position than either A or B; although he has \$5,000 more cash upon the sale of his capital asset (\$210,000 less the \$100,000 initial cash investment and less repayment of \$105,000 principal and interest), he will show a loss for tax purposes equal to the \$5,000 of interest paid. Such disparities make no tax sense and will distort investment and borrowing decisions.

The economic distortions and tax shelter possibilities of the Archer amendment are only beginning to be analyzed by tax specialists. For example, the special inflation adjustment granted to owners of corporate stock would undoubtedly lead to the subterfuge of incorporating assets not eligible for the adjustment. Indexing the basis of depreciable assets only for purposes of measuring gain would encourage businesses to engage in unproductive asset exchanges, using an inflation adjustment to avoid reporting gain on the exchange while taking a stepped-up basis to increase depreciation allowances for the newly acquired equipment.

The amendment would introduce staggering new complexities into the tax law. Taxpayers and the Internal Revenue Service would have to make determinations such as: (i) Whether a particular asset qualifies for indexation, either in whole or in part; (ii) if an asset qualifies only in part, the portion of the asset's basis that is "adjustable"; (iii) whether a particular transaction is one in which indexation is allowed; and (iv) the holding period for measuring adjustments where, for example, the basis of an asset is the sum of the cost of numerous property improvements made through the years. The answer to each of these questions might differ from that applied for other tax purposes. Recordkeeping and return preparation burdens for taxpayers would be increased substantially, and disputes with the IRS would arise more frequently.

The revenue cost of the Archer amendment would exceed \$4 billion annually by 1983. This cut is twice as large as all the other forms of capital gains reductions in the bill. In combination with the other capital gains changes and tax reductions on business and investment income, this amendment would result in a tax bill that provides 71 percent of the total relief to the owners of capital. As H.R. 13511 now stands with the Archer amendment, it is a bill tilted far too heavily away from American wage earners.

In addition to this proposal's inequity, complexity, and excessive cost, there is a problem with Archer that is even more fundamental. Indexation is a response to high inflation rates, but the proliferation of indexation schemes tends to make those rates an accepted fact of economic life. The economic defect becomes institutionalized. Rather than accommodating to inflation, we should bend all efforts to control it.

Conclusion

As I conclude my remarks, it is appropriate to acknowledge the time constraints under which you are working. The committee is considering this bill late in the legislative session. For this reason, we are not proposing that you consider far-reaching structural changes in H.R. 13511 that would consume an inordinate amount of time. In fact, we are recommending that the committee delete from the bill proposals such as the Archer amendment that can be considered properly only after extensive testimony and debate.

The recommendations I have outlined today are designed to bring the House bill closer to the tax policy objectives outlined by the President. We urge that greater tax relief be provided to middle- and low-income families. We believe the investment incentives in H.R. 13511 should be modified in order to increase their efficiency and

fairness. And we are suggesting a reasonable extension of the tax reforms in the House bill so that the system can be made more equitable and simpler. The administration is anxious to work with this committee to accomplish these objectives.

APPENDIX

Feedback Effects and Revenue Estimation

The term "revenue feedback effect" refers to the fact that the actual change in revenues resulting from a tax revision will depend upon economic responses to that revision. There is general agreement that such feedback effects can be important. To understand more clearly the implications of feedback effects for revenue and receipts estimation, it is useful to separate economic responses into three types.

First, there are *shortrun responses to changes in spendable income* that result from tax increases or reductions. A tax cut, for example, will raise the amounts of after-tax income available to households and to business firms. If there is sufficient additional capacity, higher after-tax incomes will lead to increased consumption and investment which in turn will generate higher incomes and higher revenues. A number of standard macroeconomic forecasting models are usually employed to estimate the magnitude of these shortrun income effects.

A second type of feedback effect deals with *longrun factor-supply responses* to tax changes. Taxes alter the after-tax returns for work effort and for saving and thus will influence the supply of labor and capital offered to the market. The size of the capital stock and labor force will in the long run determine economic capacity and, therefore, the income base potentially available for future revenues.

The third type of feedback effect is the *behavioral response to price increases or decreases* brought about by tax changes. As tax changes alter relative prices, households and business firms tend to shift patterns of consumption and investment away from those activities that have increases in price or cost toward those that have decreases. That is, taxpayers will move into activities which have been granted a tax benefit and away from activities which have lost such a benefit. The result influences the allocation or composition of economic activity and also the volume of Federal revenues.

Therefore, to estimate all potential revenue feedbacks requires determination of: (1) The increase or reduction in spending due to changes in income, (2) the changes in economic capacity due to changes in the supply of labor and capital, and (3) the substitution of lower cost for higher cost activities. In general, estimating procedures currently used by the Treasury do incorporate such feedback effects. Budget receipts for each fiscal year include the impact of tax changes on aggregate demand. Longer run receipt projections allow for the likelihood of tax-induced changes in the capacity of the economy. Furthermore, whenever it is reasonable to do so, the allocation effects of price changes resulting from tax revisions are incorporated into revenue estimates. Each of the three types of feedbacks is discussed in more detail below.

Macroeconomic responses

According to the macroeconomic models, tax law changes which reduce Government revenues will, over time, increase demand, resulting in higher GNP, personal incomes, and corporate profits, and higher tax receipts. Consequently, estimates which do not take into account these shortrun multiplier effects tend to overstate revenue losses resulting from proposals which reduce tax rates or narrow the tax base and overstate revenue increases resulting from proposals to raise taxes. Treasury estimates are alleged to suffer from this defect.

However, this criticism is based on a misunderstanding of the longstanding Treasury practice to provide two types of revenue estimates for proposed changes in tax law. The first type of estimate is made for the complete program of tax changes in the President's budget. Feedback effects on incomes and tax receipts resulting from shortrun multiplier effects are always incorporated in these figures to show the actual impact of the President's program on the economy.

For example, Treasury estimates of total tax receipts during the 1963-68 period incorporated such feedback effects. The stimulative effects of the Kennedy tax cut along with anticipated growth in the population, the labor force, prices, and

productivity were more than enough to fully offset the reduced revenues resulting directly from lower income tax rates. While total receipts were projected to rise over this period, it is generally agreed that the 1964 tax cut, by itself, could not have induced an economic response sufficient to restore the initial revenue loss. The figures in table 1 demonstrate that Treasury anticipated the feedback revenues. The estimating errors taken from the annual budget documents for that period ran about 4 1/2 percent, far too close to the mark for estimates which did not accurately include shortrun feedback effects.

TABLE 1.—*Comparison of estimated and actual unified budget receipts—fiscal years 1963–68*
[\$ billions]

	Fiscal years					
	1963	1964	1965	1966	1967	1968
1963 budget (January 1962).....	113.5					
1964 budget (January 1963).....	105.4	109.3				
1965 budget (January 1964).....	*106.6	111.3	115.9			
1966 budget (January 1965).....		*112.7	114.6	119.8		
1967 budget (January 1966).....			*116.8	124.7	141.4	
1968 budget (January 1967).....				*130.9	150.3	158.6
Actual receipts.....	106.6	112.7	116.8	130.9	149.6	153.7
Estimating errors:						
Estimate made 18 months prior to yearend minus actual receipts.....	+7.0	-3.4	-0.9	-11.0	-8.1	+4.9
Error as percent of actual receipts.	+6.5%	-3.0%	-0.8%	-8.4%	-5.4%	+3.2%

* Denotes actual level of unified budget receipts.

In the context of the current tax debate, table 2 illustrates the impact on receipts of shortrun multiplier effects resulting from the President's proposed \$20 billion tax reduction program. The midsession review of the 1979 budget shows estimated unified budget receipts of \$448.2 billion in 1979 and \$507.3 billion in 1980. These figures include proposed tax reductions of \$14.1 billion and \$21.8 billion, respectively. However, in the absence of these proposed tax reductions, revenues are estimated to be \$459.3 billion in 1979 and \$521.1 billion in 1980. Thus, the net cost to the Treasury of the President's proposed program is \$11.1 billion in 1979 and \$13.8 billion in 1980. These net tax program figures include \$3 billion and \$8 billion of offsetting revenues attributed to shortrun multiplier effects. These feedback revenues are included in the receipt totals but are not separately identified in the published midsession budget review.

The estimation of multiplier effects requires making a number of critical assumptions, including actions the Federal Reserve may take to adjust the money supply and interest rates. These assumptions can influence the multiplier effects on the economy and the resulting revenue feedback. However, there are no plausible assumptions under which induced feedback effects from tax cuts will lead to an increase in tax receipts over what they otherwise would have been. In fact, none of the macroeconomic models of the U.S. economy predict revenue feedback sufficient to offset the initial revenue loss.

The second kind of estimate made by Treasury involves the revenue change from specific proposals without feedback effects (except to the extent Treasury is able to estimate price effects as described below). This kind of estimate is also appropriate for the kind of policy questions which may arise. For example, great attention is focused on the distribution of tax changes among taxpayers at different income levels. For distributional analysis policymakers should look at the direct impact on taxpayers engaged in a particular activity such as paying private school tuition, or on those receiving a particular source of income such as capital gains.

In contrast to the tax side of the budget, there is general agreement that feedback effects are not appropriate for the expenditure side of the budget. Congressional decisions concerning the expenditure side of the budget are also properly made on the

basis of gross expenditures. We should not estimate, for example, that a dam, highway, harbor, or even aircraft carrier costs only 60 percent of its initial outlay on the argument that the Federal Government recoups the rest in the form of higher revenues. A dollar of outlay costs a dollar in resources used up, and a dollar of tax reduction releases a dollar for use in the private sector. The macroeconomic feedback effects of both of these changes are important, but it is also important to evaluate the initial impacts correctly.

Treasury policy to include multiplier effects when overall positions of fiscal policy are being established, as described earlier, is consistent with excluding multiplier effects when alternative programs are being considered that do not markedly alter the desired fiscal posture. The assumption is made that each separate tax proposal being considered is designed to be incorporated into a comprehensive package of proposals, with net tax reductions consistent with the overall fiscal policy. In this framework, it is clearly incorrect to include offsetting multiplier effects in revenue estimates for individual tax proposals. This is because the budget receipt estimates already include the feedback effect of the aggregate change in taxes. To again include feedback effects, as each component of an overall tax package is being considered, would be to double count induced revenue changes and misguide policymakers as to the size of the budget deficit or surplus.

TABLE 2.—*Proposed tax reductions included in the administration's midsession budget review*
[\$ billions]

	Fiscal years	
	1979	1980
Unified budget receipts published in the midsession review	448.2	507.3
Receipt effects of the President's tax reduction and reform proposals:		
Gross change in receipts	- 14.1	- 21.8
Offsetting induced receipts	3.0	8.0
Net change in receipts	- 11.1	- 13.8
Unified budget receipts in absence of the President's tax reduction and reform proposals	459.3	521.1

Capacity responses

Much attention has recently been focused on the potential for increasing economic capacity by reducing rates of tax. Since income taxes necessarily reduce the reward from additional work effort or from adding to savings or investment, reductions in rates of income taxes—especially reductions of the highest marginal rates—would increase significantly the aggregate amount of work effort and capital supplied in the economy. This increased work effort and larger capital stock would provide increased capacity to produce income that is subject to tax, offsetting at least some of the initial revenue lost by tax reduction.

The fundamental logic of this argument is sound, but there are a number of practical considerations that recommend against regularly reporting separate estimates of these aggregate capacity, or "supply side," effects of tax changes. There are presently no economic models that fully incorporate supply effects and that have also developed a track record over a period of years. In fact neither the magnitude nor the timing of such effects is well known and there is consequently wide professional disagreement about their importance. For example, some advocates of the Roth-Kemp tax reductions claim that induced supply responses would be so large that general rate reductions would bring about higher revenues than would occur without them. Some of these advocates argue that the responses would be so rapid that revenue increases from induced supply would occur in the first year. Other analysts, including those who have developed the well-known econometric forecasting models, predict that in the first few years following a tax change, there will be no significant increases in economic capacity resulting from higher wages or increased returns to saving.

In the case of induced labor supply even the direction of change is at issue. Historically, there has been a tendency, as incomes have increased, for the average worker to work shorter hours and to retire at an earlier age. When taxes on labor income are reduced, the positive response to higher after-tax earnings will be offset, perhaps completely, by this tendency to take some of the increased potential earnings in the form of increased leisure.

The greatest weight of professional opinion is that increased capacity in response to reduced tax rates will take effect much more slowly than the demand effects induced by higher incomes. Any tendency for labor supply to respond to increases in after-tax wages will be translated into increased economic capacity only over a period of years. In part, this is because it takes time for households to adjust—to seek out a second job, to arrange for child care, to take more schooling, and the like. More important, however, is that it takes time for businesses to make the additional investment necessary to accommodate the increased labor supply.

Nevertheless, these longrun supply effects are very important since they will help to determine the underlying growth and composition of employment and output in the future. Significant supply side factors are not ignored in deriving the long-range receipts projections that are included in the budget. These projections show the path of Federal receipts through time that are consistent with attainable increases in capacity and aggregate demand.

The Treasury has been devoting substantial resources to understanding and estimating supply effects. We also closely monitor new research in this area. Analysis of the longer run implications of tax policy will build upon new research findings as they become available.

Price effects

Tax policy changes have consequences for economic behavior other than their aggregate demand effects and supply side responses. A further important effect of tax policy changes is that they alter the relative prices or costs of particular types of consumption and investment goods. As a consequence, households and firms respond by changing their consumption and investment patterns. Not all tax changes have significant price effects. Changes in exemptions, the standard deduction, and even across-the-board cuts in tax rates do not bring about significant changes in relative prices. However, when such relative price effects do occur and when there is broad agreement as to both the magnitude and the direction of these impacts, revenue estimates incorporate the behavioral responses to the relative price changes. There are numerous examples of such behavioral responses. They include—

- The taxable bond option, where it is assumed that some fraction of municipal debt will be issued on a taxable basis as a result of the lower interest costs of issuing subsidized taxable debt compared to the prevailing rate on tax-exempts;
- The automobile efficiency tax, where consumers are assumed to modify their pattern of automobile purchases in response to the increased prices of gas-inefficient vehicles;
- Residential and business thermal efficiency and solar tax credits, where the reduction in prices of the subsidized activities are assumed to induce households and firms to install more insulation and to use lower cost sources of energy;
- Any new program such as subsidies for exports (DISC) or for new retirement programs (IRA), where the revenue estimates depend upon the extent to which the new provision will be used;
- Integration of corporate and personal taxes, where an increase in corporate dividends would be expected to accompany the reduction in the combined level of personal and corporate taxes on these dividends.

In all of these cases, there may be disagreement over the magnitude of the behavioral responses. Nevertheless, a good faith effort is made to incorporate behavioral responses into the revenue estimates where the behavioral responses will obviously occur and they

are believed to be substantial. But we do not try to estimate feedback effects where the predominant responses are unpredictable or where there is no objective basis for making a judgment.

Two specific cases of tax-induced price changes are currently of particular interest. They are the cuts of capital gains taxes and the reduction of top marginal tax rates. It has been alleged in both cases that the price effects of the tax change will induce a flood of new revenues to the Treasury, outweighing the initial revenue loss. In the case of capital gains cuts, the claim is made that the increased realizations will be so large as to yield an increase in tax receipts on capital gains. In the case of a reduction in the top marginal tax rates, the switch of investment from sheltered to unsheltered activities along with a vast increase in work effort are the alleged sources of the higher tax receipts.

Claims have been made that solid empirical analysis underlies both behavioral responses. But these claims are greatly overstated. The empirical work to date concerning the response of gains realizations to changes in capital gains tax rates has not distinguished between shortrun transitional effects and longrun effects. Further, if the results are interpreted as estimates of permanent longrun effects, they imply such enormous reductions in the average holding periods of assets as to be totally at variance with the observed historical stability of these holding periods. Also, the estimates assume that every investor has an unlimited amount of unrealized accrued gains just waiting to be realized at lower tax rates, an assumption surely contrary to the facts. Moreover, it may be very difficult to separate statistically the effect of the marginal tax rates from the effect of high itemized deductions for medical expenses or casualty losses. Higher realizations of capital gains may be due to high itemized deductions rather than to low marginal rates themselves.

Attempts to adduce the likely responses of high-income taxpayers to reductions in their marginal tax rates by examining historical data for the years before and after the 1964 tax cut also are seriously deficient. While it may be true that at substantially lower marginal tax rates individuals would find tax shelters of much-diminished economic advantage and would therefore tend to invest more in fully taxed assets, the likelihood and magnitude of such a response cannot be determined by merely looking at the income taxes paid by those in the upper income classes before and after the tax cuts of 1964. The upper income group did, in fact, pay more in taxes after their marginal rates were cut, but all income classes experienced tax cuts and all realized significant increases in incomes along with the general expansion of the economy in 1964-66. The share of before-tax income reported by the highest income classes was remarkably stable over the entire period from 1952 through 1972. In addition, it should be pointed out that most of the increased taxable income in these income groups was from higher realized capital gains. But the 1964 Revenue Act did not change the 25-percent alternative tax on capital gains. Thus while it may be desirable to reduce marginal tax rates to provide additional incentives to work and to save, there is little evidence for claiming large revenue gains to the Federal Treasury as a result of tax-induced price effects.

Conclusion

First, estimates of aggregate budget receipts do include the additional receipts resulting from the impact of tax changes on aggregate demand. However, estimates for particular tax changes, just like estimates for particular expenditure changes, do not include feedback effects. To do so when they are already in the aggregate estimates would be double counting.

Second, projections of longrun budgetary figures also accommodate the impacts of tax changes on economic capacity. As research sheds more light on the nature of these effects, it may be possible to incorporate them more formally into longer run projections.

Third, Treasury does incorporate estimates of changes in specific types of investment or consumption induced by relative price changes whenever it appears the effects are important and it is possible to make reasonable estimates.

Trade and Investment

Exhibit 35.—Excerpts from press releases dated October 31, 1977, May 15, 1978, June 22, 1978, and July 14, 1978, respectively, regarding new projects of the United States-Saudi Arabian Joint Commission on Economic Cooperation

SECRETARY BLUMENTHAL SIGNS SOLAR ENERGY RESEARCH AGREEMENT WITH SAUDI ARABIA (October 31, 1977)

Secretary of the Treasury W. Michael Blumenthal and Saudi Arabian Finance Minister Abalkhail yesterday signed a \$100 million project agreement for jointly sponsored solar energy research.

Under the 5-year program, each country will make available \$50 million for mutually agreed solar research projects. The new U.S. Department of Energy, which cosigned the agreement along with the Saudi Arabian National Center for Science and Technology, has been designated the "action" U.S. agency and is expected to guide the entire research program.

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In their remarks at the signing both Secretary Blumenthal, and Minister Abalkhail emphasized the importance of solar power and stated that the research results would be made internationally available.

Noting the Saudi role as the world's largest oil exporter, Secretary Blumenthal said: "While the United States has come to recognize the importance of solar energy belatedly when our own fossil fuel resources are dwindling, Saudi Arabia is taking the long view and acting when its petroleum reserves may seem limitless."

This project is the 13th major project to be carried out by the United States-Saudi Arabian Joint Commission on Economic Cooperation, for which Secretary Blumenthal and Minister Abalkhail are cochairmen. * * *

U.S. TREASURY TO PROVIDE SERVICES TO SAUDI GENERAL CONTROL BOARD (May 15, 1978)

The U.S. Treasury will be sending a four-man team to Saudi Arabia in the near future to work with the Saudi General Control Board (GCB) in upgrading its technical and managerial capabilities and in instituting training programs for its employees. The GCB has the responsibility of auditing and substantively reviewing the hundreds of development projects currently underway throughout the Kingdom.

In an agreement signed on May 15 between the United States and Saudi Governments under the auspices of the United States-Saudi Arabian Joint Commission on Economic Cooperation, Treasury will provide the GCB with two auditors and two management analysts for a 2-year period. The Treasury team will work primarily in the areas of audit management and administration, computerization and data management, and executive development. The team will also work with GCB in establishing an Office of Policy Planning and will assist it in drafting a charter which will provide audit and accounting standards for the Saudi Government.

This project will be the 14th major project to be undertaken by the United States-Saudi Arabian Joint Commission on Economic Cooperation, for which Secretary of the Treasury W. Michael Blumenthal and Saudi Arabian Finance Minister Muhammad Abalkhail are cochairmen. * * *

U.S. CUSTOMS TO PROVIDE ASSISTANCE TO SAUDI ARABIAN CUSTOMS DEPARTMENT (June 22, 1978)

* * * * *

Under the auspices of the United States-Saudi Arabian Joint Commission on Economic Cooperation, an agreement was signed in Riyadh, Saudi Arabia, on June 11 which calls for the U.S. Customs Service to provide four full-time customs advisers to

the Saudi Customs Department in Riyadh, and to furnish orientation and training to up to 95 Saudi customs officers a year in the United States. The new program will be the most all-inclusive agreement of its kind that the U.S. Customs Service has ever entered into with another nation.

The four U.S. advisers stationed in Riyadh will work with their foreign counterparts to improve Saudi Customs' administrative, technical, and management skills. At the same time, the U.S. Customs Service will enroll up to 80 designated Saudi customs officers a year in specially designed seminar programs to be held at a university location in the United States. As part of the program, the Saudi officers will observe Customs programs in operation at selected regional offices. Up to 15 additional Saudi customs officials a year will be enrolled in graduate-level programs in public administration at various U.S. universities and colleges and will also participate in related work-study programs.

This project is the 15th major project to be carried out by the United States-Saudi Arabian Joint Commission on Economic Cooperation, for which Secretary of the Treasury W. Michael Blumenthal and Saudi Arabian Finance Minister Muhammad Abalkhail are cochairmen. * * *

U.S. GENERAL SERVICES ADMINISTRATION TO ASSIST SAUDI MINISTRY OF FINANCE IN PROCUREMENT AREA (July 14, 1978)

The Department of Treasury, the General Services Administration (GSA), and the Government of Saudi Arabia signed an agreement yesterday *** for the implementation of the centralized procurement project. Under this agreement, GSA will provide two specialists to work with the Saudi Ministry of Finance and National Economy to upgrade its procurement procedures through the introduction of improved organizational and management techniques.

In addition, training programs and seminars, both in-country and in the United States, will be developed for the Saudi personnel. Provisions have also been made for the extensive use of other GSA experts on a short-term basis as they are required. The total cost of the project will be over \$1.3 million.

This is the 16th major project to be carried out under the United States-Saudi Arabian Joint Commission on Economic Cooperation, for which Secretary of the Treasury W. Michael Blumenthal and Saudi Arabian Finance Minister Muhammad Abalkhail are cochairmen. * * *

Exhibit 36.—Remarks by Secretary Blumenthal, November 14, 1977, to the National Foreign Trade Convention, New York, N.Y., on the foreign trade position of the United States

I welcome this opportunity to discuss the foreign trade position of the United States.

The most recent interest in international trade comes, of course, from our record deficit for 1977—which we expect will reach about \$30 billion this year. A deficit of this size is worrisome and certainly cannot be allowed to persist forever. Through the Economic Policy Group, I am focusing the energies and resources of all executive department agencies on finding solutions to the problem. It is important, however, to keep the trade deficit in perspective.

First, the deficit represents only about 1 1/2 percent of our total GNP.

Second, the United States possesses today one of the strongest and most rapidly growing economies in the world.

Third, despite vigilant and continuing scrutiny, we have seen as yet no evidence of significant deterioration in our relative competitive position.

Finally, against unfair trade our antidumping and countervailing duty statutes provide a potent recourse to protect domestic industries.

There is, accordingly, no reason for panic and no excuse for reactions in ways that jeopardize the overall health of the U.S. economy or that adversely affect world recovery in general.

Our policy should reflect a thorough understanding of the real character of the trade deficit.

In this, two factors stand out—oil imports and the U.S. economic recovery. It is chiefly these factors that have led the growth of our imports to outpace the growth of our exports.

Of these two factors, oil is the most important. A fivefold increase in oil prices and an 80-percent increase in the volume of U.S. oil imports since 1972 together are the most significant single cause of the current trade deficit. U.S. oil purchases will total about \$45 billion in 1977, compared with \$4.7 billion in 1972.

This has coincided with the decline of domestic production, since 1972, of 1.5 million barrels a day, while our consumption has increased by 2.5 million barrels a day.

OPEC imports of U.S. goods and services, while rising rapidly, have not kept pace with this extraordinary growth of oil trade. This year our trade deficit with the OPEC countries should be about \$30 billion.

The second major factor has been the difference in economic performance of the United States and the other major trading countries. In a sense, we are victims of our own success—our imports are outpacing our exports because our economy is growing more rapidly than of those of our trading partners.

During the last 2 years, the U.S. economy has grown in real terms at an annual rate of about 5 1/2 percent while the rest of the OECD has averaged only about 4 percent. This is a sharp reversal, of traditional postwar growth. During the 1960's and early 1970's, for example, U.S. real growth averaged 4.2 percent annually and the rest of the OECD averaged 6.8 percent. Foreign demand for our capital goods has been particularly sluggish, because investment is lagging in Europe, Japan, and elsewhere.

High oil prices and foreign exchange constraints have caused many of our developing trading partners to reduce their imports as part of broader stabilization programs. Mexico and Brazil, for example—2 of our 10 largest export markets—have recently accounted for sharp declines in U.S. exports.

In the agricultural sector—which accounted for a substantial increase in U.S. exports during the early 1970's—our trade balance has been hurt by the otherwise happy fact that harvests around the world have recently improved.

So, the main factors causing our deficit have little to do with the inherent competitiveness—the price and quality—of our goods and services.

There is no evidence that the U.S. competitive position has deteriorated significantly in export markets during the past 18 months. On a nation-by-nation basis, our exports have basically held their own.

An initial study indicates that the U.S. share of industrial country markets did not change significantly in volume between the last half of 1976 and the first half of 1977. A small loss in the U.S. share measured by value reflects a smaller rise in dollar export prices of our goods—in other words, slower inflation rates here—rather than a greater volume of goods sold by our competitors.

We have held our own or slightly improved our exports to the 2 fastest growing economies—Japan and West Germany—and maintained or increased our share of manufactured goods in 13 of the 18 major non-OPEC markets.

Over the longer term, it is clear that we have reversed the trend of the late 1960's and early 1970's, when our declining share of world manufactured exports was falling because of the declining competitiveness of U.S. products and the overvaluation of the dollar. Since our historical low point in 1972, the U.S. share of world export markets has risen significantly in virtually every major U.S. manufacturing sector, except transport equipment.

In summary, our current deficit does not reveal any significant loss of our competitiveness. This is, of course, no reason for smugness. Given our oil import bill, we need a dynamic export sector that seizes every legitimate opportunity to increase our competitiveness. In production and marketing, our efforts at innovation and enterprise must be unstinting. We are now a trading nation, an economy that depends on virorous leadership in world trade.

Having set the background, let me sketch for you our basic approach to the deficit problem.

We have ruled out three approaches that would directly injure the U.S. economy as a whole.

The first would be to restrict imports artificially; for example, through import quotas, increased tariffs, an import surcharge, or an import deposit scheme. This would be inconsistent with our commitment to open trade, would invite retaliation by other nations, and would have a clearly destructive impact on our exports, on world trade in general, and on the U.S. and world economies.

Second, we have absolutely ruled out efforts to depress artificially the value of the dollar. Our exchange rate policy is, as I stated it in Houston on October 19, that a strong U.S. dollar is in the U.S. and international interest, that world economic conditions point to a strong dollar, that a depreciation of the dollar is not required by our trade deficit, that such a depreciation is not an answer to the deficit, that exchange rates should reflect underlying economic and financial conditions and should be permitted to adjust to changes in those underlying conditions, and that we will intervene in foreign markets only to counter disorderly conditions.

Third, we have ruled out the deliberate reduction of domestic U.S. economic growth to reduce U.S. demand for imports. This would be a tail-wagging-the-dog approach—to attempt to handle our foreign trade position by increasing unemployment and reducing production at home. This is unacceptable to us, and to our partners in the global economy who would suffer from its spillover effects.

Instead, our approach to the deficit is integrated with our goals for the domestic and world economy generally.

Our approach is to implement an effective domestic energy policy, so as to reduce our dependence on oil imports and to encourage our trading partners who are in a position to do so to resume more vigorous economic growth, consistent with the worldwide effort to reduce inflation. In the meantime, we must continue to keep inflation under control at home and to increase our own productivity.

Internationally, we are defending the open, liberal trade and payments system. We are pursuing a substantial liberalization of trade through the multilateral trade negotiations. We are working toward a broadening and strengthening of the international consensus on export credits. We believe that exchange rates should be permitted to play their appropriate role in the adjustment process. And we are enforcing domestic statutes designed to protect domestic industries from unfair foreign trade practices.

We are also urging that countries running large trade and current account surpluses move promptly to reduce and, over time, eliminate those surpluses. We are working particularly closely with the Japanese authorities on this. We and the Japanese have agreed to establish a Joint U.S.-Japan Trade Facilitation Committee to help reduce Japan's large and persistent surpluses in ways which expand, rather than constrict, trade. This is in the interest of both countries and is a major step forward in the friendly cooperation that should characterize all of our relations with Japan.

The Departments of Commerce and Agriculture are taking new measures to improve the flow of information to U.S. industries and producers about trading opportunities overseas.

An important aspect of our effort to improve the U.S. trade balance is the activity of the Export-Import Bank. Our ultimate goal is to reduce, and ultimately eliminate, the counterproductive competition that exists between official export credit agencies. But this must come through a multilateral agreement. In the interim, the Eximbank holds a big position in our export drive. From 1973 through 1976, Eximbank authorizations supported exports with a value of \$12 billion per year on the average—equal to 18 percent of U.S. manufactured goods exported in those years.

For the future, the Eximbank will increase substantially its support of U.S. exports. It has recently lowered its interest rates as a further stimulus to U.S. sales abroad, while remaining carefully within the internationally agreed guidelines on official export credits.

We are taking care not to trigger a trade war through trade finance. We took an important step last year with an agreement on basic guidelines for officially supported export credits. It is now essential that we broaden and strengthen those guidelines, and the United States has made proposals to achieve that objective. This goal was endorsed

at the London economic summit in May, and discussions have been initiated for an International Arrangement to succeed the present Consensus.

At home, serious problems of import competition threaten U.S. jobs in particular industries. We are handling these problems expeditiously case by case, but always within the context of our overall commitment to negotiate a regime of more open world trade. Where injury is due to unfair foreign trade practices, notably export subsidies or dumping, our laws provide strong remedies to protect U.S. industries. Where adjustment assistance is needed, we will provide it. Adjustment is and should be our primary response to the problems of noncompetitive firms.

We recognize that industries cannot adjust overnight. Mutual cooperation to moderate trade flows—as in the cases of color television and shoe imports—may be necessary in very exceptional cases.

We are trying to achieve international agreement in the multilateral trade negotiations on precisely what trade measures are acceptable in these cases, and to define when they are justified. We are also working on a new international subsidy/countervailing duty code in the MTN to define more precisely what are fair and unfair trade practices, and how nations should respond to unfair trade.

I am convinced that these efforts reflect a sound, pragmatic approach to the problems created by our record deficit. In this way, we can improve our international trade position without adversely affecting our domestic economy or the economies of other nations. This is the only sensible course.

Looking to the immediate future, the United States cannot expect to reduce the trade deficit substantially unless we slow the growth of oil imports.

That is precisely the objective of the President's energy program. With a strong emphasis on conservation and incentives for new production, the program would begin reducing our oil import needs rapidly. By 1985, it would reduce projected oil imports by 4.5 million barrels a day—for an annual savings of \$23 billion, at today's oil prices.

The energy program is the most urgent priority of this administration. It is a balanced, fair, and effective plan that provides the only real alternative to increasing dependence on foreign oil and, consequently, an increasing trade deficit.

Looking to the longer term, we must recognize that the world trading system will face a number of structural problems.

First, the massive increases in energy costs over the last 5 years have not yet worked their way through the world economy. Second—partly as a result of these higher energy costs, but also of other fundamental developments—world growth rates may well be significantly lower in the last quarter of the 20th century than they were during the third quarter.

Third, the pattern of growth among the industrial countries may have shifted structurally. For some years, the United States may grow faster than the rest of the OECD, notably Europe, whereas the opposite situation held during the first postwar generation. Fourth, the developing countries will be increasingly formidable competitors—they have already doubled their share of world trade in the last decade.

These structural developments will produce intensified pressures everywhere to export more and to restrain imports, in order to maintain employment and production. It is obvious that these pressures are inconsistent with each other in a world context.

Our task is to make that world context prevail. We must meet these challenges through strengthened international cooperation.

We have already made major progress in creating a new international monetary system which, while not perfect, is clearly better than any feasible alternative. We have also helped assure that sufficient official financing is available so that the system can accommodate wide variations in economic performance and high energy costs.

We have agreed on a strategy for sustained world economic recovery—an international commitment to promote domestic economic growth and price stability, to resist protectionist pressure, and to make rapid progress in reforming the international trading system.

We have agreed to progress in the multilateral trade negotiations. The continued liberalization of trade is the only sure antidote to increasing protectionist pressures. Our people must be shown, by clear results, that employment and production are increased

more by expanding trade—on a fair, competitive basis—than by retreating into inefficient, "siege" economies.

Our own prosperity thus depends on expanded international cooperation in the economic sphere. But cooperation will only present us with competitive opportunities. Our own economy must be ready to seize those trade opportunities.

To ensure that we are ready will be the administration's top priority over the coming months. We need an economy where real investment grows at 10 percent a year or better, where productivity returns to the robust growth rates of the early and mid-1960's, where capital is formed as quickly as men and women enter the work force to use it, where innovation and risk taking reap a full reward.

This will take some doing. Business investment remains sluggish, and businessmen remain uncertain, after the battering of double-digit inflation and severe recession. Real profit remains too low to sustain vigorous real growth.

Within several months, the administration will present its tax and budget policies for 1979. We intend this to be a charter for a full and balanced recovery of investment, growth, and employment over the coming years.

Obviously, we face formidable economic problems, both internationally and at home. But there are clear paths through those problems.

By working together, rather than against each other, we all can assure an increased measure of prosperity for ourselves and our children. That is our goal, and with the proper policies, I am convinced we can achieve it.

Exhibit 37.—Remarks by Secretary Blumenthal, November 14, 1977, to the U.S.-U.S.S.R. Trade and Economic Council, Los Angeles, Calif., on expansion of United States-Soviet trade and economic relations

I appreciate the honor of speaking to you tonight, an honor shared with Minister Patolichev, the distinguished representative of the Soviet Union.

We attach special value to the presence of Minister Patolichev here tonight. We know how difficult it is for him to leave his heavy responsibilities in Moscow and journey nearly halfway around the world to Los Angeles. We welcome him as an old friend and valued colleague.

The presence here of high officials and business leaders of our two countries is indicative of our mutual interest in strengthening Soviet-American economic relations.

As a personal note, let me add that I am here tonight because I favor expanded United States-Soviet trade—I am aware of both the prospects and the problems of this trade—and I am willing to work toward a sustained, healthy expansion of this trade.

We can take satisfaction in the great strides made in developing closer ties in recent years. At the same time, we recognize that much remains to be done.

Before I go into this, however, let me describe some of the recent history.

Just 6 years ago, trade between the Soviet Union and the United States was small. Two-way trade totaled \$221 million in 1971. The summit meeting at Moscow in May 1972 marked a turning point in our economic relations. It produced an agreement on basic principles, which underscored the importance of commercial and economic ties to our overall relations. Formation of the Joint U.S.-U.S.S.R. Commercial Commission and the negotiation of commercial agreements followed shortly thereafter.

With official encouragement, trade rapidly increased and economic ties were broadened. By 1976, two-way trade totaled \$2.5 billion, about 12 times the 1971 level. Over 58 U.S. firms, for example, had entered into industrial cooperation agreements with their Soviet counterparts, and many other such agreements were under negotiation.

The formation of the U.S.-U.S.S.R. Trade and Economic Council in 1973 was an important step in fostering economic relations.

Even after passage of the Trade Act of 1974, United States-Soviet trade continued to grow, reaching \$2.1 billion in 1975 and \$2.5 billion in 1976. This was principally because of large shipments of U.S. agricultural goods.

Soviet imports of U.S. manufactured goods also increased in 1975 and 1976, due in part to a "pipeline effect." Contracts had been signed before passage of the Trade Act,

and the Export-Import Bank continued to finance U.S. exports in accordance with prior commitments.

By 1977, we have seen a downturn in United States-Soviet trade. Total trade fell to less than \$1.4 billion in the first 8 months of 1977, compared with almost \$1.9 billion in the comparable period of 1976. In large part, this reflects reduced purchases of U.S. grain, after the bumper harvest in the Soviet Union last year. These purchases are expected to rise again as a result of the shortfall in the Soviet grain harvest this year.

But U.S. exports of manufactured goods also decreased markedly, to \$391 million in the first 8 months of 1977, a decrease of 28 percent compared with the same period of 1976. Our projections indicate that this downward trend in manufactured goods will be even more pronounced during the rest of 1977.

There are indications of a downturn in Soviet purchases from most other Western countries also. This is probably due in part to Soviet efforts to reduce their trade deficit with the West and to restrain the rate of increase in their hard-currency debt.

That brings us to today and to the question of the future of United States-Soviet trade. Will we remain where we are today, or can we expect expansion? And what can we do to encourage this expansion?

I am happy to note that there are signs of progress toward the normalization of economic relations which we all desire. There has been an improvement in the tone of the political relations between our two countries. There has also been an increase in the number of persons emigrating from the Soviet Union. In working toward normalization, factors like these affect Soviet-American economic relations, and can help to maintain trade momentum and improve the structure we have built.

I believe that these favorable developments are being noted by the American people and the Congress, as well as by the executive branch. We hope that trends will continue to a point where we can reach complete normalization of our trading and credit relations.

I joined Minister Patolichev in a meeting with President Carter, during the Minister's brief stop in Washington before coming up here. The President expressed his hope for expanded economic relations with the U.S.S.R. in the improving context which I have just discussed. He also looked forward to the time when these relations would be fully normalized.

Our economic relations not only are deeply affected by our political relations, but they in turn influence our political relations in ways which are almost always beneficial. They lead to closer contacts between our two peoples, which lead to improved understanding, which then can strengthen the fabric of peace. They give both of our nations an enduring interest in continued good relations.

Our relations inevitably comprise elements of both cooperation and competition. By promoting economic relationships, we foster the cooperative aspects, to our mutual benefit and the benefit of the entire world, which so deeply desires continued peace.

The U.S. Government strongly favors increased trade with the Soviet Union and the continued improvement of economic relationships. It is a major aspect of our goal of building a better and more cooperative international environment.

I would like to see our economic relations develop still more as a tie between our nations, linking our two systems, so different in many respects, in mutually advantageous collaboration.

On the American side, the development of such relations should be in harmony with basic principles which we consider to be essential elements of our system. We rely on private initiative as the impetus behind economic activity in the United States. We prefer to limit Government intervention to what is required in the national interest. In international trade, we are committed to an open trading system, although we recognize that in some circumstances it may be necessary for governments to intervene.

We recognize that in doing business with a much different system such as that of the Soviet Union, a large measure of adaptation is necessary to reach solutions acceptable to both sides. The commercial agreement negotiated in 1972 provided that both Governments would promote cooperation in projects for the development of natural resources and in manufacturing.

The United States has been a latecomer in this field, compared with other major Western nations which have entered into more cooperation agreements than the United

States. These have involved, for example, gasfield equipment and large diameter pipe, to be paid for with natural gas; forestry equipment and pulp plants, to be paid for with wood products; and aluminum refineries, to be paid for with aluminum. The agreements have resulted in large increments of trade between the Soviet Union and these countries.

Americans are catching up, however, as indicated by new agreements between American enterprises and their Soviet counterparts. The U.S. Government welcomes such cooperation while recognizing that the decision to participate rests with the parties directly concerned. We can all take satisfaction from the increasing number of cooperative arrangements successfully underway or under negotiation.

These arrangements have varied widely in type, from simple licensing agreements to complex compensation deals in which American companies supply hundreds of millions of dollars' worth of equipment and services, and products of the project are exported from the Soviet Union with proceeds used to repay loans from Western banks.

Compensation arrangements were involved in about one-fourth of the value of Soviet orders placed in the United States for machinery in the 1973-75 period. Deputy Minister Sushkov has indicated that an even larger percentage will involve compensation arrangements in the 1976-80 period.

However, these arrangements pose special problems.

In some cases, significant problems come from the very large size of the projects, the large credits required, and the tremendous quantities of product to be marketed outside the Soviet Union. The dimensions of such projects exceed the capacity of all except the largest consortiums of Western countries, and even these feel the need of assurances of support from their governments. In some cases, the projects are so large that they can have significant impact upon the economy of the United States—for example, projects involving large imports of materials in short supply, or manufactured goods in quantities which might cause market disruption.

Problems have arisen in resolving differences in customary practices in the two countries. For example, American investors frequently think in terms of equity investment in foreign projects, but this has not been possible in the Soviet Union. Also, American firms have had a legitimate interest participating in quality control of products to be sold outside the Soviet Union under the American firm's brand name. In some cases, there has been the problem of determining the degree of administrative responsibility to be exercised by an American firm over operations in the Soviet Union to which it contributes its know-how.

There have also been problems in agreeing upon prices, and the basis for adjusting prices to reflect inflation and changes in world markets. On the Soviet side, there has been the desire to insure stable marketing arrangements as an important element in long-term planning.

Experience has shown that, with goodwill on both sides, such problems can be resolved. In the process, both sides gain a better understanding of each other's point of view, paving the way for further advances in cooperation.

An important problem in our trade relations is the imbalance between our imports and exports. In 1976, U.S. exports to the Soviet Union totaled over \$2.3 billion, while our imports totaled only \$221 million. These imports were principally raw materials and semiprocessed goods—platinum-group metals, petroleum and products, and chrome ore. Finished manufactured products accounted for a minor share.

We believe that there are important markets which can be developed in the United States for Soviet products under existing trading conditions. We have welcomed the opportunity to collaborate in marketing seminars and to explore means of developing markets for Soviet products in the United States. We look forward to cooperating in similar seminars in the future.

Industrial cooperation arrangements involving compensation or buy-back provisions also offer possibilities of greatly increasing Soviet exports to the United States. The Occidental Petroleum fertilizer project is a good example. It is expected to generate billions of dollars in Soviet exports to the United States of ammonia and other products over the years.

There have been other significant moves in developing our economic relations.

About a year ago, Belarus Machinery of U.S.A., Inc., of Milwaukee, was formed to market Soviet tractors and related equipment in the United States. The U.S.-U.S.S.R. Marine Resources Co. was set up in Seattle in mid-1976, with ownership divided equally between the Soviet fishing fleet organization and the Bellingham Cold Storage Co.

There is also the possibility that Soviet banking interests will be represented more actively in the American banking community.

These developments can strengthen the infrastructure of United States-Soviet economic relations and foster better understanding.

Much remains to be done in promoting Soviet-American commercial relations. There is a need for more complete and timely information on Soviet projects to assist American businessmen in meeting Soviet import needs. Negotiating procedures need to be improved so that agreement can be reached more quickly. Better working conditions in Moscow and an increase in the number of accredited offices would promote United States-Soviet commercial relations, as would the facilitation of visas and travel for American businessmen.

In the process of developing cooperation between the economies of our two countries, the U.S.-U.S.S.R. Trade and Economic Council plays an important role. It does more than provide facilities and assistance to businessmen in promoting trade. It serves a valuable purpose in identifying existing and potential problems, and assisting in their solution. It brings to the attention of both Governments the difficulties encountered by businessmen, and it makes recommendations as to how to resolve them. It has emphasized the need for a stable and predictable commercial environment in which economic relations can flourish, without being hostage to passing political considerations.

I commend the Council for the valuable functions it has so effectively carried out, and look forward to its continued service in strengthening relations between our countries.

In conclusion, I would like to read to you a message from President Carter to the Council. It is signed by the President at the White House and reads as follows:

I am pleased to greet the delegates at this meeting of the Directors and Members of the U.S.-U.S.S.R. Trade and Economic Council.

In the few years since its inception, this Council has become a catalyst in the expansion of U.S.-Soviet trade relations and has provided a much needed forum for the resolution of problems and for the discussion of new ideas. My Administration firmly supports expanded bilateral trade as an important factor in promoting world peace and goodwill.

I hope that the Council will continue its efforts to strengthen the commercial and economic ties between our two countries, and that this meeting will be a highly productive one for all concerned.

I would like to add my own personal good wishes to those of the President for the continuing success of the Council.

Exhibit 38.—Remarks by Under Secretary for Monetary Affairs Solomon, December 2, 1977, before the United Steelworkers of America, Washington, D.C., on the current steel crisis

As U.S. steelworkers who have been seriously affected by the current problems of the domestic steel industry, you are acutely aware of the seriousness and urgency of the current steel crisis. As many as 60,000 U.S. steelworkers have been laid off by steel cutbacks and closings this year alone. Many of your members are receiving unemployment assistance, and have little prospect of obtaining new jobs for the next several months. Your communities have been hurt as well, especially the concentrated steel communities in Ohio, Pennsylvania, and New York: Youngstown, Lackawanna, Johnstown are a reality and a human tragedy for many of you. And the prospect of more plant closings and cutbacks remains a real possibility for the future, unless positive action is taken now to improve the industry's competitive position.

My objective in speaking to you today is to help explain our analysis of what has happened to the U.S. steel industry in recent years, on the basis of our recent review

of the industry's problems—and, equally important, to emphasize the administration's concern for the future of the steel industry. Our primary aim is to help assure that the industry can be viable and competitive in our own market. Our actions should mean more jobs for you, greater security in the jobs you hold, and an industry that is strong and growing and which can produce efficiently for the benefit of all Americans.

What has happened to the steel industry

The present crisis in the U.S. steel industry has been developing for a number of years; its problems date back to the 1950's but have been heightened by the recent deep recession in world steel markets.

Indeed, the current steel "crisis" is not unique to the United States; it is global in nature and equally affects our major steel trading partners, Japan and the European Community, which have relied on steel exports to our market to help maintain employment and production in their countries.

The present steel situation is marked by high excess production capacity in all of the major producing nations, due in large part to slow recovery in global steel demand from the 1974-75 world economic recession and to large increases in foreign capacity in recent years. The EC's industries are operating at 65 to 70 percent of capacity; Japanese industries at less than 75 percent; and U.S. industries at approximately 81 percent of steel capacity. Our own economic recovery has been strong, but recovery in the other industrialized countries has been disappointingly slow.

Even a strong global economic recovery, however, would not by itself relieve the broader problems of our domestic industry:

1. A significant erosion in its competitive position over the past several years, due in part to low-priced foreign imports, but also to the increased use of substitute materials;
2. Abnormally low earnings in recent years (the return on sales for the first half of 1977 was 1.4 percent after taxes);
3. Heavy investment requirements for modernization, pollution control, and plant maintenance which the industry cannot meet because of inadequate cash flow and an inability to raise the needed capital in private markets.

U.S. domestic demand for steel has been relatively strong this year, especially for lighter, flat-rolled products. Total consumption of steel mill products may reach 108 to 110 million tons in 1977—a level exceeded only twice before, in 1973 and 1974. Many markets, however, remain depressed, especially those for structurals, plates, and bar products, which reflect the still depressed demand for capital goods.

The problem is that imports, rather than U.S. production, are satisfying an increasing share of domestic demand (up from 13 percent of U.S. steel consumption in 1973-76 to a 20-percent share in recent months). At current rates, imports could total 19 million tons in 1977, a 5-million-ton increase over 1976. Imports of this magnitude suggest more than a competitive response to the continued gradual growth of U.S. steel demand and rising U.S. steel prices.

While Japanese exports to the United States reached a record 7.9 million tons in 1976, imports from the European Community have been the major factor behind increasing U.S. imports in 1977. The pressure of low capacity utilization, large financial losses, and a stonger U.S. recovery has led EC firms to attempt to improve their operating results by aggressive pricing in the U.S. market.

The steel industry argues that the recent surge in imports is largely attributable to unfair trade practices, principally dumping. Accordingly, numerous antidumping complaints have been filed since February of this year; indeed the 19 separate petitions presently before the Treasury Department in various stages of investigation are an unprecedented number with respect to a single industry in so short a time frame. Efforts to assure prompt and adequate relief for the U.S. steel industry from unfair foreign pricing practices must be a central element of our response to the current steel crisis.

The need for Federal Government involvement

The U.S. Government does not normally become involved in developing policy programs designed to assist a specific U.S. industry. We do so in this case because the steel industry is one of the largest U.S. industries and a substantial and continuing

shrinkage of the U.S. capacity to produce steel is not in the interest of the U.S. economy; because its problems already have had a broad and serious impact on thousands of workers and several communities; and because resolving its problems requires international cooperation to avoid unfair trade practices and a concerted approach to assist the industry in meeting its capital investment requirements in order for it to maintain a competitive position in the future.

Global nature of steel problems.—The depressed global steel situation is expected to continue for some time; a return to even 85 percent of capacity operation is not even forecast by 1980. In this environment steel prices, which fell as much as 50 percent below their peak 1974 levels during 1975 and 1976, are not expected to recover in the near future.

Aggressive export practices by foreign exporters also assure that imports will continue to present problems for the domestic industry. We are seeking means to provide a prompt and effective remedy to this problem. And we must do so in a manner which is the least disruptive to international trade, to foreign production, and to relations with our major trading partners.

Investment needs.—A major obstacle to investment in U.S. steel facilities (for modernization, plant maintenance, or pollution control) is the uncertainty in many areas of government policy. Continuing changes in water and air pollution legislation, the uncertainty of energy legislation affecting coal supplies, the length of time required and uncertain outcome of dumping complaints lodged by the industry—all affect the industry's willingness to invest in new facilities. Inadequate cash flow also seriously restricts the ability of the industry to invest in new or improved facilities. This problem is complicated by the fact that there is a substantial range in the efficiency of steel plants, new technologies have not been easily adapted to the older facilities, and the market for steel has shifted from the East to the Mideast.

All of these factors argue for a comprehensive policy approach to the problems of the steel industry and a positive cooperative effort by industry, labor, and government alike to assure that the U.S. steel industry can operate in a fair and equitable environment which will stimulate its health and its efficiency.

Task force review of steel problems

In preparing its proposed comprehensive steel policy program for the President, the interagency steel task force which I chair has been guided by the following principal objectives:

- Promoting a healthy, competitive domestic steel industry;
- Ameliorating the serious economic and social effects of steel plant closings and cutbacks on laid-off steelworkers and steel communities; and
- Relieving the industry from the pressures of imports below foreign costs without removing the healthy price discipline provided by fair import competition.

To meet these objectives, we will need to take specific policy actions in five major areas: Trade relief, modernization, rationalizing environmental policy and procedures, community and labor assistance, and other general measures.

The following measures of assistance are presently under consideration:

A "trigger price system" for steel imports.—The adoption of a trigger reference price system for steel imports has been under consideration as a method for allocating the Treasury resources to expedite antidumping investigations and accelerate remedial action. Present procedures take 13 months after a case is filed and to this must be added the time needed by petitioners to prepare their complaints. The trigger price is intended to compress this process substantially. First, steel prices will be constantly monitored abroad and at ports of entry. Second, data on the health of the U.S. industry and the effect of imports will be constantly collected. The trigger price mechanism is intended to provide the facts for the Secretary's self-initiation of investigations based on this data and to permit a rapid decision.

The trigger price would be based upon the costs of production of the most efficient steel producers, and would be revised quarterly. It would apply to carbon and alloy steel imports. Substantial sales under the trigger price would result in an expedited investigation and, if warranted, application of antidumping duties. The procedure,

while more abbreviated, will not deny anyone concerned here or abroad the legal rights under our law to start cases or to object to Treasury actions taken—or not taken. But we hope that when it is in place and operating, there will be no need for continuing most of the pending cases or filing new ones.

We think this would effectively deter dumping in the U.S. market. It would be fully consistent with U.S. law and U.S. international obligations. It should permit the domestic industry to recapture a substantial part of the market held by imports. It should also help to generate a substantial increase in U.S. steel production and in the steel labor force.

Improvements in industry cash flow.—The steel industry presently faces large investment requirements for stepped-up modernization and pollution abatement control. There is a clear gap in the available cash flow of the industry to meet these requirements. If steel industry earnings improve through such measures as the adoption of a trigger price system, some of this gap could be met through improved access of the industry to private capital markets. We are also considering additional Government measures to help alleviate the cash flow gap and to assist financially depressed small steel firms.

Environmental issues.—The steel industry is a major polluter and faces substantial costs in meeting environmental regulations, especially as older facilities are brought into compliance. We clearly must not relax our present environmental goals. Yet we can reexamine current regulations to ensure that they are economically efficient and that they do not present unnecessary barriers to modernization. Our objective would be to look into alternative ways to achieve present environmental goals at lower cost.

Aid for steel communities.—The recent massive layoffs of steelworkers have seriously affected some communities which are heavily dependent upon steel production and related industries. The cutbacks or closings cause both economic damage to the community and real social problems for those workers who have been laid off. To help meet these problems, special Federal aid for hard-hit communities could help to combat unemployment and provide alternative job opportunities.

The creation of an interagency task force to review potential alternative uses for abandoned steel facilities, to report their findings by June 30, 1978. Projects involving community or worker takeover of such abandoned steel facilities which are proven by hardheaded feasibility studies to be economically viable could be given serious consideration for funding assistance under current Government programs.

Research and development.—Research and development is an important area which can help to promote a more efficient and productive U.S. steel industry. A review of the adequacy of current Federal R. & D. funding in the steel industry, especially funding of research on energy conservation and pollution abatement technology, could be helpful in determining what is needed in this area.

The creation of a task force to review transportation systems serving the steel industry, and to propose regulatory or other reforms to improve efficiency and lower the cost of these transport systems is another measure which could be helpful.

The establishment of a tripartite committee of industry, labor, and government representatives would help to ensure a continuing cooperative approach to the problems and progress of the steel industry. In particular, we hope that labor and industry will cooperate in seeking to increase their productivity, thereby reducing costs and helping to make the industry more competitive.

Conclusion

In summing up, a combination of some or all of these measures, if adopted, could significantly reduce the serious problems of the U.S. steel industry. It would relieve the industry from the pressure of below-cost imports without removing the healthy price discipline provided by fair import competition. It would help restore jobs in an industry which has lost 60,000 jobs so far this year. It would raise industry earnings and increase capacity utilization from its current depressed level. An additional increase in the industry's cash flow position could result from proposed tax measures, and, together with increased earnings, should enable the bulk of the industry to secure sufficient capital from private markets to undertake necessary investment for modernization, pollution control, and plant maintenance. The industry, in turn, should commit itself to stepping up modernization to help reduce production costs.

The interagency task force has coordinated closely with industry, labor, congressional, and consumer representatives in conducting its review of steel problems. We hope to offer a program which has the essential support of all these groups, as well as support in principle from our major foreign trading partners, the European Community and Japan. If successful, this program should provide a major infusion of new energy in helping to promote a healthy, competitive domestic steel industry.

Exhibit 39.—Excerpt from address by Secretary Blumenthal, February 16, 1978, to the Puget Sound Chamber of Commerce, Seattle, Wash., entitled "The Economic Challenge Ahead: A View from Washington, D.C."

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The President is well aware that, in occasional instances, a sudden surge of imports can threaten the survival of industries that are unable to adjust to such changes overnight. Consequently, we have been willing to examine serious problems of import competition on a case-by-case basis and to make appropriate adjustments.

But we remain committed to the overall objective of improving the freedom and openness of the international trading system. Our position is grounded neither in abstract economic theory nor in neighborly charity. It is based on the overall national interest of the United States:

- One manufacturing job in eight produces for the export trade. In Washington State, 280,000 jobs are tied to exports, one way or another.
- Exports take 40 percent of our entire production of construction machinery, for example, and about one-third of our aerospace output. In Washington State, about half the aerospace production is exported.
- Every third acre of American farmland produces for the export market. More than half our wheat, soybeans, and rice are sold abroad. In Washington State, 85 percent of the wheat is exported.
- Nearly one-third of our corporate profits now come from the international activities of U.S. companies, their foreign investments as well as exports.
- The share of trade in our gross national product almost doubled over the past decade. The level of exports is now equal to the outlays for private plant and equipment. In Washington State, the value of exports in 1976 exceeded \$4 billion.

These figures come as a surprise to many Americans who are unaware of the extent of our exporting. When jobs are affected by import competition, the process is direct and highly visible. Unfortunately, the number of jobs that are dependent on exports and the impetus that exports give our entire economy are acknowledged less frequently.

American workers producing for export generally are not aware that their jobs depend on foreign markets or that protectionism here will end in shutting off those markets. The producer interest in free trade is insufficiently vocal. The consumer interest, also, is too often silent. The costs of import competition are selective and specific, while their benefits—wider choice and lowered prices—are immense but broadly spread across the whole economy. These facts must be more generally acknowledged if we are not to risk dangerous protectionism that would ultimately affect our exports as well as our imports.

President Carter has mapped new policies to benefit our exports and thereby help improve the U.S. balance of trade. The Export-Import Bank is expected to quadruple its direct lending activity in this fiscal year. The budget proposed for the coming fiscal year calls for another \$700 million increase to a level of \$3.5 billion. The Bank's guarantees and insurance authorizations are expected to increase by \$1.8 billion this year and by almost as much next year. Also, we are negotiating with other industrial nations to prevent the kind of cutthroat competition among official export credit agencies that has occurred in the past.

Loans by the Commodity Credit Corporation are expanding in support of agricultural exports. The sales budget for financing U.S. exports of wheat, feed grains, soybeans, cotton, and other agricultural commodities is \$1.7 billion this year, more than double the original estimate. This total is 70 percent higher than actual financing in the last fiscal year.

In the end, however, neither subsidies nor loans will assure us a healthy export sector. The future of that sector, like the future of our economy, depends on the prosperity of our export markets—on world economic recovery. During its first year the Carter administration has taken the lead in promoting a balanced world recovery, supported by sound arrangements for international cooperation. I would like to share some of these initiatives with you. They are: An important tax treaty with the United Kingdom, our successful economic negotiations with Japan, our leadership in reviving the multilateral trade negotiations, and our participation in creating the Witteveen Facility of the International Monetary Fund.

The proposed income tax treaty between the United States and the United Kingdom, which is now before the Senate Foreign Relations Committee, deserves early ratification. It has the backing of the American corporate community, and for good reason. It would mesh our system of taxation with that of the United Kingdom and set a valuable precedent for similar treaties with many other countries.

It would also limit the application of unitary taxation systems which can lead to double taxation and impose severe administrative burdens on companies. As a result, unitary taxation, now used by several States for United Kingdom-based corporate groups, has proven to be a disincentive to foreign investment in these States. The relatively minor direct revenue cost to the States of the provision could well be more than offset in the long run by added revenues from increased foreign business activity in the State.

The proposed treaty would also correct a current inequity in the treatment of American investors in British corporations. A London investor in a British corporation receives a dividend credit against his individual income tax, but an American investor in a British corporation does not, under British tax law. Ratification of the convention, which for this purpose would be retroactive to 1973, would permit refunds to flow to American investors in British firms. Refunds would also be made to U.S. parent corporations retroactive to 1975. These would amount to about \$375 million initially and \$85 million a year thereafter. We are urging prompt action by the Foreign Relations Committee on this important and mutually beneficial agreement.

Let me turn next to the Japanese situation. During the past 2 years, as Japan's imports lagged in response to weak domestic growth, its trade and current account surpluses soared to record levels, threatening to rupture the fabric of world trade. In a series of meetings during the latter half of 1977, the United States expressed its concern about the effect of those surpluses on the world economy.

We also took strenuous exception to Japanese regulations which limited imports of agricultural and manufactured goods, including wood products. These difficult discussions occurred during a period of rising tensions in both countries. Steel mills were being shut down in the United States, with imports from all countries being cited as a factor. In Japan, there was a growing concern among businessmen as the current account surplus led to appreciation of the yen on foreign exchange markets.

Last month, however, we reached an important agreement that will resolve most of these tensions. Japan now plans major measures to boost its domestic growth rate and has agreed to take steps to reduce quickly its current account balance, to increase its imports of beef, citrus, and wood products, and to increase the share of imports of manufactures from the United States and other countries. These steps represent solid progress in opening the Japanese market to imports.

The results reflect the calm determination of Prime Minister Fukuda and President Carter that our countries reach a fair and amicable solution, one that would not disturb the intimate political and economic ties between our two countries.

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Exhibit 40.—Excerpt from statement by Assistant Secretary Bergsten, March 20, 1978, before the Subcommittee on International Finance of the Senate Committee on Banking, Housing and Urban Affairs, regarding a 5-year extension and an increased authorization to \$40 billion for the Export-Import Bank

The administration strongly supports a 5-year extension and increased authorization to \$40 billion for the Export-Import Bank. These proposals are an important part of the President's international economic program, because Eximbank can help our

national effort to reduce the U.S. trade deficit—at no cost to the U.S. taxpayer. My testimony will address, and answer affirmatively, two key questions surrounding this legislation: Does the United States need an effective program of export finance? Does Eximbank provide such a program?

Eximbank and the U.S. trade deficit

The U.S. current account deficit increased from \$1 billion in 1976 to an estimated \$19 billion in 1977. The trade deficit, measured on a balance of payments basis, increased from \$9 billion to \$31 billion. Imports increased nearly \$28 billion, while exports rose less than \$6 billion. The magnitudes of these deficits are likely to be similar in 1978. They are, and must be, a major source of concern for U.S. policy.

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*** Especially during a period of large U.S. trade deficits, an accelerated Eximbank program is an appropriate response to assist exports.

During the past 2 or 3 years, with world trade growing more slowly than normal, some of our major trading partners have undertaken aggressive export promotion activities. Trade finance has been one of the mechanisms used by governments to promote exports.

So far, counterproductive interest rate competition has been avoided—largely due to the Consensus Guidelines on export credits, which were negotiated originally at U.S. initiative and which I will discuss shortly. But the danger of escalating official export credit competition is real and we should have an Export-Import Bank strong enough to provide a restraint on other countries, as well as to support our own sales abroad. With this as background, I wish to turn to the specific role of Eximbank and whether it is effective in supporting U.S. exports.

Benefits and costs of Eximbank

Does Eximbank financing actually increase U.S. exports? Is the Bank assisting exports which would not otherwise be sold? This question of “additionality” is a difficult one to answer. Yet it is fundamental for any U.S. Government export credit program.

Treasury staff has recently tried to estimate the extent to which Eximbank fosters new U.S. exports, using a comprehensive sample of Eximbank transactions for FY 1976 and spot-checking the results by a partial analysis for FY 1974. To identify additionality, it is necessary to exclude the effect of such factors as price, quality, and marketing, where Eximbank does *not* play a role; the concentration must be on the effect of deficiencies in the financial market, where Eximbank *does* play a role.

There are identifiable deficiencies in the private market's ability to finance U.S. exports. These commonly cited deficiencies, which we have confirmed in extensive discussions with the private sector, are independent of the form of the international monetary system, and thus are not affected by the shift to floating exchange rates. They can be divided into three basic categories:

1. *Loan maturity.*—Commercial banks do not readily make export loans with repayment terms of over 5 years. The longer the terms needed, the more difficult it is to obtain private financing. Fixed interest rate financing—often necessary for longer term projects—is also increasingly difficult for longer maturities.

2. *Loan amount.*—The greater the value of a particular export, the more difficult it is to obtain financing. If an export is less than \$10 million, financing is not difficult to obtain. If the loan is over \$60 million, financing may be difficult. Many high-technology and large-scale projects cost this much or more.

3. *Risk assessment.*—It is generally assumed that the higher the per capita income of a country, the more creditworthy it is. This assumption is obviously oversimplified. There are often cases where a low-income country is creditworthy, either because of its overall economic performance or because the project is particularly good. Nevertheless, many less developed countries do not find ready acceptance in the private capital markets of industrialized countries.

Treasury has attempted to measure the additionality of Eximbank financing through its ability to overcome these three deficiencies. * * *

The results indicate that Eximbank added almost \$4 billion to total U.S. export sales in FY 1976. About two-thirds of the total U.S. exports which it financed directly

represented additional sales which might not have been made if Eximbank financing had not been available. About \$2.1 billion of Exim loans were associated with \$5.2 billion of total U.S. exports, of which perhaps \$3.4 billion were additional. In this sense, U.S. exports benefited by well over 100 percent of Exim direct lending. In addition, about 30 percent of the guarantee program produced additional sales, as did about 27 percent of the insurance program, according to the estimates for FY 1976 in the study. In FY 1974, the comparable figure for additional total exports exceeded \$5.6 billion.

The second key factor in assessing the merits of an expanded Eximbank program is that it carries no cost to the U.S. taxpayer. The Bank borrows from the Treasury Department at one-eighth percent over the interest cost to Treasury of placing 5- to 8-year notes on the private market. The Bank extends credit at a sufficient spread to cover its administrative and operating costs, to place some retained earnings into reserves, and to pay a dividend to the Treasury. It places no net charge on the U.S. taxpayer.

Eximbank hence comes out extremely well in terms of cost-benefit analysis. Its programs strongly support U.S. exports. At the same time they are self-supporting. Hence Eximbank is an effective tool for supporting U.S. exports, and an efficient device for helping to reduce our trade deficit.

Official export credit competition

Statistical indicators such as those just outlined can only present a partial picture of the benefits to U.S. exports generated by Eximbank. For example, the efforts may induce and enable smaller firms to enter the export market for the first time—a major objective of the program. In addition, the need for Eximbank must also be examined within the context of assistance made available by other governments to their exporters. Export financing offered by major foreign countries is supported by government agencies, sometimes with substantial subsidies to provide lower than market interest rates. Eximbank support to U.S. exports is necessary to offset such government intervention in the interest of keeping U.S. exports competitive.

Of our major trading partners, only Canada has a smaller official export finance program than ours. Overall Eximbank support, as a percentage of total merchandise exports from the United States, was 7 percent in 1976. Canada's ratio was 5 percent. By comparison, Germany supported 10 percent of its merchandise exports with official financing; the United Kingdom, 23 percent; France, 39 percent; and Japan, 48 percent.

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These data suggest the presence of more aggressive efforts by other large exporting nations to stimulate their exports through the use of officially supported credits, guarantees, and insurance than the United States has used in the past. They are one reason why we are proposing a larger Eximbank program.

International guidelines on export credit

At the same time, there is very real danger of a self-defeating export credit war. A first step to deal with this risk was taken by the seven major trading countries—the United States, the United Kingdom, France, Germany, Italy, Japan, and Canada—on July 1, 1976, when they adopted Consensus Guidelines designed to reduce counterproductive competition in government-supported export credits. The Consensus was subsequently adopted by other OECD member countries and there are now 20 participating countries.

Last year, consistent with the legislative mandate contained in section 2 of the Export-Import Bank Act, the U.S. Government took the initiative to propose to the participants that negotiations should be undertaken to improve the Consensus. Intensive discussions and negotiations led to a successful conclusion on February 22, 1978, when the representatives of 20 governments and the Commission of the European Community agreed, on an ad referendum basis, to a new international Arrangement on Officially Supported Export Credits. The new Arrangement will take effect on April 1, 1978.

¹ Sec. 2(b) (1) (A) of the Export-Import Bank Act states the Bank shall "seek to reach international agreement to reduce government subsidized export financing."

This Arrangement is not a legally binding agreement, but an informal set of guidelines for the official export credit agencies in the 20 countries. We are not yet at the stage when governments are willing to make binding commitments in this area. On the whole, however, we believe that derogations by participants will be minimal.

The U.S. Government has confirmed its intention to implement the Arrangement. The Japanese Government has similarly confirmed its acceptance. We expect other governments to take similar action as quickly as their internal processes permit.

The main features of the Arrangement are:

1. A cash payment of at least 15 percent of the export contract value is required.
2. Repayment terms should not exceed 8 1/2 years for relatively rich countries and intermediate countries, and 10 years for relatively poor countries. The repayment of official export credits should normally be in equal and regular installments, and not less frequently than every 6 months.
3. The minimum interest rate ranges from 7.25 percent to 8 percent based on the number of years in the repayment period and the classification of the country receiving the credit, i.e., a relatively rich, an intermediate, or a relatively poor country. Interest shall normally not be capitalized during the repayment period, but shall be paid not less frequently than every 6 months during that period.
4. The financing by export credit agencies of local costs connected with an export project is limited.
5. Prior commitments not in conformity with the Arrangement must be reported and the procedure for such reporting is spelled out. Similarly, the procedures for reporting on derogations and matching offers by other export credit agencies are set out in considerable detail.
6. Excluded from coverage under the Arrangement are export credits for military equipment, agricultural commodities, aircraft, nuclear powerplants, and ships. In the aircraft and nuclear powerplant sectors, there is a "standstill" agreed upon in the OECD which applies. With respect to ships, there is an OECD understanding which does not apply to the United States because we are not parties to it. The terms of the understanding are more stringent than those in the Arrangement, so we have agreed to notify the participants if we offer terms on ship finance that are more favorable than those provided for by the Arrangement.
7. There is a provision to enable other OECD member countries and others to participate.
8. Review of the Arrangement is provided for at least annually, with the first review scheduled for October 1978.
9. Finally, withdrawal from the Arrangement requires notice of not less than 60 days; otherwise, there is no termination date.

We view this Arrangement as an additional step in the effort to avert wasteful export credit competition. Its strength is in the procedures which enable export credit agencies to operate on the basis of knowledge about the export credits offered by their competitor agencies abroad. Its major weakness is that the minimum interest rates do not reflect market rates of interest for comparable credits denominated in different currencies.

We recognize that no single set of minimum interest rates can reflect differences in market interest rates (and underlying rates of inflation) in the currencies of several different nations. Obviously, the minimum points should be different for different currencies. This was something that was not possible to negotiate in the initial Arrangement.

However, the single set of interest rates across all currencies is useful in that it reduces the danger of excessive official export credit competition. Before a country goes below these rates, it is expected to notify the other parties to the Arrangement. Because the other parties will have the opportunity to match the lower than minimum interest rate, the competitive incentive to go below the minimum rate is substantially reduced.

We anticipate that shortcomings will be addressed in future reviews of the Arrangement. Besides the question of different interest rates for different currencies, other issues we will look at closely in future reviews include expanding coverage to

those sectors now outside the Arrangement, and developing reporting methods for related programs which impact on commercial exports such as mixed credits and export inflation insurance schemes.

The international Arrangement is far from perfect and needs to be substantively improved. However, it constitutes progress in constraining export credit agencies in granting official export credits. The standard interest rate schedule of the Export-Import Bank is above the minimum interest rates provided in the Arrangement, but we benefit from the Arrangement because it sets a floor on the interest rates which competitor export credit agencies charge and because it acts as a brake on self-defeating competition.

Need for 5-year authority and \$40 billion ceiling

In order to assure that the official export credit of the United States is adequate to meet the deficiencies in the private capital market and to maintain financial competitiveness with foreign official export credit programs, a 5-year extension (until September 30, 1983) of the Export-Import Bank Act is needed. A shorter term of authorization would impair the Bank's mission by adversely affecting the Bank's planning and programming abilities, and possibly by raising questions in the minds of exporters, bankers, and foreign buyers regarding the dependability of relationships with Eximbank. It is important, therefore, to have the flexibility that a longer term commitment to the Bank represents.

The administration believes that a \$15 billion increase to \$40 billion in the Bank's overall ceiling is important. This would meet the needs envisioned in the FY 1979 budget submitted by the President, which contemplates a \$3.8 billion increase in direct credit authorizations. Assuming an increase through fiscal year 1983 of 10 percent per year in the direct loan and other programs, a ceiling of \$40 billion would leave an unused margin of only about \$3 billion at the end of the authorization period.

Conclusion

The administration strongly supports the legislation before this committee as an important component of U.S. international economic policy. * * *

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In his December 21 statement concerning our balance of payments situation, the President indicated his desire to increase sharply the lending activity of the Export-Import Bank. In this regard, he said, "We will not engage in unfair competition for export markets; we will fully respect our understandings with other governments regarding export credit terms. But within these understandings there is room for a more active effort to expand our exports."

The administration believes that the proposed extension of the Export-Import Bank Act and the increase in its authority to \$40 billion would be a clear signal to both U.S. industry and labor that the Government will support them in increasing sales. It is a program which is highly beneficial to fundamental U.S. interests, at no cost to the U.S. taxpayer. It is a necessary restraining force on official export credit competition by other countries. I urge your support for it.

Exhibit 41.—Excerpt from remarks by Secretary Blumenthal, April 21, 1978, before the U.S.-Arab Chamber of Commerce, Inc., International Business Conference in Washington, D.C., on United States-Arab economic relations and cooperation

I am delighted to be here today to discuss United States-Arab economic relations and the importance for the world as a whole of our continued cooperation. It was the importance of improved cooperation in an increasingly interdependent world which took me to the Middle East last fall to discuss a number of matters of mutual interest and to establish personal relationships with the key government officials of Egypt, Saudi Arabia, and Kuwait.

I returned from my visits with President Sadat, King Khaled and Crown Prince Fahd, and Shaykh Jabir al-Sabah and Minister al-Ateeqi very encouraged by their clear perception of the problems facing the world economy, and their willingness to work with us in resolving them. We place a high priority on these relations. We will work hard to maintain them.

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United States-Arab cooperation

I would like to turn now to a few specific areas in which cooperation between the United States and the Arab nations is essential.

First, we must work in a constructive manner to achieve an accommodation on the important issue of the Arab boycott of Israel.

Our laws specifically acknowledge the legitimacy of a direct boycott of one country by another, although we regret the existence of such a boycott directed against another friendly country.

Our antiboycott laws draw a distinction, however, between a direct boycott and indirect boycotts which call upon Americans to refuse to engage in certain types of transactions with Israel or with other entities which engage in such transactions, as a condition for trading in the Arab world. Such practices clearly run counter to our longstanding commitment to fair and open competition in the marketplace, and we cannot accept them. Indeed, Americans who comply with the indirect boycott are subject to the loss of foreign tax credit, deferral, and DISC tax benefits as well as criminal penalties.

We believe that the laws which have been passed reflect substantial compromises on the part of the United States. We are hopeful that our Arab friends will also find it possible to adjust their boycott practices. We have seen evidence of their willingness to do so.

Second, United States-Arab trade relations are becoming increasingly important to each of us, and we should do our best to assure that trade will continue to grow, unimpeded by artificial or unnecessary restraints.

U.S. exports to your countries now represent almost 10 percent of our total exports. These exports reached \$10 billion in 1977, an increase of more than 40 percent from 1976 and triple the 1974 level of \$3.3 billion.

Although the growth of imports by the Arab countries has been slowed by absorptive, and in some cases financial, constraints, there remains a great potential for continued expansion of United States-Arab trade and commercial relations, especially for the kind of goods and services in which U.S. companies excel; for example, transportation, communications, and industrial machinery and processes.

The Export-Import Bank of the United States had \$740 million in direct loans to Arab countries and \$600 million in insurance and guarantees, as of January 31. We expect Eximbank to play an increasingly important role in support of U.S. exports to Arab countries. For many of these countries, access to long-term private capital finance is limited. For many others, access to long-term World Bank loans is either limited or insufficient for their needs. An Eximbank guarantee to private lenders or an Eximbank long-term loan effectively fills the gap in the financial resources available to Arab countries. We should both benefit from the expanded use of these programs.

Third, we are proposing changes in our tax laws to reduce the tax liability of Americans overseas and to make them more equitable.

It has become increasingly apparent that the changes made in section 911 of the U.S. tax code, which permits the exclusion of a portion of foreign earned income from taxable income, by the Tax Reform Act of 1976, are unsatisfactory and in some cases unfair. The net effect of the changes would be to increase greatly the U.S. tax which some Americans in the Middle East would have to pay, thus causing many to consider leaving the area or to decline jobs which they otherwise might accept.

An overall reduction in American involvement in the economic development efforts of the Middle East would be severely injurious to U.S. policy objectives. Such involvement contributes positively and substantially to U.S. exports to the area, as well as to the economic development of an area of major importance.

Therefore, the administration has proposed special deductions for Americans living abroad for certain housing and education costs and for the cost of travel to the United

States on home leave. We believe this approach to section 911 is more equitable, and we hope for prompt congressional action on this important issue.

Finally, we should continue to expand our economic assistance to the poorer Arab nations and bilateral programs of economic cooperation.

The immense oil earnings of the oil-producing Arab States have enabled them to contribute substantial amounts toward the development of other countries in the area, especially their Arab neighbors. We understand that bilateral aid commitments by Saudi Arabia, Kuwait, the United Arab Emirates, and Qatar last year were about \$8 billion. Actual disbursements over the last 3 years probably totaled about \$10.5 billion.

The United States has also had extensive aid programs in effect in the area for many years. The United States has committed more than \$2.3 billion in economic assistance to Egypt alone since mid-1974. Congress recently appropriated an additional \$750 million for FY 1978, and we expect food aid programs to add another \$150 million to this amount. This is the largest single U.S. economic assistance program ever.

The United States is also committed to the long-term development of the Jordanian economy. Our economic assistance to Jordan is planned to increase from approximately \$80 million in FY 1977 and \$100 million in FY 1978 to a proposed \$150 million in FY 1979.

In addition to these major assistance programs, the United States is also actively working with Saudi Arabia to aid its economic development, using U.S. technical expertise and Saudi capital deposited in a dollar trust with the Treasury Department. The United States-Saudi Arabian Joint Commission on Economic Cooperation currently is implementing projects valued at over \$600 million, involving more than 100 U.S. experts now working in Saudi Arabia.

The Joint Commission provides a valuable forum in which the two Governments can discuss a wide range of financial and economic matters of mutual interest. I personally am very enthusiastic about the work of the United States-Saudi Arabian Joint Commission and the significant contributions its economic assistance programs are making to the strengthening of our bilateral economic and commercial relationship. This represents a new and vigorous effort in international economic cooperation.

Conclusion

President Carter has pointed to the high level of our oil imports and the increasing rate of inflation as the two developments which most seriously threaten our Nation's economic health. They both imperil our economic recovery and threaten the strength of the dollar. They must be controlled.

As I have discussed in my comments today, the United States is taking major initiatives in each of these areas. We depend upon other nations to play their appropriate roles, as well, in helping to promote world recovery. For the major Arab countries, and especially for the oil-producing nations, this means maintaining needed restraint on the price of their oil exports, continuing to offer substantial economic assistance to the developing nations, and meaningful, effective cooperation in seeking to resolve our mutual economic problems. I am confident that, by pursuing the cooperative economic efforts we now have underway, and by avoiding actions which could disrupt those efforts, the answers to these problems can be found.

Further development of our economic relations with the Arab countries will continue to be an important U.S. policy objective. We hope that this will also encourage real progress toward a just and lasting peace in the Middle East, bringing with it the true promise of a better life for all of our people.

Exhibit 42.—Remarks by Assistant Secretary Bergsten, May 9, 1978, before the Brazilian-American Chamber of Commerce, New York, N.Y., entitled "Economic Relations Between the United States and Brazil: A Focus on Trade"

The economic relationship between Brazil and the United States has undergone substantial change in recent years. Today Brazil is clearly one of the most important participants in the international economic system. We fully recognize and welcome that position as the basis for strengthened cooperation between our countries in a wide range

of policy areas and as a basis for helping to achieve a more effectively functioning world economy.

In the past, economic discussions between the United States and Brazil have tended to focus on bilateral relations between our two countries. Today, I am pleased to report that there are no major bilateral economic problems between us. This is doubly fortunate because our economic relationship should now, in any event, focus increasingly on the global roles of the United States and Brazil—and on our potential contributions to the future strength of the world economy, for our own benefit as well as that of other nations.

In recognition of the sharp distinctions which exist within the universe of less developed countries (LDC's), we will henceforth refer to Brazil and other advanced developing countries as ADC's—as opposed to the poorer developing countries (PDC's). These ADC's in particular have as vital an interest as our own in the future of the international economy: In the continued operation of an open international trading system; in maintaining stable international monetary arrangements; in ensuring adequate rates of growth of global production; and in assisting the poorest countries in eradicating extreme poverty.

The key issue for Brazil and other ADC's, as well as for the world's industrialized economies, is how to work together to translate their enhanced economic positions into more effective participation in the affairs of the world economy. The United States has actively supported the increased participation of the ADC's in international institutions, as well as through our bilateral relations. For example, the IMF's currency basket for purposes of denominating special drawing rights was recently expanded to include the currencies of two key ADC's—Saudi Arabia and Iran.

We must also remember, however, that leadership implies responsibility, and we regard as extremely important the principle of graduation along a continuous spectrum from least to most advanced levels of economic achievement. In the trade field, graduation involves the transition from having preferential access to the markets of others through opening up one's own markets to eventually providing preferences to less fortunate nations. In development assistance, it involves a gradual shift from receiving foreign resources and technical expertise to providing such resources to others.

For Brazil in particular, but also for other ADC's, this new economic situation raises fundamental, and profound, questions:

- What should be their relationship with the United States, with the other industrial countries, and with the developing world?
- Do they lie closer to the countries which still receive large amounts of outside assistance or to those which extend such assistance? Should they be somewhere in the middle, neither giving nor receiving? Should they continue to receive in some areas, and give to PDC's in others?
- How should the monetary, trading, and investment rules apply to these countries: as they do to the industrial powers, or as they apply to the poorer countries? Or are new rules needed for Brazil and others in a more intermediate position?
- How are these nations' own vital interests affected by the impact on others of their answers to these questions—in terms, for example, of the willingness of the United States and other industrial countries to maintain policies which help foster their further economic growth?

We in the United States have no clear answers to these questions. Indeed, it would be highly presumptuous for us to suggest answers even if we thought we had them.

We feel, however, that it is essential to raise the questions because the answers to them which emerge over the next few years will go far to determine the economic future of Brazil and other ADC's, the United States, and perhaps the world economy as a whole.

Indeed, Brazil has already taken some important steps in accepting the responsibilities that go along with its new economic strength. It participates as a donor in the African Development Fund and has become a donor to the Inter-American Development Bank. It has agreed not to borrow convertible currency from the soft window of the Inter-American Bank. It extends bilateral assistance to several less fortunate countries in Latin America.

U.S.-Brazil trade relations

It is the area of international trade, however, which perhaps offers the best opportunity for improving mutual cooperation between Brazil and the United States. The United States fully recognizes the high priority which Brazil places on access to our markets and to those of other industrialized countries—access for its exports of manufactured goods and primary products, as well as access to private capital. The other ADC's have similar interests. U.S. policy is to provide such access to our markets to the maximum extent possible.

We are also fully aware of concern, in Brazil and elsewhere, that—to the contrary—the United States is on the verge of going protectionist. I believe that concern to be unjustified.

Soon after President Carter took office last year, he had to make decisions on a number of recommendations from the International Trade Commission for comprehensive controls on imports of several major products. At least two of these, shoes and sugar, were of major importance to Brazil. Brazilian exports of shoes to the United States totaled \$120 million in 1977, and of sugar about \$90 million. Domestically, the President risked congressional override if he rejected the Commission's proposals.

But the President did reject them. He viewed the imposition of such controls as harmful to our own economy, because they would intensify inflationary pressures and insulate us from the beneficial effects of international competition. But he also rejected import quotas because of their injurious impact on other countries, notably developing countries. The impact on Brazil was a specific consideration in both those decisions.

Congress subsequently legislated an increase in the U.S. sugar tariff, but even that action will be superseded as soon as the new International Sugar Agreement is able to raise world prices to its floor level. This agreement, which was negotiated last fall in large part due to the efforts of the United States and Brazil, will help sugar exporters such as Brazil by raising prices from their current low levels.

Early this year, the President also rejected an International Trade Commission recommendation for import relief to domestic producers of high-carbon ferrochromium. Brazil has been among the top five exporters of this product to the United States over the past 5 years, with exports of \$8 million for 1976.

In addition, there have been a multitude of proposals to remove specific products—many of interest to Brazil—from eligibility under the system of generalized tariff preferences (GSP) which we extend to exports from developing countries. In some cases, Brazilian products have been removed from GSP eligibility because of the requirement in U.S. trade law that exports of specific products from individual countries must be disqualified from preferences once that country becomes internationally competitive in those articles. Beyond these, however, very few products have been withdrawn.

One result of this policy is that Brazil's exports to the United States under GSP increased significantly in 1977. In 1976, the first year the GSP program was in effect, Brazil exported about \$215 million under it to the United States. In 1977, this figure grew by more than 60 percent to almost \$344 million. A large percentage of the increase was accounted for by manufactured goods, especially automotive and electrical parts and equipment. More than 10 percent of Brazil's exports to the United States in 1977 entered free of duty under GSP.

For the future the United States has taken the lead in infusing new life into the multilateral trade negotiations in Geneva. We are seeking further liberalization of world trade, by steep cuts in tariffs and meaningful reductions of nontariff barriers. We are encouraged by the active engagement of other major trading countries, including Brazil in the last few months. We hope and expect that the negotiations will bring major success this year.

The record is thus clear. Partly in order to provide growing markets for world trade, we have taken steps to assure continued rapid growth of our own economy and urged the other stronger countries around the world—notably Japan and Germany—to do the same. We have consistently rejected comprehensive new import restrictions. We have sought renewed trade liberalization. Our concern to maintain market access for Brazil and other developing countries has been central to these efforts. Our success can be measured by the fact that Brazil significantly reduced its bilateral trade deficit with the

United States from 1975 to 1977, accounting for nearly \$1.5 billion of the adverse swing in the U.S. trade balance during that period.

Trade, however, reveals the intimate interaction of national policies. We do face serious pressures to restrict imports, as do all other industrialized countries. And we are now seeing clearly how policies and economic performance in one major country, Japan, can jeopardize the openness of the entire trading system via the reactions which it triggers in other major countries. It is not too soon to ask whether Brazilian policies might have somewhat similar effects in the future.

Brazil maintains extremely high tariffs. In recent years, it has instituted and tightened quantitative import restrictions on a wide array of products. It extends export incentives, often of considerable magnitude, to many of its manufactured products—some of which can run directly afoul of countervailing duty statutes in the United States and elsewhere. Through the “performance requirements” which it levies on incoming multinational enterprises such as minimum export quotas and value-added taxes, Brazil’s policies also impinge upon economic developments in other countries.

We fully recognize that Brazil has adopted many of these measures in recent years under extreme balance of payments pressures, and in response to a marked slowdown in world economic growth (and thus export markets). We recognize that many of them are intended to offset distortions elsewhere in the economy, and to accelerate the diversification of Brazil’s economy. We recognize that some are intended to counter what is perceived as the excessive strength of firms based outside Brazil. We know that current practices cannot be eliminated overnight. Yet we are deeply concerned that the prolonged continuation, and certainly any further tightening, of such policies will help bring about the very response which Brazil is so right to fear, and which would be so injurious to its own vital interests.

Export subsidies and countervailing duties

In particular, we are facing potential problems on subsidies and countervailing duties which, if a solution is not found speedily, could be a major source of conflict in U.S. Brazil trade relations and, indeed, in overall relations between our countries.

The problem is not a new one. Brazil’s export promotion policies have prompted numerous countervailing duty complaints, and as a result the United States has placed additional duties on several products imported from Brazil. To date, there have been no serious disruptions to trade. Several pending events, however, threaten to change that picture for the worse.

First, Treasury’s authority to waive the application of countervailing duties under certain circumstances expires on January 3, 1979. Loss of the waiver authority would eliminate any flexibility to work out bilateral arrangements on subsidy-countervailing duty problems. Given the wide array of Brazilian export subsidies, it would almost certainly produce a large number of tariff hikes against Brazilian sales to the United States. A major trade impact could result.

There are also several specific results which can be foreseen. There would be an immediate imposition of countervailing duties on handbags from Brazil. Late in the last administration, Treasury ruled that these handbags were receiving bounties or grants and should be assessed a 14-percent countervailing duty. However, it agreed to waive imposition of the duties. Brazilian exports of handbags to the United States accounted for \$6 million in 1977.

Two other countervailing duty cases are cause for serious concern—footwear and textiles. The countervailing duties now in effect on Brazilian footwear were calculated according to conditions prevailing in 1973. Treasury at present is seriously considering recalculating these duties to take into account apparent recent changes in Brazilian policy. We are not certain what changes would result from a recalculation. Higher duties are a possibility. Recalculation in itself could have an unsettling effect on imports of Brazilian footwear.

Textiles also pose potential problems. Treasury is now investigating a countervailing duty complaint against a wide array of Brazilian textile imports. Exact figures are not available, but millions of dollars in annual imports are at stake. I would not want to prejudge this case in any way—Treasury has not yet issued a final determination and

will not do so until it conducts a thorough investigation. But I do want to flag it as an example of the potential trade disruption that could ensue if we do not resolve the subsidy-countervailing duty issue.

The importance and urgency of this matter has led us to conclude that the old case-by-case waiver approach is grossly inadequate for dealing with the problem, and may indeed even be counterproductive by falsely allaying concern over the need to find a comprehensive solution. This is why, early in the current administration, we decided not to provide such waivers on imports from Brazil of cotton yarn and scissors and shears. To deal with the problem effectively, we instead place top priority on reaching an agreement on subsidies and countervailing duties in the multilateral trade negotiations:

We need to put a lid on the growing use of subsidies to spur export-led growth at the expense of other trading nations.

We need to reinforce the commitment already accepted by most industrial nations not to use export subsidies.

We need new international discipline to guard against the disguised protection of domestic markets through internal or production subsidies.

We need to strengthen the present GATT provisions on dispute resolution to ensure that these rules are enforced effectively.

This approach must be balanced, however. New guidelines on the use of countervailing duties should go hand in glove with increased discipline on subsidies. As a general rule, duties should be applied only when a subsidy threatens or causes injury to a domestic industry. However, when there is a specific commitment not to use certain subsidies, countries should be able to take quick counteraction if that commitment is violated. There must be effective implementation of rules on both subsidies and countervailing duties.

We of course recognize that subsidies can play an important role in national economic policymaking. Flexibility in the rules is needed for countries on different rungs of the development ladder. We expect fully developed countries to subscribe to all the provisions of an eventual agreement. At the other extreme, the poorest developing countries with the greatest need should be accorded special and differential treatment.

For those nations which lie between these two categories—Brazil and other ADC's—the new code should recognize their growing responsibility in the world trading system, and provide for increased obligations as their industries become internationally competitive. Naturally, we do not expect this to happen overnight. A commitment to freeze the existing level of subsidization of exports might be a first step.

And then might it not be sensible for Brazil, and other ADC's, to embark on a deliberate and announced course of winding down—and eventually eliminating—their export subsidies? This could be negotiated to occur over a certain period of time. In return, guarantees might be included in the MTN agreement to ensure that other countries respond constructively and apply countervailing duties only when a subsidy is shown to have injured an industry in the domestic market.

Such an arrangement would be similar in many respects to a recent agreement between Treasury and the Government of Uruguay regarding subsidies and countervailing duties. Uruguay agreed to phase out all its export subsidies on leather products by the beginning of 1979, and on all other products by 1983. In return, Treasury agreed to waive application of countervailing duties on footwear and leather products receiving export subsidies. We believe this agreement, which demonstrates both the merits and the practicality of a comprehensive approach, will greatly improve the climate for trade between Uruguay and the United States by neutralizing a major disruptive threat to Uruguayan exports.

An agreement regulating the use of subsidies and countervailing duties is one area of the MTN where positive action by Brazil is crucial. It seems to us that the United States and Brazil should work closely together on all these issues, sharing as we do the perspective of great exporters of both industrial and primary products. Surely it would seem that such an emphasis would more benefit Brazil's stature and interests than any continuing focus on receiving "special and differential treatment" and bindings of tariff preferences—which hardly seem likely to be the central issues for Brazil's trade

relations through the 1980's, the period for which the MTN will provide the global trading framework.

None of the steps mentioned are easy to undertake, for either of our countries. All confront economic and political pitfalls. Yet a failure to face them would be a dereliction of duty on the part of countries, like ours, whose own vital interests would be deeply affected by a relapse into trade restrictions around the world. We will, of course, take into consideration Brazilian efforts in this area (as well as in the tariff negotiations and work on other NTB codes), as part of the overall MTN package, in determining the concessions which we will offer in return.

Conclusion

I have spoken at some length today about U.S. trade relations with Brazil as an example of measures which each of our countries can take to improve their economic ties and begin to implement a greater sharing of the responsibilities for maintaining an open and mutually beneficial international trading system.

Brazil today is clearly one of the most advanced of the world's developing economies. It is moving toward the front ranks of the world's economic powers. We fully recognize this new status and welcome Brazil, as we welcomed Japan in the late 1950's and early 1960's, as a nation prepared to play an enhanced role on a whole range of international economic issues.

The economic relationship between the United States and Brazil—indeed, much of our political relationship as well—is likely to focus increasingly on ways in which these responsibilities can be exercised more effectively. The recent lengthy discussion in Brasilia of problems of the Middle East between President Carter and President Geisel is a further indication of our desire to more fully consult with Brazil on the widest possible range of issues.

Brazil's new position offers a unique opportunity to help pave the way for other ADC's to also share in the greater responsibilities and benefits of enhanced consultation on the management of the international economic order. We hope that Brazil will accept this challenge and this opportunity, both for itself and for other nations who may soon be ready to follow in its footsteps.

Exhibit 43.—Excerpt from remarks by Assistant Secretary Bergsten, June 20, 1978, before the French-American Chamber of Commerce, New York, N.Y., entitled "Trade and Money: The Need for Parallel Progress"

During the past 15 years, we have all come to appreciate the need for parallel effort: to improve the international trade and monetary systems to better meet the demands of our rapidly changing global economy.

Major strides have been made in reforming the international monetary system, in large part due to the efforts of the United States and France. Much remains to be done to make the new monetary system work better, and all nations have committed themselves to that effort. It is now proceeding in the International Monetary Fund and elsewhere.

But progress in the trade area has been much slower. The pending conclusion of the multilateral trade negotiations now provides an opportunity for the needed catchup. Meaningful agreements must be reached soon to preserve an adequate basis for the continued expansion of world trade and investment which has been a major ingredient of our postwar economic prosperity.

France has frequently pointed to the importance of parallel progress in monetary and trade relations. Indeed, such a view draws on a fundamental tenet of classical economic theory: that the maintenance of a monetary system which promotes effective adjustment of payments imbalances is a vital prerequisite for an open trading system.

In the absence of such monetary arrangements, the competitive position of nations with overvalued exchange rates is progressively eroded and political support for open trade gives way to an ever larger circle of restrictive measures. Similarly, the economic structure of countries with undervalued exchange rates becomes excessively skewed.

toward exports—provoking constant pressures on their trading partners even long after the undervaluations have disappeared, and generating strong domestic pressures to retain an undervalued rate or to replace it with other export aids of similar magnitude.

The Bretton Woods understanding, in the aftermath of World War II, was designed to promote monetary stability through the maintenance of relatively fixed rates of exchange. Changes were to be made in par values only after it became inescapably clear that a fundamental shift in economic relationships had occurred—suggesting that such changes might come too late, even under the best of circumstances. Even these changes were made with great difficulty, if at all, and major disequilibria were permitted to develop.

For the United States, stability in exchange rates during the 1960's came to mean an appreciating U.S. dollar against the weighted average of other major currencies despite increasing balance of payments difficulties. Part of the problem lay with the unwillingness of surplus countries to initiate the needed adjustment measures from their side. But a fundamental contradiction pervaded the international economic policy of the United States: It sought to lead the world toward freer trade, but made little effort to lead the world toward a monetary system which promoted effective payments adjustment.

Indeed, largely because of this policy contradiction, the United States faced an ironic paradox. In the early 1960's, unemployment was extremely high in the United States but the country as a whole, including organized labor, was largely supportive of a liberal trade policy. Through the 1960's, profits rose to record levels and unemployment steadily declined to post-Korea lows—but protectionist pressures at home steadily increased, to a point where the Mills bill nearly passed the Congress in 1970 and the Burke-Hartke bill became a serious matter for concern in 1971 and 1972.

And when the United States decided in August 1971 that it wanted to adjust the exchange rate of the dollar, partly in belated realization that such a step was crucial to restore the prospects for a liberal trade policy, it found that the international monetary system made such action very difficult. The United States was caught in its own policy contradiction.

The reverse paradox has, to some extent, characterized the 1970's. In large part because adjustment measures had been effectively carried out, and the international monetary system reformed in the nick of time, the Trade Act of 1974 could authorize U.S. participation in the widest ranging international trade negotiations in history despite the existence at the time of its passage of the highest rate of unemployment at home since the Great Depression. Monetary progress permitted a resumption of trade progress.

Reform of the monetary system

The Smithsonian agreement and the generalized float of major currencies in 1973 represented the first major steps in reforming the international monetary regime. The subsequent agreements at Rambouillet and Jamaica paved the way for the creation of a new monetary system based on greater flexibility in exchange rate arrangements and a broader emphasis on stability in underlying economic and financial conditions.

The new exchange rate provisions give members wide latitude in the choice of exchange rate practices best suited to their needs, and can accommodate a wide variety of exchange rate mechanisms—including freely or managed floating rates, rates pegged to a currency or basket of currencies, and the common margins arrangements of the EC snake. Under the newly amended IMF Articles of Agreement, each member undertakes a general obligation to direct its economic policies toward orderly growth with reasonable price stability, and a specific obligation to avoid manipulating exchange rates either to prevent balance of payments adjustment or to gain unfair competitive advantage. The IMF is given responsibility for conducting continuing surveillance over the operations of the international monetary system and members' compliance with their obligations regarding exchange rate policies.

This is the heart of the new system. It represents the potential both for a stronger IMF, and for a more effective and symmetrical operation of the balance of payments adjustment process. To date, the IMF's ability to influence national policies has been limited, for the most part, to those members borrowing in the IMF's credit tranches.

The new provisions on IMF surveillance provide the potential for IMF influence on the policies of all members, in surplus and deficit alike, as they bear on the operation of the international adjustment process.

The task before us now is to make this system work. This will require active cooperation among all the major nations. The IMF has been given the job of insuring that the obligations are respected. We intend to do what we can to support the IMF in that endeavor—both in our contacts with other nations and in our policies at home.

Improving the trading system

The last round of international trade negotiations—the Kennedy round in the 1960's—made substantial progress in reducing tariffs, but could not have been expected to deal effectively with the primary trade problems of the 1970's and 1980's. Today, trade reform lags monetary reform.

Our immediate task is to secure a meaningful package of agreements in the multilateral trade negotiations in Geneva, the Tokyo Round. This package should further reduce tariffs, but must break new ground in reducing nontariff barriers to trade and addressing the problems created by excessive government intervention. It must do so if our new monetary system, and indeed the world economy as a whole, is to continue to prosper—for trade interventions beget monetary interventions, just as surely as monetary interventions foster trade interventions.

The objectives of the United States in these trade negotiations are quite specific:

- The successful negotiation of a new international code to discipline the use of subsidies which distort international trade. This is a prerequisite for U.S. adherence to a new package of trade agreements.
- Improved markets access for U.S. agricultural products.
- Reductions in tariffs by an average of 40 percent, with minimal exceptions, to be phased in over a period of 8 to 10 years.
- Agreement on acceptable "safeguard" measures which may be taken by governments in emergency situations. This agreement should clearly limit the circumstances in which governments can impose restraints on trade, i.e., it should provide "safeguards against safeguards."
- A new international understanding on the use of government procurement measures, with the broadest possible sectoral coverage and maximum transparency of contract offers and awards.
- A new mechanism for dispute settlement which will assure both timely and meaningful resolution of trade conflicts in all of these areas.
- Special and differential treatment for the developing nations, supplemented where feasible with their offering reciprocal commitments on tariffs or market access for specific products and an acceptance of greater responsibility—in particular, among the advanced developing nations—for maintaining an open trading system.

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Exhibit 44.—Statement by Deputy Assistant Secretary Hufbauer, July 14, 1978, before the Subcommittee on Trade of the House Committee on Ways and Means, on the international trade aspects of recent A-300 Airbus and Rolls-Royce engine sales to U.S. airlines

I welcome the opportunity to discuss the international trade aspects of recent A-300 Airbus and Rolls-Royce engine sales to U.S. airlines. At the outset I want to stress that the administration does not seek to prevent Airbus Industrie or other European manufacturers from fair competition in the U.S. aircraft market. However, recent aircraft sales to U.S. airlines suggest the possibility that European governments might employ financial practices which introduce an element of unfair competition to the world aircraft industry.

The financing of aircraft exports has assumed an aggressive character in recent months. The Government of the United Kingdom—through its export credit agency (ECGD)—induced Pan American to select Rolls-Royce engines for its new Lockheed L-1011's by offering highly concessionary terms. The 15-year loan guarantee for 100 percent of the value of the Rolls-Royce engines and 100 percent of the value of the airframes involved a triple derogation of international understandings. The British failed to require any downpayment, exceeded the agreed-on 10-year maximum term for repayment, and violated an OECD understanding limiting local cost financing.

The recent sale of 23 A-300's to Eastern Airlines raises a somewhat different question. Airbus Industrie is essentially a partnership of French, German, Dutch, and Spanish aircraft manufacturers established under French law in 1969. The French and Spanish partners are government-controlled corporations, while the German and Dutch partners are private corporations. Airbus Industrie manages the development, manufacture, and marketing of the Airbus. The funding of research, development, and production was financed primarily by the French and German Governments and is repayable from the sales of the Airbus. Each of the partners produces a part of the plane which is then assembled in Toulouse, France. In addition, the engines used on the Airbus are produced by General Electric in the United States and the wings are produced by Hawker-Siddeley in the United Kingdom. At this time, Airbus planes are assembled at the rate of 18 per year.

We know that the official export credit agencies of France and Germany help finance the export of the Airbus. We have not completely evaluated the extent of French and German Government support of Airbus Industrie financing aside from official export credits. Reportedly the A-300 sale to Eastern Airlines involved the acceptance by Airbus Industrie of a subordinated debenture amounting to \$96 million and a senior note in the amount of \$66 million. Also, General Electric accepted a subordinated debenture from Eastern Airlines in the amount of \$45 million. Both the Airbus Industrie and General Electric financing provide for repayment over a period as long as 15 years or as short as 4 years depending on factors which are not publicly known. Further, the interest rate reportedly will vary, depending on Eastern's profitability during the repayment period.

In addition, there will be a lease arrangement for 15 years for the 4 aircraft which have been operated by Eastern Airlines under a cost-free 6-month trial period. Finally, official export credit in the amount of \$250 million repayable over 10 years at a reported 8.25-percent interest covers the remaining portion of the estimated external financing package of \$552 million.

As we understand the delivery schedule for these A-300 B4's, there will be 3 additional aircraft delivered in 1978 and 4 aircraft each year from 1978 through 1982 for a total of 23 aircraft.

Mr. Chairman, before the Treasury can judge the consistency of this transaction with existing international understandings, we need more facts and more time to digest those facts. The transaction raises three basic and related issues.

First, is Airbus Industrie itself a de facto government concern that comes within the scope of our international understandings on export credits? In order to answer this question, we need to examine Airbus Industrie's ownership, management, the degree to which government financing forms the basis for its productive capacity, and other relevant factors.

Second, even if Airbus is not a government concern, does its financial structure involve the use of substantial government-guaranteed credit on a back-to-back basis to finance export sales? In order to answer this question, we need to examine the link, if any, between export credit offered by Airbus Industrie and its own use of government financial guarantees.

If the answer to either of these two questions is "yes," then the credit extended by Airbus Industrie itself should conform to international understandings which govern the terms of officially supported export credits.

Third, and finally, even if Airbus Industrie were strictly privately owned and had no government guarantees to support its financial base, there is a question whether the

export of the A-300 might nonetheless be subject to the requirements of OECD credit understandings because private and official financing are linked together in a single package. When official export credits are linked in a package with private credits, and any part of that package exceeds the terms of international understandings on official export finance, the United States views the entire credit arrangement as a derogation from such understandings.

At this point I wish to indicate, as precisely as possible, our interpretation of the OECD Aircraft Standstill and the Local Cost Understanding. We believe these international understandings require that officially supported financing be subject to a downpayment of at least 10 percent, should not cover local costs in excess of the downpayment, should carry an interest rate at least as high as the prevailing interest rate for aircraft financing as of May 1975, and should require repayment not in excess of 10 years for a loan, or 12 years for a lease.

At the OECD Ministerial meeting in June, Secretary Blumenthal emphasized the importance of negotiations this year to strengthen international export credit understandings, including those which deal with aircraft exports. We look to the scheduled October review of the International Arrangement on Export Credits to provide a forum to launch these negotiations.

We strongly believe that negotiations to improve the International Export Credit Arrangement are the only responsible way to deal with our concerns in this area. But as Secretary Blumenthal cautioned his colleagues at the OECD meeting, "if there are no restraints agreed this year on predatory official export credit competition and such competition continues to escalate, there will be swift and effective U.S. reaction."

Thus, the U.S. Government must consider the alternatives available to preserve equal opportunities for its exporters in the world market. We face a challenge both in foreign markets and in the domestic market. We believe that present legislation provides the administration authority to respond in both areas.

Greatly expanded activity by the Eximbank is one way to meet the competition offered by official export credit agencies in other countries. The Bank is already moving in this direction and, with a 30-percent increase in its budget authority for fiscal year 1979, will be able to take an even more active role.

After careful examination, the Treasury does not believe that the Eximbank or any other official agency should attempt to match the financing which might be provided by Airbus or indeed any other foreign firms which sell in the U.S. market. The cost of such financing for the aircraft industry alone could be very high over the next several years. The adoption of a program for the aircraft industry would likely be followed by tremendous pressure from other industries for similar protection. The cost of such a broad program could easily run into many billions of dollars. Moreover, companies might claim or create foreign competition where none actually exists. Therefore, in the domestic market, a different response is needed.

In select circumstances, the appropriate response to concessionary financing of aircraft exports to the United States, which adversely affects U.S. industry, might be found in the countervailing duty law. The fact that a particular export financing transaction violates an international credit arrangement might not in itself establish the extent of a "bounty or grant" within the meaning of our law. In the past, the extent of a bounty or grant has been measured with respect to commercial practice in a foreign country. However, the violation of an international understanding might well serve to trigger a countervailing duty investigation. The Treasury is not trigger happy. We would want to analyze carefully the credit terms, including the presence of government ownership, before considering a countervailing duty action.

Another option the U.S. Government has is the use of section 301 of the 1974 Trade Act, which gives the President authority to retaliate against foreign subsidization of exports both to the United States and to third-country markets, or against any other act he finds unreasonable and restrictive of U.S. commerce. This authority may include suspension of any trade agreement concessions made to the offending foreign country or the imposition of duties or other import restrictions, such as quotas, on the foreign product. Clearly, this is a powerful weapon. It is not a weapon we use lightly.

Section 301 does not yet have a history of well-defined application. It has never been used to withdraw trade concessions made to foreign nations. The mere threat of section 301 use has resulted in the removal of offending foreign practices in a few instances. In all situations, the use of this instrument has had to be carefully tempered to avoid retaliation from our trading partners.

The possibility of retaliation is a particular concern in the aircraft industry where U.S. dominance is perceived abroad to stem from past U.S. Government subsidies, and where our own sales of aircraft to foreign airlines are enormous. The apparent potential in section 301 for adding tensions in world trade strongly indicates that its use would be unproductive in present circumstances.

In conclusion, I want to stress the need for us all to view the introduction of this fresh competition from Europe in some perspective. Neither this Government nor the industry should view recent developments either with complacency or with panic. We in the U.S. executive branch constantly face assertions by our foreign counterparts that U.S. programs such as DISC, NASA, FAA, and DOD research assistance, and the Emergency Loan Act under which Lockheed received a now-canceled \$250 million Government guarantee, all constitute support to our own commercial aircraft industry. This support may be limited and indirect compared to other support programs. Nevertheless, our own experience reminds us that the problem does not have a simple solution.

For many years the manufacture of medium- and long-range commercial aircraft has been virtually an American preserve. That era is over. However, air traffic is increasing sharply and many airlines face a need to replace aging fleets. Under these circumstances, American aircraft manufacturers, operating in an atmosphere of fair competition, will substantially increase the dollar volume of business in the years ahead, even if foreign manufacturers succeed in gaining a share in the U.S. and other markets.

Exhibit 45.—Excerpt from statement by Assistant Secretary Bergsten, August 1, 1978, before the Subcommittee on International Trade, Investment, and Monetary Policy of the House Committee on Banking, Finance and Urban Affairs, on current issues in international trade policy

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

We believe that subsidies represent one of the most critical problems for the world trading system in the decade ahead, because governments are increasingly tempted to export their problems to others through direct financial and other types of help to favored industries. At the same time, we recognize that the present U.S. countervailing duty statute—alone among major countries—includes no injury test, which many countries view as disruptive to their trade. We also recognize that the temporary waiver authority in the statute will expire next January, with possibly dire consequences for world trade unless an effective new regime has been negotiated by that time. Hence we seek three basic objectives in any new code:

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

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The subsidy/countervail code

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

As part of the proposed agreement on subsidies and countervailing duties, we are prepared to recommend to the Congress that it accept inclusion of an injury test in the U.S. countervailing duty law. This is an issue of major importance for our trading partners, for understandable and justifiable reasons. Only the United States now operates without an injury test, and our continued failure to adopt one places us in clear violation of the spirit of the GATT. Our willingness to recommend this change—within the context of an agreement containing effective discipline on the use of subsidies themselves—demonstrates our great interest and sincere desire to avoid trade disputes in this area in the future.

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

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

The subsidy/countervail code also provides an excellent opportunity to engage the advanced developing countries (ADC's) more actively in the international trading system. We recognize that subsidies can contribute to development in poorer countries but also believe that ADC's should assume responsibilities commensurate with their level of development and should accept increased obligations as their industries become internationally competitive. The current proposal affirms this principle, and seeks to provide a flexible basis for the adoption of obligations on subsidies which are appropriate for individual developing countries.

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

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

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

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

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

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Commodities and Natural Resources

Exhibit 46.—Statement by Assistant Secretary Bergsten, March 9, 1978, before the Subcommittee on Energy of the Joint Economic Committee, on the impact of higher energy costs on the U.S. balance of payments, and expanded investment in worldwide energy production

I appear before you today to discuss two aspects of the world energy situation that are of special concern to the Department of the Treasury: The impact of the energy situation on our balance of payments, and the roles of the multilateral lending institutions and our own Overseas Private Investment Corporation (OPIC) in helping to promote energy investment in the oil-importing developing countries.

Energy and the trade balance

The primary area of Treasury concern is the role of energy in the U.S. balance of payments. The increased price of oil has been the single most important factor underlying the adverse shift in the U.S. trade balance. Our overall trade deficit was about \$31 billion in 1977, and should range in the same order of magnitude in 1978. Our oil imports cost about \$45 billion in 1977—up from less than \$5 billion as recently as 1972. Increased import volume would have raised the bill only to \$9 billion; higher prices account for the remaining \$36 billion. While our sales to OPEC countries also increased, our trade deficit with the OPEC countries amounts to about \$20 billion.

In contrast to developments in virtually all other oil-importing countries, the volume of our oil imports has risen because of reduced domestic output as well as higher domestic consumption. Over the last 5 years, domestic production declined by 1.5 million barrels a day and consumption increased by 2.5 million barrels a day. Roughly 40 percent of the increase in U.S. oil imports since 1972, or about \$16 billion, can thus be attributed to reduced production and 60 percent to increased oil consumption. The effect of higher oil prices on the U.S. trade balance has been magnified by the erosion of our position as a major producing country—not just by rising demand, as is the case of the other major oil-importing countries. This erosion, of course, was underway before the oil price increases and is only now being partly offset by rising Alaskan oil production.

In years to come, the energy component of the trade balance will be dominated by the relationship between the growth in the capacity of the oil-producing countries, in particular the surplus countries, to absorb imports and the U.S. need to import oil. Adoption of a comprehensive national energy program which both pares consumption and expands U.S. energy production is an essential U.S. response to this central part of our trade balance problem.

Early action on this front is necessary to strengthen confidence in the dollar in the exchange markets as well. The weakening of the dollar since late 1977 has correlated closely with growing doubts, both around the world and in the United States itself, that we were ever going to take decisive action to reduce oil imports. Though the national energy plan would not produce its maximum results for a few years, its adoption—more than any other single step, from an international financial perspective—would provide convincing evidence that the United States could and would respond decisively to its energy problem. Adoption of comprehensive energy legislation is thus critical for both longrun and shortrun reasons.

In addition, I should mention that this administration has made a major effort to avert any increases in world oil prices—in order to avoid further increases in our oil import bill, as well as to avoid reigniting inflationary pressures and renewed recessionary tendencies around the world. To this end, we have carried out an extensive and ongoing dialog with the key oil-producing countries. Our recent efforts to convince them that any price increase would be disruptive—for both them and ourselves—were successful. Continued success in these efforts, however, will depend in turn on our ability to limit our own demand for energy imports.

The final issue relating energy and our international economic position is the financing of the large U.S. imbalances of 1977 and 1978, and the role of OPEC in that

financing. The key here is that U.S. capital markets continue to play a major role in the process of global intermediation between depositors and borrowers, including the United States itself. The U.S. capital market is roughly as large as the combined national markets of the other major developed countries. The breadth and depth of our market makes it the world's leading national financial market.

We expect that our markets will continue to play a vital role in the financial intermediation process, including investment of OPEC funds and the channeling of funds from OPEC surplus countries to borrowers elsewhere. We estimate that, as of end-September 1977, about \$40 billion of OPEC's total assets of \$170 billion were in the United States. These assets are held primarily in the form of Treasury securities, other marketable bonds, equities, and deposits in U.S. banks. In addition, we estimate that \$70-\$80 billion of OPEC assets has been placed in either national capital markets outside the United States or in the Eurobanking market. Most of these placements were dollar denominated.

Expanded energy production

This discussion has emphasized that U.S. vulnerability to foreign decisions on oil prices plays a major role in our balance of payments difficulties. At the same time, the United States has taken certain steps that should reduce our vulnerability to supply interruptions—including the creation of our strategic petroleum reserve and the IEA emergency oil-sharing program.

We need to take additional action, however, if we are to be successful in influencing price decisions. Conservation measures go only part of the way. In the longer run, we need to develop all possible energy resources, new and conventional, which can be produced at economic prices. Thus, we need additional energy measures that encourage—

- Expanded production of conventional oil and gas, both within the United States and in other areas where potential reserves exist which can be exploited economically;
- Increased investment in development of synthetic liquid and gaseous hydrocarbons, or close substitutes such as methanol;
- Increased investment in development of new technologies for more flexibly utilizing our enormous solid fuel resources; and
- Intensified development of energy technologies such as solar power, fusion, wave motion, et cetera, which have the advantage of nondepletable resources.

U.S. policy toward oil and gas production in non-OPEC developing countries complements our domestic energy objectives, by seeking to encourage the LDC's to develop their indigenous energy resources. This effort deals directly with one of the most severe bottlenecks to their own development—the crushing costs of oil imports. At the same time, it will improve the worldwide energy demand/supply balance.

Such steps will require substantial investment. It was necessary, therefore, to consider the best way to provide the resources needed for such investment as well as to remove barriers to it wherever possible. This led the administration to take several initiatives: notably in expanding the role of the international development banks and our own OPIC in energy development.

We believe this is an area where the multilateral institutions should logically play a major role. The United States and other participants at several summit meetings have committed themselves to help assure adequate levels of investment in energy production in the nonoil LDC's. The CIEC Ministerial conference reached similar conclusions last June, including a recommendation that the IBRD expand its activities so as to increase capital flows into development of LDC energy resources. We have made similar proposals to the Inter-American Development Bank.

Our support for this approach is based on the belief that the World Bank, and perhaps the regional banks, could usefully serve as a catalyst in expanding LDC energy production, both through direct participation in energy projects and as a source of lending. Historically, the primary determinant of development banks' role has been the fact that they do not finance activities for which private capital is readily forthcoming. Except for power projects, therefore, their direct financing of energy was largely limited to a few coal projects. Oil projects were left primarily to the international oil companies.

Any role for the development banks was limited to associated infrastructure.

After the oil price increases in 1973, LDC energy problems became a focal point of international concern. Initially, particular attention was paid to the impact of increased import costs on their external payments positions. Once facilities were in place to deal with this immediate problem, attention turned to the longer term impact of energy costs on LDC growth prospects.

Perhaps the first major effort to do something concrete in this area was the U.S. proposal at UNCTAD IV (May 1976) for an International Resources Bank (IRB) to promote investment in LDC mineral and energy resources, primarily through an international insurance mechanism. In September 1976, the United States asked the World Bank to study the IRB proposal. This led to a review of the proposal and the general problem it was intended to overcome.

The World Bank's study (Report No. 1588, "Minerals and Energy in the Developing Countries," May 4, 1977) concluded that "establishment of an IRB would not be feasible or generally acceptable, and * * * other solutions of the investment problem in mineral resource development should be sought." As a result of the Bank study and our own further review, this administration decided not to pursue the IRB concept—but, at the same time, to pursue the same objectives vigorously through existing institutions.

The World Bank report concluded that there was significant potential for additional energy production in 30–40 LDC's, with a total impact on world production of 5–6 million barrels per day. (The bulk of this production would be in Mexico, Egypt, and Oman.) The report made a number of recommendations for an expanded effort to promote additional LDC energy sector investment. These recommendations were the basis for an IBRD Board decision in July 1977, approving for FY 1980 an IBRD/IDA lending program of \$400–\$450 million in fuel minerals alone—which would relate to projects totaling \$2–\$2.5 billion—and an IFC lending level of \$50–\$75 million in fuel and nonfuel minerals. Annual IBRD lending might average \$500 million thereafter. The Board also agreed that the Bank should act as a catalyst to mobilize increased private investment in the mineral sector and should emphasize technical assistance. Bank management was instructed to coordinate with the other development banks and report back to the Board in 1 year. At that time the whole program will be reviewed to set new guidelines for lending limits in the light of experience gained in the first year.

This major shift of Bank policy enjoys the strong support of the industrialized and developing countries alike. An important reason is the conviction among member countries that the Bank's presence in negotiations on energy projects could help alleviate friction between private investors and host governments. In particular, host countries might consider the Bank's presence helpful in protecting their interests against giant corporations and in providing impartial advice and information. At the same time, companies might find it helpful in assuring fair treatment in later years. We believe that unilateral action to change contract terms at a later time, which has become a major deterrent to private investment in energy resources in developing countries, is much less likely if both parties are satisfied that a fair agreement was reached at the outset—and if unilateral steps to abrogate contracts later were to involve the entire international community, through the World Bank, rather than just a single company or even a single country.

On June 30, 1977, the Board approved its first loan for petroleum exploitation—a \$150 million loan for the development of oil and gas fields near Bombay in India. Since July, the Bank has proceeded to implement the Board's decisions. Among the steps it has taken are the following:

- Three additional loans are being prepared for Board approval: An engineering loan to Thailand for preparation of an oil production project, a project in Pakistan to improve the productivity of an existing field and finance a feasibility study for a new oilfield, and a project in Tunisia for development and transmission of offshore gas resources.
- The Bank's Energy Division has grown from 4 to 12 professionals. Two provide advice on energy planning and use, and the others search out projects.
- Bank staff has had discussions with major U.S. oil companies, seeking to interest them in participating with the Bank in this effort. It is not yet clear how they will respond, but they have expressed interest.

- The Bank is seeking to facilitate exploration by providing advice to LDC's on the laws and incentives needed to attract private capital. It is also prepared at the exploration stage, to indicate a willingness to participate directly in the development phase if exploration proves successful.
- Over the next several years, the Bank intends to survey some 40 developing countries for potential projects. All of these have at least promising geologic prospects.
- Bank staff is developing a coordinated approach with staff of the regional banks, which are also developing energy projects.

We believe that the World Bank has responded in a positive way to our initiative to expand LDC energy production, and that the regional banks will soon be doing so as well. Indeed, these developments show, once more, the great value of these institutions in moving rapidly to promote both U.S. and global economic objectives—a major reason why we should continue to support them strongly. We recognize that energy is an area where the Bank has not had much experience, and will be closely following its further actions in this area as well as steps by the U.S. private sector to take advantage of the Bank's initiatives. The Board's review of the program's first year scheduled for this coming July, will provide an opportunity for a thorough assessment.

We will also be stepping up our bilateral technical assistance to support LDC energy development, particularly under new authority provided by section 119 of the Foreign Assistance Act. The Agency for International Development has already submitted recommendations to the Congress as to how to implement this section and is carrying on studies to identify the energy needs, uses, and resources which exist in the developing countries. In addition, the Department of Energy is developing a program of cooperation with developing countries in nonnuclear energy technologies.

OPIC energy projects

Finally, we are expanding the activities of OPIC to include LDC energy projects. OPIC has introduced a program to develop coverage for new types of energy investments—joint ventures, service contracts, and the like. This type of financing may open up new opportunities for the exploration and development of energy resources. The administration wants OPIC to continue, and expand, its use of insurance and guarantees in non-OPEC LDC energy projects.

Before 1977, OPIC's exposure in energy projects other than oil refineries was negligible. Under its new program, however, OPIC has insured a production-sharing project for oil exploration in Jordan and insured an oil concession project in Ghana. In the Ghanaian project, OPIC insurance facilitates nonrecourse bank financing that would not otherwise be available for the project.

Private firms have already begun to demonstrate the feasibility of management contracts, service contracts and other nonequity arrangements in oil and minerals projects. These approaches offer economic benefits to host countries and profitable opportunities to American companies, and respond to the desire of many developing country governments to maintain sovereign control over their natural resources. They reduce the risk of subsequent contract disruption, and thereby encourage private investment to proceed.

OPIC can play an important role in helping U.S. investors and host countries work out such mutually acceptable arrangements. This will help reduce the tensions which have diverted investment from the developing countries. Also, by reducing the likelihood of expropriation, it will help avoid the inevitable problems for U.S. policy which arise when expropriations occur, including issues posed by the legal requirements of the Hickenlooper and Gonzalez amendments and section 502 of the Trade Act.

The dollar amounts of OPIC activity in this field will be small compared with the capital requirements for most energy and raw materials projects. Leveraging of OPIC involvement will thus help it have a significant impact. To do so, OPIC is seeking to coordinate its efforts with similar institutions in the 16 other countries in which they exist—particularly in the European Community, which has already begun to coordinate its efforts for similar reasons. This coordination would minimize the likelihood that host countries would renege on their end of investment bargains, by increasing the number

of home countries which would be adversely affected and thus increasing the stakes of host countries in maintaining cooperative arrangements.

Conclusion

Thus, to conclude, we have made some progress in putting in place policies that will reduce U.S. vulnerability to foreign price and supply decisions, assist the poorer countries to expand production of their indigenous energy resources, and reduce the impact of higher oil prices on our balance of payments.

Additional actions, however, are necessary. Quick passage of the administration's energy program is the major such step. For the longer run, we will continue to promote increased production throughout the world. As new energy production comes onstream, both within the United States and elsewhere, both the United States and the world as a whole will become less vulnerable to the energy crisis.

Exhibit 47.—Excerpts from remarks by Assistant Secretary Bergsten, April 7, 1978, before the 1978 Financial Conference of the American Mining Congress, Phoenix, Ariz., entitled "U.S. Commodity Policy: The Integration of Domestic and International Requirements"

* * * * *

U.S. commodity policy seeks to integrate domestic and international elements into a single, coherent approach. In so doing, it has focused on four interrelated, complementary policy instruments:

- International commodity agreements between producers and consumers, to reduce excessive price volatility in world commodity markets;
- Promotion of increased productive capacity abroad for key raw materials through greater activity by the World Bank, the regional development banks, and our own Overseas Private Investment Corporation (OPIC);
- A strategic stockpile policy based on revised strategic objectives and implemented in ways which are consistent with our national and international economic goals;
- Support for the stabilization of export earnings of producing countries through the compensatory financing facility of the International Monetary Fund.

* * * * *

International commodity agreements

The prices of primary commodities are exceptionally unstable. It is not unusual for commodity prices to double or even triple within a year or two and then plummet back toward previous levels, though such behavior is extremely rare for manufactured or processed goods.

* * * * *

ICA's which effectively reduce price instability can provide significant economic benefits for the United States: Dampening of inflationary pressures, smoothing of income flows to U.S. commodity producers, more stable investment patterns over time, stabilizing and reducing operating costs for domestic producers and processors (and thus prices for their consumers). Moreover, such agreements spread the burden of responsibility for international commodity problems among producing and consuming countries, and promote cooperative efforts toward their solution.

* * * * *

When we are successful in designing agreements which provide net economic benefits to the United States, we will join them. Otherwise, we will not. In fact, only a handful of agreements now seem feasible: ICA's already exist for tin, coffee, cocoa, and most recently sugar, and advanced discussions are underway on wheat, natural rubber, and copper. For other products such as tungsten and jute we are extremely

dubious despite proposals for ICA's emanating from some producing countries.

We believe that certain principles are essential to serve the multifaceted interests of the United States as a major importer/consumer or exporter/producer of virtually every primary commodity: They must be designed to stabilize prices around underlying market trends, not to raise prices; they must balance the interests of producers and consumers, in terms of responsibilities and benefits; they must provide wide latitude for the operation of market forces.

* * * * *

International buffer stocks

We believe price stabilization agreements should operate wherever possible through buffer stocks. Bought when prices are low and sold when they are high, within an agreed price range, buffer stocks can be more effective than any other approach in stabilizing prices without distorting markets or production patterns. We even expect them to make profits to help cover operating costs.

Buffer stocks are far preferable to supply controls regarding market efficiency, effectiveness, operational simplicity, and consumer benefits. Buffer stocks allow price to allocate resources to the most efficient producers, whereas production controls force low-cost and high-cost producers to cut back output equally, creating inefficient production patterns. Production and export quotas, usually allocated according to some historical average of market shares, tend to freeze the production/marketing status quo and bar entry by newer, possibly more efficient, producers.

* * * * *

Not every commodity is suited to buffer stocking. There are three basic criteria which must be met for this, our preferred, approach to apply to a given commodity.

The first is that the international price must be established in an open market. * * *

Secondly, the commodity should be either nonperishable or easily rotated in storage facilities, so that stock maintenance is feasible and carrying costs do not become exorbitant. * * *

Thirdly, the commodity should be relatively homogeneous in the sense that most trading takes place in a limited number of well-defined grades whose prices move in tandem. * * *

* * * * *

In designing and evaluating buffer stock arrangements which will fully defend the interests of the United States, we seek—

- Stocks which are large enough to protect against price surges as well as price declines;
- Price ranges which are (1) compatible with the size of the buffer stock, (2) easily adjustable to market trends, and (3) sufficiently wide to allow the market to operate effectively in allocating resources;
- Schemes which rule out the use of production controls and limit any use of export quotas to extreme market conditions, * * *
- Assurance that the commodity sector in producing countries receives the direct benefits which accrue to those countries from stabilization, in order to benefit from the proper economic incentives for the commodity concerned.

* * * * *

It is important that the ICA's provide sufficient flexibility to adjust the price band as underlying market forces shift, in order to continuously bracket the long-term market trend. We will in no case sanction the establishment of agreements designed to raise prices above long-term market trends, or permit ICA's to operate in such a manner.

* * * * *

Export quota/national stocking schemes

I have already indicated clearly our general opposition to supply controls as a price stabilizing mechanism. At the same time, there may be a case for export quota/national stocking schemes for commodities which are unsuitable for an internationally held buffer stock. This applies particularly to agricultural commodities, where price

instability comes mainly from the supply side and which have low price and income elasticities. * * *

The export quota/national stocking arrangement can promote greater price stability by coordinating the accumulation and release of national stocks through internationally agreed export quotas. Such arrangements should not deviate from the principles laid out for buffer stocks except that there is greater reliance upon the export quota mechanism. In addition, these arrangements should provide for flexibility through frequent reallocation of quotas to permit efficient, lower cost producers to increase their market shares. Flexible reallocation provides added reassurance to consumers through the encouragement of investment by efficient producers who wish to increase their market shares in future years. There are two types of export quota/national stocking arrangements now in place, for coffee and sugar. * * *

Strategic stockpile policy

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The Carter administration has adopted new stockpile goals which resulted from the 1975-76 interagency reexamination chaired by the Federal Preparedness Agency, and has been developing an annual materials plan for achieving them. Since these new goals are consistent with the needs of a wartime economy during a 3-year global war, as opposed to the previous assumption of a 1-year conflict, they will require large acquisitions and in some cases disposals.

* * * * *

The administration is supporting the principle of using proceeds from sales of surplus materials to purchase deficit materials. We are willing to hold those funds in a separate account for about 2 years. However, we oppose holding such proceeds indefinitely in escrow to fund future purchases. Such a procedure would violate accepted budget practice by tying up idle funds for several years.

Two other principles are legally binding on the administration in managing the stockpiles: (1) They should be used for strategic, not economic, purposes, and (2) acquisitions and disposals should not disrupt markets. * * *

We believe that quick congressional action to provide for the sale of substantial amounts of tin (and the purchase of substantial amounts of copper) will help stabilize the tin market. * * * Once the United States fully establishes its policy with respect to the tin stockpile, our efforts to improve the operation of the ITA buffer stock should be much more effective.

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Exhibit 48.—Statement by Deputy Assistant Secretary Junz, August 17, 1978, before the Subcommittee on Oceanography of the House Committee on Merchant Marine and Fisheries, on the relationship between U.S. international economic policy and the seabed negotiations at the U.N. Law of the Sea Conference

I am pleased to testify before this committee in order to clarify the relationship between U.S. international economic policy and the seabed negotiations at the U.N. Law of the Sea Conference. While consistency with the international economic policies of the United States, especially in the areas of commodity policy and technology transfer, is important, it clearly cannot be the only criterion for assessing the seabed text. A comprehensive LOS treaty, in the overall national interest, needs to balance a broad spectrum of policy objectives and interests, of which commodity and investment policies are an integral but not an overriding part.

I would like to summarize U.S. policies in these latter areas as they might apply to seabed mining considerations.

The administration's commodity policy

The Carter administration has sought to integrate domestic and international policy concerns in the commodity area into a single, coherent approach. Central to this approach is our willingness to negotiate international agreements for individual

commodities (ICA's) designed to reduce excessive price volatility. Such agreements form a basic part of our efforts to assure a stable domestic and international production, investment, and trading climate for raw materials. In addition, we have agreed to find ways and means to assist in the financing of buffer stocks as part of individual commodity agreements, and to use existing financial institutions, both national and international, to expand production and processing of raw materials.

Both producing and consuming countries currently face important problems in the commodity area. Excessive short-term price fluctuations can ratchet up inflation in importing countries, and destabilize economic development in exporting countries. Inadequate investment in the production of raw materials creates supply shortages, which in turn result in longer run inflationary pressures worldwide.

International commodity agreements

In devising economically rational ICA's, we believe that certain principles are essential to serve the multifaceted interests of the United States as a major importer/consumer or exporter/producer of virtually every primary commodity:

- They must be designed to reduce short-term price fluctuations around underlying market trends, and *not* to raise prices in the longer term;
- They must balance the interests of producers and consumers in terms of responsibilities and benefits;
- They must provide wide latitude for the operation of market forces; and
- Decisionmaking within ICA's should be weighted to reflect the relative economic interests of each producer or consumer.

The United States opposes production controls in ICA's. By artificially cutting back on supplies, production controls in ICA's tend to distort markets, raise prices above market trends, and provide short-term gains for producers to the detriment of consumers. Such production controls also create inefficient production patterns by forcing both low- and high-cost producers to cut back output, thereby raising the average cost of production.

Because they are usually based upon some average of historical market shares, production controls tend to freeze production and marketing patterns and restrain the entry of newer, possibly more efficient producers. The implementation of supply controls is difficult, with leakages frequent, and errors not easily corrected in the short run. Supply control mechanisms usually are based on previous years' data and sometimes involve precarious forecasts of future output. Finally, they require long leadtimes before significant impact on the supply and demand situation becomes apparent. For these reasons, in negotiating ICA's, the administration prefers buffer stock arrangements.

Commodity investment policy

The United States seeks to facilitate investment in mining and processing in order to: avoid misallocation of important economic resources and the inflation such misallocations cause; diversify supply and contribute to a reduction in U.S. vulnerability to collusive price arrangements and disruptions of supply; and help developing countries expand their economies.

There is evidence of global misallocation of resources which, if continued, could significantly increase the cost of raw materials over the long run. A recent World Bank survey found that 80 percent of all exploration expenditures in 1970-73 were being made in the industrialized countries—the United States, Canada, Australia, and South Africa. Private firms are reluctant to invest in developing countries, primarily because of political risks. U.S. firms, for example, prefer to develop a copper deposit with less than one-half percent richness in the United States than deposits which are more than twice as rich in an LDC. Yet the rate of return on minerals projects in developing countries can be higher than in industrial countries. Indeed, for some Fourth World countries, minerals projects may be the only good projects that external private investment could develop.

To avoid this misallocation of resources, the administration has encouraged the international financial institutions such as the World Bank to take measures which will

stimulate investment in developing country mining and processing projects. The United States has also expanded the mandate of the Overseas Private Investment Corporation so that it can offer investment insurance for U.S. investors in overseas raw materials projects.

Production controls in LOS treaty

In the Law of the Sea Conference, land-based producers of nickel are seeking to protect and preserve their future investments from competition from seabed mining. They fear that seabed mining will be subsidized in one way or another and, accordingly, be able to compete with unfair advantage over land-based mining. Canada, as the leader of this group, has stressed the nickel production potential of tropical developing countries in order to gain additional allies. Many might have deposits of nickel bearing laterite ores. The G-77, as a whole, have adopted the position that a production control mechanism is necessary in order to protect nickel producers in developing countries, even though the number is small.

The United States has agreed to negotiate production control mechanisms that should interfere as little as possible with the currently anticipated production from seabed mining. To this end, we have been prepared to agree to a control formula that would allow ocean miners to supply 100 percent of the projected growth of the nickel market. Offering to agree to such a formula represented a significant effort to reach a compromise as well as a departure from the pure principle of efficient resource allocation by market forces.

At the last session, on an ad referendum basis, the U.S. delegation negotiated a formula with the Canadians that would be limited to the first 20 years of seabed mining and in which seabed mining would be restricted, under standard assumptions, to a range of 60-70 percent of the projected growth in the world nickel market.

Admittedly, there may be economic costs associated with any production control formula. A restrictive production control formula may misallocate resources and distort efficient market patterns if it attempts to assure any group of producers a fixed share of the projected growth of the market regardless of the relative costs and efficiency of various modes of production.

The interests the United States has in a Law of the Sea treaty and in a seabed mining regime clearly are much broader than those that govern our general policy vis-a-vis commodity agreements on specific commodities. Moreover, the entire regime being considered for deep seabed mining raises a unique set of circumstances in which the costs and benefits of any of the elements of that system, including production controls, need to be assessed. Thus, a production limitation that would be unacceptable in a commodity price stabilization agreement might be found acceptable to U.S. interests in a Law of the Sea treaty. Any production limitation would, of course, have to be examined in light of all relevant provisions of the text and economic factors to determine to what extent, if any, it in fact would limit expected seabed mining operations. The administration still is weighing the costs and benefits of the various navigational, environmental, scientific, and economic considerations that attach to the treaty as a whole.

The administration's policy on technology transfer

With regard to privately owned technologies, the administration favors a generally open, market-oriented international system. In keeping with our foreign investment posture, we do not actively promote or discourage proprietary transfers through special measures, although the activities of our Overseas Private Investment Corporation and Eximbank indirectly affect such flows. We support efforts that facilitate an environment conducive to flows of capital and technology. In particular, we support the efforts of LDC's to generate a scientific and technological infrastructure to support economic growth. We believe, however, that a system of appropriate rewards and incentives, including protection of industrial property rights, is essential to induce and sustain high levels of innovation. Such a system should not, however, lend itself to collusion among technology suppliers.

The main forum for the North-South dialog on the transfer of technology is the

United Nations Conference on Trade and Development (UNCTAD), where negotiations on an international code of conduct for technology transfer have been ongoing since 1975. The United States and other industrial countries support the adoption of voluntary guidelines for technology transfer, perhaps similar to the OECD guidelines for multinational enterprises adopted in June 1976. This might involve a code setting out balanced guidelines for government action in respect to technology transactions and conduct by enterprises.

The developing countries, however, are looking for a legally binding convention based on the principle that all countries should have the right of access to technology in order to improve the living standards of their peoples. Thus, the G-77 seek to extend the concept of the universal heritage of mankind to the field of technology. The developing countries seek to revise and limit the protection accorded industrial property rights and to institute rules at the national and international level which limit the negotiating flexibility of enterprises.

The United States believes that erosion of the traditional rights associated with proprietary technology would constitute a significant disincentive to the generation and dissemination of technology.

Many developing countries have national laws and policies affecting the transfer of technology which the United States could not accept as part of an international agreement on technology transfer. For example, some developing countries have laws which tend to reduce patent protection for certain types of technology, require patent rights to lapse if not worked in a short period of time, or tax royalties as if they were profits.

The G-77 often have used restrictive policies regarding technological transfers adopted at a national level as a basis for their positions in multilateral negotiations.

The negotiations on technology transfer conducted at the Law of the Sea Conference are unique in the sense that they aim at assuring that the Enterprise will in fact be able to operate its sites productively. Thus they back up the basic principle of the parallel system. While the Enterprise will need to have access to requisite technology, such transfer clearly also must occur under fair and commercial terms. The negotiations on technology transfer in the Law of the Sea Conference will be pursued further at future sessions. The administration will weigh provisions regarding the transfer of technology in an LOS treaty seriously, given the far-reaching implications they could have for the future of ocean mining.

International Monetary Affairs

Exhibit 49.—Press release, January 4, 1978, on utilization of the Exchange Stabilization Fund under a swap agreement between the Treasury and the Deutsche Bundesbank

The U.S. Treasury and the Federal Reserve Board today issued the following announcement at 1:15 e.s.t.:

The Exchange Stabilization Fund of the United States Treasury will henceforth be utilized actively together with the \$20 billion swap network operated by the Federal Reserve System. A swap agreement has just been reached by the Treasury with the Deutsche Bundesbank and is already in force. Joint intervention by the Treasury, the Federal Reserve and foreign central banks is designed to check speculation and re-establish order in the foreign exchange markets.

Exhibit 50.—Text of statements by Minister of Economy Gosta Bohman of Sweden, January 23, 1978, in his capacity as Chairman of the Group of Ten, released in Stockholm, Sweden, and Under Secretary for Monetary Affairs Solomon, on G-10 gold arrangements

MINISTER BOHMAN

The transitional arrangements on gold agreed upon on August 31, 1975, by the countries of the Group of Ten and Switzerland, and to which Portugal has also adhered, will be expiring on January 31, 1978. The participants having completed the review

called for in these arrangements agreed that, in view of the impending amendment to the IMF Articles of Agreement, there is no need to extend the transitional arrangements.

UNDER SECRETARY SOLOMON

The United States supports this statement. We believe that the G-10 gold arrangements have served a useful role. However, in light of the experience of the past two years—including the absence of actions to peg the price of gold or otherwise increase the monetary role of gold—and in the expectation that this situation will continue, the U.S. has concluded that these transitional arrangements need not be formally extended. If this situation were to change, however, and we saw a need for resumption of these, or similar arrangements, the U.S. would not hesitate to seek them.

Exhibit 51.—Press release, March 13, 1978, on a joint statement by Secretary Blumenthal and Minister Matthoefer of the Federal Republic of Germany

U.S. Secretary of the Treasury Blumenthal and Minister Matthoefer of the Federal Republic of Germany, following discussions between the two governments as well as between the Federal Reserve System and the Deutsche Bundesbank, today issued the following announcement:

1. Both sides are agreed that recently the exchange markets have occasionally been marked by disorder, including excessively rapid rate movements going beyond what is justified by underlying economic conditions.

They recognize that stability in the foreign exchange markets depends on a climate of confidence and a high degree of stability in the world economy. Although progress has been made in some respects, these conditions have not yet been adequately met: Growth rates in some countries are still lower than desirable; unemployment remains too high and inflationary pressures persist in many parts of the world, hampering more growth-oriented policies.

2. Both sides reaffirm that continuing forceful action will be taken to counter disorderly conditions in exchange markets and that close cooperation to that purpose will be maintained.

As part of this cooperative effort—

It has been agreed by the Bundesbank and the Federal Reserve to double the amount of their Swap arrangement;

The U.S. Treasury has arranged for the sale of SDR 600 million (approximately \$740 million) to purchase deutschmarks;

In addition, the United States has a reserve position in the IMF (automatically available in amounts up to approximately \$5 billion) which it will draw if and as necessary to acquire additional foreign exchange.

3. Both sides agree that it is of paramount importance that protectionist pressures be resisted worldwide. They renewed their firm resolution to strive together with their partners, for positive, comprehensive and early results from the multilateral trade negotiations.
4. Both sides affirm that they are prepared, jointly with their partners in the EC and the OECD, to monitor closely the further economic evolution in their countries and in the area as a whole. Economic developments during the first quarter of 1978 will be particularly important in determining the future course of economic policies in the Federal Republic of Germany and elsewhere. However, data to permit such an evaluation will not be available before mid-spring. German and U.S. economic policies will remain firmly oriented toward self sustaining recovery, steady non-inflationary growth, and stability in foreign exchange markets. These objectives require close cooperation by, and joint efforts of, all industrialized countries.
5. Swift and resolute action to conserve energy and to develop new sources is to be given high priority. Secretary Blumenthal reaffirmed President Carter's determination to take strong and effective action to deal with the energy problem. He indicated that the coming weeks would be critical in terms of assessing the shape of the energy legislation that would finally be approved by

- Congress and that the President would determine whether further action on his part was required in the short term following such an assessment.
6. Secretary Blumenthal and Minister Matthoefer recall that their two governments will be engaged in a series of discussions (EEC, OECD, IMF, et al.) over the next months. These discussions will provide a proper and cooperative framework for thorough analysis and, if necessary, additional action to deal with fundamental economic problems. The question of whether additional resources are needed to deal with exchange markets disorders will be kept under careful review.

Exhibit 52.—Statement by Under Secretary for Monetary Affairs Solomon, April 19, 1978, before the Subcommittee on International Trade, Investment, and Monetary Policy of the House Committee on Banking, Currency and Housing, on H.R. 9066, a bill to place the administrative expenses of the Treasury in the international affairs area on an appropriated basis and to discontinue the funding of those expenses from the ESF

I appreciate this opportunity to testify on H.R. 9066, which would place the administrative expenses of the Treasury in the international affairs area on an appropriated basis and discontinue the funding of those expenses from the Exchange Stabilization Fund. Following my testimony on this bill, I would like to take a few minutes of the committee's time to discuss a related point on the effect of recent exchange rate changes and revisions of certain accounting standards on the financial statements of the ESF.

H.R. 9066

When this administration assumed office, one of the first decisions to be addressed by the head of each department was that of internal organization and management. As part of that process, we at the Treasury were faced with a more specific question, which had been one of some congressional concern: Whether to continue payment of administrative expenses connected with Treasury's international responsibilities from the Exchange Stabilization Fund (ESF). Our decision is reflected in the bill you are considering today—H.R. 9066—which was proposed by the Treasury.

The main purposes of the bill are: (1) To discontinue the use of the ESF as a source of payment of administrative expenses; and (2) to authorize appropriations to meet all administrative expenses associated with the Treasury Department's international affairs functions. The bill also includes the various technical provisions necessary to accomplish this change with minimum disruption to the ongoing work of the Department.

The Exchange Stabilization Fund was created by the Gold Reserve Act of 1934 to provide financial resources for the Secretary of the Treasury to "stabilize the exchange value of the dollar." Those resources are authorized to be used for financial and monetary transactions (ESF "operations") and for the payment of administrative expenses associated with carrying out the ESF's purpose.

The responsibilities of the Treasury Department in international affairs have increased substantially since 1934. In addition to managing the Exchange Stabilization Fund, the Secretary of the Treasury serves as U.S. Governor of the International Monetary Fund, International Bank for Reconstruction and Development, International Development Association, International Finance Corporation, Inter-American Development Bank, Asian Development Bank, and African Development Fund. The Secretary of the Treasury, as chief financial officer of the United States, serves as Chairman of the Economic Policy Group, the National Advisory Council on International Monetary and Financial Policies, and the East-West Foreign Trade Board; and participates in a variety of interagency committees on international economic issues such as the Trade Policy Committee, the Export Expansion Advisory Committee, and the Advisory Committee on Public Law 480.

These responsibilities and the related efforts to coordinate international economic policy with domestic economic policy require a staff of experts and adequate administrative support. In today's interdependent world, effective operations in the broad area of international monetary policy require an organization equipped to develop information on, and analyze foreign activities in, the monetary, exchange, trade, investment, and development fields, and other matters bearing on the U.S. external payments position; to assist in formulating U.S. policy positions on international economic and financial issues; and to implement those policies.

Given the expanded responsibilities of the Treasury Department in international affairs, and the growing administrative costs resulting from those responsibilities, we examined the question whether it was appropriate to continue the off-budget status of these expenses through their funding from the ESF. We looked closely at the reasons why these sums had been paid from ESF resources in the past.

Historically, there have been two main reasons for funding the administrative costs of Treasury's international function from the ESF rather than from appropriations: (1) Placing the administrative expenses on budget might jeopardize the needed confidentiality of specific ESF operations which the administrative expenses support; and (2) the administrative expenses could not be included in budget projections because they could be highly unpredictable—with extraordinary developments in the international monetary and financial system at times requiring extraordinary expenditures.

In our review, we found that administrative expenses directly tied to ESF operations comprise only a very small part of the total ESF administrative budget, and that large, unpredictable administrative expenditures have been increasingly rare. The major portion of the ESF administrative budget supports the broader range of Treasury international activities not directly associated with specific ESF operations.

Accordingly, we concluded that ESF administrative expenses could be placed on budget without jeopardizing the needed confidentiality of ESF operations, and that the Treasury's administrative expenses in the area of international affairs are amenable to the same kind of annual budgetary control and projection applied to other Federal expenditures. The bill before you today would accomplish that budgetary control, and place ESF administrative expenses on a fully appropriated basis.

Senate action has been completed, with passage of the bill on March 8. I urge this committee to act promptly as well, in order to assure that we can accomplish the objective of this bill for the 1979 fiscal year.

I would also mention another question involving the ESF, which was raised soon after I came to Treasury: Access by the GAO to information and documents related to certain international economic activities of the Treasury Department. Mr. Staats and members of his staff met with me early last summer to discuss this matter.

The GAO serves a very important function in reviewing and auditing Government activities in various international areas. In conducting such authorized audits and reviews, the GAO may seek information on such international monetary matters as U.S. participation in the IMF, debt policies toward developing countries, and the interrelationships of monetary and trade policies.

In an exchange of letters with Mr. Staats, which is contained in the ESF Annual Report for Fiscal Year 1977, I provided assurance to the Comptroller General that Treasury will continue to cooperate fully in providing the GAO, on request, with such information, appropriate to its authorized audits and reports. In this regard, Treasury also will provide all information pertaining to the ESF relating to such GAO reports and studies, except where the information involves confidential ESF transactions with foreign governments and monetary authorities or information related to the ESF's market transactions. Such transactions continue, of course, to be the subject of confidential consultations with Members of Congress, and ESF agreements with foreign governments and monetary authorities are transmitted formally to the Congress under the Case Act.

I am pleased we have been able to work out cooperative arrangements in this regard which are satisfactory to the Comptroller General, and I am confident that we will have a continuing productive working relationship between the Treasury and the GAO.

ESF Annual Report for Fiscal Year 1977

Mr. Chairman, I have provided the subcommittee with copies of the ESF Annual Report for last fiscal year. This report reflects some fairly important developments and changes in the ESF's financial position and I felt it would be desirable to discuss it with you briefly today, given the opportunity of this hearing.

As indicated in the report, the very sharp appreciation of the Swiss franc in the exchange market is now creating large actual and accrued exchange losses for the ESF. The losses arise in connection with redemption by the Treasury of Swiss franc-denominated securities issued during the 1960's and early 1970's, under the Bretton Woods par value monetary system, prior to the collapse of that system in August 1971. These Swiss franc-denominated securities—the so-called Roosa bonds—were issued to help protect the U.S. gold stock and maintain the par value system. Although these securities were issued by the Treasury's general account, the ESF has borne the U.S. exchange risk on such securities since their introduction in 1961.

The contractual exchange risk provisions on these securities covered discrete par value changes. After the widespread move to floating exchange rates in 1973, the exchange risk provisions became indeterminate and subject to discussion between the U.S. and the Swiss authorities. Negotiations continued over a period of several years, during which no repayments were made by the Treasury and no losses were recorded.

During fiscal year 1977, three things occurred. First, in October 1976, understandings were reached on the terms of redemption for these securities, and repayments began in November 1976. Second, exchange rates—and particularly the exchange rate between the dollar and the Swiss franc—began to move substantially, and potential exchange losses in connection with these securities began to rise. Finally, a new accounting standard was applied to the ESF for the first time, calling for *accrued* exchange losses to be recorded currently on the ESF balance sheet as a liability, rather than to be recorded only when realized.

These developments have created substantial differences between the ESF's financial statements in this year's report and the reports of previous years.

The points I would like to stress are the following. First, the cash exchange losses the ESF has realized to date have not substantially affected the ESF's assets, and the ESF's resources are adequate to meet the further prospective losses now foreseen. These cash and accrued exchange losses will not impair the U.S. ability to conduct necessary monetary operations. The ESF's cash position remains strong and its available SDR holdings are large. Although we presently record SDR allocations as an ESF liability, it is most improbable that this liability would ever become payable. The SDR allocations would have to be repaid only if the IMF or the SDR Department of the IMF were liquidated, if the United States withdrew from the IMF or the SDR Department, or if SDR allocations were canceled. These are all highly unlikely contingencies, and the latter two are fully under the control of the United States.

Second, the ESF's resources are important, but they are only a segment of the overall international monetary resources available to the United States. The ESF's accounts do not include, for example, Treasury holdings of gold; U.S. rights to use our reserve position in the IMF and to draw on the credit facilities of the IMF; or the reciprocal currency arrangements maintained by the Federal Reserve System.

Third, the ESF accounts nor other Treasury accounts presently reflect the gains that could at some point accrue to the U.S. Government as a consequence of issuing the Swiss franc securities. As the subcommittee knows, the essential purpose of issuing these securities was to forestall foreign purchases of U.S. gold as part of an effort to maintain the old Bretton Woods par value system. We estimate that issuance of the Swiss franc securities resulted in the retention of about 36 million ounces of gold by the United States. Valued at the current market price for gold, this gold represents a potential gain of about \$4 1/2 billion for the U.S. Government, or nearly four times the currently estimated losses on the Swiss franc securities.

While the ESF thus remains sound and capable of fulfilling its functions, we are nonetheless considering whether the present ESF financial statements convey a fully accurate and meaningful picture of the ESF's financial condition. Accordingly, I have asked the Comptroller General to work with the Treasury to determine whether the

accounting treatment presently applied to the items I mentioned earlier is fully appropriate and, if not, to recommend alternative approaches for the Secretary's consideration. I would expect to consult with the committee again when this work has been completed.

Exhibit 53.—Press release, April 19, 1978, announcing the sale of gold for dollars by the U.S. Treasury

The Department of the Treasury announced that it is requesting the General Services Administration to initiate a series of monthly public auctions of gold beginning on May 23, 1978. Approximately 300,000 ounces of gold will be sold at each of the first six auctions. The Treasury expects to review the experience at these auctions to determine whether the amounts to be offered at succeeding auctions should be altered.

These sales of gold will have the effect of reducing the U.S. trade deficit, either by increasing exports of gold or by reducing the imports of this commodity. The sales will also further the U.S. desire to continue progress toward the elimination of the international monetary role of gold.

The Treasury plans to study the technical aspects of selling gold against payment in West German deutsche marks with a view to determining whether sales of gold also provide a technically feasible and advisable means of acquiring deutsche marks for use in countering disorderly conditions in foreign exchange markets. Invitations to bid at the initial auction will specify payment in U.S. dollars and provide for delivery at the U.S. Assay Office in New York or at other U.S. gold depositories. Any change in these arrangements will be announced prior to future auctions.

Auctions will be conducted at 11:00 a.m. on Tuesday, May 23, 1978, and the third Tuesday of each month thereafter in the GSA Office at 7th and "D" Streets, SW., Washington, D.C. At the May 23 auction, the minimum bid accepted will be for 400 ounces. A bid deposit of \$10 an ounce will be required.

The gold will be made available in bars each containing approximately 400 ounces. Sales will be by competitive bids with all successful bidders paying the price bid for each ounce of gold. The Treasury reserves the right to reject any or all bids. Bids by or on behalf of foreign government or central banks will not knowingly be accepted.

Formal invitations to bid in the auctions will be issued by the GSA within 10 days. Bid forms will be mailed to firms or persons on GSA's precious metal mailing lists. All others wishing to receive an invitation to bid should communicate with: General Services Administration, Metals Branch, Office of Stockpile Disposal, 18th and "F" Streets, NW., Washington, D.C. 20405 Telephone: Area Code 202-566-1986.

Exhibit 54.—Communique of the Interim Committee of the Board of Governors of the International Monetary Fund on the International Monetary System, April 29-30, 1978, issued after its 10th meeting in Mexico City, Mexico

1. The Interim Committee of the Board of Governors of the International Monetary Fund held its tenth meeting in Mexico City on April 29-30, 1978, under the chairmanship of Mr. Denis Healey, Chancellor of the Exchequer of the United Kingdom. Mr. H. Johannes Witteveen, Managing Director of the International Monetary Fund, participated in the meeting. The following observers attended during the Committee's discussions: Mr. G. D. Arsenis, Director of Money, Finance and Development, UNCTAD; Mr. Rene Larre, General Manager, BIS; Mr. Emile van Lennep, Secretary-General, OECD; Mr. F. Leutwiler, President, National Bank of Switzerland; Mr. Francois-Xavier Ortoli, Vice President of the Commission, CEC; Mr. Gardner Patterson, Deputy Director General, Trade Policy, GATT; Mr. Cyrus Sassanpour, Market Research Analyst, OPEC; Mr. Ernest Stern, Vice President, Operational Staff, IBRD; Mr. Cesar E. A. Virata, Chairman, Development Committee.

2. The Committee noted with satisfaction the recent entry into force of the Second Amendment of the Fund's Articles, which has brought about a modernization of the Articles and will improve the operation of the Fund in current conditions and permit

its adjustment to future conditions as they develop. The Committee also welcomed the consents by the overwhelming majority of the Fund's members to the increases in their quotas as proposed under the Sixth General Review of Quotas and expressed the hope that the rest of the members will consent in the near future.

3. The Committee discussed the world economic outlook and the working of the international adjustment process.

The Committee recognized certain favorable developments. Notable among these were the progress made by a number of countries in achieving stabilization and growth objectives, a marked reduction in the surplus of the oil exporting countries, and improved access, over the last few years, by the non-oil developing countries as a group to sources of finance for their current account deficits, even though the combined current account deficit of these countries is expected to show an increase from 1977 to 1978.

Nevertheless, the Committee noted, world economic developments over the past year or so were unsatisfactory in some important respects. In particular, the Committee expressed concern with the slow and uneven pace of recovery from the severe 1974-75 recession, the prevalence of historically high levels of unemployment, the slow growth of world trade, the continuation of high rates of inflation in many countries, the maldistribution of current account balances, and instability of exchange rates among the industrial countries. The Committee emphasized the need to assure better economic performances, especially in the industrial countries, and an improved environment for the adjustment of external trade and payments positions.

The Committee noted with concern the risk of increasing resort to protectionist action of all kinds in the wake of slow growth, low capacity utilization, and high unemployment. It was agreed that determined and broadly conceived national and international efforts, directed at the underlying causes as well as at specific protectionist measures, were urgently needed to arrest this drift toward protectionism and to reduce trade barriers. The successful completion of the multilateral trade negotiations that are now well under way would do much to stop this development.

Considerable attention was given by the Committee to the special problems of the developing countries, including the need to accelerate their rates of growth as a continuing objective and a common responsibility of the international community. The vulnerability of their economies to slow growth of markets in the industrial world or to reduced access to such markets was a source of widespread concern, and the Committee stressed the desirability of measures on the part of the developed countries to assure continued expansion on an adequate scale of the flow of real resources to developing countries, which would help to promote the adjustment process.

In the course of the Committee's discussion, a consensus was reached on the general outlines of a coordinated strategy, containing mutually supportive and reinforcing elements, designed to promote noninflationary growth of the world economy, leading to higher employment, a reduction of imbalances in international payments, and the conservation of energy. The Committee emphasized that the implementation of this strategy—geared to the medium term, through 1980—should take due account of the wide differences in current positions of individual countries. It suggested that, among countries in the industrial world, growth policies should be related to the success achieved in reducing inflation, the strength of the external position, and the degree of current and prospective economic slack.

In view of the risk of reviving inflationary pressures, the Committee noted the utility of policies appropriate to counter the predominance of cost-push factors in the current inflation. The Committee also suggested that for those countries with strong cost-push factors fiscal stimulus provided through tax reductions might often be more appropriate than equivalent stimulus applied through increases in domestic government spending unless such spending is investment oriented.

The Committee was convinced that the general strategy envisioned would yield a more satisfactory rate of economic expansion for the industrial and developing countries and the world economy generally, within a pattern of differentiated growth rates among countries, which would reduce external payments imbalances. The improvement in basic underlying conditions would in this way contribute to greater stability of exchange markets, which is extremely important for the health of the world

economy. Greater stability in these circumstances would help to achieve the higher growth rates desired and to improve the prospects of the developing countries.

4. The Second Amendment has brought into effect the provisions of a new Article IV which stresses the objective of a "continuing development of the orderly underlying conditions that are necessary for financial and economic stability" and makes it an obligation of each member "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." In accordance with Article IV, the principles for surveillance shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members. The principles and procedures for surveillance over exchange rate policies endorsed by the Interim Committee and approved by the Executive Board in April 1977 have gone into operation under the Second Amendment. The Committee noted with approval that the Fund has recently adapted its consultation procedures and practices to take account of surveillance, and that particular attention will be focused on those cases in which there are questions as to whether the exchange rate policies of members are consistent with the agreed exchange rate principles. The Fund has always concerned itself with situations in which the value of a currency is not compatible with the smooth working of the adjustment process, or where disorderly conditions exist in exchange markets. The Committee noted that the Fund now has both the obligation and the means through surveillance to make a greater contribution than before to the effective working of the exchange rate system. In this context, some members asked that the Executive Board should consider whether the Council should be brought into being under the Second Amendment as a decisionmaking organ. Some members of the Committee do not favor bringing the Council into existence because it would not contribute to the working of the international monetary system under the Second Amendment. The Committee received suggestions for the strengthening of surveillance, including the provision of more information by both surplus and deficit countries to assure the efficient working of the surveillance process.

5. The Committee noted the report of the Executive Board on improving the characteristics and broadening the uses of the SDR under the powers of the Second Amendment and on the question of an allocation of SDRs.

The Committee agreed that in present circumstances the interest rate on the SDR should be increased from 60 per cent to no more than 80 per cent of the weighted average of short-term interest rates in the five member countries with the largest quotas, and asked the Executive Board to agree on a satisfactory formula for the rate of remuneration on this basis. Some members could support an increase in the interest rate only on the condition that an allocation of SDRs would be made.

The Committee requested the Executive Board to pursue its work with regard to additional types of uses of SDRs that might be permitted by the Fund in accordance with the provisions of the amended Articles, and to report to the Interim Committee on these matters at its next meeting. Some members favored the abolition of reconstitution and requested the Executive Board to review the rules for designation and reconstitution under the amended Articles.

A large number of members supported an allocation of SDRs; some of these believed that the present state of world liquidity was not such as to justify more than a modest allocation. Some members suggested that a proportion of quota increases should be paid by members in SDRs.

The Committee agreed to request the Executive Board to pursue its work on all these aspects of an allocation of SDRs and to submit appropriate proposals, together with draft recommendation, for consideration by the Committee at its next meeting.

The Committee also considered the suggestion of the Managing Director that an allocation of SDRs could be combined with a reduction in the amount of reserve currency outstanding through a Substitution Account administered by the Fund. Some members believe that agreement on a Substitution Account would facilitate an allocation of SDRs. The Committee agreed that this suggestion of the Managing Director should be considered further and that a report should be submitted by the Executive Board for consideration by the Committee at its next meeting.

6. The Committee noted the report of the Executive Board on the Seventh General Review of Quotas and considered the issues involved. Recalling that the Board of Governors in its Resolution No. 31-2 decided that the Seventh Review of Quotas should be completed by February 9, 1978, the Committee expressed concern at the delay in completing the Review. The Committee reaffirmed its view that there was a need for an increase in total quotas under the Seventh Review that would be adequate to meet the expected need for conditional liquidity over the next five years and that would strengthen the available sources of balance of payments financing by enhancing the ability of the Fund to provide such financing without heavy recourse to borrowing and by furthering the process of international adjustment. Most members of the Committee were of the view that an increase of the order of at least 50 per cent of the quotas approved under the Sixth General Review would be appropriate in view of the present and prospective circumstances of the international economy. Most members of the Committee agreed that the Seventh Review should be mainly equiproportional, with at most a very small number of selective quota increases, in which case most members felt that the quota share of no developing country should be decreased except for one or two members whose quotas would remain unchanged.

Some members suggested a limited increase in the first credit tranche if quota increases were more than a modest amount, but other members considered that the first credit tranche should be enlarged if the increases were not more than a modest amount.

The Committee asked the Executive Board to give priority to these matters in its work in the coming months and to submit to the Board of Governors appropriate proposals, together with draft recommendations, for consideration by the Interim Committee at the time of the next annual meeting of the Board of Governors.

Several members asked that the criteria for quota increases should be reconsidered after the Seventh General Review.

7. The Committee expressed its concern at the long delay in bringing into operation the Supplementary Financing Facility, the establishment of which was decided upon more than six months ago. In view of the need of a number of members for prompt financial assistance on the scale envisaged by the Supplementary Financing Facility, the Committee urged that all necessary steps be taken for bringing the Facility into operation at the earliest possible date. In this connection, Committee members from developing countries asked the Executive Board to review the conditionality attaching to the Facility and also to drawings under regular credit tranches, and called again for an examination, as early as possible, of the establishment of a subsidy related to the rates of charges that would be payable by low income countries. The Committee welcomed the intention of Nigeria and Guatemala to contribute to the financing of the Facility SDR 220 million and SDR 30 million respectively, and the intention of Venezuela to increase its contribution from SDR 450 million to SDR 500 million. As a result, the total financing of the Facility will be approximately SDR 8.75 billion (about US \$11 billion), as follows (expressed in millions of SDRs):

Abu Dhabi.....	150	Kuwait.....	400
Belgium.....	150	Netherlands.....	100
Canada.....	200	Nigeria.....	220
Federal Republic of		Qatar.....	100
Germany.....	1,050	Saudi Arabia.....	2,150
Guatemala.....	30	Swiss National Bank.....	650
Iran.....	685	United States.....	1,450
Japan.....	900	Venezuela.....	500

8. The members of the Committee, noting that Mr. Witteveen is about to relinquish his position as Managing Director of the Fund, expressed on their own behalf and on behalf of their constituencies their deep appreciation and gratitude for the superb manner in which he has discharged the responsibilities of his office in difficult circumstances. The members of the Committee also took the opportunity to

congratulate Mr. Jacques de Larosiere on his designation as Mr. Witteveen's successor and wished him success in his important and difficult task in the years ahead.

9. The Members and Associates of the Interim Committee expressed deep appreciation for the welcome and hospitality extended to them in Mexico and thanked the Government of Mexico for the outstanding facilities provided for the tenth meeting of the Committee.

10. The Committee agreed to hold its next meeting in Washington, D.C. on September 24, 1978.

Exhibit 55.—Remarks by Under Secretary for Monetary Affairs Solomon, May 15, 1978, before the International Herald Tribune/Forex Research Ltd. conference on "Managing Foreign Exchange Risk," New York, N.Y., entitled "Exchange Market Developments and U.S. Policy"

I appreciate the opportunity to participate in this conference on managing foreign exchange risk. Many here today are in a real sense on the frontlines of the international monetary system, making operating decisions that collectively can have a profound effect on the operation of that system and the stability of the world economy. It is important that we in government understand your concerns and problems and that you understand the objectives of government policies.

The value of the dollar

The U.S. current account balance deteriorated rapidly in the latter half of 1976 and in 1977. By the fourth quarter of last year, the deficit was running at an annual rate of \$28 billion. The rapidity and extent of the deterioration did not become fully apparent until the third quarter of 1977 and, to some extent, caught the markets by surprise.

Two major factors in the deterioration are by now well known:

The United States has been growing markedly faster than other industrial countries. Since 1975, industrial production in 13 other leading OECD countries has grown only 14 percent compared to 25 percent for the United States. Last year, U.S. industrial production grew almost 6 percent while production abroad failed to grow at all.

U.S. oil imports in 1977 were \$45 billion, up from \$27 billion in 1975 and less than \$5 billion in 1972. Continued delay in congressional action on the energy legislation served to highlight the difficult structural adjustments that have to be made to curb our voracious energy appetite.

As the fourth quarter of 1977 approached, growing awareness of the change in our position and doubts about early correction led to a change in expectations about the dollar exchange rate. Changing expectations, in turn, brought uncertainty and disorder in the markets. In this atmosphere, there was an outflow of private capital, plus unrecorded transactions, of some \$10 billion in the fourth quarter of 1977, compared to an outflow averaging \$1 1/4 billion during each of the first three quarters. With exchange markets under substantial pressure, countries in surplus intervened heavily to slow the appreciation of their currencies. Official dollar holdings rose \$15 1/2 billion in the fourth quarter, primarily through accumulations by a small group of industrial countries in strong surplus positions.

Uncertainty and disorder continued periodically through most of the first quarter of this year. Gradually, in recent weeks, the tone of the foreign exchange market has improved. The amount of official intervention has abated sharply, and the intervention that has taken place has more frequently taken the form of dollar sales rather than dollar purchases—indeed, there have been net intervention sales of dollars on the order of \$2 to \$3 billion since March. The dollar has appreciated against OECD currencies by about 1 1/2 percent since the end of March, with larger increases against the currencies of the main industrial countries in surplus.

In part, this change in tone reflects greater awareness of U.S. determination to take the fundamental measures required for a sound dollar. It may also reflect greater recognition of some important improvements in the underlying economic situation. With an improvement in market confidence, interest rate differentials have begun to exert more influence on the direction of capital flows. The performance of the stock market may also be having an impact.

Before discussing the U.S. approach to exchange market developments, I want to put recent exchange rate movements in perspective. The two formal dollar devaluations in 1971 and 1973 were part of major multilateral realignments of exchange rates designed to correct the over- and under-valuation of a wide range of currencies that had accumulated during the postwar period. Since the general move toward more flexible rates in March 1973, several currencies have appreciated substantially against the dollar—the Swiss franc by 64 percent, the German mark 35 percent, and the Japanese yen by 17 percent. However, during the same period, other currencies have depreciated against the dollar, including the Canadian dollar by 11 percent, the pound sterling by 26 percent, and the Italian lira by 35 percent.

There are various calculations that attempt to measure overall changes in the exchange values of currencies. The Treasury publishes an average for the dollar vis-à-vis the currencies of all other OECD countries, with individual exchange rate changes weighted on the basis of U.S. bilateral trade with the countries concerned. On this basis during the past few years, the dollar has fluctuated within a narrower range than against some individual currencies. The recent movement, a decline of about 6 percent since September, is large but substantially less than the press reports might suggest. Such changes have occurred in the past in both directions when economic conditions were particularly unsettled. In the latter half of 1973 the dollar rose by 13 percent, and during the last three quarters of 1975 by 8 percent. On balance the dollar is at present about 2 percent above its March 1973 level on this average basis.

That the dollar should have depreciated in relation to some currencies while rising in relation to others over the past 5 years should not be surprising, in view of the wide disparities in economic performance among major countries on growth, inflation, and external imbalances. There have nonetheless been charges that the United States has practiced a policy of benign or even malign neglect on exchange rate matters in order to gain a competitive advantage. The evidence simply does not support such a charge, and I can assure you that that is not and will not be U.S. policy.

The impact of exchange rate changes on competitiveness is extremely difficult to measure. Exchange rate changes reflect capital movements as well as trade. Nonprice factors—quality, delivery, financing—also play an important part in competitiveness. Comparisons are also sensitive to the base from which one starts. However, independent analyses show that changes in dollar exchange rates have generally offset relative inflation rates and that there was virtually no net change in the U.S. competitive position—as measured by price adjusted exchange rates—between mid-1975 and the first three quarters of 1977. The most recent exchange rate movements have, of course, led to a modest improvement in the U.S. competitive position. But even taking these changes into account, at the end of March 1978 the dollar's position on this measure was only about 1 to 2 percent above the level prevailing at the time of the general move to more flexible rates 5 years earlier. Exchange rate changes for the dollar have broadly kept pace with inflation differentials in the last few years, not significantly more.

The experience of other major countries on this measure of "real" exchange rates since the move to more flexible exchange rates in March 1973 has been mixed. As of the end of March 1978—

Italy, Canada, and Japan had experienced modest improvements in their competitive positions. In Italy and Canada, the rate of exchange rate depreciation more than offset relatively poor price performance producing real exchange rate changes on the order of 5–10 percent. In Japan, yen appreciation was more than fully compensated by a relatively good record on inflation, resulting in a gain in price competitiveness of somewhat less than 5 percent. *Germany and the United Kingdom* had experienced deterioration in their competitive position on the order of 5–10 percent. The appreciation of the German mark has more than offset relatively good price performance. Relatively

poor price performance in the United Kingdom was only partly offset by a depreciation of sterling.

France, like the United States, was in roughly the same position as 5 years ago, with only a very minor deterioration in the competitive position.

The evidence suggests that, with some exceptions, exchange rate changes over the period as a whole have tended to stabilize real exchange rates. That is, they have been in the direction needed to offset or partly offset relative price differentials, and thus have resulted in smaller real exchange rate changes than would have occurred otherwise. This is a sensible result: It has probably helped in the correction of existing imbalances in some cases, and has certainly helped to avoid the emergence of even larger imbalances in others.

The outlook

In terms of the market, what happened yesterday, let alone last year, is history. Your concerns are about today, tomorrow, and, perhaps, next year. Your program suggests that some speakers may be willing to offer exchange rate forecasts. I wish them success but will not join in a forecasting effort. What I will do is offer my view of underlying trends in the world economy and discuss U.S. exchange rate policy.

As I look at the world economy for 1978, three positive points stand out.

First, real growth will be somewhat better balanced among countries. U.S. growth will be somewhat slower than last year although the 4- to 4 1/2-percent rate which we now expect will still be enough to reduce unemployment further. Although first-quarter growth has been disappointing in Europe—as well as in the United States—European and Japanese growth should pick up modestly later in the year. On average, these countries may reach 3 1/2 percent this year, about 1/2 percent higher than in 1977. The EC is aiming at an average growth rate of 4 1/2 percent by mid-1979. The developing countries should experience more vigorous growth than their industrial country counterparts, perhaps 5 1/2 percent. By the latter part of the year, growth rates abroad should be nearly equal to that of the United States. This expected convergence of growth rates among industrial countries should tend to reduce existing payments imbalances.

Second, the OPEC current account surplus should drop a startling \$10 to \$15 billion in 1978 to about \$20 billion or so. The principal factors include the decision to freeze prices, new sources of supply from the North Sea and Alaska, more efficient utilization of energy, and the slower growth in industrial countries which leaves total demand below earlier expectations. Moreover, an increasing portion of OPEC's financial surplus is being invested at medium term and, as the world's largest capital market, the United States receives a substantial share. We estimate that some 70 percent of the cumulative OPEC surplus has been placed in dollar instruments, about 25 percent in the U.S. market itself. Contrary to some press reports, there is no evidence of an OPEC shift away from dollar investments during the recent exchange market disorders. Indeed, very preliminary information for the first quarter of this year indicates that a high and perhaps even larger proportion of OPEC assets was placed in the United States. An OPEC surplus in the range expected in 1978 is manageable in the medium term and should allow the industrial countries to return toward a more traditional position of current account surplus.

Third, inflationary pressures are continuing their slow decline, at least for the developed world as a whole. In 1978, consumer price rises in industrial countries may average 7 percent, following 8 percent last year, with the disparity in inflation rates narrowing. Inflation in the United Kingdom is moving below double-digit rates for the first time in 5 years. With the possible exception of the United States, all OECD nations are expected to hold current inflation rates or register some improvement this year.

Even with the prospect of somewhat higher growth and slower inflation in most areas, there is widespread concern about the economic outlook. This is particularly true in Europe where even the higher growth rates now in prospect are too low to reduce unemployment. In many of these countries, unemployment continues at near-record levels. The short-term outlook for plant and equipment investment in most European countries remains weak, especially for this phase of the recovery cycle, and particularly

in light of the need to replace capital stock rendered obsolete by the sharp increase in energy costs.

The current account imbalances among industrial countries remain large. The U.S. deficit was \$20 billion last year. It is likely to be at least as large in 1978 as a whole given the very high trade deficit of more than \$11 billion in the first quarter, though that deficit is expected to decline in the last three quarters. The surpluses of Japan, Germany, and Switzerland are equally large. In fact they now approximate the OPEC surplus. Clearly there is a need for more adjustment by all four of these major industrial countries. For Japan, Germany, and Switzerland, that adjustment should come primarily from faster growth, an opening up of markets, and structural change in production patterns.

For the United States, the responsibility is threefold. On April 11, President Carter announced important new action to carry out those responsibilities. He has—

First, announced a comprehensive program to curb inflation by limiting the size of Federal budget deficits; by restricting Federal wage increases as part of a general deceleration of wage and price rises; by acting to reduce the inflationary consequences of Government regulations; and by resisting legislative proposals that would add to inflation.

Second, pressed hard for congressional action on comprehensive energy legislation and indicated that oil imports would be limited by administrative action under present law if Congress fails to act.

Third, initiated work on a program to promote exports.

The President has chosen his course. It is the right one. Now we must deliver, and we are determined to do so. We trust that others will meet their responsibilities as well.

U.S. exchange rate policy

Recent exchange market developments have raised fears that exchange rate instability may thwart economic recovery by undermining business investment and consumer spending. In part, such concerns reflect the difficulty other major countries are having in spurring domestic expansion but which they were clearly experiencing before the recent exchange market disturbances. For many countries, the foreign sector plays a much more dominant role than in the United States and has traditionally been a major source of economic growth and employment. Thus, the Netherlands exports 54 percent of its GNP, Germany 28 percent, Japan 14 percent, and France 19 percent. The United States exports about 7 1/2 percent of GNP.

It is not surprising that such concerns generally surface during episodes of dollar weakness in the exchange markets. The U.S. economy is substantially larger than any other individual country, accounting for 40 percent of total OECD GNP. The yearly increase in U.S. output is equivalent to half the total output of a country the size of the United Kingdom. Countries are naturally concerned about a loss of their competitive position in the large U.S. import market or vis-a-vis U.S. exporters. In addition, the large role of the U.S. capital market and the dollar in international financial transactions and balances also leads to concerns at times of dollar instability. The U.S. capital market is as large as all other major financial markets combined and constitutes a major source of finance and investment for the entire world economy. In the past few years, 60 percent of all Eurobond issues have been denominated in dollars. The proportion of external claims denominated in dollars by banks in G-10 countries is about 75 percent. The dollar is also the principal vehicle for international transactions and continues to constitute over 80 percent of official foreign currency reserves.

Concerns about the possible effects of exchange rate instability have spawned suggestions which focus on efforts to achieve greater stability through financial means, including exchange rate zones supported by massive official intervention, greatly expanded credit arrangements, foreign currency borrowing by the United States, and "substitution" arrangements to sterilize official currency reserves. Such proposals treat the symptoms rather than the causes of present economic problems. Experience of the past decade has demonstrated repeatedly that exchange rate stability cannot be imposed on the system but must be the result of sound domestic economic policies.

The world economy has undergone fundamental changes since the Bretton Woods

par value system was established. The growth of international trade and payments, the ability of many countries to tap world capital markets, and the existence of large liquid balances provide a scope for capital movements that dwarfs the ability of official institutions to control rates through exchange market intervention or artificial barriers. Attempts to prevent exchange rates from reflecting basic trends would lead to a repetition of the disturbances that punctuated the latter part of the Bretton Woods era and could be extremely disruptive for the world economy.

In recognition of this fact of life, the members of the IMF have agreed on a different approach. The basic philosophy of the new monetary system incorporated in the amended IMF Articles, in particular article IV on exchange arrangements, is that international monetary stability cannot be imposed from without, but must be developed by countries from within, through the application of sound underlying economic and financial policies.

In line with that concept, our program for assuring a strong and healthy dollar relies on fundamental economic performance, not on market operations to hold or attain a particular exchange rate or maintain a particular exchange rate zone. We do recognize, of course, that markets can become disorderly, subject to great uncertainty, dominated by psychological factors and speculation. We have made clear that we are fully prepared to intervene in the markets to counter such disorders. We have intervened, at times in large amounts, for that purpose. And we have taken other steps such as interest rate moves by the Fed and announcement of gold sales by the Treasury that appear to have been useful in strengthening the tone of the market. The resources at our disposal for intervention are very large and we are prepared to use them if and as required to counter market disorders.

IMF surveillance

With the entry into force of the new IMF Articles, we are emerging from a long period in which the international monetary system has been operating without the benefit of an effective legal foundation. The new exchange rate provisions give members wide latitude in the choice of exchange rate practices best suited to their needs, and can accommodate a wide variety of exchange rate mechanisms; for example, freely or managed floating rates, rates pegged to a currency or basket of currencies, and the common margins arrangements of the EC snake. One can easily imagine expanded European monetary arrangements in the broad framework of the new system as some European leaders seem to be considering in an effort to give renewed impetus to their longstanding goal of monetary union.

But neither such arrangements, nor other exchange rate mechanisms, can create stability if there is instability in the domestic economies of major countries. It is the underlying stability which, correctly, is the focus of the obligations placed on countries by the new article IV. Under this provision, each member undertakes a general obligation relating to efforts to direct its policies toward orderly growth with reasonable price stability, and a specific obligation to avoid manipulating exchange rates to prevent balance of payments adjustment or gain unfair competitive advantage. The IMF is given the responsibility for conducting a continuing surveillance over the operation of the international monetary system and members' compliance with their obligations regarding exchange rate policies. This is the heart of the new system, and it represents the potential both for a stronger IMF role in the operation of the balance of payments adjustment process and for a more effective and symmetrical operation of that process.

The central, recurrent international monetary problem in the past half-century has been the system's inability to encourage orderly adjustment in a manner that was generally considered to be equitable and balanced, and which was elastic enough to accommodate widely differing political and social systems and to provide time and scope for adjustment measures that were not unduly harsh or abrupt. The mechanisms of the gold standard and the Bretton Woods system in the end could not meet these tests. Efforts over the years in the IMF, in the OECD, and in periodic summit meetings have not produced lasting improvements in the adjustment process. Nor were the negotiators in the C-20 reform effort able to construct a mechanical apparatus that was adequate to the task.

The new article IV thus focuses on the fundamental sources of imbalance and instability—national policy. All agree in principle that countries in both surplus and deficit have responsibilities for balance of payments adjustment. To date, the IMF's ability to influence national policies has been limited for the most part to those members borrowing in the IMF's credit tranches. The new provisions on IMF surveillance provide the potential for IMF influence on the policies of all members, in surplus and deficit alike, as they bear on the operations of the international adjustment process.

In a real sense, the new system will rely on analysis and judgment—rather than mechanical rules and operating procedures—in the continuing effort to achieve a stable and smoothly operating international balance of payments adjustment process.

The key to successful implementation of the new provisions rests with governmental commitment and efforts to work with and through the IMF to make surveillance effective. The United States is committed to making this process work and thereby improving the balance of payments adjustment process. We have made a number of proposals of a procedural nature aimed at ensuring that the IMF has (a) the information it needs to ensure that surveillance applies equally to surplus and deficit countries; (b) a political level body that is capable of dealing effectively with the difficult issues involved in adjustment; and (c) a means of bringing the full force of its moral suasion to bear on individual countries. We will continue to work to make the new system of IMF surveillance a strong force for a stable international monetary system. We hope that others will join us in this important task.

Conclusion

Some have argued that flexible exchange rate arrangements remove discipline from the world economy by providing governments with an easy way out of their economic problems. Events of the past year highlight the fallacy of that view. Exchange rate changes are a highly visible and merciless barometer of whether a country is pursuing the right policies on growth, inflation, and balance of payments adjustment. The market sets an exacting standard which governments cannot ignore. Some progress has been made in the past year on achieving underlying economic and financial stability, and the new IMF provisions on surveillance represent the potential for much greater—and lasting—progress. Much obviously remains to be accomplished. The daily decisions regarding exchange risk management which you in this audience will make will constitute the report card of how well governments meet the challenge.

Exhibit 56.—Remarks by Secretary Blumenthal, June 15, 1978, at the Ministerial meeting of OECD, Paris, France, on shared problems in the economically interdependent world

Ministers of Finance and Economics find themselves meeting in one international forum or another every few weeks. Their advisers gather even more frequently; their heads of state confer with increasing frequency. We are intensively engaged in international cooperation in all aspects of economic policy. In this economically interdependent world it is essential that this consultation process continue.

Our consultations brought us to an increasing awareness of the complexity of today's economic problems. We are well informed about developments and policies in each other's economies which affect our own economic performance and the effectiveness of our own international policies. We know we share common problems:

- In nearly all our economies, unemployment is too high, especially among our youth, with all that this means in terms of wasted economic and human resources.
- Inflation is too high in nearly all our countries, distorting savings and investment decisions and exacerbating domestic social tensions.
- Most of our countries are experiencing rates of private investment so low as to have adverse implications for the rate of increase in employment and output for the longer run, as well as for the near-term prospect for self-sustaining growth.
- Despite strong resistance by all our governments, protectionist pressures are unabated and continue to take new forms as political pressures mount to save

jobs in sensitive industries or sectors. Our governments are tempted to act in ways which reduce the opportunities for foreign competition in domestic markets or give inappropriate aid to domestic firms to maintain or expand markets abroad. The financing of civil aircraft exports is an example of the type of practice which violates OECD-sanctioned standards of conduct.

- There is a strong temptation to export our problems, rather than taking steps to deal with them at home. It is always easier to postpone painful decisions. But in an increasing number of situations we have allowed supposedly temporary measures to prop up ailing industries or support employment in particular markets or sectors of the economy to become permanent features of our economies.
- Our economies are still struggling to achieve the basic structural changes made necessary by the very abrupt disruptive move from cheap energy to relatively high-cost energy. Our economies also face the need to adjust to the rapid expansion of production of manufactured goods in advanced developing countries. These developments in basic economics—divergent growth, high and diverse rates of inflation, protectionist moves, and difficulties in achieving structural adjustment—have led to imbalances in international payments patterns, to substantial shifts in nominal exchange rates, and at times of quite disorderly conditions in exchange markets. Erratic fluctuations of rates have in turn tended to discourage investment and deter growth.

Our understanding of these common problems has helped us in formulating and implementing policies to alleviate them. We should not underestimate the progress we have made. But much more can be done.

Growth

In the sphere of economic growth, we believe that a number of the countries represented here could expand internal demand over the next year or two at a more rapid rate than they achieved in 1977 without significantly increasing the risk of inflation or materially affecting the rate at which inflation is being reduced. The scope for such action varies from country to country but each of these nations is in a position to take some action as befits the structure and traditions of its economy.

There are a number of other countries among us which could accept the higher domestic growth rates that might result from an expansion of world markets leading to relaxation of a balance of payments constraint. Still others, however, must give priority to the strengthening of stabilization policies, since their primary constraint is domestic inflationary pressures.

My own country falls in this last category. For more than 3 years the average rate of economic growth in the United States has been well in excess of the rate of increase in our potential output. We have added 9.7 million persons to our employment rolls in 38 months, and our unemployment rate has dropped from a peak of 9.1 percent in May 1975 to 6.1 percent in May of this year despite an increase in the labor force. The unemployment rate for male heads of households has been reduced to 2.8 percent. We expect only a small further reduction before the year is out. Increasingly, we shall have to rely heavily on matching labor skills and locations to economic needs to achieve further reductions in unemployment without adding to inflation.

The U.S. inflation rate, as measured by the Consumer Price Index, dropped from 12.2 percent in 1974 to 6.8 percent last year. Recent rates have been even higher due to temporary factors. The underlying rate seems to be stuck between 6 1/2 and 7 percent. We are working hard to bring this so-called underlying rate down still further and are committed to doing so. But for all of 1978 it is likely that the inflation rate will be in the 7-percent range. Thus there are real limits to continued rapid expansion of U.S. domestic demand.

Energy

Energy is a problem. All of us know that if we are going to sustain growth over the medium and long term, we must strengthen our programs to conserve energy and to develop new sources. No nation has a greater responsibility in this area than my own. We are making progress. Our new cars get better mileage. As a result of mandatory standards, the fuel economy of our 1985 automobile fleet will be roughly double, on

average, its 1974 level. More and more Americans are insulating their homes and businesses, and installing fuel-saving furnaces and thermostats. Such actions, together with corresponding efforts in the industrial sector, have reduced the energy required by our economy to produce a dollar of real output by more than 6 percent since 1973. Throughout the economy the trend is toward further energy-saving investments.

But the comprehensive energy legislation which President Carter put before the Congress 14 months ago has not yet been enacted. We are deeply frustrated and embarrassed by this inability of the Congress to act. We have recently redoubled our efforts to assure passage of this critical legislation this year. Progress is being made. Should it fail, the President has made clear that he will take administrative action under existing laws.

Protectionism

Our consultations have also made it obvious that we must work to resist protectionist pressures and reduce governmental interference in the flow of international trade. We have agreed to renew the OECD trade pledge. But there is more that we should do. For one thing, we need to complete the MTN this year with an agreement that provides truly meaningful trade liberalization.

Moreover, we need to go forward—if we are not to be forced backward—in reducing and eliminating destructive competitive practices in official export financing activities. The recently concluded Export Credit Arrangement, while good in its way, goes only part way to meeting the need. The first few months' experience under it strongly suggests that it needs to be strengthened and expanded. And it must be enforced; an agreement serves no purpose unless it is obeyed. The United States will join in the efforts, which should be undertaken immediately, to improve the International Arrangement. But it should be understood that if there are no restraints agreed this year on predatory official export credit competition and such competition continues to escalate, there will be swift and effective U.S. reaction.

The spread of governmental influence on trade has become extremely serious. Our new IMF Articles—article IV—contain a prohibition against action to manipulate exchange rates and the monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. I believe we must now find equivalent means to insure that countries do not manipulate the international trading system, through governmental regulation or subsidy or other actions which have the same effect. In the present situation, with growth still too low and unemployment still too high, there has been an accelerating, destructive tendency to subsidize production in inefficient plants and industries. Though frequently introduced for laudable purposes—maintaining employment and fostering longer term industrial development—such measures have also become a common means of avoiding structural adjustment. In the process, trade flows are affected and trading patterns become distorted, just as with more traditional protectionist measures such as tariffs or quotas.

Thus I strongly support the proposals which have been developed for a policy stance favoring, rather than resisting, needed structural adjustment. We must actively promote the dynamic changes in our economics required by high energy costs, by the need for balance of payments adjustment, by technological change, and by world progress generally. Avoiding the short-term costs of structural change now merely multiplies the inevitable, eventual price we must pay.

We must, in addition, adjust our economies to the very rapid surge of production of manufactured goods in the more advanced developing nations. We have for years encouraged the cry for "trade, not aid." Quite a number of nations are ready to take us up. We must keep our markets open to these nations and adjust our own production to supply the goods these nations seek. At the same time, these countries must come to a better understanding of their responsibilities in opening their markets and reducing and eliminating their export subsidies.

Many developing countries still have a need for resource inflows to support development programs which they are not in a position to finance fully by borrowing from the private markets. In fact, the magnitudes required continue to increase, even though the number of countries requiring such aid is diminishing.

Most of the members of this organization maintain bilateral aid programs and also provide funds to the international development lending institutions. Every effort should be made to increase the amount of these contributions. It is President Carter's objective to increase the size of U.S. official assistance to LDC's substantially. U.S. aid commitments for the current fiscal year are expected to be \$6.8 billion, an increase of \$1.2 billion from FY 1977. Congressional approval of our FY 1979 budget request would lead to a further increase in commitments to \$7.6 billion next year.

Those nations among us who find their external payments positions in strong and persistent surplus should make a particular effort to expand their aid programs quickly and to untie their aid.

These areas—noninflationary growth, trade liberalization, positive adjustment, including export credit cooperation, energy, and aid—constitute the basic elements of an action program which would gradually ease the problems which plague the economic policy makers.

Stability in exchange markets

Adequate progress in these areas will also bring with it stability in foreign exchange markets and greater stability in exchange rates. Stability in foreign exchange markets will feed back on investment and trade prospects and help us to achieve our growth targets. Maintaining this stability is important to us all—as important to the United States as to any nation here.

Thus the United States is prepared to work for exchange market stability. Markets can become disorderly, subject to great uncertainty, dominated by psychological factors and speculation. We have made clear that we are fully prepared to intervene in the markets to counter such disorders. We have intervened, at times in large amounts, for that purpose. And we have taken other steps, such as interest rate moves by the Fed and announcement of gold sales by the Treasury, that appear to have been useful in strengthening the tone of the market. The resources at our disposal for intervention are very large and we are prepared to use them if and as required to counter market disorders.

But all of us know that the real key to reductions in the speed and extent of changes in foreign exchange rates and to stability in foreign exchange markets lies in better performance on the "fundamentals." The maldistribution of external payments balances has resulted from the simultaneous impact of widely divergent rates of inflation and, even more important, an unusually wide divergence in rates of growth and capacity utilization as well as the structural disruption of the oil price shock. When we collectively demonstrate to the financial community that growth will improve and that both the rate and the divergence in inflation rates among nations will diminish, there will be less movement of exchange rates and less risk of disorder in the foreign exchange markets. The IMF will be developing detailed procedures for implementing its new responsibilities for multilateral surveillance of the economic policies which provide the basis for exchange rate stability.

Development of political will

As finance or economic ministers, each of us has been seeking to put in place the policies which will best meet the problems of our respective countries. Each of us represents a sovereign nation, which of course makes its own decision within the framework of its own political system. Each must respond to the national self-interest as perceived by his own electorate.

The message I hope Ministers have drawn from all our consultations and all the information about developments elsewhere is that, in the long run, the national self-interest of each nation is best served by policies which foster a healthy world economy—a world economy of sustainable growth with reasonable price stability in the context of an open, liberal trade and payments system. Moreover, it requires that international implications be factored into the decisionmaking in virtually all aspects of domestic economy policy—even in a country like the United States where exports are only 7 1/2 percent of GNP.

What it also means is that when national economic policies are properly coordinated they will be mutually reinforcing. If we all move forward together, we will all move forward farther.

I hope that this meeting will lay the basis for what the Secretariat has called a program of concerted action, with each participant undertaking actions appropriate to his own situation but mutually reinforcing in the international context.

We all know what should be done. Our common task is to explain the need for action to our own peoples and to build the domestic political support which will enable us to carry out the policies required to succeed individually and collectively. Our destinies are inextricably linked. We must go forward together or not at all.

Exhibit 57.—Text of the declaration issued following the meeting of heads of state or government of Canada, the Federal Republic of Germany, France, Italy, Japan, the United Kingdom of Great Britain and Northern Ireland, and the United States of America, July 16–17, 1978, in Bonn, West Germany (official English version)

The heads of state and Government of Canada, the Federal Republic of Germany, France, Italy, Japan, the United Kingdom of Great Britain and Northern Ireland and the United States of America met in Bonn on 16th and 17th July 1978. The European Community was represented by the president of the European Council and by the president of the European Commission for discussion of matters within the community's competence.

1. We agreed on a comprehensive strategy covering growth, employment and inflation, international monetary policy, energy, trade and other issues of particular interest to developing countries. We must create more jobs and fight inflation, strengthen international trading, reduce payments imbalances, and achieve greater stability in exchange markets. We are dealing with long-term problems, which will only yield to sustained efforts. This strategy is a coherent whole, whose parts are interdependent. To this strategy, each of our countries can contribute. From it, each can benefit.

Growth, employment and inflation

2. We are concerned, above all, about worldwide unemployment because it has been at too high a level for many years, because it hits hardest at the most vulnerable sections of the population, because its economic cost is high and its human cost higher still. We will act, through measures to assure growth and develop needed skills, to increase employment. In doing this, we will build on the progress that has already been made in the fight against inflation and will seek new successes in that fight. But we need an improvement in growth where that can be achieved without rekindling inflation in order to reduce extremes of balance-of-payments surpluses and deficits. This will reduce destabilizing exchange-rate movements.

Improved growth will help to reduce protectionist pressures. We need it also to encourage the flow of private investment, on which economic progress depends. We will seek to reduce impediments to private investment, both domestically and internationally. Better growth is needed to insure that the free world is able to develop to meet the expectations of the citizens and the aspirations of the developing countries.

3. A program of different actions by countries that face different conditions is needed to assure steady noninflationary growth. In countries whose balance-of-payments situation and inflation rate does not impose special restrictions, this requires a faster rise in domestic demand. In countries where rising prices and costs are creating strong pressures, this means taking new measures against inflation.

- Canada reaffirmed its intention, within the limits permitted by the need to contain and reduce inflation, to achieve higher growth of employment and an increase in output of up to 5 percent.
- As a contribution to avert the worldwide disturbances of economic equilibrium the German delegation has indicated that by the end of August it will propose to the legislative bodies additional and quantitatively substantial

measures up to 1 percent of gross national product, designed to achieve a significant strengthening of demand and a higher rate of growth. The order of magnitude will take account of the absorptive capacity of the capital market and the need to avoid inflationary pressures.

- The president of the French Republic has indicated that, while pursuing its policy of reduction of the rate of inflation, the French Government agrees, as a contribution to the common effort, to increase by an amount of about 0.5 percent of G.N.P. the deficit of the budget of the state for the year 1978.
- The Italian Prime Minister has indicated that the Government undertakes to raise the rate of economic growth in 1979 by 1.5 percentage points with respect to 1978. It plans to achieve this goal by cutting public current expenditure while stimulating investment with the aim of increasing employment in a noninflationary context.
- The Prime Minister of Japan has referred to the fact that his Government is striving for the attainment of the real growth target for fiscal year 1978, which is about 1.5 percentage points higher than the performance of the previous years, mainly through the expansion of domestic demand. He has further expressed his determination to achieve the said target by taking appropriate measures as necessary. In August or September he will determine whether additional measures are needed.
- The United Kingdom, having achieved a major reduction in the rate of inflation and improvement in the balance of payments has recently given a fiscal stimulus equivalent to rather over 1 percent of G.N.P. The Government intends to continue the fight against inflation so as to improve still further the prospects for growth and employment.
- The President of the United States stated that reducing inflation is essential to maintaining a healthy United States economic policy. He identified the major actions that have been taken and are being taken to counter inflation in the United States: tax cuts originally proposed for fiscal year 1979 have now been reduced by \$10 billion. Government expenditure projections for 1978 and 1979 have been reduced. A very tight budget is being prepared for 1980. Steps are being taken to reduce the direct contribution by Government regulations or restrictions to rising costs and prices, and a voluntary program has been undertaken to achieve deceleration of wages and prices.
- The meeting took note with satisfaction that the common approach of the European Community already agreed at Bremen would reinforce the effectiveness of this program.

Energy

4. In spite of some improvement, the present energy situation remains unsatisfactory. Much more needs to be done.

5. We are committed to reduce our dependence on imported oil.

6. We note that the European Community has already agreed at Bremen the following objectives for 1985: to reduce the community's dependence on imported energy to 50 percent, to limit net oil imports, and to reduce to 0.8 the ratio between the rate of increase in energy consumption and the rate of increase in gross domestic product.

7. Recognizing its particular responsibility in the energy field, the United States will reduce its dependence on imported oil. The United States will have in place by the end of the year a comprehensive policy framework within which this effort can be urgently carried forward. By year end, measures will be in effect that will result in oil import savings of approximately 2.5 million barrels per day by 1985. In order to achieve these goals, the United States will establish a strategic oil reserve of 1 billion barrels. It will increase coal production by two-thirds, it will maintain the ratio between growth in gross national product and growth in energy demand at or below 0.8 and its oil consumption will grow more slowly than energy consumption. The volume of oil imported in 1978 and 1979 should be less than that imported in 1977. In order to discourage excessive consumption of oil and to encourage the movement toward coal, the United States remains determined that the prices paid for oil in the United States shall be raised to the world level by the end of 1980.

8. We hope that the oil-exporting countries will continue to contribute to a stable world energy situation.

9. Looking to the longer term, our countries will review their national energy programs with a view to speeding them up. General energy targets can serve as useful measures of the progress achieved.

10. Private and public investment to produce energy and to use it more efficiently within the industrial world should be increased. This can contribute significantly to economic growth.

11. The further development of nuclear energy is indispensable, and the slippage in the execution of nuclear power programs must be reversed. To promote the peaceful use of nuclear energy and reduce the risk of nuclear proliferation, the nuclear-fuel cycle studies initiated at the London summit should be pursued. The President of the United States and the Prime Minister of Canada have expressed their firm intention to continue as reliable suppliers of nuclear fuel within the framework of effective safeguards. The President intends to use the full powers of his office to prevent any interruption of enriched uranium supply and to insure that existing agreements will be respected. The Prime Minister intends that there shall be no interruption of Canadian uranium supply on the basis of effective safeguards.

12. Coal should play an increasingly important role in the long term.

13. Joint or coordinated energy research and development should be carried out to hasten the development of new, including renewable, energy sources and the more efficient use of existing sources.

14. In energy development, the environment and human safety of the population must be safeguarded with greatest care.

15. To help developing countries, we will intensify our national development assistance programs in the energy field and we will develop a coordinated effort to bring into use renewable energy technologies and to elaborate the details within one year. We suggest that the O.E.C.D. will provide the medium for cooperation with other countries.

16. We stress the need for improvement and coordination of assistance for developing countries in the energy field. We suggest that the World Bank explore ways in which its activities in this field can be made increasingly responsive to the needs of the developing countries, and to examine whether new approaches, particularly to financing hydrocarbon exploration, would be useful.

Trade

17. We reaffirm our determination to expand international trade, one of the driving forces for more sustained and balanced economic growth. Through our joint efforts we will maintain and strengthen the open international trading system. We appreciate and support the progress as set forth in the framework of understanding on the Tokyo Round of multilateral trade negotiations made public in Geneva, July 13, 1978, even though within this framework of understanding some difficult and important issues remain unresolved.

The successful conclusion of these negotiations, the biggest yet held, would mean not just a major trade-liberalization program extending over the 1980's but the most important progress yet made in the GATT in relation to nontariff measures. Thus the GATT rules would be brought more closely into line with the requirements of the next decade — particularly in relation to safeguards — in ways which would avoid any weakening of the world trading system and be of benefit to all trading countries, developed and developing alike. A substantially higher degree of equity and discipline in the international trading system would be achieved by the creation of new mechanisms in many fields for consultation and dispute settlement. Uniform application of the GATT rules is vital and we shall move in that direction as soon as possible.

In all areas of the negotiations the summit countries look forward to working even more closely with the developing countries. We seek to insure for all participants a sound and balanced result, which adequately takes into account the needs of developing countries, for example, through special and differential treatment, and which brings about their greater participation in the benefits and obligations of the world trading system.

At least year's Downing Street summit we rejected a protectionist course for world trade. We agreed to give a new impetus to the Tokyo Round. Our negotiators have fulfilled that commitment. Today we charge them, in cooperation with the other participants, to resolve the outstanding issues and to conclude successfully the detailed negotiations by Dec. 15, 1978.

18. We note with satisfaction the renewal of the pledge to maintain an open-market oriented economic system made by the O.E.C.D. Council of Ministers last month. Today's world economic problems cannot be solved by relapsing into open or concealed protectionism.

19. We welcome the statement on positive adjustment policy made by the O.E.C.D. ministers. There must be a readiness over time to accept and facilitate structural change. Measures to prevent such change perpetuate economic inefficiency, place the burden of structural change on trading partners and inhibit the integration of developing countries into the world economy. We are determined in our industrial, social, structural and regional policy initiatives to help sectors in difficulties, without interfering with international competition and trade flows.

20. We note the need for countries with large current account deficits to increase exports and for countries with large current account surpluses to facilitate increases in imports. In this context the United States is firmly committed to improve its export performance and is examining measures to this end. The Prime Minister of Japan has stated that he wishes to work for the increase of imports through the expansion of domestic demand and various efforts to facilitate imports. Furthermore, he has stated that in order to cope with the immediate situation of unusual surplus, the Government of Japan is taking a temporary and extraordinary step of calling for moderation in exports with the aim of keeping the total volume of Japan's exports for the fiscal year of 1978 at or below the level of fiscal 1977.

21. We underline our willingness to increase our cooperation in the field of foreign private investment flows among industrialized countries and between them and developing countries. We will intensify work for further agreements in the O.E.C.D. and elsewhere.

22. In the context of expanding world economic activity, we recognize the requirement for better access to our countries' markets for the products of the developing countries. At the same time we look to increasing readiness on the part of the more advanced developing countries to open their markets to imports.

23. Success in our efforts to strengthen our countries' economies will benefit the developing countries, and their economic progress will benefit us. This calls for joint action on the basis of shared responsibility.

24. In the years ahead the developing countries, particularly those most in need, can count on us for an increased flow of financial assistance and other resources for their development. The Prime Minister of Japan has stated that he will strive to double Japan's official development assistance in three years. We deeply regret the failure of the Comecon countries to take their due share in the financial assistance to developing countries and invite them once more to do so.

25. The poorer developing countries require increased concessional aid. We support the soft loan funds of the World Bank and the three regional development banks. We pledge our governments to support replenishment of the International Development Association on a scale that would permit its lending to rise annually in real terms.

26. As regards the more advanced developing countries, we renew our pledge to support replenishment of the multilateral development banks' resources, on the scale needed to meet the growing needs for loans on commercial terms. We will encourage governmental and private cofinancing of development projects with these banks.

The cooperation of the developing countries in creating a good investment climate and adequate protection for foreign investment is required if foreign private investment is to play its effective role in generating economic growth and in stimulating the transfer of technology.

We also refer to our efforts with respect to developing countries in the field of energy as outlined in paragraph 15 and 16.

27. We agreed to pursue actively the negotiations on a Common Fund to a successful conclusion and to continue our efforts to conclude individual commodity agreements and to complete studies of various ways of stabilizing export earnings.

International monetary policy

28. The erratic fluctuations of the exchange markets in recent months have had a damaging effect on confidence, investment and growth throughout the world. Essentially, exchange rate stability can only be achieved by attacking the fundamental problems which have contributed to the present large balance-of-payments deficits and surpluses. Implementation of the policies described above in the framework of a concerted program will help to bring about a better pattern of world payments balances and lead to greater stability in international exchange markets. This stability will in turn improve confidence and the environment for sustained economic growth.

29. Although exchange rates need to respond to changes in underlying economic and financial conditions among nations, our monetary authorities will continue to intervene to the extent necessary to counter disorderly conditions in the exchange markets. They will maintain extensive consultation to enhance these efforts' effectiveness. We will support surveillance by the International Monetary Fund to promote effective functioning of the international monetary system.

30. The representatives of the European Community informed the meeting of the decision of the European Council at Bremen on 6-7 July to consider a scheme for a closer monetary cooperation. The meeting welcomed the report and noted that the community would keep the other participants informed.

Conclusion

31. It has been our combined purpose to attack the fundamental economic problems that our countries confront.

The measures on which we have agreed are mutually reinforcing. Their total effect should thus be more than the sum of their parts. We will now seek parliamentary and public support for these measures.

We cannot hope to achieve our purposes alone. We shall work closely together with other countries and within the appropriate international institutions; those among us whose countries are members of the European Community intend to make their efforts within this framework.

We have instructed our representatives to convene by the end of 1978 in order to review this declaration. We also intend to have a similar meeting among ourselves at an appropriate time next year.

Exhibit 58.—Statement by Assistant Secretary Bergsten, July 19, 1978, before the Joint Economic Committee, entitled "International Economic Policy—Where We Stand"

I welcome this opportunity to discuss with you longer term problems in the international economy. Far too often, the Congress and the executive branch focus solely on the short run. While this "firefighting" approach is inevitable to some extent, it is essential occasionally to step back and review the broader and longer term issues—and how our country is seeking to deal with them. The Carter administration has been in office a year and a half, and it is thus particularly timely to review our international economic policies.

Philosophy

The administration's philosophy centers on two basic factors: (1) The need to maintain and strengthen an open trade and payments system; (2) the requirements of global economic interdependence.

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 worldwide, 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.

But trade relations must be reciprocal. 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 undertake efforts to offset such distortions, both to defend our own producers and to try to deter others from interfering in these markets themselves.

This is a basic tenet of our philosophy—"domestic" and "international" economic issues are inextricably linked. The pressures on governments to intervene in private markets, in pursuit of their numerous policy objectives, is matched by their increased dependence on external transactions. On the one hand, this adds to the temptation to manipulate international flow. On the other hand, it compels countries to play by the international rules if they are to avoid self-defeating retaliation or evaluation by other countries. Hence increased interdependence simultaneously produces centrifugal and centripetal forces as regards the maintenance of an open world economy based largely on market principles.

Faced with this situation, the United States—to oversimplify for presentational purposes—faces two basic choices: To fight, or to join the trend toward increased government involvement abroad. In practice, we will of course do some of both.

But our basic philosophy is to resist this trend in the hope and belief that the market-oriented approach is both far superior and likely, over time, to prevail. In many key instances—such as the adoption by most major countries of flexible exchange rates, and the recent progress at Geneva in reducing tariffs and other barriers to trade—there has recently been impressive evidence of the vitality of the market approach, and the confidence of nations in it.

The maintenance of an open trading system produces essential support for jobs abroad and jobs in the United States, both directly and through its effects on the policies of others. A well-functioning monetary system, sustained, noninflationary growth abroad, reasonably stable commodity prices, and healthy international competition are essential components of our fight against inflation and unemployment.

Strategy

The strategy we have developed for converting philosophy into concrete results is multifaceted. We have operated simultaneously on a number of fronts: Macroeconomic policies at home and abroad; trade policy in general and the MTN in particular; further improvement in the international monetary system; more effective economic relationships between the industrialized and developing countries; and energy. Actions on each front are consistent with our basic approach; each reinforces other elements in the overall strategy. The list of specific parts of the entire program is rather long.

On *macroeconomic policy*, we have focused our domestic efforts on maintaining adequate growth, reducing unemployment, and controlling inflation. In discussions with our allies, we have pressed for accelerated growth wherever possible and for restraint where necessary due to domestic or external imbalances.

In pursuing the *multilateral trade negotiations*, we have pushed for maximum tariff cuts, sought reductions in nontariff barriers, supported a new internal trading framework, and argued for controls on subsidies and export credit competition.

In the *monetary* field, we have maintained our support for the system of flexible exchange rates, emphasized the need to address fundamental imbalances in order to restore international financial stability, increased efforts at expanding U.S. exports to promote the strength and stability of the dollar, intervened in the exchange markets where necessary to counter disorderly conditions, proposed legislation for expanding IMF resources through the Witteveen Facility, sought a better definition of the concept of IMF surveillance over the exchange rate system, and increased the availability of data on private bank lending to assess more closely any risks involved in bank exposure in foreign countries.

We have had constant discussions with the *developing countries* regarding commodity agreements, reduction of trade barriers, and a possible common fund, and have expanded our own foreign assistance efforts considerably.

Finally, in the *energy* field, we have continuously pushed for a comprehensive national energy policy, worked actively with OPEC and other countries to limit the world price of oil, and pursued multilateral discussions on longer term energy policies in the International Energy Agency.

Our ability to pursue these several initiatives successfully will be a major factor in providing answers to the questions raised in your letter of invitation, Mr. Chairman:

- The evolution of the U.S. balance of payments will be determined largely by the relationship between economic growth rates at home and abroad (in both the industrialized and developing countries), by our success in controlling our own rate of inflation and our appetite for oil imports, by our national export effort and the willingness of other countries to reduce their barriers to imports.
- The OPEC surplus, which will decline sharply this year to under \$20 billion, will turn largely on the evolution of demand for energy in this country and abroad, our success in developing new sources of energy production around the world, rates of economic growth, the stability of the international monetary system (because of its impact on decisionmakers in the OPEC countries), and our ability to work constructively together both with other oil-importing countries and with the OPEC countries themselves in their efforts to develop their own economies.
- The debt problems of the developing countries will turn on the growth and stability of the economies of the industrialized countries, the evolution of the world price of oil, the willingness of all countries to maintain open markets for LDC exports and to provide adequate flows of public and private capital in support of development, and the wisdom of the development policies which the developing countries adopt themselves.

This tabulation of our international economic policy efforts, and their implications, for some of the most important policy issues which we face, illustrates the interrelationships between our strategy and philosophy, the breadth of our activity in the international economic area, and the inextricable links between domestic and international issues. I would like to discuss some of the more directly international aspects of these actions in somewhat more detail.

International monetary system

Our basic approach to international monetary affairs centers on our approach to the domestic economy. It aims at the fundamentals of price stability and continued economic growth, and seeks as well to curb oil imports and expand U.S. exports. The success of our international financial policy will ultimately be determined by our success in addressing these four basic issues.

Reinforcing this strategy are our efforts to strengthen the operation of the international monetary system itself. The system encompassed in the new amendment to the IMF Articles of Agreement retains the basic Bretton Woods philosophy of cooperation and liberal trade and payments. But it moves away from trying to force stability on nations through an external mechanism—as the gold standard to an extreme degree, and the Bretton Woods system to a lesser degree, had tried but failed.

Instead, it aims at developing stability through the application of sound underlying economic and financial policies in individual countries. It is a more realistic, more pragmatic approach. It focuses attention less on the symptoms of instability in the world economy such as conditions in the exchange markets and more on the root cause: the pursuit of divergent, and in some cases inappropriate, national policies by individual countries.

The main obligations placed on nations under the new IMF Articles are twofold. First, each nation must endeavor to direct its policies toward orderly growth with reasonable price stability. Second, each nation must avoid manipulation of its exchange rate to avoid adjustment or gain unfair competitive advantage.

These are tough demands. The monetary system would function well if all nations followed sensible policies directed toward noninflationary growth, and if they did not

try to maintain exchange rates at artificial levels. But we must frankly acknowledge that neither the new monetary system, nor any conceivable alternative system, can force sovereign nations against their will to adopt particular domestic economic and financial policies.

Those who seek refuge in an automatic self-policing monetary system are chasing shadows. History clearly shows that monetary stability and underlying economic stability do tend to coexist, and to be mutually reinforcing, but that the causality runs primarily from underlying national stability to the international arena, rather than vice versa.

What we can do—and are trying to do—is to increase the extent to which national policies make a positive contribution to international stability and the degree to which the international system contributes to constructive national policies. German and Japanese growth policy is made by German and Japanese authorities but should be made with a view to their global impact. American economic and energy policy is made by the President and the Congress but must take their international effects fully into account. The exchange markets give strong signals to all these authorities and point to the costs of inadequate action on all such issues. Today's system provides the basis for this two-way interaction; all of our efforts such as this week's summit aim to operate it more effectively.

Trade relations

Perhaps in no other area has the administration moved simultaneously on so many fronts. The maintenance of an open and liberal trading system is a keystone of our international economic policies. In pursuit of this goal, we have been actively involved in the MTN, including proposals for revitalizing the GATT; discussions on a wide variety of commodity issues; and the development of positive adjustment programs.

In the recently completed high-level discussion in Geneva on the MTN, we have sought a new international trading framework which will address a wide variety of major problems: Injurious import competition, government subsidization, government procurement, the use of export controls, the role of the developing countries, methods of dispute settlement. The new trade rules are needed to complement the new international monetary system of flexible exchange rates, by updating the existing body of international rules to meet the demands of a rapidly changing international economy and providing a cooperative basis for addressing and resolving mutual problems. As in the monetary area, the new trading framework must be flexible and recognize that the needs and problems of domestic economies will differ among nations yet provide acceptable guidelines and limitations upon national actions that interfere with trade flows.

In addition to these new codes and understandings, we also need to look beyond the MTN and to the need for improved mechanisms of cooperation in trade among nations. We need to assure that trade problems can be addressed and mutually resolved before they erupt in open conflict. To do so, we must inter alia expand the means and mechanisms for increasing participation by the more advanced developing nations (ADC's) in the global economy both through improved consultation and rights, and through their acceptance of greater responsibilities in international trade.

Relations with developing countries

Building better relationships with the developing world has been a primary goal of this administration. Our major instruments to that end are to provide foreign assistance, conclude mutually beneficial commodity agreements where appropriate, negotiate an effective, financially sound common fund, and reduce barriers to trade.

To assist the developing countries in meeting their development needs, we have sought sharply increased levels of foreign assistance. To increase the effectiveness of our effort to eradicate the worst forms of poverty, we have targeted our bilateral assistance on meeting basic needs—in agriculture, education, and health—of the poorest. We have also encouraged the multilateral development banks to increase their emphasis on meeting basic human needs, while recognizing the crucial role of these institutions in other areas such as infrastructure. While a greater deal still needs to be

done, we can already see positive results from our efforts: Increases in health standards and life expectancy, better education systems, faster economic growth, and in a number of countries declines in the rate of population growth.

The FY 1979 appropriations bill for foreign assistance and related programs is now before the Congress for floor action. The bill has been extensively cut in committee, and further cuts are threatened on the floor. Moreover, appropriations for the multilateral banks are severely threatened by possible restrictive amendments on either country or commodity grounds. The banks cannot accept any funds with such restrictions attached, so such amendments would severely undermine our continued participation in them—a participation that is vital to our Nation's economic and political interests. I urge your support for the amounts recommended by the Appropriations Committee, and ask your help in averting the adoption of restrictive amendments.

In the wake of the massive economic dislocations brought about by the oil crisis, the establishment of a cohesive set of policies dealing with commodity prices has been a major aim of our development policy. Over the past 18 months, we have sought to develop a comprehensive approach to this issue which can provide substantial benefits to both consumers and producers of primary commodities in the United States and in other countries.

That policy seeks to integrate domestic and international elements into a single, coherent approach. In so doing, it has focused on five policy instruments:

- International commodity agreements between producers and consumers to reduce excessive price volatility in world commodity markets. We have negotiated a sugar agreement, agreed to contribute to the buffer stock of the tin agreement, laid the basis for negotiating natural rubber and wheat agreements, seriously considered the possibilities of a copper agreement, and indicated our willingness to participate in a renegotiation of the cocoa agreement.
- A common fund which, by pooling the financial resources of individual commodity agreements, would provide for adequate financing of agreements while reducing the budgetary burden on individual governments.
- Promotion of increased productive capacity abroad for key raw materials through greater activity by the World Bank, the regional development banks, and our own Overseas Private Investment Corporation (OPIC).
- A strategic stockpile policy based on revised strategic objectives and implemented in ways which are consistent with our national and international economic goals.
- Support for the stabilization of export earnings of producing countries through the compensatory financing facility of the International Monetary Fund.

A key component of U.S. policy toward the developing nations is general trade relations. Their need for access to our markets for manufactured products comes at a difficult time because our own unemployment remains too high and our trade deficit has reached record proportions.

Nevertheless we must recognize that these countries are large and growing markets for our exports. We believe that open trading arrangements are very much in the interests of the United States to minimize inflation, to create millions of export- and import-related jobs, and to avoid the imposition of nontrade restrictions in other countries. The administration has therefore resisted proposals for wide-ranging curbs on U.S. imports from the developing (and other) countries, as an essential element of our approach to the developing countries. In addition, the multilateral trade negotiations seek to further reduce barriers to international trade, particularly for products sold by the developing countries.

Conclusion

Given this long and complex shopping list, one cannot expect instant results. In some areas, our strategy has already produced significant successes. In others, there is movement in the right direction. In still others, we have recorded less progress so far.

In any event, it is clear that much work remains to be done if we are to maintain an open international economic system in today's interdependent world.

First and foremost, we must have congressional action on energy.

Second, we must move forward to complete the MTN and develop a new international trading framework.

Third, we need to develop guidelines for IMF surveillance of exchange rates as a prerequisite for a smoothly operating international monetary system.

Fourth, we need to develop a means for more effectively including the ADC's in the international system. They are fast becoming important actors, but they are not yet active in many of the major international institutions where global problems are discussed.

Progress in all of these areas is necessary in our continued pursuit of economic and political gains for both the United States and the world economy as a whole. I greatly welcome this opportunity to discuss the whole range of matters with you.

Exhibit 59.—Statement by Under Secretary for Monetary Affairs Solomon, July 24, 1978, before the Subcommittee on Economic Policy of the Senate Committee on Foreign Relations, on the role of the dollar and other currencies in the international monetary system

Your hearings are covering a wide range of policy issues. My statement will be directed toward that part of your agenda dealing with the role of the dollar and other currencies in the international monetary system. Specifically, my comments are focused on two questions: What should the U.S. attitude be toward the reserve currency role of the dollar? and what should the U.S. attitude be toward proposals for European monetary integration?

Reserve currency role of the dollar

The large expansion in the dollar's reserve currency role arose not by design but through the evolution of the international monetary system following the Bretton Woods agreement in 1944. In the years after World War II, the dollar increasingly assumed a central role in the system. Other countries expressed their par values in terms of dollars; intervened in their exchange markets to maintain par values by buying and selling dollars; and financed much of their balance of payments surpluses and deficits by increasing or reducing their dollar balances. Private firms and foreign governments borrowed in the United States because our capital markets were the largest, most efficient, and, except for the period of the mid-1960's and early 1970's, readily accessible. In part because the rest of the world on balance wanted to run surpluses and many individual countries set their exchange rates vis-a-vis the dollar to achieve that goal, the U.S. balance of payments and reserve position weakened progressively. And there was no practical scope for the United States to adjust the dollar's exchange rate to halt and reverse that trend.

The question whether that system—particularly the dollar's reserve role—imposed heavy costs on the United States or gave us special benefits was debated for many years but never resolved. The system clearly did constrain our ability to undertake needed exchange rate adjustment. But it also provided a form of external financing not available to others. The ease of financing for the United States was seen as an unfair privilege by others. But the costs of the system to the U.S. economy became increasingly important. Those costs took the form of an overvalued dollar and undervalued currencies abroad. The misalignment of rates created an artificial incentive for foreign and U.S. investors to locate productive facilities abroad rather than in the United States. It cost us in competitiveness and jobs, while it contributed to the evolution of export-dependent foreign economies.

With the move in recent years to a more flexible exchange rate system, both the costs and the benefits of the reserve currency role of the dollar have been greatly reduced. The freedom of the dollar to adjust is now much greater, and the freedom of other countries to choose to accept or not accept dollar inflows is also much greater.

Although the constraints on the United States have been reduced, they have not been eliminated. We are not in a world of freely floating exchange rates in which there would be greatly reduced need for reserve currencies. Instead, we are in a world in which there are restraints on exchange rate adjustment, a world in which there is still a considerable amount of exchange market intervention, to counter market disorder or, in some cases, for other purposes.

A nation realistically cannot have and should not expect total freedom of exchange rate behavior—any exchange rate is of legitimate interest to at least two nations. This concept is recognized in the new IMF Articles, which provide nations freedom of *choice* in adopting exchange rate arrangements, but not freedom of *behavior*. Most importantly, the Articles enjoin countries to avoid manipulating their exchange rate to prevent effective balance of payments adjustment or gain unfair competitive advantage. This is an important new obligation. It says, in effect, that *prevention* of exchange rate change, in either direction, can be undesirable and harmful, just as “competitive devaluation” was considered undesirable in the Bretton Woods system. We will rely on IMF surveillance to assure that this obligation is fulfilled.

Thus, if the international monetary system operates in the way we envisage, the important systemic bias of the par value system against exchange rate adjustment will have been reduced but not eliminated. There will continue to be intervention to influence rates, and there will continue to be large dollar balances held in official reserves. The question arises whether the continued existence of large dollar balances in official reserves—or, more broadly, the wide use of the dollar in international transactions—imposes an undesirable burden on the United States. That is, does this use put pressure on us to follow domestic policies that we should not otherwise want to follow?

I believe that the broad international role of the dollar *does* reinforce our responsibility to maintain economic discipline—to get the fundamentals straight and keep them straight. The exchange markets reflect assessments of official policies here and abroad, and assessments of those policies made by holders of dollar-denominated assets are a legitimate part of that process.

There are two points that should be made here:

- The first is that a distinction must be drawn between private and official balances. Private balances are quite volatile at times. The official balances are much less so. Shifting of official dollar balances has not been particularly significant, though there have been some minor movements. On the whole, central banks are careful not to take actions to disrupt the markets.
- The second is that ownership is not the dominant consideration. Even if foreigners—private or official—did not hold large volumes of dollar-denominated assets, there would still be the potential for large-scale capital movements and pressures on rates when underlying positions and payments balances get out of line. Particularly for the United States, with our huge volume of international transactions in trade and services, and our large, open capital markets, there is ample scope for capital movements quite independent of the existing stock of foreign-held dollar-denominated assets.

Stressing the potential volatility of the private markets, some commentators have suggested that the United States should attempt to restrict private international use of the dollar and remove any pressures arising from that use through imposition of capital controls. I do not believe that would be a desirable or fruitful approach. In my judgment, the existence of relatively open and efficient capital markets in the past few years of severe imbalance and strain has been of enormous benefit to the world economy and our own. Our experience during the 1960's suggests that controls would not be very effective very long, and controls on outflows could discourage needed inflows. Nor do I think that is the heart of our problems.

Another proposal has been put forward which would have the IMF provide open-ended exchange rate guarantees for all present and future official dollar balances. This proposal is based on the hypothesis that foreign monetary authorities have an unyielding desire to shift portfolios out of dollars into other currencies, regardless of the state of the dollar, the U.S. balance of payments, or anything else. I find no facts to support this hypothesis; there has been no decline in the ratio of dollars as a percent of total foreign currency holdings over a long period of years. Even if the hypothesis were valid, I do not think an open-ended exchange rate guarantee arrangement would be either practical or wise. One implication of such an arrangement would mean that any foreign country which wished to do so could intervene to prevent all changes in the dollar exchange rate vis-a-vis its currency without being subjected to any exchange risk.

The adoption of capital controls or exchange rate guarantees is not the way to assure a strong dollar and an appropriate dollar exchange rate.

Action to cut inflation, to curb our dependence on imported oil, to improve our export performance is needed. It is needed not only because of the balance of payments but also because it is right for our own economy and well-being. We are taking important steps to correct our underlying position, and the exchange markets have responded well to the evidence of our intentions. If we deal with the basic problems, I have every confidence that this will be reflected appropriately in financial markets. We will face constraints under any international monetary system that can be devised. But I do not believe that the dollar's reserve currency role under the present system, or the existence of large foreign dollar balances—private or official—and open capital markets, have caused us to follow policies that are inconsistent with our economic interests or could otherwise have been avoided. Nor do I feel that these factors have created pressures that were not warranted by underlying conditions.

Should the United States make an active effort to get out of the reserve currency role—speaking here of the reserves of official institutions? My judgment is that the reserve role is not a significant source of our problems, and changes in the reserve role should not be the focal point of our efforts to improve the functioning of the system. And, most importantly, moves designed to change significantly the dollar's reserve role are likely to have broader implications for other aspects of the international monetary system which are far more important, and which must be considered carefully. We should not change the system unless we see a better alternative, and I do not at present see an alternative that is both feasible and attractive.

Looking ahead, there may of course be further changes in the monetary system. It seems to me that a realistic possibility would be for other currencies or the SDR to assume gradually over time a larger role as an international monetary reserve, supplementing the dollar. In principle, I would not oppose such a development as a natural evolution in the system though the way in which such an evolution would occur is not yet clear, and I would want to evaluate such changes in terms of the objective of a smoothly functioning world monetary system.

I do not believe the United States has an interest in trying to maintain a particular international role for the dollar if that does not correspond to the needs of a liberal, efficient system of international trade and investment. The role of the dollar has evolved not because it was legislated but because economic and financial forces demanded it. If those forces change as the world economy evolves, efforts to preserve that role would not succeed.

Proposals for European monetary cooperation

Against this background, what should be the U.S. attitude toward recent proposals for European monetary integration?

At a meeting of heads of government in Bremen earlier this month, the EC countries agreed that a closer monetary cooperation within the Community was a desirable objective. The Chancellor of the Federal Republic of Germany and the President of France presented the broad outline of a plan to create a "zone of monetary stability." The EC leaders agreed that this plan should be used as a point of departure for further study.

The EC Finance Ministers are meeting today to develop guidelines for a study to be conducted and completed by the competent EC bodies by October 31. The hope is that final decisions can be taken at a European Council meeting on December 4-5.

The main elements of the German-French proposal include:

- Exchange rate arrangements that limit fluctuations among European currencies. They also would establish a coordinated EC exchange rate policy vis-à-vis the dollar, but that policy has not been worked out.
- Pooling of a portion (figures of 10 to 20 percent have been mentioned) of European gold and dollar reserves to help finance official intervention in the foreign exchange market, in order to promote rate stability within Europe and possibly in terms of the dollar and other outside currencies.
- Expanded arrangements for lending EC currencies on conditions designed to encourage the harmonization of policies needed to maintain the agreed exchange rates among EC currencies.
- Creation of a European reserve asset (the European currency unit) to be used in official EC transactions.

The United States has long supported the objective of economic unity in Europe. Close monetary cooperation may be an important part of this process. At the Bonn summit last week, the participants welcomed the EC's report on their efforts and noted that the EC countries would keep other participants informed as their work progressed.

The President did not express a view at this stage on the particular proposals which Chancellor Schmidt and President Giscard d'Estaing have advanced as the vehicle for achieving stability. The members of the Community do not, themselves, appear to be in full agreement on these proposals. Moreover, the effect of the proposed arrangements on the world economy, the global monetary system, and on the dollar would depend critically on features which have not been spelled out.

It is our hope that the plan to be designed will promote economic growth in Europe and in the world as a whole. We could not, of course, support a plan which prevented the dollar exchange rate from responding to underlying economic and financial factors. We would wish to be certain that any new arrangements agreed upon would be administered in full conformity with and in support of the revised Articles of Agreement of the IMF and in close consultation and cooperation with the monetary authorities of other countries.

It may well be that a European currency, or a European currency unit of account, will in time come to play a more prominent role in the international monetary system as a consequence of EC efforts to achieve greater economic harmonization and exchange rate stability within the Community. Such a development, provided it were compatible with the broad interests of a smoothly functioning, efficient world monetary system, should not be a source of concern. However, since details of new European monetary arrangements have not been worked out and there is no agreement except on the objective, we cannot at this time assess the implications for the world monetary system or the dollar.

We will be following developments closely as the Europeans progress with their studies, and we expect to have opportunities to express our views on the implications of their plans for the United States and for the global system.

In summary, let me emphasize three points:

First, the reserve role of the dollar is not a significant source of our balance of payments difficulties, and a change in that role would not eliminate our problems. The solution lies in dealing with the fundamental factors causing those difficulties—inflation, energy imports, inadequate export performance—not in changing the monetary system to try to escape those difficulties.

Second, proposals to force changes in the role of the dollar and other currencies, for example, through controls or guarantee mechanisms, could have profound implications for all aspects of the monetary system, and such proposals should be approached with care.

Third, we have long supported the objective of European economic integration and we welcome EC efforts to consider ways of achieving greater European monetary

cooperation. We will examine carefully any specific proposals for closer European monetary cooperation to assure they are compatible with the broad interests of a smoothly functioning international monetary system.

Exhibit 60.—Press release, August 22, 1978, entitled "Increase in the Amount of Gold Sales by the U.S. Treasury"

The Treasury announced today that it will increase the amount of gold offered at its monthly auctions to 750,000 ounces, beginning with the scheduled November 1978 auction. Currently 300,000 ounces are sold at each auction.

At the new level of 750,000 ounces per month, Treasury gold sales will be roughly equivalent to the 1977 rate of net gold imports. The sales will thus make an important contribution toward reducing the U.S. balance of payments deficit on current account. At the current price the balance of payments benefit would be more than \$1.8 billion at an annual rate. The continuing sales will also represent further progress toward elimination of the international monetary role of gold.

When the present gold auction program was announced last April, the Treasury indicated that the auction level of 300,000 ounces per month would be maintained for 6 auctions and that the amounts to be offered at subsequent auctions would be determined in the light of the initial experience. Four of these auctions have now been completed. Results have been quite satisfactory. The receipts, which have totaled \$230 million in the four auctions held to date, can be said to have reduced the U.S. trade and current account deficits by that amount. Since those deficits remain at an excessive level, however, and net gold imports in the period preceding the initiation of the auctions were running at an annual rate of about 9.5 million ounces, the Treasury has concluded that a substantial increase in the rate of sale would be desirable.

The 750,000-ounce level of sales will be continued for a period of 4 months. The amounts of sales at subsequent auctions will be reviewed well in advance of the final auction of this 4-month series.

For the present no changes are planned in the manner in which the auctions are conducted or in the bid procedures. It is expected that invitations to bid will continue to specify payment in U.S. dollars and provide for delivery at the U.S. Assay Office in New York or at other U.S. gold depositories. Auctions will be conducted at 11:00 a.m. on the third Tuesday of each month in the General Services Administration office at 7th and D Streets, SW., Washington, D.C. The minimum bid accepted will be for 400 ounces. A bid deposit of \$10 an ounce will be required.

The gold will be made available in bars, each containing approximately 400 ounces. Sales will be by competitive bids, with all successful bidders paying the price bid for each ounce of gold. The Treasury reserves the right to reject any or all bids. Bids by or on behalf of foreign governments or central banks will not knowingly be accepted.

Exhibit 61.—Statement by Assistant Secretary Bergsten, August 25, 1978, before the Senate Committee on Banking, Housing and Urban Affairs, on the question of Treasury gold sales and on S. 2843, a bill to provide for the issuance of gold medallions by the Treasury

It is my privilege, on behalf of Secretary Blumenthal, to respond to your invitation to testify before the committee on the question of Treasury gold sales and on S. 2843, a bill to provide for the issuance of gold medallions by the Treasury. You have asked us to address a number of specific questions, Mr. Chairman, and I will do my best to respond.

The monetary role of gold

The monetary role of gold, both domestically and internationally, has been declining progressively over a period of many years due to the general recognition that neither gold nor any other commodity provides a suitable base for monetary arrangements—a view that is strongly shared by the administration.

New gold production is strictly limited. Industrial demand is growing as GNP expands. Hence the residual supplies available for monetary use are both inadequate for, and unrelated to, the liquidity needs of an expanding national or world economy.

Furthermore, the extreme volatility in the market price of gold makes it a high-risk asset. For example, the price of gold moved from a peak of \$195 per ounce at the end of 1974 to a trough of \$104 in mid-1976, and back to a new high of \$215 on August 16. As of August 24, the price was about \$203 per ounce.

To our knowledge, there is no major nation in the world today in which official gold holdings act as an effective limit on the domestic money supply. The United States abandoned the domestic gold standard by a series of laws enacted in 1933-34 which effectively removed the domestic monetary system's direct link with gold. Moreover, the provision in the Federal Reserve Act for a gold certificate reserve against bank-required reserves was eliminated in 1968. In August 1971, the United States also ended the convertibility into gold of U.S. dollars held by foreign monetary authorities.

Since August 1971, transactions in gold between central banks have been very rare and limited primarily to a few instances in which gold has been used as collateral for official loans; there have also been a few instances in which gold has been sold in the private market to acquire foreign currencies to finance balance of payments deficits. Basically, there is now a general reluctance among central banks to acquire gold, given the fact that there is no fixed official price and no commitment by any central bank to buy or sell, and in view of the volatile private price. I have attached at table 1 a listing of the gold holdings of IMF members which shows the slow but steady decline in world gold reserves since 1972.

TABLE 1.—*Gold reserves*
[End of period; millions of ounces]

	1972	1973	1974	1975	1976	1977	1978 (May)	Change ^a	
								1972- 77	1978 to May
World	1,177.6	1,176.4	1,175.3	1,174.1	1,164.0	1,154.7	1,152.1	-22.9	-2.6
International Monetary Fund	153.4	153.4	153.4	153.4	149.5	131.6	128.6	-21.9	-3.0
IMF members:									
All countries	1,017.3	1,017.4	1,015.9	1,014.8	1,009.9	1,011.7	1,013.4	-5.6	1.7
Industrial countries	850.1	850.7	850.7	849.4	849.3	857.0	859.1	6.3	^b 2.1
Other Europe	51.9	52.0	52.4	52.3	52.3	49.2	48.0	-2.7	-1.2
Australia, New Zealand, S. Africa	25.4	26.4	25.7	25.1	20.1	17.4	17.6	-7.9	.1
Oil-exporting countries	33.3	33.7	34.3	34.9	37.0	34.4	34.6	1.0	.2
Other less developed countries	56.0	54.7	52.9	53.1	51.3	53.7	54.1	-2.3	.4

^a As part of the 1975 IMF gold agreement, the IMF has initiated a program to dispose of one-third of its gold holdings by selling 25 million ounces at public auction for the benefit of developing countries and restituting a further 25 million ounces to members by sales at the official price. The change in IMF gold holdings in 1976 and subsequent periods reflect these transactions. Information on these IMF gold transactions are listed below and are based on data contained in the IFS:

	[million ounces]		
	1976	1977	1978 (to May)
Restitution	—	11.9	0.3
Sales	3.9	6.0	2.6
Total	3.9	17.9	2.9

^b Reflects change in Japanese gold reserves due to transfer of gold between government accounts.

Source: International Financial Statistics, August 1978.

The amended IMF Articles of Agreement, which entered into force in April of this year, formally removed gold from its previous role in the international monetary system. The amendments contain three major changes with respect to gold. First, the official price of gold is abolished and gold loses its formal position as a common denominator for the IMF (and thus the international monetary system). Second, gold is eliminated as an important instrument in IMF transactions, and the IMF is prohibited from accepting gold unless specifically provided for by a decision requiring an 85-percent majority vote. Finally, the IMF is empowered to dispose of its remaining gold holdings in a variety of ways. These actions constitute important progress in phasing out the monetary role of gold.

In 1976, the IMF initiated a 4-year program to dispose of one-third of its gold holdings, with 25 million ounces being sold at public auction for the benefit of developing countries and a further 25 million ounces sold to members in proportion to their quotas at the official price of SDR 35 per ounce. Thus far, the IMF has held 24 public auctions at which about 15 million ounces of gold were sold, at a profit of nearly \$1.7 billion. About 12.3 million ounces have been distributed to members under the second program, of which the United States has received about 2.8 million ounces. (See table 2.)

TABLE 2.—International Monetary Fund gold auctions: summary statistics

Date	Pricing method	Place of delivery	Ounces bid (thousands)	Sub- scription ratio ¹	Number of bidders		Number of bids		Cutoff price	Average award price	Average market price ²	Differential
					Total	Successful	Total	Successful				
June 2, 1976.....	Common	New York	2,320.0	2.97	30	20	220	59	\$ 126.00	\$ 126.00	\$ 126.78	—0.78
July 14, 1976.....	Common	New York	2,114.0	2.71	23	17	196	56	122.05	122.05	122.23	— .18
Sept. 15, 1976.....	Bid	New York	3,662.4	4.70	23	14	380	41	108.76	109.40	110.38	— .98
Oct. 27, 1976.....	Bid	New York	4,214.4	5.40	24	16	383	37	116.80	117.71	117.75	— .04
Dec. 8, 1976.....	Common	London	4,307.2	5.52	25	13	265	33	137.00	137.00	135.15	1.85
Jan. 26, 1977.....	Common	New York	2,003.2	2.57	21	15	192	49	133.26	133.26	132.55	.71
Mar. 2, 1977.....	Bid	New York	1,632.8	3.11	21	7	187	14	145.55	146.51	144.98	1.53
Apr. 6, 1977.....	Bid	New York	1,278.0	2.43	18	11	136	22	148.55	149.18	147.90	1.28
May 4, 1977.....	Bid	New York	1,316.4	2.51	17	14	107	38	147.33	148.02	147.85	.17
June 1, 1977.....	Common	New York	1,014.0	1.93	14	13	75	35	143.32	143.32	143.80	— .48
July 6, 1977.....	Common	Paris	1,358.4	2.59	15	15	83	35	140.26	140.26	140.80	— .54
Aug. 3, 1977.....	Common	London	1,439.2	2.74	18	16	136	44	146.26	146.26	145.93	.33
Sept. 7, 1977.....	Bid	New York	1,084.4	2.07	15	11	115	21	147.61	147.78	147.25	.53
Oct. 5, 1977.....	Bid	New York	971.2	1.85	17	12	103	32	154.99	155.14	155.13	.01
Nov. 2, 1977.....	Bid	London	1,356.4	2.58	18	7	90	21	161.76	161.86	161.63	.23
Dec. 7, 1977.....	Common	New York	1,133.6	2.16	19	19	108	58	160.03	160.03	160.45	— .42
Jan. 4, 1978.....	Common	New York	984.8	1.88	19	19	103	64	171.26	171.26	172.18	— .92
Feb. 1, 1978.....	Common	Paris	598.4	1.14	17	17	76	62	175.00	175.00	176.50	— 1.50
Mar. 1, 1978.....	Bid	New York	1,418.0	2.70	19	16	127	76	181.13	181.95	183.15	— 1.20
Apr. 5, 1978.....	Bid	New York	1,367.0	2.60	21	15	122	30	177.61	177.92	178.53	— .61
May 3, 1978.....	Bid	London	3,104.0	5.91	24	17	192	36	170.11	170.40	170.38	.02
June 7, 1978.....	Bid	New York	1,072.4	2.28	21	15	137	28	182.86	183.09	182.95	.14
July 5, 1978.....	Bid	New York	797.2	1.69	22	19	101	44	183.97	184.14	184.20	— .06
Aug. 2, 1978.....	Bid	New York	1,467.6	3.12	21	20	117	42	203.03	203.28	203.25	.03

¹ The ratio of total bids to the amount on auction; i.e., 780,000 ounces in the auctions from June 2, 1976, through Jan. 26, 1977; 525,000 ounces in auctions from Mar. 2, 1977, through May 3, 1978; and 470,000 ounces in subsequent auctions.

² Average of London fixing prices on auction day.

The United States has strongly supported these changes. This administration, like its predecessors, considers gold to be an unsuitable basis for a stable monetary system. This view has been endorsed by the Congress, which authorized the actions removing gold from the U.S. domestic monetary system and approved the recent amendments to the IMF Articles by a wide margin. In its 1973 report on the amendment of the Par Value Modification Act, the Senate Banking Committee stated that "it is important that a reformed international monetary system calls for a diminished role for gold and eventual removal of gold from the center of the system. In that connection the Committee believes that sales of gold in the private market from official monetary stocks could make an important contribution to this goal and to more orderly conditions in international currency markets."

Consistent with the general move toward elimination of a monetary role for gold, and toward its treatment internationally and domestically like any other commodity, the United States repealed the prohibition on the holding of gold by private U.S. citizens effective December 31, 1974.

At that time, U.S. gold stocks totaled 276 million ounces, a sum roughly equivalent to nine times the world's annual production of new gold. Given the reduction in gold's utility as a monetary reserve, and the fact that strategic requirements are less than the volume of annual domestic production, gradual disposal of these stocks has been appropriate and has contributed to two important U.S. objectives—continued demonetization of gold and a reduction of our trade and current account deficits. (Since the United States acquired 2.8 million ounces from the IMF in 1977 and 1978 under the restitution program, the total U.S. stock despite the sales program has risen to 277 million ounces as of end June.)

At the same time, the market for gold can be affected importantly by the rate at which the United States and others dispose of gold, and we have faced the task of determining under what circumstances and at what rate we should sell.

Two auctions were held in 1975, at which a total of 1.3 million ounces of gold were sold. Shortly after the Carter administration took office, Chairman Reuss of the House Banking Committee wrote to Treasury Under Secretary Solomon urging the resumption of U.S. gold sales. In response, Mr. Solomon stated that U.S. policy remained to sell gold from time to time to help meet U.S. demand for imported gold and in support of our objective of reducing the monetary role of gold. He indicated that the timing of such sales would depend inter alia on U.S. demand for gold imports, the IMF gold sales program, the needs of other countries to sell gold for balance of payments purposes, and progress towards eliminating gold's monetary role.

The Treasury gold sales program

On April 19, 1978, Treasury announced the initiation of a series of monthly gold auctions, indicating that auctions of 300,000 ounces each would be held for 6 months and that the amounts to be offered in subsequent auctions would be determined in the light of the initial experience. Four auctions have now been completed, and Treasury earlier this week announced monthly sales of 750,000 ounces beginning with the November auction. The new auction level will be maintained for 4 months, with amounts to be offered at subsequent auctions to be determined well before the end of the 4-month series.

This latest action is being taken on the basis of two main considerations. First, the sales program has operated smoothly and the results to date (summarized in table 3) have been quite satisfactory, with receipts of \$230 million having reduced the U.S. trade and current account deficits by a roughly equivalent amount. Our judgment is that the market should be able to absorb substantially larger U.S. sales without serious difficulty.

TABLE 3.—U.S. Treasury gold sales, 1978

	May 23	June 20	July 18	Aug. 15
Number of bidders.....	44	31	27	17
Quantity bid (troy ounces).....	1,364,000	1,036,000	1,385,600	564,400
Number of successful bidders ...	12	21	9	12
Quantity sold (troy ounces)	300,000	300,000	300,000	300,000
Price range of awards (per ounce).....	\$180.01-\$182.35	\$186.52-\$190.29	\$185.05-\$189.00	\$213.23-\$216.17
Average price (per ounce).....	\$180.38	\$186.91	\$185.16	\$213.53
London second fixing	(\$179.75)	(\$186.50)	(\$184.85)	(\$213.20)
Proceeds (millions of dollars)	\$54.1	\$56.1	\$55.5	\$64.1
Retirement of gold certificates	\$12.7	\$12.7	\$12.7	\$12.7
Miscellaneous receipts of the Treasury	\$41.4	\$43.4	\$42.8	\$51.4

Second, the United States must take all appropriate actions to improve its trade and current account positions. A variety of measures is needed—most importantly to reduce our energy imports, to combat inflation, to promote exports, and to encourage satisfactory growth abroad.

Sales of gold can also make a significant and quite tangible contribution to this effort. At the new level of 750,000 ounces per month, such sales will be at an annual rate nearly equal to the 9 1/2 million ounces of net U.S. gold imports in 1977. At current prices, this would represent an improvement in the trade position of about \$1.8 billion annually. The sales will also represent continued progress toward elimination of gold's monetary role.

TABLE 4.—World supply and demand for gold
[Millions of ounces]

	1975	1976	1977
Production:			
South Africa	22.9	22.9	22.5
Canada	1.7	1.7	1.8
United States	1.0	1.0	1.0
Other	5.2	6.5	5.8
Total	30.8	32.1	31.1
Net Communist sales	4.8	13.3	12.9
IMF sales	—	3.9	6.0
U.S. sales	1.3	—	—
Other official (net)	— 1.8	— 1.6	1.8
Total other	4.3	15.6	20.7
Total supply	35.1	47.7	51.8
Fabrication demand:			
Jewelry	16.6	30.0	31.5
Other industrial fabrication	5.8	6.7	7.2
Official coins	7.8	5.9	4.4
Fake coins, medals .....	.7	1.5	1.6
Bars for hoarding .....	.2	5.7	2.2
Residual ¹	5.0	— 3.0	4.9
Total	36.1	46.8	51.8

¹ Believed to be bars for investment; includes errors in estimating supply and demand.

Source: Gold 1978, Consolidated Gold Fields Ltd.

The United States has been a major importer of gold. Net imports (on a balance of payments basis) last year totaled 9.5 million ounces, including 1.6 million ounces of gold imported in the form of coins. In the first half of 1978, net imports amounted to 4.8 million ounces, of which 1.5 million ounces were coins. In 1977, net U.S. gold imports were equivalent to roughly 18 percent of supplies coming onto the world market, including new gold production and sales from stocks. Sources of gold moving into world markets and their estimated uses are shown in table 4. These are rough estimates, but they help to provide a composite picture of the world gold situation.

Table 5 offers a similar estimate of sources and uses of gold for the United States alone. You will note that the domestic demand for gold, including demand for inventories and trading purposes, has been running about five times domestic production, leaving us primarily dependent on imports in the absence of sales from the Treasury stock.

The figures on gold transactions reported in the U.S. balance of payments statistics need a bit of explanation. The relevant data assessing the balance of payments impact of the gold sales program are those presented on a balance of payments basis. They differ substantially from the data series on U.S. gold trade compiled by the Census Bureau, which records the actual physical movement of gold into and out of the United States (table 6). The Census data show large net exports of bullion in 1977 (rather than net imports), and also very small net exports during the first 6 months of this year.

In measuring the balance of payments impact, the Census data must be adjusted to reflect the fact that, in addition to actual physical shipments of bullion into and out of the country, there are very large amounts of foreign-owned gold—especially those stocks held at the New York Federal Reserve Bank for the IMF and foreign central banks—already physically located in the United States. Sales from these stocks—for example, when the IMF holds one of its periodic auctions—into the private New York market are included in U.S. import statistics on a balance of payments basis, but not on the Census basis. Transactions between central banks are excluded entirely from the U.S. statistics on either basis. With the exception of transactions between central banks, all physical shipments of gold abroad show up in the Census export statistics. Since much of this gold originated in central bank or IMF stocks already in the United States, the Census data do not record the offsetting import and thus give the impression that the United States is a net exporter of gold when in fact we are a net importer, as the data on a balance of payments basis show.

TABLE 5.—*Supply and distribution of gold in the United States*
[Millions of ounces]

	1975	1976	1977	January-June 1978
Source:				
Domestic production ¹	2.2	2.0	2.1	1.3
Treasury sales.....	1.3	—	—	.3
Net imports of bullion.....	.6	4.8	7.9	3.3
Gold coin imports.....	1.7	1.3	1.6	1.5
Total.....	5.8	8.1	11.6	6.4
Uses:				
Industrial and commercial fabrication.....	3.7	4.7	4.9	2.3
Commodity exchange stocks ².....	.5	—2	1.5	1.2
Industry stocks.....	.1	—	1.0	—9
Coin purchases.....	1.7	1.3	1.6	1.5
Unexplained.....	—2	2.3	2.6	2.3

¹ Refinery production which includes gold from U.S. mining output and old scrap. These were 1.0 million ounces, and 1.1 million ounces, respectively, in 1977.

² Includes gold held by dealers to back up trading on commodity futures exchanges.

TABLE 6.—*U.S. foreign trade in gold by month—1977-78*
[Thousands of ounces]

	Gold bullion							Gold coin imports	Total net imports and exports ¹
	Imports				Exports				
	Census ¹	IMF account ²	Foreign accounts ²	Total	Census ¹	Foreign accounts ²	Total			Net imports and exports^{1}
1977									
January.....	227	—	959	1,186	1,103	—	1,103	83	243
February.....	175	780	167	1,122	481	—	481	641	753
March.....	183	514	236	933	42	—	42	891	1,013
April.....	161	32	259	452	13	—	13	439	550
May.....	194	1,025	937	2,156	671	—	671	1,485	1,622
June.....	615	529	165	1,309	197	32	229	1,080	1,172
July.....	182	—	188	370	31,642	64	1,706	-1,336	-1,297
August.....	190	—	965	1,155	664	18	682	473	597
September.....	601	525	560	1,686	50	41	91	1,595	1,689
October.....	287	525	803	1,615	1,612	—	1,612	3	124
November.....	1,072	—	1,120	2,192	259	—	259	1,933	2,090
December.....	372	525	214	1,111	510	11	521	590	935
	4,259	4,455	6,573	15,287	7,244	166	7,410	7,877	9,491
1978									
January.....	443	525	672	1,640	1,061	164	1,225	415	642
February.....	191	—	43	234	146	—	146	88	319
March.....	773	525	55	1,353	207	31	238	1,115	1,480
April.....	523	525	32	1,080	1,028	32	1,060	20	178
May.....	289	—	129	418	188	14	202	216	537
June.....	434	463	638	1,535	126	—	126	1,409	1,596
	2,653	2,038	1,569	6,260	2,756	241	2,997	3,263	4,752

¹ Includes small amounts of ores, scrap, and base bullion.

² Gold delivered to and from foreign official accounts at the Federal Reserve Bank of New York.

³ Exports for the month of July 1977 include 1,602 million ounces which were actually exported in prior months.

The principal purchasers of gold at the U.S. auctions have been 17 firms and banks which specialize in gold trading. The largest purchasers of the 1.2 million ounces sold through August have been the Dresdner Bank (641,600 ounces), the Swiss Bank Corp. (145,200 ounces), the Union Bank of Switzerland (128,000 ounces), and the Bank of Oman (100,000 ounces). These firms normally purchase for the account of their customers; the ultimate buyer and his purpose cannot be identified.

The fact that large purchases have been made by firms owned by residents of the United Kingdom, Switzerland, and Germany does not necessarily mean that the purchases are for the account of foreign customers. These firms have branches in the United States and are active suppliers and dealers of gold in the United States. Furthermore, U.S. trade figures show that very little of the Treasury gold has actually been exported. This suggests that it is effectively being sold to U.S. customers, particularly since the Treasury gold is industrial grade needed by U.S. fabricators.

You have asked about the factors which determine the market price of gold, and about the impact of the Treasury sales on that price. There are no definitive answers to either question. There are two widely divergent types of demand for gold, and they react to changing conditions in very different ways. Industrial and commercial demand appears to follow a pattern quite similar to that of demand for other metals. When the economy is growing rapidly, industrial and commercial demand for gold will grow. When the price rises rapidly, particularly in relation to the prices of other metals which can be used as substitutes, the industrial and commercial demand slackens.

The hoarding demand for gold, however, rises when the fear of inflation grows and falls when there is a prospect of growing price stability. In some periods, the prospect for price stability has been such that hoarding demand has disappeared and there have been efforts to dispose of such holdings.

It is not possible to say what effect the Treasury gold sales have had on the gold price. As a significant addition to supply, one would expect some price effect. However, the impact has not been such as to disrupt the market or to be inequitable to American producers and firms holding gold inventories.

All sales at the Treasury auctions have called for payment in U.S. dollars. In announcing the sales program last April, Treasury stated that it planned to study technical aspects of selling gold against payment in West German deutsche marks, with a view to determining whether sales of gold would provide a technically feasible and advisable means of acquiring deutsche marks for use in countering disorderly conditions in foreign exchange markets.

The major gold markets, both here and abroad, operate in U.S. dollars. Prices are normally quoted in U.S. dollars and payment is normally made in U.S. dollars. Typically, nonresidents of the United States who buy gold in these markets either use existing dollar balances or enter the foreign exchange markets to buy dollars with which to purchase the gold.

If Treasury were to call for payment in deutsche marks at its auctions, it is likely that many buyers, whether American or foreign, would sell dollars on the foreign exchange market to obtain the deutsche marks to make the payment. Holders of deutsche marks might simply forego purchases of dollars which they would have had to make to finance a gold purchase payable in dollars. In such cases, the initial impact on the dollar's position on the foreign exchange markets would be negative, and the subsequent sale of deutsche marks by the Treasury would do little more than offset the earlier adverse impact. Nonetheless, the situation is not absolutely clear, and it may be that at some point such sales would appear desirable.

The manufacture and sale of gold coins and medallions

American residents presently have ample opportunities to buy gold in small amounts, both in coins and other forms. A number of bullion coins currently being minted are available in the United States such as the Krugerrand, Mexican peso, Austrian krona, and British sovereign. These coins contain 1/4 ounce to 1 ounce of gold. Small gold bars, produced by Swiss banks, are also available in the 1/2-ounce and 1-ounce sizes.

The markup charged by South Africa on the Krugerrand, 3 percent over the bullion price, is enough to cover only the minting and advertising costs to the South African Chamber of Mines which markets the coin. The dealers, in turn, are free to take what

markup they can, but efficient competition has generally limited this markup to an additional 2 to 3 percent above the gold value of the coin.

For this reason, private minters of gold medallions have been unable to compete effectively with the Krugerrand. One U.S. refiner, Engelhard Industries, did mint a 1-ounce medallion called the "American Prospector," which was sold to dealers at the same markup as the Krugerrand. However, only about 20,000 of these medals were sold before the effort was ended because it was felt that the advertising costs necessary to sell large amounts of the medallion would be too high to permit a reasonable profit.

Official production of gold medals and medallions has been very small. Most countries that have produced gold coins in recent years have done so for a combination of revenue and commemorative purposes. The markup on such issues has usually run from 50 percent to 100 percent over the market value of the gold in the coin, and the issues have usually been limited in order to enhance their numismatic value. For example, of the 49 countries that minted gold coins in 1977, 42 limited the issues to less than 15,000 ounces each. The total official gold coinage by all countries other than South Africa in 1977 contained only 1.5 million ounces of gold. South Africa and the U.S.S.R. were the only countries producing coins as a technique for marketing gold production, rather than for coinage profit or a commemorative purpose. The minting of Krugerrands amounted to 2.9 million ounces in 1977 and 2.7 million in the first half of 1978.

The American Revolution Bicentennial Administration produced three Bicentennial gold medals in 1976, as part of a program of selling bronze, silver, and gold medals. The Treasury sold gold to the Bicentennial Administration at the current market price and the Administration contracted with the Mint to produce the medals. Sales of the medals involved about 36,000 ounces of gold and yielded profits of about \$2.7 million which were used to finance Bicentennial activities. This also was a limited issue sold as a collectors item.

Proposed Gold Medallion Act

Let me turn now to the bill on which you have asked us to comment. S. 2843 would provide that, upon determination by the Secretary of the Treasury to sell gold, all or part of the sales would be in the form of 1-ounce and 1/2-ounce gold medallions. The first 1.5 million ounces to be sold in the first fiscal year after the passage of the act would be required to be sold in this form, while any remaining gold to be sold could be in a manner as the Secretary deems appropriate. In following years, the Secretary of the Treasury would have the discretion to determine the number of medallions to be produced and sold in light of anticipated import demand.

The medallions, although not legal tender, would have the style of coins, with the Great Seal of the United States on one side. The bill specifies that they would be sold at market-related prices and in a manner to encourage broad public participation. The purposes of producing the medallions would be to reduce sales to the American public of South African Krugerrands and other similar gold coins, and to provide U.S. citizens the opportunity to buy a U.S.-issued source of gold.

The administration believes that issuance of gold medallions as called for by this bill would be unwise and inappropriate for several reasons.

On the one hand, there would be little, if any, additional balance of payments or budgetary receipts from the sale of gold medallions rather than gold bullion. In order to compete against the 1-ounce Krugerrand, any U.S. gold medallion would have to be priced close to the market value of the gold bullion content, as is the case of the Krugerrand.

In addition, there would be direct budgetary costs arising from the manufacturing and distribution of the medallion. The U.S. Mint estimates that the cost of minting a U.S. medallion would be about \$2 per medallion. While the General Services Administration is unable to make an accurate estimate of distribution costs, the medallion would be expensive to distribute to the public on a wide basis. It should be borne in mind that the Krugerrand has been in production for some time and the distribution system is well developed and efficient. Furthermore, that coin is deliberately designed to develop a market for South African gold production, rather than to generate revenue.

While being of little or no budgetary or balance of payments benefit to the United

States, the proposal in S. 2843 would have several negative effects. It would: (1) raise questions about the Government's determination to fight inflation, (2) offer official encouragement to U.S. citizens to invest in a highly speculative commodity, and (3) call into question the sincerity and credibility of the policy of eliminating the monetary role of gold, contrary to longstanding and widely supported U.S. policy. Accordingly, the administration opposes the passage of S. 2843.

First, the issuance of these medallions would tend to create the erroneous impression that the U.S. Government needs to supply the public with an officially issued gold piece as a hedge against inflation. This implication would be particularly apparent in the case of a medallion deliberately patterned after the Krugerrand, because the latter is actively promoted as a hedge against inflation.

There may have been one or two instances where the intent of governments in issuing gold pieces was to absorb domestic liquidity as a means of fighting inflation. For the United States, however, such a policy would be totally impractical. No amount of gold sales which could realistically be absorbed by the market would have any appreciable effect on liquidity in the United States, nor would such sales meet any needs that cannot be met by use of existing monetary policy instruments.

It is thus clear that gold medallion sales could make no positive contribution to the effort to combat inflation. They are much more likely to be harmful to that effort.

Second, the production and sale of an American medallion, as specified in S. 2843, could be interpreted as a U.S. Government effort to encourage investment in gold. The fact that the medallions were minted by the U.S. Government and bore the Great Seal of the United States would suggest to potential investors that the U.S. Government was favorably disposed toward such investment.

As I have pointed out, gold is a highly speculative commodity subject to volatile swings in price. The investor in such a Government-sponsored medallion at the end of 1974 would have seen the value of his investment drop by 47 percent by mid-1976. We should thus avoid any implication that the U.S. Government is promoting such investment.

U.S. citizens who want to buy gold for investment or speculative purposes can, of course, do so in the private markets now. There is no need for U.S. Government involvement to enable U.S. investors, large or small, to buy gold coins or medallions.

Third, there are certain aspects of S. 2843 which would be inconsistent with the U.S. policy of continuing progress toward demonetizing gold. In introducing the bill last April, Senator Helms suggested that a U.S. gold medallion would meet a commercial need in connection with payment of gold clause contracts. But such a use of these medallions would give them a clear monetary character.

In addition, the very existence of the U.S. Seal on the gold medallion would be an invitation to those who favor the remonetization of gold to press for designation of the medallions as legal tender—if not now, then at some subsequent date. Foreign governments might well question whether passage of this legislation meant that the U.S. Government was reconsidering its policy with respect to gold.

Conclusion

The trend toward demonetization of gold has evolved gradually but with steady progress over many years. This trend has reflected the inherent inadequacies of basing either a national or an international monetary system on a commodity. The United States and other nations have removed gold from their domestic monetary systems. Quite recently, the international community has followed this path formally through amendment of the Articles of Agreement of the IMF.

With the reduced monetary role for gold, continued large U.S. gold imports and trade deficits, and the existence of large U.S. gold stocks, it has seemed desirable to engage in a program of gold sales by the Treasury. The sales have been successful, and it is desirable to maintain flexibility to adapt the program to changing circumstances.

The proposed gold medallion legislation would add nothing toward achieving any of the objectives which are already being met by the bullion sales program. To the contrary, it would raise some important problems and questions concerning U.S. domestic and international economic policy. For these reasons we urge the committee not to approve this proposal.

Exhibit 62.—Communique of the Interim Committee of the Board of Governors of the International Monetary Fund on the International Monetary System, September 24, 1978, issued after its 11th meeting in Washington, D.C.

1. The Interim Committee of the Board of Governors of the International Monetary Fund held its eleventh meeting in Washington, D.C. on September 24, 1978, under the Chairmanship of Mr. Denis Healey, Chancellor of the Exchequer of the United Kingdom. Mr. J. de Larosiere, Managing Director of the International Monetary Fund, participated in the meeting. The following observers attended during the Committee's discussions: Mr. Gamani Corea, Secretary-General, UNCTAD; Mr. Ali M. Jaidah, Secretary-General, OPEC; Mr. Rene Larre, General Manager, BIS; Mr. Emile van Lennep, Secretary-General, OECD; Mr. F. Leutwiler, President, National Bank of Switzerland; Mr. Olivier Long, Director General, GATT; Mr. Robert S. McNamara, President, IBRD; Mr. Francois-Xavier Ortoli, Vice-President, CEC; Mr. Jean Ripert, Under-Secretary-General for International, Economic and Social Affairs, UN; and Mr. Cesar E. A. Virata, Chairman, Development Committee.

2. The Committee discussed the world economic outlook and the working of the international adjustment process.

The Committee recognized that progress had been made on various fronts in overcoming the serious difficulties that had beset the world economy during the years 1973-75. In countries that had taken policy measures to adjust to the disturbances of those years, the favorable effects were clearly evident. Nevertheless, the Committee noted, the current situation remained unsatisfactory in several important respects.

The Committee expressed concern that in most member countries rates of price increase continued to be much too high and substantial underutilization of economic resources, including high levels of unemployment, continued to prevail. On the international adjustment process, the Committee noted that wide differences in rates of inflation and growth in domestic demand had contributed to the continuation of large deficits and surpluses on current account among the industrial countries. These imbalances had resulted in unstable foreign exchange markets during the past year, and that this instability, in turn—through its effects on prices, confidence, and investment—had made the formulation and implementation of policies more difficult. The Committee emphasized that a return to exchange market stability would require the adoption of national policies to reduce inflation and to achieve more convergent rates of growth in domestic demand. In a further observation on the adjustment process, the Committee noted that a number of nonindustrial countries were encountering difficult problems of adjustment and external financing, in part because of the slow pace of world trade.

The Committee noted that inflation has continued to subside in a number of industrial countries but that it has tended to accelerate in some others, including the United States, where inflation has become the top priority of economic policy.

With respect to growth and resource utilization in the industrial world, the Committee's concern focused mainly on the abnormally high unemployment rates and substantial slack in industrial capacity prevailing outside the United States. Attention was drawn to the marked differences in growth rates in recent years between the United States, where a relatively full cyclical recovery has taken place, and most of the other industrial countries, where real economic activity has not generally expanded fast enough since 1975 to reduce unemployment.

The Committee noted that in the group of non-oil developing countries the average rate of growth in total output had been relatively well sustained, but at a level appreciably below that of the 1967-72 period, so that only little room was left for gains in real income.

The Committee reiterated its concern about the risk of increasing resort to protectionism, and stressed the importance of an early and successful completion of the Multilateral Trade Negotiations.

In its discussion of the current situation and outlook, the Committee concluded that a welcome change in international trade flows was emerging. This reflected the effects of changes in exchange rates for major currencies that had taken place over the past year and a half. The effects on exports and imports in volume terms, which take

considerable time to come through, were beginning to produce favorable shifts in the current account balances of the United States, Japan, and certain other countries. These shifts, the Committee observed, may be expected to increase and, over time, could lead to a substantial improvement in the current account balances of industrial countries, provided that the pattern of price increases and growth rates in domestic demand among countries was an appropriate one. Achievement of such a pattern, the Committee stressed, would require that countries adopt internal measures to offset the expansionary effects of exchange rate depreciation and the deflationary effects of exchange rate appreciation.

The Committee reaffirmed the conviction it expressed at the April 1978 meeting in Mexico City that a coordinated strategy of policy, including measures with respect to energy, was needed in present circumstances in order to encourage noninflationary growth of the world economy and to ensure a reduction in imbalances in international payments, thereby promoting underlying conditions conducive to economic and financial stability as well as to greater stability in exchange markets. The Committee emphasized that implementation of such a strategy for the medium term would require each country to contribute to growth of the world economy in relation to the strength of its external position and the success of its anti-inflation policy.

Successful pursuit of a medium-term strategy in the industrial countries would lead, in the Committee's view, to marked improvement of the global environment for trade and development, with substantial benefits for the developing countries and other primary producing countries. The Committee believed that an improved world trading environment would help to arrest the recent ominous tendency toward use of protectionist trade measures. In addition, the Committee emphasized the desirability of measures on the part of the developed countries to open their markets more widely to products of the developing countries, to provide those countries more generous access to their capital markets, and—more generally—to assure the developing countries an adequate inflow of real resources, including a more satisfactory level of official development assistance.

3. The Committee considered a number of questions concerning the SDR on the basis of a report of the Executive Board on the subject. The Committee reached the conclusions set forth in paragraphs 4 and 5 below with the understanding that these conclusions are interrelated and must be adopted in their entirety together with the understandings reached by the Committee on the Seventh General Review of Quotas. In the view of the Committee, therefore, decisions on all these issues relating the SDRs and on the Seventh General Review should be taken at the same time.

4. The Committee discussed the question of the resumption of allocations of SDRs and, in that connection, took into account the various views and considerations presented in the report of the Executive Board. The Committee agreed to recommend that a decision to allocate SDRs, on the basis of a proposal to be made by the Managing Director concurred in by the Executive Board by November 1, 1978, should be acted on by the Board of Governors before the end of the year in order to help meet the long-term global need to supplement existing reserve assets in a desirable manner. Such an allocation would also help to promote the objective of the amended Articles of making the SDR the principal reserve asset in the international monetary system. In the Committee's view the Fund should make allocations of 4 billion SDRs in each of the next three years 1979 to 1981.

5. The Committee reached the following conclusions with regard to other aspects of the SDR.

(a) It was agreed that the interest rate on the SDR should be increased from 60 percent of the weighted average of the short-term interest rates in the five member countries with the largest quotas to 80 percent of that average and that the rate of remuneration should be set at 90 percent of the interest rate on the SDR, that is, at 72 percent of the combined market rate. This change would be subject to the following understandings: (i) Shortly before the end of each financial year, the Fund would consider whether the estimated net income of the Fund for that year was sufficiently large to permit the average annual rate of remuneration applicable for that year to be raised to a level above 90 but not above 100 percent of the average annual rate of interest on the SDR and, in this connection, would also consider the possibility of

lowering periodic charges on the Fund's currency holdings in the future. (ii) At the time that the Executive Board decides to adopt the new formula for the rate of remuneration, it would take a decision to prevent an automatic increase in the initial rate of periodic charges on the Fund's holdings that would otherwise occur under the Fund's Rules and Regulations. The Executive Board would review the Fund's financial position, and would take such action as might be necessary to protect that position, if the Fund's total expenses exceeded its income in any period of six successive months.

(b) The Committee noted that the Executive Board had been pursuing its work with regard to additional types of uses of SDRs, namely, for loans, collateral security, and the direct settlement of obligations, that could be permitted by the Fund in accordance with the provisions of the amended Articles and expressed the hope that the Executive Board would complete this work, take the necessary decisions in the near future, and report on them to the Committee at its next meeting.

(c) The Committee endorsed the view of the Executive Board that the requirement of reconstitution of special drawing rights, namely, the obligation to maintain a minimum average balance of SDRs over specified periods, should be reduced from 30 to 15 percent of net cumulative allocations and that this requirement should be considered further in the light of experience.

(d) The Committee noted that the Executive Board intends to keep under review the question of a substitution account.

6. The Committee resumed its discussion of the Seventh General Review of Quotas and considered three major issues relating to it: the size of the overall increase in quotas, selective quota adjustments, and the method of payment of the increases in quotas. These issues were considered by the Committee in conjunction with the various issues relating to the SDR with which they are regarded as interrelated. The Committee recalled its view that there was a need for an increase in total quotas under the Seventh Review that would be adequate to meet the expected need for conditional liquidity over the next five years. The Committee also recalled its view that an adequate increase would strengthen the available sources of balance of payments financing by enhancing the ability of the Fund to provide such financing without heavy recourse to borrowing and by furthering the process of international adjustment.

The Committee's view was that an increase in the overall size of quotas of 50 percent would be appropriate to bring about a better balance between the size of the Fund's resources and the need of members for balance of payments financing over the medium term. The Committee noted that the Executive Board does not intend to propose a general adjustment in quotas for five years after the Board of Governors approves the increase in quotas under the Seventh Review, unless there is a major change in the world economy and its financing needs.

The Committee noted with satisfaction that agreement had been reached on selective quota increases for 11 developing member countries: Iraq, Iran, Korea, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Singapore, and United Arab Emirates.

Taking into account the conclusions reached on the issues relating to SDRs, including allocations of SDRs, the Committee was of the view that, for the quota increases proposed as a result of this review, participants in the Special Drawing Department should pay 25 percent of the quota increase in SDRs and that nonparticipants should pay the equivalent of 25 percent of the increase in foreign exchange.

The Committee agreed to request the Executive Board to prepare and complete by November 1, 1978, for final decision and vote by the Board of Governors before the end of the year, a proposed resolution on increases in the quotas of members, which would include necessary provisions dealing with participation, the effective date of quota increases, and the method of payment of the increases in accordance with the understandings reached in the Committee.

7. In view of the need of a number of members for prompt financial assistance on the scale envisaged by the Supplementary Financing Facility, the Committee stressed again the importance it attached to the entry into operation of the Facility at the earliest possible date and urged all members that are expected to contribute to the financing of the Facility to take the necessary action so that it could be brought into operation at the earliest possible date.

8. The Committee noted that, in accordance with the Committee's request, the

Executive Board has begun a review of the conditionality attaching to the use of the Fund's resources and that it intends to resume its consideration of the subject as soon as possible after the Annual Meeting of the Board of Governors.

9. The Committee agreed to hold its next meeting in Washington, D.C. in the spring of 1979.

Exhibit 63.—Statement by Secretary Blumenthal as Governor for the United States, September 26, 1978, at the joint annual meetings of the Boards of Governors of the International Monetary Fund and the International Bank for Reconstruction and Development and its affiliates, Washington, D.C.

We meet at a time when the public perception of the world economy is one of uncertainty and worry: About the persistence of high inflation; about the world's unemployed and how to put them to work; about international payments imbalances and how they can be managed so as to avoid undue strain on the international monetary and trading systems; and worry also about the outlook for the economy of the United States.

The message I wish to leave with you today is that we must not allow these concerns to distort our vision. To be sure, unacceptably high rates of inflation and unemployment remain a serious problem in a number of countries. And in some, including our own, external imbalances, both on the surplus and deficit side, are too large. These are serious problems that must be resolved, and that is not an easy task. But we must not lose sight of the fact that crisis points have been passed, that progress has been made, and that further improvement is underway. The progress that the nations represented in this room have collectively and individually made is significant and must not be overlooked. For it shows how far we have come, that difficult problems are not insoluble, and hence that further progress can be made.

The record of world economic recovery

Three years ago, the world faced what looked like an intractable problem—stagnating world production, rising unemployment, and surging double-digit inflation. It was feared that the greatly swollen payments imbalances could not be financed, and that industrial as well as developing countries would be forced into severe financial restraint and contagious protectionism.

That has not happened. Progress has been much greater than generally acknowledged.

- In 1974, inflation averaged 15 percent worldwide, and 13 percent in the OECD. Today the global rate is under 10 percent, and the OECD rate is under 8 percent.
- In 1975, economic output in the OECD fell 1 percent. This year it will show a respectable average growth of 3 1/2 percent.
- In 1974, the OPEC payments surplus was \$70 billion. This year it will be about \$16 billion.
- In 1975, the developing countries' aggregate current account deficit was \$30 billion. In 1978, it will be about \$16 billion, and borrowing countries generally are in a stronger position to attract capital. In fact, the developing nations as a group have increased their official reserves by some \$30 billion over the past 2 1/2 years.
- Most of the industrial countries facing major payments deficits in 1974 and 1975 have been able to cut those deficits substantially, in some cases to move into surplus.

Obviously the world economy has not fully recovered the health and vigor we seek. But it has come a long way and we know what still needs to be done.

In the IMF Interim Committee, in the OECD, and in the Bonn meeting of the seven largest industrial countries, there has been agreement on a basic strategy for achieving further progress in the reduction of unemployment, inflation, and payments imbalances. That strategy is being put into effect. The Government of Japan has announced

a broad series of measures to assure the achievement of its domestic growth targets and to speed up the reduction in its current account surplus. The Government of the Federal Republic of Germany has presented to its Parliament a series of measures to assure more rapid economic growth. And elsewhere in the industrial and developing world, a stronger foundation now exists to resume trend rates of economic growth.

It is against this background that I would like to report to you on the U.S. economy. Our economy has performed remarkably well and today is at a more advanced stage of recovery than most other industrial countries. Since the trough of recession in 1975, we have added 10 million persons to our employment rolls. We have increased total employment by 12 percent. Unemployment has come down from more than 9 percent to below 6 percent. Industrial production has increased 31 percent. It is now 10 percent higher than the prerecession peak, a far stronger expansion than in any other industrial country. We achieved 5.7 percent growth in 1976 and 4.9 percent growth in 1977. Our real gross national product increased almost 18 percent since 1975. This has been a substantial accomplishment in the aftermath of the shocks and strains of the early 1970's. The U.S. economy is now approaching optimum utilization of productive capacity.

We now expect a tempering of growth to a rate more consistent with the underlying rate of increase in the productive potential of our economy. We will pursue this growth path while reducing the Federal budget deficit, the rate of inflation, and the current account deficit.

In 1976, the Federal budget deficit exceeded \$66 billion. For the fiscal year ending next week, the first budget submitted by the Carter administration will result in a deficit of around \$50 billion or less—a \$16 billion reduction. For the next fiscal year, we expect to cut the deficit by at least another \$10 billion, and in fiscal year 1980 it is the President's intent to make a further major cut in the deficit. This increasingly tight fiscal policy is essential to achieving domestic goals of reduced inflation and to reinforcing the movement towards external balance reflected in the strategy recommended by the IMF.

With regard to the U.S. balance of payments, a number of key factors making for improvement are coming into place.

We are at long last making progress on energy. The congressional committees have already agreed on several measures that will promote conservation and improve the efficiency of energy use. Final passage of these measures is expected soon.

I am heartened by the decision to put the natural gas bill to a vote in the Senate this week. Passage of this bill alone will result, as early as 1979, in a reduction of oil imports of as much as 500,000 barrels per day from levels that would otherwise obtain—an annual import savings of more than \$2 billion. The Congress recognizes the great importance that the world community attaches to this issue because of its implications for our balance of payments and the stability of the dollar. I am confident that the Senate vote will reflect this recognition.

While dependence on oil imports is being reduced, efforts are being made to expand U.S. exports. The President will announce this afternoon the first elements of a national export policy which will encourage our manufacturers and our farmers to take advantage of the export opportunities which are now available to them. It is not an instant solution to our laggard performance. But it will begin giving export markets the priority they require if we are to eliminate our current account deficit.

I am confident that these efforts, combined with the slowing of the U.S. economy and more satisfactory growth worldwide, will substantially reduce our current account deficit, by perhaps as much as 30 percent to 40 percent from current levels. If at the same time there is a major reduction in Japan's current account surplus, and further reductions in the surpluses of Germany and the OPEC nations, we can expect a world payments pattern which will be more conducive to orderly foreign exchange markets.

Critical to the achievement of this goal is the reduction of inflation in the United States. In the first half of the year, the cost of living rose at an annual rate of over 10 percent partly as a result of adverse weather and its impact on food prices. For the second half of the year, we expect a considerable moderation in this rate of inflation as clearly reflected in the July and August figures. Nevertheless, it is clear that these levels are still too high and that further action must be taken.

As said yesterday, the President views this as the most urgent priority of his administration. He will shortly announce an intensification of our effort designed to achieve further steady progress in bringing inflation down.

This intensified anti-inflation effort will not be a one-shot affair. It will dovetail with the monetary policy currently being pursued by the Federal Reserve—a policy designed to reduce the rate of inflation while permitting our economy to grow at a rate consistent with its underlying potential. It will dovetail also with the tax proposals that the President has put before the Congress. These proposals are aimed at encouraging a higher rate of capital formation and expansion of our industrial capacity. This facet of our economic program is critical both to the maintenance of noninflationary growth and to the international competitiveness of our industry.

In sum, the world's economic and financial system is a great deal stronger and more resilient than is commonly perceived. The strains of the past few years have been severe. But the system has weathered the storm. The private markets have responded to unprecedented demands for financing. Governments have complemented private lending with increased concessional aid. The World Bank and the regional development banks have expanded their development lending. The International Monetary Fund has effectively financed the official balance of payments needs of its members. The system has demonstrated its capacity to adapt to rapidly changing world economic conditions.

International Monetary Fund

The International Monetary Fund is the institutional centerpiece of our international monetary system. Since our last meeting, comprehensive changes in the Fund's Articles and an agreed increase in quotas have been put into effect. These actions culminate years of negotiations on the future shape of the system. Our efforts must now be directed to implementation of the new provisions, to supporting the Fund in its expanded role in surveillance over the monetary system, and in responding to the balance of payments financing needs of a growing world economy.

I am pleased to report that the Congress is in the final stages of approving U.S. participation in the Supplementary Financing Facility. I am confident that work will be completed shortly to enable us to participate in this cooperative effort to strengthen the international monetary system in the period ahead.

At the same time, we must lay plans for the longer term. We must assure that the permanent resources of the Fund remain adequate, that it is in a position to fulfill its responsibility for providing balance of payments financing and fostering stabilization and adjustment in the years ahead. The Interim Committee has now reached a consensus on measures to strengthen the Fund's position. The United States believes that a quota increase of 50 percent, to cover a period of 5 years, is reasonable and necessary. A prime IMF responsibility is to provide official financing subject to the conditionality requirements that have been so central to the Fund's record of success. The quota increase, on which the final decision will be made by the end of the year, will assure that the Fund has the capability to continue that essential work.

We also support an annual 4 billion SDR allocation over the next 3 years. It is consistent with the liquidity needs of an expanding world economy and with the need to maintain the SDR as a viable and important reserve instrument. We know that today's inflationary problem dictates moderation in any official decision to expand world reserves. The allocation recommended by the Interim Committee represents a prudent compromise and will in no way weaken our efforts to control inflation. The Interim Committee has also agreed on significant new steps to increase the usability and usefulness of SDR's. We welcome this important progress in the development of that reserve asset.

The Fund has begun to implement new policies and procedures in surveillance over exchange arrangements and the international monetary system more generally. We believe that development of the Fund's role in surveillance is critical to our future management of the international monetary system. We will give our full support, and we are confident that others will do likewise.

We note with great interest the actions being undertaken by members of the European Economic Community to move toward their goal of economic and monetary integration, a goal the United States has long supported. It is of key importance that

the monetary arrangements developed by the European Community contribute to the strengthening and stability of the global monetary system and to the central role of the IMF within that system. I am confident that this will be the case.

The developing countries and the World Bank

I turn now to the second half of our agenda—the problems of the developing nations and the actions needed to support the World Bank group in carrying out its major responsibilities.

I am greatly encouraged by the economic progress the developing countries continue to make. Economic growth has remained strong in the face of the deep economic disturbances of a few years ago. The developing nations' trade has been robust, and their foreign exchange reserves have been greatly strengthened.

Thus the flexibility, strength, and dynamic character of the world economic system have effectively served the interests of developing as well as industrial countries.

All this is promising, but it is far from enough. President McNamara yesterday painted a broad, balanced, and vivid canvas for all of us to ponder. The Bank's World Development Report also gives us an invaluable guide to the tasks ahead.

We confront a somber situation. Even if the present encouraging trends continue, there will still be 600 million people in the world facing absolute poverty by the end of the century. If the economic pace should falter, or if family-planning programs do not expand, that number could be 1 billion. A tolerable world for the next generation requires that the developing economies grow faster, and that the benefits of that growth be distributed more widely. This outcome will depend on greater efforts in a number of areas by both industrial and developing countries, and closer cooperation among them.

First, the developing countries must have the opportunity to earn their own way through trade. The United States will do its share, along with other industrial countries, to maintain an open world trade system. In the GATT negotiations, the United States supports a 40-percent across-the-board reduction in present tariffs using the principle of normalization to reduce higher tariffs by larger amounts. It supports easing of nontariff restrictions. It will resist pressures for safeguards to limit the market access of developing countries.

For their part, the developing countries—particularly those whose trading interests are already strong—must participate as partners in this endeavor, providing reciprocal concessions and doing their share to support the rules that make an open trading system possible. Otherwise, the prospects for trade liberalization will be diminished.

Second, the developing countries must have access to a growing flow of nonconcessional capital from abroad. This is particularly needed by the middle-income countries. Here again mutual obligations exist. The industrial countries must make sure that capital markets remain open and that mechanisms are in place that will enable them to operate smoothly. To sustain this flow, the borrowing countries must demonstrate that they can use this capital productively, and that they can maintain an encouraging investment climate.

Third, concessional capital flows must increase in real terms, must go predominantly to the poorer countries, and must produce tangible benefits and enlarged economic opportunities for the poorest people in those countries. The United States proposes to increase its concessional aid in the future and expects to appropriate \$6.8 billion for such aid in fiscal year 1979.

Fourth, the objectives we seek to achieve will require greater policy emphasis on efforts to alleviate rural and urban poverty, to increase the productivity and employment opportunities of the poor, and to increase food production.

Energy is another high-priority area. The high cost of oil greatly increases the need to develop new sources of primary energy fuels in the developing countries. The United States strongly supports World Bank initiatives in this area and stands ready to help with technical and other assistance for energy development.

The World Bank stands at the center of this exercise in economic cooperation. It is the largest single source of development capital and a catalyst for the mobilization of private foreign capital. Bank projects are increasingly concentrated on improving the productivity of the poor and on fostering a wider distribution of the benefits of

economic growth. Because of its sustained and wide experience in development, the Bank is in a position to provide sound advice to borrowing governments, and because of its financial structure, the Bank ensures a fair system of burden-sharing for lenders and donors.

For these reasons, the United States will continue to provide firm support for the World Bank group along with the regional development banks.

- This year the United States expects to appropriate \$2.6 billion for its share in financing the multilateral development banks.
- At the Bonn summit meeting the United States joined other nations in pledging to support an increase in IDA lending in real terms. I can assure you that my Government will play an active, constructive role when IDA VI negotiations begin this year.
- The United States believes that the World Bank lending should increase by roughly 5 percent a year over the medium term and supports a substantial increase in the capital of the World Bank to make this possible. I hope that discussions on a general capital increase can resume this fall and that agreement in principle will be reached soon.

In sum, my Government supports an expansion in the operations of the World Bank and the redirection of its effort in the fight against poverty. This is an essential underpinning to a healthy international economic and political order.

Mr. Chairman, in addressing this meeting, I find myself following the convention of commenting separately on the activities of the Fund and the Bank. This is a useful convention, but somewhat artificial. Those who participated at Bretton Woods were keenly aware of the interrelationships in the work of the twin institutions they founded in a world recovering from war. Recent events have once again demonstrated that the course of world inflation, international payments, international trade, and economic development are inextricably linked.

The progress that nations have made on all these fronts since the world recession has been considerable. But more must be done. My Government will do its part to promote this progress by supporting an open world economy, by continuing to assure the free flow of goods and capital, by increasing aid flows, and by working to strengthen its own policies at home.

Developing Nations

Exhibit 64.—Remarks by Under Secretary for Monetary Affairs Solomon, December 5, 1977, to the Council of Americas at its XIII Annual Membership Meeting, New York, N.Y., on Latin America's role in the world economy

I am pleased to participate in this thoughtful consideration of Latin America's role in the world economy and of our country's relations with our neighbors to the south. This is a good time to assess the significant changes that are occurring. Our hemisphere has been challenged by a worldwide recession and by the energy crisis. Politically, the last few years have seen the emergence of a strong sense of individuality among the Latin nations and increasing reluctance to continue relationships not characterized by mutuality of interest and parity of dignity and respect. I believe our nations are adjusting to these challenges responsibly and effectively. This improving relationship will contribute significantly to economic growth in Latin America as well as to an enhanced political influence by this region on global issues.

Let us take a closer look at what has happened. Most remarkable, and heartening, has been the rapid economic growth rate in Latin America. Between 1965 and 1976 the gross domestic product of the region, excluding Venezuela, expanded at an average annual rate of 6.2 percent. This compares with an average growth rate of 5.7 percent for all non-OPEC developing countries and about 4 percent for the world as a whole. Thus, Latin America has progressively increased its share of world output.

The sharp increase in the prices of petroleum products since 1973 and the ensuing world recession exerted a profound impact on the region. Even today, none of the countries has fully adjusted to that shock. The magnitude of this problem is illustrated

by the fact that petroleum imports rose by 15 percent in volume between 1970 and 1975, while the value of such imports expanded by 460 percent from \$1.4 billion to \$8.1 billion. Combined with the rapid rise of public sector expenditures in many of the Latin nations, the rise in oil prices resulted in an acceleration of external borrowing and a concurrent growth in external indebtedness.

Whereas the annual level of foreign borrowing averaged only \$1.5 billion in the 1965-69 period, it had risen to over \$10 billion last year. In 1965, the public and publicly guaranteed debt of the region stood at \$870 million. By the end of 1975, it had expanded to \$41 billion, and more than half this increase came in the preceding 3 years. Unguaranteed bank credits also have risen sharply from \$2.5 billion 12 years ago to \$25 billion at the end of 1975. Much of this private financing represents a recycling of OPEC surplus funds, through banks in the industrial countries. At the end of 1976, for example, U.S. banks held over \$23 billion in claims on Mexico and Brazil alone.

We have an obvious strong interest in the economic well-being of the borrowing countries. While Latin American countries have borrowed unprecedented amounts in private capital markets, this rapid expansion of debt has been concentrated in relatively few countries. Mexico and Brazil together account for nearly two-thirds of the regional debt total, and the inclusion of Argentina, Chile, Colombia, and Peru would raise the fraction to nine-tenths.

This large increase in external indebtedness has given rise to considerable public concern and raised questions about the possibility of widespread defaults on bank loans. In our judgment, such fears have been exaggerated. Borrowing has been concentrated among a few, more advanced developing countries whose export performance, growth, and creditworthiness had gained them access to private capital markets. The poorer countries have continued to rely on official sources of financing, often on concessional terms, so that bank exposure in these countries remains quite small. For the countries which have borrowed heavily, servicing their debts has not become a problem. Their exports have risen fast enough to keep their debt service ratios nearly stable over the past decade.

As long as the OPEC surplus continues, the oil-importing countries collectively must continue to bear the corresponding deficit. And the international system will continue to face large financing needs. What these circumstances require is not for deficit countries to stop borrowing, but rather that they stabilize their economies and ensure that borrowed funds are invested productively to increase their ultimate debt service capacity, rather than to maintain consumption at artificially high levels. Domestic adjustment efforts will be required to bring borrowing needs down to levels compatible with sustainable capital flows and, in the process, to strengthen creditworthiness in the eyes of private lenders. An expansion of exports will also be critical for countries with increased debt service requirements.

A particularly notable trend in Latin American trade patterns during recent years has been the decline in the relative importance of trade with the United States. Between 1960 and 1976, Latin America's share of total U.S. imports declined from 20 percent to 14 percent. Perhaps even more significantly, the U.S. share of total Latin American imports declined from 46 percent to 33 percent. Most of the latter change was due to increased European and Japanese penetration into the Latin markets.

During the first half of 1977, the United States has experienced a sharp turnaround in its trade account with Latin America and the Caribbean. What was a \$100 million surplus last year has turned into a \$3 billion deficit this year, largely due to higher coffee prices, increased petroleum imports, and reduced U.S. exports to Brazil and Mexico. We expect this situation to improve somewhat as import demand picks up, particularly in the largest countries. However, we do think that the longer term changes in trade shares I noted above are not likely to prove subject to rapid reversal.

Generally the countries of the region have recovered rapidly from the world recession, and many have made considerable progress in stabilizing their economies. As a group, the Latin countries weathered the oil crisis better than most of the industrialized countries, which experienced little or no real growth in 1974 and 1975. Mexico, Peru, Argentina, Uruguay, Panama, and Jamaica also have undertaken stabilization measures through agreements with the IMF. Brazilian retrenchment

efforts are beginning to show concrete results even though the economy probably will grow at a substantial rate of about 6 percent this year.

The role of foreign investment has changed significantly in Latin America, as you know. Here again, the U.S. stake is a large one. By the end of 1976 the book value of U.S. direct investment in the area totaled \$23.5 billion—more than 80 percent of all U.S. direct investments in developing countries and more than twice the amount of only a decade ago.

Throughout most of their history, to their credit, the countries of Latin America have welcomed foreign investment. Recently, however, their attitude has become more cautious and, frankly, rather ambivalent. In the early 1970's, the countries of the Andean common market had a very strict code governing foreign investment which appeared to be highly negative and defensive. Since then some countries have loosened their restrictions on profit remittances to allow annual repatriation of up to 20 percent of registered capital, and they have liberalized other investment requirements as well. On the other hand, the trend in the two major recipients of foreign investment, Brazil and Mexico, seems to be the opposite direction. It is clear that all Latin American countries are now more selective about the types of foreign investment they are encouraging or even allowing to enter their country.

Reflecting these basic economic trends, our policies toward Latin America are changing and are becoming more complex. Economic issues are becoming more pressing and problematic. It has become critical for the United States and other industrialized countries to assure sufficient capital flows to the region and to keep markets open for exports from the region. Resource increases for the international development institutions are crucial, as are the multilateral trade negotiations in Geneva. The traditional donor-client relationship is giving way to healthier arrangements based on mutual benefit and cooperation.

This administration is committed to policies that take into account each Latin nation's diversity and potential. Neither the former "special relationship," nor a single policy toward the diverse nations in Latin America, makes sense. Our policies will be based on specific, mutual interests with particular countries, resulting in varying degrees of closeness in our relationships. Increasingly, our attention is focused on specific trade, commodity, and investment issues.

Trade.—The United States recognizes the priority the developing countries, including our neighbors in Latin America, place on access to our markets for their exports and our public and private capital flows. U.S. policy is to maintain access to our markets to the maximum extent possible. Despite protectionist pressures, the administration continues to reject comprehensive import controls in major industries of direct interest to Latin America, such as shoes and sugar. Similarly, the administration faces additional pressure to restrain further imports in textiles and steel. The President rejected tightening of the multifiber agreement on textiles and the imposition of quantitative barriers on steel. Continued access to our markets by Latin America, in particular, weighed heavily in the President's decision on textiles.

The high tariffs, import quotas, and export subsidies, often of considerable magnitude, of certain Latin American nations make it more difficult to resist protectionist sentiments in the United States. At times they conflict with our own countervailing and antidumping statutes. We and our Latin trading partners must work together more closely on both a bilateral and multilateral basis to assure that the international trading system remains as open as possible.

Commodities.—The United States and Latin American countries are both important consumers and producers of commodities traded on the world markets. Recently we worked together toward successful negotiation of the International Sugar Agreement. The United States is prepared to participate in negotiating other international agreements to stabilize prices when it is in our mutual interest to do so. There are other areas of mutual interest such as energy where we have a shared need for conservation, development of new sources, and moderation in international oil pricing.

Capital.—The United States is by far the world's largest lender in the international capital markets while some Latin states, notably Brazil and Mexico, are among the largest borrowers in the world. The United States is also the single largest contributor to the international development institutions which play so very important a role in the development of Latin America.

Despite their success in attracting needed private foreign investment, Latin Americans feel a need to maintain controls over incoming investors, as do most countries which host multinational enterprises. Yet foreign investors must be assured of fair and consistent treatment if they are to continue to operate. In contrast to the trade area, there are, as yet, hardly any international rules to protect the legitimate interests of all the concerned parties. To maintain the open international system, here again there may be room for cooperation looking toward the possibility for new international action in both the bilateral and multilateral channels.

Human rights.—There is no question that our human rights policy has caused some strains in our relationship with Latin America. Yet I believe it has produced positive results in a number of cases. The American commitment to foster human rights will not change. But as we gain experience, and if Congress permits us the necessary flexibility, we can be more effective in promoting human rights without a confrontational atmosphere.

Panama.—Panama perhaps affords the best example of how the relationships of the past must give way to those of the future. One of the least advanced of the Latin American countries, Panama is striving to reach the breakthrough already achieved by Brazil, Mexico, and Venezuela. It still depends on exports of a small number of primary products and inflows of investment to provide needed foreign exchange. In the decade prior to 1974, Panama's GNP increased at an average annual rate of 7.3 percent. In 1974, however, economic growth abruptly slowed to 2.6 percent, and last year there was no growth at all. A major cause was uncertainty over the future of the canal, which was reflected in a marked decrease in private investment activity. Private investment increased only slightly in 1974 and 1975 and fell by 26 percent by 1976. In addition, the increase in the price of oil, the sharp decline in sugar prices, and the worldwide recession also contributed to Panama's large current account deficits.

Our policies toward Panama must be modified to bring them into line with prevailing political and economic realities. If we wish to encourage the development of a stronger economy and greater Panamanian self-reliance, we must be prepared to take steps which will facilitate this process. The single most important factor in bringing renewed vigor to the Panamanian economy will be settlement of the canal issue and the ensuing restoration of a favorable investment climate in Panama. We expect that, as a result, foreign and domestic private investment will rise appreciably, leading to higher employment, reduced pressure on the Panamanian Government budget, and improvement in Panama's external accounts.

What's in it for us? The new treaties governing the Panama Canal support U.S. objectives in several fundamental ways. First, these treaties protect and advance our national security interests. Second, they provide for an open, stable, and efficiently operated canal for this hemisphere and for other nations throughout the world. And third, they will promote positive and constructive relationships between the United States and other nations in this hemisphere.

The concept of partnership is central to the new kind of relationships we are seeking. Throughout the discussions of the past years, our objective has been to shape a close and enduring partnership with Panama in maintaining an open and efficiently operated canal. The partnership envisioned in the new treaties has three aspects:

- The United States and Panama will be partners in the operation of the canal through the end of this century. During this period, the United States will continue to exercise the responsibility for managing the canal enterprise, but it will be preparing the Panamanians to carry on our tradition of reliability after the year 2000.
- The United States and Panama will be partners in protecting the canal. We will have the primary responsibility for defense of the waterway for the duration of the Panama Canal Treaty, but Panama will also contribute forces to canal defense.
- Finally, the United States and Panama will share a long-term responsibility for maintaining the canal's neutrality. Our role in assuring neutrality will continue as long as the canal remains in operation—even after management responsibility passes to Panama.

Today, more than six decades after its completion, the Panama Canal remains an engineering marvel, one of our greatest accomplishments in this century. The United States can also point with pride to the way we have operated the canal. For 62 years it has been run as a public service for the nations of the world, rather than as a business. Tolls have been set as low as compatible with meeting costs and providing a modest return, and world commerce has been a major beneficiary.

But while the canal has been a source of deep pride to the United States, it has been a troubling and festering presence in Panama. Under the Treaty of 1903, the United States exercises jurisdiction over the Canal Zone courts. It has established the Zone schools, jails, and police force. It has set up what the Panamanians regard as a colonial enclave, splitting their country in two and using 550 square miles of their territory. And the Panamanians resent especially that these U.S. actions were pursuant to a treaty that was not even signed by a Panamanian.

The new Panama Canal Treaties must be evaluated in terms of this history. We must recognize also that this is an issue which goes beyond our bilateral relations with Panama to affect our relations with all of Latin America. In the eyes of our Latin American neighbors, the canal runs—not through the center of Panama alone—but through the center of the Western Hemisphere. All the countries of the hemisphere look upon our position in the Canal Zone as the last vestige of a colonial past which evokes bitter memories. Their attitude toward us will be importantly influenced by our resolution of the Panama Canal issue. By going forward with the new treaties, we will be improving our relations with virtually all of the countries of the hemisphere. We will be demonstrating our intention of building relationships on the new concept of partnership rather than the old notion of colonial power.

We must recognize, too, that our primary interest in the canal is to assure that it remains secure and open on a neutral, nondiscriminatory basis. The greatest threat to the security of the canal would be to try to retain an outmoded treaty and its anachronistic provisions. In the past, these provisions have triggered hostility and violence, and they could so easily do so again in the future. Accordingly, the best way to preserve an open and secure canal is to substitute for the 1903 treaty a new arrangement which will be mutually fair, which will properly provide for Panama's just aspirations, and which will take into full account our own national interests.

Under the new treaties, the United States does not, under any circumstances, lose the right to assure that the canal remains open or to protect it in time of peril. The United States has committed itself to assure indefinitely that the canal shall remain secure and open to peaceful transit by the vessels of all nations in times of peace and in times of war. This applies not only up through the year 2000, during which period the treaties remain in force, but after that time as well.

Panama will not receive a financial windfall from the United States under the terms of the treaties. During the negotiations, we strongly and successfully resisted inclusion of any new financial grants to Panama. The payments Panama receives will reflect more fairly the fact that it is making available its major national resource—its territory. These payments will come entirely from canal revenues, and the amounts established are based on realistic projections of the canal's earning capacity. This arrangement gives Panama a vital stake in assuring the canal's efficient operation.

It is in our interest that we have a strong partner in operating the canal. For this reason, we proposed and the Panamanians accepted a nonconcessional assistance package outside of the treaties. These economic cooperation arrangements were formulated to help promote stable economic growth in Panama, which is the single most important way to assure the security and smooth operation of the canal. The arrangements include guarantees by OPIC of up to \$20 million in borrowing in the U.S. capital market by the Panamanian development bank; \$200 million in Eximbank loan guarantees, and insurance for U.S. export sales over a 5-year period; housing investment guarantees of up to \$75 million over a 5-year period; and up to \$50 million in guarantees under our foreign military sales program over a 10-year period.

These particular arrangements were selected for the benefits that they are expected to bring to both the United States and Panama, as well as the reasonable level of risk they present and their compatibility with the financial assistance programs involved. All of these offers are subject to the normal requirements and procedures of the administering agencies. Furthermore, the U.S. Government has successfully undertaken programs of this kind with Panama in the past.

I want to dispel any misunderstanding about the financing of the Panama Canal Commission, which would be an independent U.S. Government agency to operate the canal over the life of the treaty. An essential point in negotiating the treaty was that any new entity must be self-financing. We strongly believe that the Commission must not be financed by the American taxpayer. The administration will make every effort to see that the costs of the canal operation are contained and that revenues are sufficient to cover liabilities. Any borrowings by the Commission should be used strictly to support its operations, and the interest rate charged on such loans should be determined by market forces. Furthermore, all loans must be fully repaid prior to the expiration date of the treaties.

I believe that the Panama Canal Treaties deserve our support because they are in our interest as well as in the interest of Panama. For the people and Government of Panama, there is the knowledge that eventually they will assume full jurisdiction over their territory. There are significant revenues to be gained from efficient canal operations, and there are substantial economic benefits to be derived from the guarantees, loans, and credits we have made available on their behalf.

For the United States, there is the assurance that the canal will be open, neutral, secure, and operated efficiently, for our benefit and that of other nations around the world. These objectives will be accomplished without appropriating any of the American taxpayer's money, and we stand to gain respect throughout Latin America and the rest of the world for addressing this complex issue constructively and equitably.

Ratification of the treaties must be perceived as being positive and constructive, rather than as a concession on our part. It must be viewed as a realistic and desirable accommodation to the increasingly interdependent world in which we live. It should be taken as a sign of success in our efforts to promote the economic growth and maturity of the developing countries. It should be welcomed as a movement away from a one-way dependence to a partnership of rights and responsibilities.

The task of conveying this message does not promise to be an easy one. While the position of developing countries in the global economy has changed radically, and our own relations with them have been transformed commensurately, public perceptions and attitudes have lagged behind. The support of groups like yours in the weeks and months ahead will be invaluable. We will need your assistance in explaining the rationale behind the treaty's provisions, in clearing up any misunderstandings, and in creating greater public understanding of the far-reaching implications of the treaties for harmonious and constructive relationships with our Latin American neighbors.

Through financial links, direct investments, and trading ties, the economic well-being of the United States is inextricably involved with developments in Latin America. We have vital and expanding interests there which encompass the full spectrum of our affairs: Economic, political, national security, and humanitarian. Timely and appropriate policies to advance our interest in Latin America are fundamental for our own economic well-being and the achievement of our broad foreign policy objectives. Our efforts to achieve progress in the North-South dialog depend on harmonious and cooperative political relationships with these countries. Achievement of the goal of a stable and peaceful world order also hinges critically on the character and quality of our relations with our Latin American neighbors, as well as with other developing countries. The trend for the future is clear: more interdependence, not less. Surely it is in our own self-interest to encourage the trend toward increasing self-reliance and economic maturity on the part of our friends in Latin America.

Exhibit 65.—Remarks by Assistant Secretary Bergsten, February 7, 1978, before the International Development Conference, Washington, D.C., entitled "The United States and World Development"

The U.S. interest

The United States has a wide range of interests in the developing countries. Indeed, two developments have thrust them into the forefront of U.S. policy concerns.

One is our increasing dependence on the rest of the world for our security and our prosperity as our preoccupation with Middle East policies and the continuing oil crisis

depict so vividly. The second is the leap of the developing nations into world prominence by achieving nuclear capabilities, pivotal positions in regions of political turmoil, and an ever-growing role in the world economy.

Politically, the most likely arenas of future conflict lie in these areas, conflicts which could damage major U.S. interests directly, be they our concern for Israel and black Africa or our need for imported oil and other raw materials. Nuclear capabilities may well proliferate in specific developing nations unless effective agreements can be reached to halt them. To accomplish our aim of effectively limiting world trade in conventional arms, we must secure the cooperation of the developing countries.

The United States also has deep humanitarian interests in alleviating the sickness, hunger, and deprivation which prevail in the developing countries. More than 1 billion citizens of this planet do not now have access to potable water; 700 million do not have enough to eat; 550 million cannot read or write; 250 million do not have adequate shelter. It is inconceivable that any American who is aware of these conditions could ignore them. This administration is determined to be in the forefront of the international effort to meet basic human needs throughout the world.

It is not often recognized, however, that the United States also has major economic interests in the developing nations. One of the most dramatic developments of the past 20 years has been the rapidly growing dependence of the economy of the United States on the rest of the world: The fraction of our GNP deriving from trade has doubled; exports now contribute more to our GNP than does private corporate investment; 1 out of every 8 manufacturing jobs in this country produces for export; 1 out of every 3 acres of U.S. farmland produces for export; 1 out of every 3 dollars of U.S. corporate profits now derives from the international activities of our firms; over one-fourth of our consumption of 12 of the 15 most important industrial raw materials is imported.

The developing nations represent a major component of this growing U.S. reliance on external economic forces. The nonoil developing countries purchased one-quarter of our total merchandise exports in 1977. Including OPEC, the developing world took 40 percent of our exports of manufactured goods, creating almost 1 million jobs in this country.

In addition, the United States—and the rest of the industrialized world—increasingly depends on the developing countries for its energy supplies and other natural resources. Annual U.S. payments for oil now amount to \$45 billion, virtually all of it to developing countries. Five developing countries supply almost 50 percent of world copper; 2 account for more than 50 percent of world tin exports; 2 supply almost 75 percent of the world's consumption of natural rubber; 4 supply nearly 60 percent of world trade in bauxite. We also import from developing countries virtually all of our coffee, cocoa, tea, nuts, spices, vegetable oils, bananas, and fibers.

Third, the developing countries host a sizable share of U.S. direct investment. Last year, the income earned on our investments in these countries amounted to \$7 billion—about 37 percent of our net direct investment earnings worldwide, an important element of strength for the dollar in the exchange markets. Some of these investments also help expand the output of critical raw materials needed by our economy, and increase our exports by stimulating demand for U.S. goods, technology, and managerial skills.

U.S. policy: The general framework

It is clear that our most central national interests have become inextricably linked to the future of the developing countries. We are past the time when most international issues were a function of the balance of power between East and West, or turned primarily on events in the industrialized nations alone.

It is thus essential that U.S. policy respond positively to the legitimate concerns of the developing countries themselves, and provide an effective framework within which overall U.S. relations with them can prosper. The development issues, which are the topic of this conference, are an integral part of such a policy.

In shaping this policy, three cardinal points must be kept clearly in mind. *First*, there are two widely different categories of developing countries. There is a Third World of roughly 1 billion people in about 40 countries which is becoming a truly international middle class with respectable and rising per capita incomes, embryonic but impressive

manufacturing industries, and abundant endowments of natural resources. They are well able to take advantage of world trading and financial markets, and it is here that our policies toward them must focus.

At the same time, there exists a Fourth World which also comprises 40 or so countries and another billion people. It faces perhaps the most dire situation on Earth: Endemic hunger and even starvation, massive illiteracy and ill health, stagnant economies which have grown very little if at all during this decade. Its needs include concessional financial and technical assistance.

Second, a wide range of policies must be mobilized by the United States (and other industrial countries) to promote our interests in the developing nations. They must in fact encompass the whole range of our domestic and international economic policies: The growth of our own economy, the international monetary system, trade, commodities, and investment. Traditional programs of concessional aid are of little importance in the Third World, and can play only a supplementary role even in the Fourth World.

Indeed, development policy is far too important to be segmented from overall U.S. economic and foreign policy. Rather, each and every component of those broader efforts must be formulated and implemented with the needs of the developing countries kept fully and constantly in mind. Proposals which would seek to isolate development policy from the mainstreams of U.S. international economic policy, or overall U.S. foreign policy, are bound to backfire. They would weaken, not strengthen, the ability of the United States to contribute to development around the world.

Third, to be sustainable in the Congress and with the U.S. public, our policies toward the developing countries must demonstrably promote U.S. economic interests as well as our relations with those other nations. Fortunately, careful planning and skillful international negotiation can generate such policies in every key area of our relations with the poorer countries. I will indicate how this is so in each individual policy area, and return to the issue of congressional criticism at the close of my remarks.

U.S. policy: Specific measures

The single most important step we can take to provide a strong base for U.S. relations with both sets of developing countries is to assure dynamic, noninflationary growth in the United States itself. Strong growth in the U.S. economy provides a buoyant market for sales by the developing countries to the United States itself, and to other countries whose own economies are heavily influenced by our own. No developing country, from Japan to Brazil, has prospered without the benefit of extensive exports to the United States. In addition, strong economic performance at home makes much easier everything we wish to do abroad, by providing a domestic political climate conducive to constructive policies ranging from liberal trading arrangements to increased foreign assistance.

The economic program proposed by President Carter for 1978 will assure continued rapid growth in the United States, without rekindling inflationary pressures. It will thereby provide a growing opportunity for the developing countries to expand their own productive base and export earnings at the same time that it creates jobs and income at home.

Second, stability of the international monetary system is essential for all nations including the United States and, especially, the developing world. The ability of the system to stand the shocks of the last few years is a testimony to its strength and resiliency. But further measures are needed to ensure its continued effective functioning, and its support for the huge flows of private capital which have played such a crucial role in sustaining development in the poorer countries in recent years.

The administration strongly supports the creation of the Witteveen Facility in the IMF, to assure the ability of the Fund to meet all legitimate needs for official balance of payments finance during the next few years. The facility is scheduled to add about \$10 billion to the resources of the Fund, with the United States providing \$1.7 billion.

An important reason why this administration decided to support the Witteveen Facility, instead of the OECD safety net proposed by our predecessors, is its ability to lend to developing as well as industrialized nations. The Witteveen Facility does not constitute foreign aid—loans by the Fund are repayable over 3 to 7 years at market interest rates, and we receive a fully liquid claim on the Fund immediately upon making

our contribution. But the facility can help developing countries finance their external deficits and adopt improved economic policies, thereby contributing importantly to the world development process as well as to international financial stability.

A third key area of U.S. policy toward the developing nations is trade. The Third World, in particular, needs access to our markets for manufactured products.

We are implementing U.S. trade policy in a difficult period because unemployment remains far too high and our trade deficit has reached record proportions. Nevertheless, we believe that the most open possible trading arrangements are very much in the interests of the United States—to minimize inflation, to create millions of export- and import-related jobs, and to avoid protectionist outbursts in other countries.

The administration has therefore resisted all proposals for wide-ranging curbs on U.S. imports from the developing—and other—countries. The President rejected the proposal by the International Trade Commission to place comprehensive quotas on imports of shoes, a major and growing industry in developing countries, particularly in Latin America. He rejected comprehensive new import restraints on color television sets and sugar, and more recently on steel and textiles.

In short, the administration has sought to avoid imposing new barriers to imports from the developing countries. This will remain our policy. It is an essential element of our approach to the Third and Fourth Worlds. In addition, we are making a major effort in the multilateral trade negotiations in Geneva to further reduce barriers to international trade, particularly for products sold by the developing countries.

The Third and Fourth Worlds also need stable commodity prices, as both exporters or importers, to avoid disruption of their development strategies. We believe it is also in the economic interest of the United States to negotiate international commodity agreements where they can help to stabilize prices around market trends. In cases where buffer stocks are technically feasible, we will support their establishment and share in their financing.

A common fund, to link together specific commodity agreements, is an idea that has captured the imagination of the developing countries. We support an arrangement which, by pooling the financial resources of individual agreements, would expand the resources available to each.

One specific commodity is worth particular mention: oil. It is in the interest of both developed and developing countries to avoid further increases in oil prices, to expand production of oil and other fossil fuels, to adopt conservation measures, and to promote research and development of alternative sources of energy.

Our national energy policy is designed to benefit the developing nations, as well as ourselves, by reducing energy demand that otherwise could place upward pressure on energy prices. In addition, we have urged the World Bank and other multilateral development institutions to devote increased attention to energy projects, and they are doing so. We have stepped up our bilateral technical assistance in the energy field. We have proposed the creation of an International Energy Institute for similar purposes. We have expanded the activities of the Overseas Private Investment Corporation (OPIC) in supporting energy—and nonfuel mineral—projects in the LDC's.

Finally, foreign investment is an area in which the United States and the developing countries have common interests. The Carter administration is continuing the basic U.S. policy of not interfering in the decisions of private investors.

At the same time, we are taking steps to remove any unnecessary barriers to investment in the developing countries. Our major effort is to support the extension of OPIC, which we have already given a new mandate to focus on the poorest developing countries which truly need outside help to attract foreign investment.

The role of aid and the development banks

Finally, in assessing our relations with the developing countries early in this administration, we concluded that a substantial increase in foreign aid was appropriate. The United States presently allocates only 0.27 percent of its GNP for foreign assistance, compared with an average of 0.61 percent for our industrial-country partners. The United States should be doing more.

U.S. aid has several elements: Bilateral development assistance, multilateral assistance via the international development banks, commodity assistance (Public Law

480), military assistance, and security supporting assistance. I will focus today on what appears, at this point in time, to be the most controversial component of the program—our participation in the development banks.

The development banks represent an extremely effective mechanism for translating our assistance into sound development programs and improvement in the basic human needs of the citizens of recipient countries. This is partly because the banks have built the most professional corps of development experts in the world, and can assure effective utilization of their loans. It is also because they can best promote improved economic policies in the developing countries; political factors usually prevent bilateral donors from pressing recipient countries too hard to adopt proper policies. Indeed, the policy changes stimulated by the multilateral donors may be a more important force for development than the resources actually transferred.

A second fundamental reason for U.S. support of the development banks is that they assure equitable burden-sharing among the United States and the other donor countries. The United States contributed only about 25 percent to the latest round of bank replenishments, compared with our 40-percent share of the combined GNP of the donor countries. The U.S. share has declined in every past replenishment in every one of the banks.

Indeed, the true cost to the United States of its participation in the banks can be understood only after first distinguishing between their two types of funding. The soft-loan windows—the International Development Association, the Asian Development Fund, the Fund for Special Operations of the Inter-American Development Bank, and the African Development Fund—are financed through actual contributions paid by the U.S. Government and other donors. These funds are passed on to borrowers at extremely concessional rates.

On the other hand, the hard-loan windows of the World Bank, Asian Development Bank, and Inter-American Development Bank are financed almost wholly by funds borrowed from private capital markets in the United States and elsewhere. To facilitate this borrowing, the donor countries subscribe capital to the banks. However, only a small fraction of the total U.S. capital subscription ever leaves the U.S. Treasury. The fraction was only 10 percent for the last replenishment of the World Bank and Asian Development Bank, and 20 percent for the Inter-American Development Bank.

The remainder is callable capital, which would only be called by the banks if defaults by borrowing countries threatened the liquidity of the lending institution. No country has ever defaulted on an international development bank loan, and there is every reason to believe this flawless repayment record will be maintained. The possibility that callable capital for any of the hard windows will ever be called is extremely remote.

For every dollar of World Bank lending, only about 2 1/2 cents of U.S. funding thus ever leave the U.S. Treasury—10 percent of our 24-percent share of the Bank's total capital. Every dollar of Asian Development Bank lending requires an actual U.S. outlay of only 9 cents. The United States pays out about 21 cents for every dollar lent by the Inter-American Development Bank to the developing countries of this hemisphere. Taking the three together, the United States contributes about a nickel to actual resources for every dollar of hard window lending.

The numbers for the soft-loan windows are not as dramatic, because lending is financed almost entirely by actual contributions, but they still achieve effective burden-sharing among donor countries. The U.S. contribution to the development banks is thus the most cost-effective contribution to development which this country can make.

This analysis places in perspective President Carter's budget request for the international development banks of \$3.5 billion. Only \$2.1 billion of this total represents actual budget outlays. The remaining \$1.4 billion is callable capital, which is highly unlikely ever to leave the Treasury. Thus the numbers are much smaller than they look, in terms of actual U.S. Government expenditures.

Last year, we sought \$2.6 billion for the banks. Congress appropriated \$1.9 billion, a sharp increase from the previous year. But its cuts, combined with smaller shortfalls from the previous year, mean that the United States is now \$835 million short of meeting its responsibilities in the international development banks.

These funds have been fully authorized by the Congress. They were pledged by past administrations in the course of international negotiations, establishing the size and

burden-sharing of the various institutions. The funds are needed, they are justifiable, and they will be productively employed.

Continued U.S. failure to supply these funds will cut the flow of assistance to the neediest countries and people in the world. It would call increasingly into question the reliability, and international credibility, of the United States in fulfilling pledges undertaken in good faith and accepted as such by the other donor countries, our major allies. The administration believes that it is absolutely imperative to secure funding for our past pledges this year.

Apart from this necessary catchup, the budget request for FY 79 exceeds the request for FY 78 by only \$54 million. Except for fulfilling the past pledges, administration requests for the IFI's have reached a plateau which will have remained virtually unchanged over a period of 4 years.

Criticisms of the banks

Long-term U.S. objectives for the international development banks are perfectly clear: To continue promoting equitable growth in the LDC's; to expand efforts to reach the poorest directly; to encourage the exploitation of energy resources; to join in pressing for an expansion in human rights in countries where they are denied; to reduce the administrative costs of the banks, especially by bringing salaries back into line.

Our goals are clear. And real progress has been made on several of these issues, and I expect to report even more progress shortly.

But during the legislative process last year, some Members of Congress suggested seeking additional objectives in the banks. The original House version of the appropriating legislation would have prevented the use of U.S. funds for loans for the production of certain commodities, or to certain countries. If these amendments had passed, the charters of the banks would have prevented their accepting U.S. funds. Let there be no mistake about it—the banks cannot, and will not, accept earmarked funds. U.S. insistence on such conditions would effectively take the United States out of the banks.

The recent increase in the magnitude of U.S. contributions to the banks, reinforced by their sharply increased proportion of the total U.S. aid effort, virtually assures—and justifies—increased congressional attention to them at the level of both broad policy and program details. The issue, as in many other aspects of U.S. foreign policy, is how to reconcile the constitutional responsibility of the administration to execute U.S. international affairs with the constitutional responsibility of the Congress to exercise its power over the purse.

The best approach would seem to be the development of a common view on the objectives to be sought by the United States in the banks, with ongoing congressional review of the means by which the administration was seeking to achieve those goals. This would replicate the approach worked out concerning U.S. bilateral aid in the early 1970's. The Congress mandated a set of "new directions" which AID has been seeking to implement ever since. In the case of the banks, it should be possible to reach agreement on a few basic goals: Concentration of soft window lending on the poor and of hard window lending on capital projects, promotion of human rights objectives, and rationalization of the administrative costs of the institutions.

Any such consensus would have to rest on one fundamental point: That the advantages to the United States of channeling an important share of its aid through the banks outweigh the inherent disadvantages of our being unable to work our will unilaterally in them. In moving toward a sustainable U.S. aid policy, attention must focus on this fundamental issue. And it must be recognized that our ability to achieve our national objectives in the banks will ultimately depend on our contributing our fair share to their replenishments, clearly defining our objectives, working diligently to achieve them consistent with the charters of the banks, and seeking cooperation of other countries in an inherently multilateral operation.

Conclusion

I have sought to outline today the vast interest of the United States—in political, humanitarian, and economic terms—in the developing nations. I have recited the several components of the comprehensive effort of this administration to promote these

interests in ways which support U.S. economic objectives directly, as well as indirectly, by strengthening our overall relations with the Third and Fourth Worlds.

Yet all of us at this conference must candidly recognize that questions have been raised in the Congress, not only about the international banks but about the wisdom of the policies which we are following in general. We must not overstate the degree of this doubt: No protectionist trade legislation has emerged, no checks have been placed on U.S. foreign investment, new U.S. participation in international commodity agreements has been ratified, and foreign aid appropriations were increased sharply last year, including a jump of more than 70 percent for the development banks.

Yet central components of our policy toward the developing world are under attack. Doubts have been expressed about the Witteveen Facility in the IMF, partly on the erroneous view that it is foreign aid. Pressures abound for import relief, particularly on products from the poorer countries. Attacks on OPIC could jeopardize our most effective program of supporting developmental private investment in the poorest countries. Misconceptions, along with legitimate concerns, plague the outlook for our contributions to the development banks and have triggered destructive proposals which would literally preclude continued U.S. participation in them.

This International Development Conference epitomizes the annual renewal of the commitment of many Americans to the development process. In a sense, it launches each year's effort in this country to promote development around the world. In 1978, that effort must lie primarily on the homefront: We will have to win the debate at home in order to achieve our purposes abroad.

The United States clearly has the means to promote development around the world. I believe that the administration has developed a comprehensive program to do so. The responsibility now lies on all of us, inside Government and out, to convince the American people that we should do the job. It is to this task that the International Development Conference in 1978 should be devoted.

Exhibit 66.—Excerpts from statement by Deputy Assistant Secretary Nachmanoff, March 14, 1978, before the Subcommittee on International Development Institutions and Finance of the House Committee on Banking, Finance and Urban Affairs, on the congressional policy directives in Public Law 95-118

* * * * *

The administration generally is in agreement with the intent of the policy directives in Public Law 95-118. We share with the Congress many of the same concerns which motivate and underlie these directives. For example, the intent of section 701(d) to channel increased assistance through the banks for basic human needs is fully consistent with the administration's own policy objectives. However, Mr. Chairman, there is one directive which we do not believe is the most effective way to deal with our concerns. The approach contained in section 901(a), mandating negative votes or abstentions on projects involving three agricultural commodities, is not appropriate because such restrictions could set a precedent and encourage other countries to take similar actions, which would seriously undermine the concept of multilateralism, and is not necessary because the banks themselves as a matter of policy will not lend for commodities in oversupply. In all cases, however, the administration has made a conscientious effort to implement these directives fully and fairly, and progress has been achieved in many areas.

The advantages of multilateralism

Before discussing the specific policy directives, I would first like to make some general comments about our ability to carry out these directives or, put in more direct terms, the degree to which the United States can exercise maximum influence in the international development banks.

First, there is a tradeoff between the advantages and disadvantages of multilateral assistance. The fundamental disadvantage of the banks, from the standpoint of the United States or any individual country, is the fact that, because they are multilateral

institutions, no one country can dictate bank policies. We will not always carry the day in the bank boards with our policy preferences, be they on the direction of bank lending, on human rights, or on the whole range of administrative issues. On the other hand, we can succeed on most issues where the basic objectives we seek to achieve in these institutions are shared by the other members and where we have the flexibility to achieve a consensus on the specifics of the issue.

Despite our lack of complete control, it is clear that the advantages we derive from our participation in the development banks far outweigh the disadvantages. The banks assure effective use of our money by insisting on sound development projects and policies in an apolitical manner. As new international needs arise, the banks are quick to respond, as the World Bank has demonstrated with its expanded program for energy and raw materials development. The constructive role of the IFI's as a forum in the North-South dialog stands out, particularly by contrast with many less constructive approaches which have been proposed in other fora. Finally, these institutions serve our interests in a cost-effective way. Our share in the latest round of replenishments is 25 percent, compared with our 40 percent of the gross national product of donor countries. Since borrowings from capital markets provide operating funds for the hard-loan windows, the United States provides only a nickel of actual resources for every dollar they lend. Thus, for every dollar the banks lend which support objectives we consider important; i.e., to help the developing nations' economies grow, adjust to the effect of oil price increase, generate increased production of energy and raw materials, meet the basic human needs of their poorest people, it costs the U.S. taxpayer 5 cents. In addition, the banks have spent about 2 dollars in the United States for every dollar we have actually paid in to them.

Maximizing U.S. influence

Within this multilateral setting, the issue for the United States then becomes how to maximize our influence in order to carry out these directives. What must we do to achieve a higher level of success in having our concerns addressed by the banks? The most critical factor is to do our fair share in supporting the operations of these institutions. Other donors consider it ironic that the country (the United States) which is behind in meeting its commitments and whose financial share has been declining seeks to impose its views increasingly on the policies and programs of the banks. From the perspective of other donors, it is difficult to understand how we can expect to exercise more influence on bank policies, while we delay or fail to pay our pledges, which represent our fair share of the burden.

Our current share in the banks is not excessive. Our share is now 25 percent and has declined substantially in each institution.

Our voting power is also declining in response to the relative decline and delay in our financial contributions. In the IBRD we currently hold 22.65 percent of the vote; after the Selective Capital Increase, it will drop to 21.6 percent if we subscribe our full share. Our vote in the IFC will drop from 26 to 24 after the current capital increase. Our IDB vote is at 34.5 percent; it cannot drop below that percentage without our consent. However, other donors have recently had to withhold their subscriptions in order to prevent our share from falling. This is because the Congress did not provide our full appropriation request last year. In the ADB, U.S. policy has been to try to maintain parity with the Japanese. However, we need to obtain the full fiscal 1979 request of \$239.2 million, including the \$35.6 million which was not appropriated last year, in order to achieve that parity.

Of course, there is more involved in the degree of U.S. influence than simply the level of our subscriptions and voting shares. Traditionally, we have derived additional leverage from our leadership role in these banks. When other donors and the institutions themselves are convinced of our support, our relative influence is greater. When it is apparent that we are sincere in trying to make the banks more effective instruments for development in the poor nations of the world, our suggestions are taken more seriously. To strengthen the moral basis of our influence, I believe three elements are essential in our approach in the banks: Cooperation with others, a positive approach with flexibility, and a clear set of priorities.

First, and most importantly, we need to enlist the cooperation of other countries. With the support of the major shareholders, we can have greater influence on IFI policies. This is the approach recognized explicitly in section 703(a), in the human rights area, and in section 601 regarding the African Fund, which calls for consultations with other members. It is necessary in other areas, too. The IFI's can be responsive where the particular concerns are appropriate and are shared by key members. For example, the IFI's are aware that most member countries support an increased emphasis on projects that go directly to the poor and address basic human needs. As a result, they are already implementing this new policy thrust. Indeed, these institutions, especially the World Bank, began to move in this direction prior to the passage of Public Law 95-118.

It is essential, however, that our concerns be aimed at advancing the development process. Other countries sometimes view policy directives proposed by the United States as not germane to development, but motivated by domestic political concerns. Indeed, restrictions explicitly based on such concerns blur and undermine the credibility of our other policy objectives, including human rights.

Therefore, as a second element in our strategy, the United States must formulate its concerns in terms of their impact on sound, effective development. We have been the most successful when we raise issues in a positive way in the context of economic and social development that is normally appropriate for bank deliberation. When we raise legitimate developmental concerns we can usually get the support of others. When we raise domestic political issues, we often find ourselves isolated and less effective in the banks.

Flexibility in our approach to development issues is also essential if we are to influence development policies. To influence policies in a body which includes many members requires flexibility to negotiate and bargain in order to build consensus. Mandatory negative votes and abstentions on projects, as called for in some congressional directives, generally do not result in disapproval of loans nor increased influence with other donors or bank managements. Such restrictions reduce our ability to negotiate for the support of other countries. Our influence at the loan approval stage is more effective when we are able to convince other shareholders of the logic of our concerns and when we can form a consensus that future projects should not contain similar deficiencies, whatever the particular issue.

Third, we must concentrate on the priority issues. U.S. influence in the banks cannot be scattered over a broad spectrum of issues if it is to be effective. The Congress and the executive must agree on the priority U.S. concerns to be addressed by the IFI's. In his statement, Assistant Secretary Bergsten identified 10 different topics where the Congress has expressed a policy direction by statute. Similarly, the list of 15 policy directives in Public Law 95-118 makes it difficult to establish priorities, especially when conflicts among the various policy objectives arise. To shorten the list, and improve our effectiveness, the administration is now proposing to concentrate its leverage potential on four issues in the IFI's: Improving the effectiveness of IFI lending, human rights, salaries and other administrative concerns, and accountability.

The conflict between directives

Mr. Chairman, your January 22 letter raised the question of conflicts among objectives. The proliferation of policy directives increases the possibility of conflicts. For example, a light technology project which promotes basic human needs may run afoul of proscriptions on agricultural loans, as in the case of palm-oil projects in poor regions of poor countries. Should we oppose palm-oil projects which provide assistance to substantial numbers of poor people? The current legislation requires that we must oppose such projects which "will cause injury to U.S. producers" regardless of the effect upon poor people. We have recently had such a case in an IBRD loan to Malaysia for palm oil. The United States opposed the loan because the palm oil would be exported, and there was a possibility of injury to U.S. producers, even though the proposed project would have improved the productivity and incomes of a substantial number of poor farmers.

Where we have discretion, our decision in addressing these conflicts is guided by a judgment of what is likely to be most effective. Sometimes we can work quietly within

the institutions to influence changes in projects and policies to avoid such conflicts. But we are less likely to be effective where our vote is predetermined, as in the case of mandatory no votes. The earlier provision on nuclear nonproliferation which the Congress wisely eliminated last year required the United States to vote automatically against loans to a very poor country without consideration as to whether or not the loan was economically sound or met our other policy objectives. In such cases, Mr. Chairman, other foreign policy tools may be more appropriate: Our vote on IFI loans is not always the most appropriate or effective instrument to achieve our nondevelopmental foreign policy objectives.

Where the administration does not have discretion, conflicts among policy objectives are resolved on the basis of the greater restrictiveness contained in some prohibitions than in others. In the example cited, the United States had to oppose loans for palm-oil production which would be exported and which could cause injury to U.S. producers regardless of the impact on human needs or development. In this context, a more preferable approach is the human rights provision worked out last year by this subcommittee which permits some flexibility in our opposing loans to violating countries and authorizes us to support loans which support basic human needs even in such countries.

Specific policy directives

Mr. Chairman, in response to your request, I would like to turn now to seven of the specific policy directives contained in Public Law 95-118. (A discussion of the other eight directives is attached to this statement.)¹ Where appropriate, I will cite the relevant legislation, provide a progress report, and assess the effects of the policy upon U.S. participation.

With regard to the legislative requirements for reports on human rights (sections 701(c) and 703(b)), light capital technology (section 801(b)), and nutrition (section 901(b)), I might simply note that the administration intends to submit each of these reports at the time required.

Let me first comment on those directives where we are in complete agreement with the intent and the approach of the Congress.

Reaching the poor

"The United States Government, in connection with its voice and vote * * * shall seek to channel assistance to projects which address basic human needs of the people of the recipient country * * *." (Section 701(d))

The Executive Directors must consider in carrying out their duties "the extent to which the economic assistance * * * directly benefit the needy people in the recipient country;" (Section 701(b)(2))

I have put these two directives together, Mr. Chairman, because they are so interrelated and, together, comprise a basic thrust of the administration's foreign economic assistance policy: reaching the poor and helping them to meet basic human needs. We are fully in agreement with these two directives. Significant progress has been made although, as I mentioned previously, much of the credit belongs to the development banks who took the initiative to move in this direction. Because of the donors' importance and high priority to these directives, I would like to discuss them in some detail.

In recent years, the international development banks have changed lending policy and practice to reach the poorest people of the world and to meet basic human needs. Since agriculture is considered the key to success in this effort, the changes have been primarily in this sector. At the same time, there is increasing interest in helping small-scale enterprises and applying intermediate technology. This can be done in both rural and urban areas. From an institutional point of view, the World Bank group has been the leader in making these changes.

Basically, the changes have been along the following lines:

¹ Not included in this exhibit.

- Increased use of aid leverage to encourage policy changes favoring better income distribution in developing countries.
- Changes in sectoral composition of lending to meet basic human needs.
- Modification in design of projects to pass greater benefits to poorer people.

Let me illustrate each of these points. In Liberia, major export crops including coffee, cocoa, palm kernels, and palm kernel oil are processed and marketed exclusively by the Liberian Producer Marketing Corporation, a 50-percent Liberian Government and 50-percent private Danish company. The LPMC operates commercially and profitably at the expense of producers, most of whom are small poor farmers. Producer prices accounted for only 50–60 percent of their f.o.b. value in the early 1970's.

The World Bank, recognizing the dangers of such a system, insisted on several conditions to a 1975 loan for agricultural development: The LPMC would be required to (a) establish annually a fixed marketing cost margin consistent with efficient marketing procedures; (b) establish a price stabilization fund that would be separate from other LPMC accounts; and (c) establish a price intervention system under which the producer would receive a minimum of 60 percent of the anticipated medium-term f.o.b. value of the commodity. The World Bank did not resolve all the marketing difficulties of poor farmers with these conditions, but the Bank's policy influences had a definite positive effect.

The changes in the sectoral composition of IFI lending during the 1970's has been impressive. Between FY 1973 and FY 1977, World Bank group lending in this sector increased from \$938 million, or 28 percent of total lending, to \$2.3 billion, or 33 percent of the total. For FY 1978, projections are that World Bank group lending for agriculture will reach almost \$2.9 billion, or 36 percent of the total.

In terms of sectoral concentration, the agricultural and other rural lending of the IDB was 35 percent of its total, or \$634 million, in 1977. This percentage reflected an increase from 31 percent in 1973. For the Asian Development Bank, agricultural lending in FY 1976 amounted to \$200 million, or 26 percent of the total. This percentage also reflected an increase from 24.5 percent in 1974.

In looking at the IBRD figures for FY 1977, \$1,452 million, or 63 percent, of agricultural lending was for rural development with benefits accruing largely to rural poverty target groups. This reflected a large shift within the sector in favor of poverty groups since FY 1973 when \$247 million, or 26 percent of total agricultural lending, was directed at these groups. The corresponding figure for FY 1978 is expected to continue high at about 58 percent. These numbers demonstrate, I think, that an important shift in the lending patterns has taken place.

More change is needed; however, an important issue is the pace of this change. Projects of this kind are more difficult to design and implement than infrastructure loans, for instance. More staff time is needed to avoid poorly targeted projects and follow-on evaluation is required. Some types of projects are still at relatively experimental stage.

A series of World Bank loans to Mexico for livestock and agricultural development illustrates the manner in which the Bank is changing the emphasis of traditional projects. The first three loans in the series, totaling \$165 million, concentrated funds on large, commercial producers. Subsequent loans in 1973 and 1976 totaling \$235 million included increasingly important small farmer components, and this trend will continue with a \$175 million livestock and agriculture project now under preparation.

Generally, Mr. Chairman, this concern is one that is shared by the Congress, the administration, the banks, and the developing countries themselves, as well as other donors. Amidst this consensus on priorities, however, I wish to express one caveat. We must recognize that not all IFI projects can be directed to the poorest people and serve basic human needs. The banks also serve other development objectives: Infrastructure investment is still needed in many of the poorest countries; lending for structural adjustment is still important given the uncertain state of the world economy. It is in the general interest of a healthy world economy to encourage IFI lending for energy and raw materials in the developing nations.

African Development Fund

“* * * The Secretary of the Treasury is directed to begin discussions with other donor nations to the African Development Fund for the purpose of setting amounts and of reviewing and possibly changing the voting structure within the Fund: * * *” (Section 601)

We have made progress here, too, Mr. Chairman. In fact, I have just returned from a replenishment discussion in Geneva on March 6. Regarding the amount of the next replenishment, a consensus is forming around the \$650–\$750 million range to cover lending from 1979–81, compared to about \$250 million in the first general replenishment without U.S. participation in the original agreement. The administration has not yet taken a position. However, it is our view that the 10.6-percent share suggested in the sense of the Senate resolution, enacted last year, may be inappropriate, given our strong foreign policy interests in Africa and our emphasis on assistance for the poorest nations. Our current share in the African Development Fund, 5.7 percent, is lower than that of 6 other countries. Other donors and the African countries have indicated their hope that we will play a larger part in the fund.

Regarding a small change in the fund's voting structure, we have explored this with other members and believe some progress is possible, though not immediately. The African Development Bank, which is the parent organization of the fund, is considering a fundamental change which would open the Bank to membership of nonregional countries. Such a change would give nonregional members (who would be principally the fund donors) representation on the Bank's board. This automatically would increase nonregional influence and voting strength in the fund, since the Bank's 50-percent voting share in the fund would of necessity have to reflect the views of the entire Bank board. However, the decision to open up the Bank to nonregional membership will have to be made by the present membership of the Bank, and may be taken up at the annual meeting in May. It is our view, and the view of other governments we have consulted, that the question of the voting structure of the fund should be deferred until the Bank membership issue is resolved. We will, of course, keep the Congress fully informed of progress on this issue. In any case, we will continue to have a voice in fund operations through our Alternate Executive Director and an increase in our share in the fund would make it extremely likely that we could obtain an Executive Director's position.

* * * * *

Commodities

“* * * The United States representatives * * * shall oppose any loan or other financial assistance for establishing or expanding production for export of palm oil, sugar, or citrus crops if such loan or assistance will cause injury to United States producers of the same, similar, or competing agricultural commodity.” (Section 901(a))

Mr. Chairman, I previously indicated that the administration is not in complete agreement with this directive. We do not think this is the best way to handle this problem. We can achieve the same objective—avoiding LDC exports of a commodity already in oversupply in world markets—by working with the banks to apply their own sound economic criteria.

For economic and financial reasons, all of the banks have explicit or implicit policies against financing projects which would produce surplus commodities. The problem is a serious one for the IFI's because it is in their interest to maintain high standards of economic viability in their projects. Each project must contribute to maintaining the creditworthiness of the institution, especially if IFI bonds are to continue to have the highest credit rating on the world's capital markets. The banks do not wish to use their resources inefficiently. The World Bank, for example, states it will consider a project only if the project is viable, the country has a clear comparative advantage, and if there are no other alternatives available for increasing income and employment.

A major problem with this directive is the dangerous precedent established. If carried to its logical extreme, this directive could encourage similar restrictions by every special interest group—not only in the United States, but in other countries. The multilateral

concept could unravel as member countries sought to protect their special interest groups. This is a very serious and troubling possibility, Mr. Chairman. The ability of the banks to carry out their objectives—assisting development and helping to meet basic human needs of the poorest people in the world—could be severely hindered. Finally, as I mentioned earlier, this kind of directive, designed solely to protect domestic interests, can undermine the credibility of our other policy objectives.

The preferred alternative to this mandatory restriction, which carries such damaging risks, is to work quietly within the banks to influence the composition of projects and to exchange views on projects with other donors. In this manner, we can achieve greater cooperation and assure that our concerns are taken into account, without damaging the integrity or development operations of the banks.

In spite of our objections to this kind of directive, Mr. Chairman, the administration has acted in good faith to carry it out. Since the directive became law, we have closely examined six loans and opposed two—one for sugar production and one for palm-oil production. Our negative vote did not stop either loan from being approved. Aside from sugar, commodities covered by the legislation are not currently in surplus and are unlikely to be when the projects approved come on stream. On one proposal, an IFC sugar loan to Swaziland, the United States did oppose the loan because of the uncertainty over the borrower's ability to increase its quota in the International Sugar Agreement to assure the economic and financial viability of the project. In the case of palm oil, we opposed an IBRD loan to Malaysia recently because the palm-oil production element of the project was completely for export, would expand that country's market share at the expense of other exporters, and might put some additional pressure on prices. We are continuing to review loans in this category very closely.

Conclusion

In conclusion, Mr. Chairman, I would emphasize one central point in regard to policy directives affecting the international lending institutions. U.S. influence is large because of our historic role in these institutions and our position of leadership in the world. In general, we share the concerns of the Congress and will continue to carry out the policy directives. However, to be effective in achieving our policy objectives, the United States must—

- Provide its fair share of the funding;
- Work within the ground rules set by the charters of these institutions;
- Enlist the cooperation of other members in supporting our objectives—such cooperation will be readily available when our objectives are directed to improving the development impact of the institutions, broadly conceived;
- Avoid taking inflexible positions such as in the commodities restriction; and
- Set clear priorities and try to minimize the conflicts among our various policy objectives.

This is how the United States contributed to the effectiveness of these institutions in the past. This is how the United States should act in the future to enable these institutions to continue to make their critically needed contribution to the world economy, and especially toward improving the lives of the world's poorest people.

* * * * *

TESTIMONY ON INTERNATIONAL MATTERS

Exhibit 67.—Other Treasury testimony in hearings before congressional committees

Secretary Blumenthal

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, U.S. Senate, 95th Congress, 2d session, on the Carter administration's FY 1979 appropriations request for the international development banks, February 27, 1978, pp. 122–62.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on FY 1979 appropriations for the international development banks, March 6, 1978, pp. 402-420.

Under Secretary for Monetary Affairs Solomon

Statement published in hearing before the Subcommittee on International Finance of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 95th Congress, 1st session, on S. 2093, a bill to discontinue use of the ESF for payment of administrative expenses on October 7, 1977, pp. 8-22 and Report of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, to accompany S. 2093 on Exchange Stabilization Fund amendments of 1978, February 6, 1978.

Statement published in hearing before the Subcommittee on International Economics of the Joint Economic Committee, 95th Congress, 1st session, on the U.S. position in international trade and its implications, October 11, 1977, pp. 43-53.

Statement published in hearing before the Subcommittee on International Finance of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 95th Congress, 2d session, regarding the impact on U.S. exports of changes in the value of the dollar and more active exchange market intervention by Treasury and Federal Reserve, February 6, 1978, pp. 4-13.

Assistant Secretary Bergsten

Statement published in hearings before the Subcommittee on Trade of the Committee on Ways and Means, House of Representatives, 95th Congress, 1st session, on change in U.S. balance of trade over past 2 years, November 3, 1977, pp. 67-9.

Remarks published in hearing before the Subcommittee on Taxation and Debt Management of the Committee on Finance, U.S. Senate, 95th Congress, 2d session, entitled "The International Economic Situation," January 23, 1978, pp. 74-80.

Statement published in hearings before the Subcommittee on International Economic Policy and Trade of the Committee on International Relations, House of Representatives, 95th Congress, 2d session, entitled "The Policy of the United States Toward International Commodity Agreements," February 21, 1978, pp. 184-205.

Statement published in hearings before the Subcommittee on International Development Institutions and Finance of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 95th Congress, 2d session, on U.S. participation in the international financial institutions, February 28, 1978, pp. 44-63.

Statement published in hearings before the Subcommittee on Foreign Assistance of the Committee on Foreign Relations, U.S. Senate, 95th Congress, 2d session, on the U.S. development assistance program and issues raised by S. 2420, March 3, 1978, pp. 279-83.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on the International Bank for Reconstruction and Development, March 7, 1978, pp. 880-82.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on the International Finance Corporation, March 7, 1978, pp. 773-75.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on the International Development Association, March 7, 1978, pp. 804-09.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on the Inter-American Development Bank, March 8, 1978, pp. 619-25.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on the Asian Development Bank, March 8, 1978, pp. 735-39.

Statement published in hearings before the Subcommittee on Foreign Operations of the Committee on Appropriations, House of Representatives, 95th Congress, 2d session, on the African Development Fund, March 8, 1978, pp. 608-11.

Statement published in hearings before the International Trade, Investment and Monetary Policy Subcommittee of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 95th Congress, 2d session, on the extension and increased authorization of the Export-Import Bank, March 13, 1978, pp. 38-71.

Statement published in hearings before the Subcommittee on International Development Institutions and Finance of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 95th Congress, 2d session, on U.S. participation in upcoming replenishments of the international development banks, April 5, 1978, pp. 345-63.

Statement before the Subcommittee on International Economic Policy and Trade and the Subcommittee on Africa of the Committee on International Relations, House of Representatives, 95th Congress, 2d session, on H.R. 12468, H.R. 13262, and H.R. 13273, which would restrict U.S. investment in South Africa, August 10, 1978.

Statement published in hearings before the Committee on Commerce, Science and Transportation, U.S. Senate, 95th Congress, 2d session, on "The Framework for a New Export Policy," September 28, 1978.

Deputy Assistant Secretary Hufbauer

Statement published in hearings before the Subcommittee on Merchant Marine and Tourism of the Committee on Commerce, Science and Transportation, U.S. Senate, 95th Congress, 1st session, on S. 2008, a bill to amend the Shipping Act of 1916, October 12, 1977, pp. 46-52.

Statement published in hearings before the Subcommittee on Federal Spending Practices and Open Government of the Committee on Governmental Affairs, U.S. Senate, 95th Congress, 2d session, on the amendments to the Buy American Act of 1933 embodied in S. 2318, March 23, 1978, pp. 141-58.

Statement before the Subcommittee on International Trade of the Committee on Finance, U.S. Senate, 95th Congress, 2d session, in support of the President's request to extend the emigration waiver authority for Romania and Hungary under Section 402 of the Trade Act, July 12, 1978.

Statement before the Subcommittee on Domestic and International Scientific Planning, Analysis, and Cooperation of the Committee on Science and Technology, House of Representatives, 95th Congress, 2d session, on the international transfer of technology, September 6, 1978.

Statement published in hearings before the Subcommittee on Merchant Marine and Tourism of the Committee on Commerce, Science and Transportation, U.S. Senate, 95th Congress, 2d session, on the Treasury Department's views on S. 2873, a bill to provide for the regulation of rates and charges by certain state-owned carriers in the foreign commerce of the United States, September 6, 1978, pp. 78-9.

Deputy Assistant Secretary Junz

Statement before the Subcommittee on Energy and Power of the Committee on Interstate and Foreign Commerce, House of Representatives, 95th Congress, 2d session, on the balance of payments implications on LNG imports, February 21, 1978.

Statement before the Subcommittee on Foreign Economic Policy of the Committee on Foreign Relations, U.S. Senate, 95th Congress, 2d session, entitled the "Review of North/South Economic Discussions," February 27, 1978.

Deputy Assistant Secretary Widman

Statement before the Subcommittee on Domestic and International Scientific Planning, Analysis and Cooperation of the Committee on Science and Technology, House of Representatives, 95th Congress, 2d session, on the size, disposition, and significance of the financial surpluses of the oil-producing countries against the backdrop of global financial developments, September 7, 1978.

Deputy Assistant Secretary Nachmanoff

Statement published in hearings before the Panama Canal Subcommittee of the Committee on Merchant Marine and Fisheries, House of Representatives, 95th

Congress, 1st session, on the economic and financial benefits derived from the Panama Canal Treaty, November 30, 1977, pp. 106-09.

Statement published in hearings before the Subcommittee on Inter-American Affairs of the Committee on International Relations, House of Representatives, 95th Congress, 2d session, on undocumented aliens and its implications for U.S. policy in the Western Hemisphere, May 17, 1978, pp. 11-15.

Organization and Procedure

Exhibit 68.—Treasury Department orders relating to organization and procedure

NO. 150-90, JANUARY 31, 1978.—CHANGE IN OFFICE DESIGNATION AND TRANSFER OF FUNCTIONS WITHIN THE INTERNAL REVENUE SERVICE

By virtue of the authority vested in me by Reorganization Plan No. 26 of 1950:

- (1) The Office of Assistant Commissioner (Administration) is redesignated as the Office of Assistant Commissioner (Resources Management).
- (2) The Office of Assistant Commissioner (Accounts, Collection and Taxpayer Service) is redesignated as the Office of Assistant Commissioner (Taxpayer Service and Returns Processing).
- (3) The Collection Division is transferred from the Office of Assistant Commissioner (Taxpayer Service and Returns Processing) to the Office of Assistant Commissioner (Compliance).
- (4) The Disclosure Operations Division is transferred from the Office of Assistant Commissioner (Compliance) to the Office of Assistant Commissioner (Taxpayer Service and Returns Processing).
- (5) The Tax Administration Advisory Services Division is transferred from the Office of Assistant Commissioner (Resources Management) to the Office of Assistant Commissioner (Taxpayer Service and Returns Processing).

The approval of the transfer of the Divisions in paragraphs (3), (4), and (5) above includes the transfer of such personnel, records, equipment, and funds as are determined by the Commissioner of Internal Revenue and the Assistant Secretary for Administration to be appropriate in connection therewith.

This Order shall become effective upon such date as the Commissioner of Internal Revenue may determine.

W. MICHAEL BLUMENTHAL,
Secretary of the Treasury.

NO. 190 (REVISION 15), MARCH 16, 1978.—SUPERVISION OF BUREAUS AND OFFICES, DELEGATION OF CERTAIN AUTHORITY, AND ORDER OF SUCCESSION IN THE TREASURY DEPARTMENT

1. The Deputy Secretary shall be under the direct supervision of the Secretary.
2. The following officials shall be under the supervision of the Secretary, and shall report to him through the Deputy Secretary:
 - Under Secretary for Monetary Affairs
 - Under Secretary
 - General Counsel
 - Assistant Secretary (Domestic Finance)
 - Assistant Secretary (Economic Policy)
 - Assistant Secretary (Legislative Affairs)
 - Assistant Secretary (Public Affairs)
 - Assistant Secretary (Tax Policy)
 - Executive Secretary
 - Comptroller of the Currency
 - Commissioner of Internal Revenue

3. The following officials shall be under the supervision of the Under Secretary for Monetary Affairs, and shall exercise supervision over those officers and organizational entities indicated thereunder:
 - Assistant Secretary (International Affairs)
 - Deputy Assistant Secretary for Trade and Investment Policy
 - Deputy Assistant Secretary for Commodities and Natural Resources
 - Deputy Assistant Secretary for International Monetary Affairs
 - Deputy Assistant Secretary for Developing Nations
 - Deputy to the Assistant Secretary for Saudi Arabian Affairs
 - Deputy to the Assistant Secretary and Secretary of International Monetary Group Inspector General for International Finance
 - (The Assistant Secretary (Domestic Finance) reports through the Under Secretary for Monetary Affairs for debt management purposes.)
 - Fiscal Assistant Secretary
 - Deputy Fiscal Assistant Secretary
 - Bureau of Government Financial Operations
 - Bureau of the Public Debt
4. The following officials shall be under the supervision of the Under Secretary, and shall exercise supervision over those officers and organizational entities indicated thereunder:
 - Assistant Secretary (Administration)
 - Deputy Assistant Secretary
 - Office of Administrative Programs
 - Office of Audit
 - Office of Budget and Program Analysis
 - Office of Computer Science
 - Office of Equal Opportunity Program
 - Office of Management and Organization
 - Office of Personnel
 - Assistant Secretary (Enforcement and Operations)
 - Deputy Assistant Secretary (Enforcement)
 - Deputy Assistant Secretary (Operations)
 - Bureau of Alcohol, Tobacco and Firearms
 - United States Customs Service
 - United States Secret Service
 - Federal Law Enforcement Training Center
 - Office of Foreign Assets Control
 - Treasurer of the United States
 - United States Savings Bonds Division
 - Director of the Mint
 - Bureau of the Mint
 - Director of Engraving and Printing
 - Bureau of Engraving and Printing
5. The following officials shall exercise supervision over those officers and organizational entities indicated thereunder:
 - General Counsel
 - Deputy General Counsel
 - Legal Division
 - Office of Director of Practice
 - Deputy Assistant Secretary (Tariff Affairs)
 - Assistant Secretary (Domestic Finance)
 - (Also reports through Under Secretary for Monetary Affairs for debt management purposes.)
 - Deputy Assistant Secretary for Capital Markets Policy
 - Office of Securities Market Policies
 - Office of Capital Markets Legislation
 - Deputy Assistant Secretary for Debt Management
 - Senior Adviser (Debt Research)
 - Office of Government Financing

- Office of Agency Finance and Market Policies
 - Deputy Assistant Secretary for State and Local Finance
 - Office of Municipal Finance
 - Office of the Deputy to the Assistant Secretary for New York City Finance
 - Office of Urban Economics
 - Office of Revenue Sharing
 - Assistant Secretary (Economic Policy)
 - Deputy Assistant Secretary for Domestic Economic Analysis
 - Office of Financial Analysis
 - Office of Special Studies
 - Deputy Assistant Secretary for International Economic Analysis
 - Office of Balance of Payments
 - Office of Data Services
 - Office of Monetary Research
 - Office of Policy Research
 - Office of Statistical Reports
 - Assistant Secretary (Legislative Affairs)
 - Deputy Assistant Secretary (Legislative Affairs)
 - Office of Legislative Affairs
 - Assistant Secretary (Public Affairs)
 - Deputy Assistant Secretary (Public Affairs)
 - Office of Public Affairs
 - Assistant Secretary (Tax Policy)
 - Deputy Assistant Secretary for Tax Legislation
 - Deputy Assistant Secretary for Tax Policy Economics
 - Office of Tax Analysis
 - Office of Tax Legislative Counsel (also part of Legal Division)
 - Office of International Tax Counsel (also part of Legal Division)
 - Office of Industrial Economics
 - Comptroller of the Currency
 - First Deputy Comptroller
 - Office of the Comptroller of the Currency
 - Commissioner of Internal Revenue
 - Deputy Commissioner
 - Internal Revenue Service
6. The Deputy Secretary, the Under Secretary for Monetary Affairs, the Under Secretary, the General Counsel, and the Assistant Secretaries are authorized to perform any functions the Secretary is authorized to perform. Each of these officials shall perform functions under this authority in his own capacity and under his own title and shall be responsible for referring to the Secretary any matter on which actions should appropriately be taken by the Secretary. Each of these officials will ordinarily perform under this authority only functions which arise out of, relate to, or concern the activities or functions of, or the laws administered by or relating to the bureaus, offices, or other organizational units over which he has supervision. Any action heretofore taken by any of these officials in his own capacity and under his own title is hereby affirmed and ratified as the action of the Secretary.
 7. The following officers shall, in the order of succession indicated, act as Secretary of the Treasury in case of the death, resignation, absence, or sickness of the Secretary and other officers succeeding him, until a successor is appointed, or until the absence or sickness shall cease:
 - A. Deputy Secretary
 - B. Under Secretary for Monetary Affairs
 - C. Under Secretary
 - D. General Counsel
 - E. Assistant Secretaries, or Deputy Under Secretaries, appointed by the President with Senate confirmation, in the order in which they took the oath of office as Assistant Secretary, or Deputy Under Secretary.

8. Treasury Department Orders No. 190 (Revision 14), July 1, 1977, and No. 250, May 3, 1977, are rescinded effective this date.

W. MICHAEL BLUMENTHAL,
Secretary of the Treasury.

NO. 200 (AMENDMENT 9), APRIL 13, 1978.—ORGANIZATIONAL CHANGES, OFFICE OF THE ASSISTANT SECRETARY (ADMINISTRATION)

By virtue of the authority vested in the Secretary of the Treasury by Reorganization Plan No. 26 of 1950, and pursuant to the authority delegated to me by Treasury Order No. 190 (Revised), the following changes are directed, effective April 1, 1978:

1. The Treasury Employee Data and Payroll Division is renamed the Treasury Payroll/Personnel Information System Division (AMD), commonly referred to as TPPIS.
2. The following payroll and personnel information systems functions, currently being performed by the Bureau of the Mint in support of the System, shall be transferred to the Treasury Payroll/Personnel Information System Division:
 - a. Accounting;
 - b. Payroll Operations; and
 - c. Development of programming enhancements and systems modifications.
3. The Bureau of the Mint shall continue to provide computer and administrative support services as determined by mutual agreement between the Office of the Secretary and the Bureau of the Mint.
4. Overall responsibility for the internal audit of the Treasury Payroll/Personnel Information System shall be transferred from the Bureau of the Mint to the Office of Audit (AD) under the Assistant Secretary (Administration).
5. The responsibility for managing and accounting for the reimbursable fund supporting the Treasury Payroll/Personnel Information System shall be transferred from the Bureau of the Mint to the Office of the Secretary.
6. The approval of the transfer of functions in paragraphs 2 and 5 shall include the transfer of such personnel, records, property, and other resources as determined by mutual agreement between the Office of the Secretary and the Bureau of the Mint.

This Order modifies Treasury Order No. 200 (Amendment 1), June 24, 1971, and (Amendment 5), November 20, 1974, to reflect the above provisions; and supersedes all previous agreements between the Bureau of the Mint and the Office of the Secretary to the extent their provisions are in conflict with this Order.

BETTE B. ANDERSON,
Under Secretary.

NO. 191 (REVISION 5), JUNE 12, 1978.—DESIGNATION OF DEPUTIES

1. In addition to other assignments, the principal assistant to each of the following officials is designated to serve as deputy to the principal involved:

Principal	Deputy
General Counsel	Deputy General Counsel
Assistant Secretary (Administration)	Deputy Assistant Secretary (Administration)
Assistant Secretary (Domestic Finance)	Deputy Assistant Secretary for Debt Management
Assistant Secretary (Economic Policy)	Deputy Assistant Secretary for Domestic Economic Policy

Assistant Secretary (Enforcement and Operations)	Deputy Assistant Secretary (Enforcement)
Assistant Secretary (International Affairs)	Deputy Assistant Secretary for Developing Nations
Assistant Secretary (Legislative Affairs)	Deputy Assistant Secretary (Legislative Affairs)
Assistant Secretary (Public Affairs)	Deputy Assistant Secretary (Public Affairs)
Assistant Secretary (Tax Policy)	Deputy Assistant Secretary for Tax Analysis
Fiscal Assistant Secretary	Deputy Fiscal Assistant Secretary
Commissioner of Internal Revenue	Deputy Commissioner
Comptroller of the Currency	First Deputy Comptroller
Director, U.S. Secret Service	Deputy Director
Commissioner, U.S. Customs Service	Deputy Commissioner
Director, Bureau of Alcohol, Tobacco and Firearms	Deputy Director
Director, Bureau of Engraving and Printing	Deputy Director
Commissioner, Bureau of Government Financial Operations	Deputy Commissioner
Director, Bureau of the Mint	Deputy Director
Commissioner, Bureau of Public Debt	Deputy Commissioner
National Director, U.S. Savings Bonds Division	Deputy National Director
Director, Office of Revenue Sharing	Deputy Director
Director, Federal Law Enforcement Training Center	Associate Director (Training)

2. Each deputy shall have authority to perform, during any absence or disability of his or her principal, or when there is a vacancy in that office, any function his or her principal is authorized to perform, consistent with Treasury Department Order No. 190 (Revised).
3. All principals shall maintain, in writing, a current order of succession within their own organizations which specifies the order in which subordinate officials shall serve in an acting capacity in the event the principal and the deputy are absent, disabled or when a vacancy exists in either office.
4. Treasury Department Order No. 191 (Revision 4) is rescinded.

W. MICHAEL BLUMENTHAL,
Secretary of the Treasury.

NO. 256, JULY 18, 1978.—ESTABLISHMENT OF THE POSITION OF INSPECTOR GENERAL

Pursuant to the authority vested in me as Secretary of the Treasury by Reorganization Plan No. 26 of 1950, there is hereby established the position of Inspector General reporting directly to the Secretary and Deputy Secretary. The Inspector General is authorized to perform the following duties:

1. Receive and analyze allegations of (i) illegal acts, (ii) violations of the Rules of Conduct of the Treasury Department or Bureaus, (iii) violations of the merit system, or (iv) any other misconduct (if the matter is one which is not appropriate for normal grievance or appeal procedure of other

- routine management action) concerning any official or employee of any Treasury office or Bureau.
2. Receive by referral from head of Treasury offices or Bureaus serious allegations of official or employee misconduct which the Treasury office or Bureau does not want to investigate using its own staff.
 3. With regard to senior Treasury and Bureau officials:
 - a. Initiate, organize, direct, and control investigations of any allegations received pursuant to paragraphs 1 or 2 against such officials which have potential validity and which, within the discretion of the Inspector General, merit such action, and
 - b. Review and report the results of investigations of senior officials conducted by the Inspector General or at his or her direction to the Secretary or Deputy Secretary for appropriate action.
 4. Refer allegations of misconduct by any non-senior official or employee of a Treasury office or Bureau that does not have an Inspection service to any Inspection service within Treasury for investigation and receive a full report of the results of such investigation.
 5. Refer any complaints concerning improper activity of a non-senior official or employee of a Treasury office or Bureau that has an Inspection service to that service and receive a full report concerning the investigation and action taken concerning any such referral.
 6. Conduct in exceptional situations such investigations as may be specifically directed by the Secretary or Deputy Secretary concerning any allegations of misconduct by an official or employee of any Treasury office or Bureau.
 7. Review existing policies, procedures, and operations for ascertaining, reporting, and investigating misconduct of officials and employees of any Treasury office or Bureau and, after consulting with other Treasury officials as may be appropriate, make recommendations, if any, to the Secretary or Deputy Secretary for their change or implementation.
 8. Carry out those duties and functions set forth in Treasury Department Order No. 246 (Rev.) which are required of the Department under Executive Order 12036 and relate to the oversight of foreign intelligence activities in Treasury.
 9. Obtain, as needed, under prescribed procedures developed pursuant to paragraph 10, investigative and other support personnel from Inspection services within Treasury for conducting investigations under his or her direct supervision, any such detailed personnel to remain on the rolls of the services from which they are detailed but to report exclusively to the Inspector General as to the matter being investigated.
 10. Develop detailed procedures and definitions for approval by the Deputy Secretary and Secretary which shall become a part of this Order.

This Order does not change or reduce the authority presently existing in Treasury offices or Bureaus having Inspection services to conduct their own investigations in accordance with their procedures with the exception of investigations being conducted by the Inspector General. Where notice is received by a Treasury office or Bureau from the Inspector General that he or she is conducting an investigation in a particular area, no investigation or similar activity will be initiated or continued in that area by any Treasury office or Bureau except with the approval of the Inspector General.

W. MICHAEL BLUMENTHAL,
Secretary of the Treasury.

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